ALERT MEMORANDUM

Cure for the Disease – Stop Worrying About German Insolvency Filing Requirements and Continue Trading

1 April 2020

Under German law, the management of a German company is in normal times strictly required to file a company insolvent without undue delay (the so-called 21-day rule) if the company becomes unable to pay its debts when due (illiquidity – *Zahlungsunfähigkeit*) or, generally, if the company's liabilities exceed its assets (overindebtedness – *Überschuldung*). But these are not normal times. With the COVID-19 pandemic hitting the economy, German companies are facing increasing financial pressure due to the decline in consumption, in part resulting from the ban on social interaction imposed by the German government, and large parts of the domestic and global economy coming to a halt.

In the face of this crisis, the German legislature reacted quickly to mitigate the pandemic-related impacts on companies and consumers alike. These measures include expanding the possibility of *Kurzarbeit* (a program that allows companies to reduce salary payments, which are being picked up by the state), the deferral of tax payments and the provision of emergency government funding to the economy. Notably, the insolvency filing requirements have been suspended until 30 September 2020 in order to allow companies to restructure or to otherwise make use of the government funding programs provided in connection with the COVID-19 outbreak.

The applicable legislation, which was enacted on 27 March 2020, suspends the insolvency filing requirement with retroactive effect from 1 March 2020 and introduces certain other insolvency-related changes as described in this alert memorandum.

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.

FRANKFURT

Michael Kern
++49 69 97103 252
mkern@cgsh.com

LONDON

David J. Billington
+44 20 7614 2263
dbillington@cgsh.com

Polina Lyadnova
+44 20 7614 2355
plyadnova@cgsh.com

Jim Ho
+44 20 7614 2284
jho@cgsh.com

1. Suspension of Insolvency Filing Requirement

The German insolvency filing requirement forms one of the most fundamental parts of German insolvency law. It determines the point in time from which a company may no longer continue trading without filing. Generally, 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. Not filing, or filing too late, can result in civil and criminal law liability for management.

Under the German COVID-19 Insolvency Suspension Act (*COVID-19 Insolvenzaussetzungsgesetz*, the "Act"), the obligation to file for insolvency is now generally suspended 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.

In this context, the Act provides for a rebuttable presumption that the insolvency was caused by the COVID-19 pandemic and that the company will become solvent again, provided the company was able to pay its debts on 31 December 2019. According to the legislative materials, such presumption can be rebutted only "*where there can be no doubt*" that the insolvency was not caused by the COVID-19 pandemic.

In addition to management not being required to file for the company's insolvency, creditors (which under German law may also file for a company's insolvency under certain circumstances) are also no longer permitted to file for a company's insolvency between 28 March and 28 June 2020, unless the company was already insolvent on 1 March 2020.

The suspension of the filing requirements and the restrictions on creditor filings may be extended by ministerial order (as opposed to a formal law) until 31 March 2021 if the crisis persists.

2. Loosening Payment Restrictions

German law also imposes restrictions on payments by a company under certain circumstances. If and for as long as a German limited liability company (*Gesellschaft mit beschränkter Haftung*) or stock corporation (*Aktiengesellschaft*) is illiquid or overindebted, its managing directors (*Geschäftsführer*) or board members (*Vorstandsmitglieder*), as the case may be, must not make any payments, unless such payments would have been made by a prudent and diligent management member in such situation. "Illiquid" in this context means that the company is not able to pay its debts when due, and "overindebted" means that, generally, the company's liabilities exceed its assets. Making payments when the relevant entity is insolvent in that sense, or nearing insolvency, where such requirements are not fulfilled would expose management members to personal liability.

The Act provides that payments made during the suspension period and in the ordinary course of business are deemed to have been made by a prudent and diligent management member if such payments are made to maintain or resume business operations or to implement a restructuring. The intention of the German legislature is to allow management to take all measures necessary to continue the operation of the company so far as possible during the COVID-19 pandemic (*e.g.*, by making payments to employees, suppliers and creditors). Otherwise, with personal liability at stake, the management of a distressed company would likely have to cease making payments and put the company out of business. It is hoped that the suspension of the filing requirement and the loosening of payment restrictions will help prevent widespread insolvencies across the economy. However, companies short on cash may still need to file for insolvency as a practical matter, or may even find an in-court restructuring an alternative in order to weather the pandemic.

3. New Loans and Collateral

The Act also provides for the following measures which are aimed at facilitating the granting of new loans by sponsors, shareholders and banks to companies affected by the COVID-19 pandemic, thereby encouraging funding into German businesses, as well as restructurings of affected companies:

— The repayment until 30 September 2023 of any new loans (including interest thereon) granted, and the grant of new security in connection with such new loans during the suspension period may not be challenged by an insolvency administrator in a subsequent insolvency proceeding. However, this forbearance does not apply to existing loans which are merely extended or novated (this would likely include any rollover of revolving credit facilities). It should be noted that loans granted by Germany's development bank, *Kreditanstalt für Wiederaufbau – KfW*, and its financing partners may not be challenged even if made after 30 September 2023;

— The forbearance in respect of new loans granted during the suspension period also applies to new shareholder loans granted during such period, but not to collateral granted to secure such shareholder loans. In addition, the normal rule that such new shareholder loans will be subordinated in insolvency is also suspended during this period; and

— The Act also states that the granting of new loans and collateral therefor will not constitute a fraudulent delay of insolvency proceedings. This will help reduce liability risks for financing providers and thereby facilitates restructurings without the need to obtain a so-called restructuring opinion. A restructuring opinion is a report from an independent qualified restructuring expert (often an accounting firm) validating the restructuring. It is required by banks and other financing providers to demonstrate that contemplated measures will likely rehabilitate the company in order to protect the financing providers from liability and the risk that security granted to them may be challenged in a subsequent insolvency proceedings.

4. Restrictions on Administrator's Rights to Challenge Transactions

Finally, the Act makes it much more difficult for insolvency administrators in a subsequent insolvency to challenge transactions made during the suspension period. In particular, payments made when due can only be challenged if the creditor was aware that there was no prospect of rehabilitation (which the creditor is not required to investigate). This rule also applies 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. All these measures are aimed at promoting a successful restructuring and allowing companies to continue trading.

…

CLEARY GOTTLIEB