ALERT MEMORANDUM

Consequences of the Disease – Start Worrying Again About German Insolvency Filing Requirements

6 October 2020

In response to the financial difficulties many companies were facing due to the lockdown earlier this year in the wake of the COVID-19 pandemic, the German legislature enacted the COVID-19 Insolvency Suspension Act (*COVID-19 Insolvenzaussetzungsgesetz*) which temporarily suspended the insolvency filing requirements for companies in case of illiquidity (*Zahlungsunfähigkeit*) and overindebtedness (*Überschuldung*). Such suspension was limited until 30 September 2020. With the pandemic continuing, the German legislature has now extended the suspension, but only in case of overindebtedness, not illiquidity.

The COVID-19 Insolvency Suspension Act (the "Suspension Act") was enacted on 27 March 2020 and suspended the insolvency filing requirement with retroactive effect from 1 March 2020. Alongside this, it also introduced certain other insolvency-related changes as described in our alert memorandum of 1 April 2020 (see here).

Acknowledging that the pandemic is still affecting the economy significantly, with many companies continuing to struggle with financial distress, the German legislature has enacted the Act to Amend the German COVID-19 Insolvency Suspension Act (*Gesetz zur Änderung des COVID-19 Insolvenzaussetzungsgesetzes*, the "Amending Act").

The Amending Act took effect on 1 October 2020 and extended the suspension of the insolvency filing requirement in case of overindebtedness until 31 December 2020. In contrast, companies that are illiquid after 30 September 2020 will have to file for insolvency. The impact of this partial suspension is described in this alert memorandum.

In addition to the extension of the suspension requirements, the German Federal Ministry of Justice on 18 September 2020 published a draft bill reforming the German restructuring framework. Watch out for our alert to come on this soon.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

If you have any questions concerning this memorandum, please reach out to your regular firm contacts, the lawyers listed on the final page, or our COVID-19 task force by clicking here.

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1. Impact on Insolvency Filing Requirements

Under German insolvency law, but for the Suspension Act, a company's management must file for insolvency without undue delay, but in any event within three weeks from the company becoming illiquid or over-indebted.

The Suspension Act initially suspended the obligation to file for insolvency until 30 September 2020, unless (i) the insolvency did not result from the COVID-19 pandemic, or (ii) there is no prospect of the company becoming solvent (*i.e.*, becoming able to pay its debts) again.

Following the Amendment Act, this suspension will continue to apply until 31 December 2020 for companies that already are or become overindebted. As a consequence, as from 1 October 2020, all companies that already are or become illiquid need to file for insolvency without undue delay.

According to the legislative materials, the protection of illiquid companies no longer appeared necessary or proportionate, given that the prospects for the continuation of such businesses are low even under normal circumstances. Allowing them to continue trading and not file for insolvency would risk eroding confidence in the integrity of the market and putting a strain on economy generally.

In contrast, an overindebted company might still be viable. Considering that the assessment whether a company is overindebted is usually based on a forecast of up to two years and such projections would be difficult to make accurately in light of the circumstances, the German legislature decided to extend the suspension of the filing requirement in case of overindebtedness.

With the pandemic continuing to strain the financial situation of many companies, ranging from hospitality and travel to retail and leisure industries, management of financially ailing companies now need to carefully examine the financial condition of their businesses and will need to file for insolvency without undue delay should the company be illiquid.

Given that that the vast majority of insolvency filings are made on grounds of illiquidity, there may well be an increase in insolvency filings from October 2020 onwards.

2. Impact on Payment Restrictions

The Suspension Act allowed managing directors (*Geschäftsführer*) or board members (*Vorstandsmitglieder*) of an illiquid or overindebted limited liability company (*Gesellschaft mit beschränkter Haftung*) or stock corporation (*Aktiengesellschaft*) to make payments during the suspension period without risking personal liability due to a violation of statutory payment restrictions. If such payments occurred in the ordinary course of business, in particular to maintain or resume business operations or to implement a restructuring, they were deemed to be prudent and diligent and, as a consequence, not subject to payment restrictions.

From 1 October 2020 onwards, management of illiquid companies will no longer be able to rely on this exemption and must comply with applicable payment restrictions which give little room for payments in an illiquidity situation.

3. Impact on Loans and Collateral

The Suspension Act made it more difficult for insolvency administrators to challenge payments on, and collateral granted for, loans that were granted during the suspension period. Payments on shareholder loans granted during the suspension period also benefitted from this, but not collateral. In addition, such shareholder loans would not be subordinated in a subsequent insolvency as would ordinarily be the case. Furthermore, the Suspension Act provided that the granting of loans and collateral during the suspension period does not constitute a fraudulent delay of insolvency proceedings, thereby reducing the liability risks for banks and other financial institutions when granting loans to financially ailing businesses.

Again, from 1 October 2020, such exemptions will apply only to loans granted to overindebted companies during the extended suspension period, but not illiquid companies.

Lenders lending to troubled companies during the extended suspension period will therefore again face the risk of becoming liable for fraudulently delaying an insolvency filing, or insolvency administrators challenging payments and collateral. From 1 October 2020, lenders will likely again require borrowing companies to provide verification confirming their liquidity. In case of restructurings, financial distressed companies will usually need to provide a restructuring opinion confirming that the contemplated restructuring will likely rehabilitate the company.

4. Impact on Administrator's Rights to Challenge Transactions

As mentioned above, the Suspension Act restricted the rights of insolvency administrators to challenge transactions made during the suspension period. For example, payments made when due if the creditor was not aware that there was no prospect of rehabilitation could not be challenged by an administrator. This principle also applied in case the company discharges its obligations by substituting payment for another type of performance, the provision of a different type of collateral than owed, or the acceleration or deferral of payments, as the case may be.

As from 1 October 2020, these exemptions will apply only to transactions during the extended suspension period if the troubled company was overindebted, but not illiquid. It is expected that creditors will act more cautiously if there are signs that the counterparty debtor faces financial or economic difficulties. Hence, debtors that are financially ailing should prepare themselves to deal with stricter payment modalities that may be applied by their creditors.

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