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A quick overview on German Insolvency Law

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Summary

The international banking crisis has hit hard. German banks and companies are also affected. This briefing provides an insight on questions that are typically raised when persons are exposed to insolvency situations which involve proceedings initiated in Germany or abroad but have a connection to Germany in certain aspects.

When does German Insolvency Law apply?

Whether or not German Insolvency Law applies in an international situation is to be decided on the basis of conflict of law rules. There are essentially two distinct sets of conflict of insolvency law regimes which coexist in Germany, each of them applying to different categories of entities and with respect to different cross-border scenarios. The EU Insolvency Regulation (Regulation) applies to insolvency proceedings for all entities except for certain financial enterprises in most of the European Union member States. If the German entity is a financial enterprise (e.g. bank or insurance company) or if the counterparty is established in a state which is not subject to the Regulation, the section on international insolvency law in the German Insolvency Code (GIC) applies. The principle which is common to both legal regimes, however, is that international jurisdiction is derived from the "centre of commercial interest" which is the place where the interests of the insolvent entity are managed (often the country where the insolvent entity is domiciled). As an exception to this concept, the insolvency laws of other jurisdictions may become relevant in case of, inter alia, rights in rem with regard to property, labour contracts, set-off rights or the termination of derivative contracts (close-out netting).

What are the German Insolvency Code's objectives?

The objective of German insolvency proceedings (Insolvency Proceedings) is to satisfy creditors either by (i) liquidation of the insolvent entity's assets and distribution of the proceeds (Liquidation Proceedings), or (ii) by reaching an arrangement by means of an insolvency plan procedure in order to restructure the insolvent entity (Insolvency Plan Proceedings). These two types of insolvency proceedings are not similar to proceedings under US Insolvency Law although the concept of the Liquidation Proceedings can be compared to Chapter 7 of the US Bankruptcy Code whereas the Insolvency Plan Proceedings are more akin to proceedings under Chapter 11. However, in contradistinction to its US counterpart, the German Insolvency Plan Proceedings are not frequently employed.

In addition to (and partially deviating from) the general principles described above and below, credit institutions must comply with specific insolvency rules in order to avoid a domino effect on the overall functioning of the financial sector. The German Banking Act provides for certain notification requirements at an early stage of financial difficulties and confers powers on the Federal Financial Supervisory Authority (BaFin) to initiate and control insolvency proceedings. Such powers comprise, inter alia,

the right to restrict or prohibit any withdrawal of cash by or any granting of loans to the shareholders of the troubled bank,

prohibiting transactions or payments of or the acceptance of cash by the troubled bank,

dismissing bank managers or even close the troubled bank's business, and/or

revoking the troubled bank's banking licence.

What are the grounds for filing for insolvency?

Insolvency Proceedings can be initiated against an entity for:

Illiquidity (incapacity to pay);

Over-indebtedness (balance-sheet insolvency - in response to the current financial crisis, the German Government has recently amended the definition of over-indebtedness in order to alleviate otherwise solvent corporations from having to file for insolvency merely on the basis of balance-sheet insolvency; here, a positive business forecast may also be taken into consideration to circumvent over-indebtedness);

Imminent illiquidity.

Who may file?

Both the insolvent entity and any creditor can file in the case of illiquidity and over-indebtedness, and only the insolvent entity in the case of imminent illiquidity. In the case of illiquidity and overindebtedness, the insolvent entity's management is obliged to file for insolvency proceedings in order to avoid civil and criminal liability.

Where the insolvent entity is a financial institution, the initiation of Insolvency Proceedings is entirely under the control of BaFin which can impose the appointment of a supervisor before any actual suspension of payments, impose or refuse the start of Insolvency Proceedings, or impose the option between recovery and liquidation. Only upon a formal filing by BaFin with the competent insolvency court can Insolvency Proceedings be initiated against the financial institution. Also, the insolvency court must consult with BaFin prior to appointing an insolvency administrator.

What happens after the filing?

Step 1: Preliminary Administration

Insolvency Proceedings are only formally initiated if the competent local court is satisfied that the entity in question is in fact insolvent. Therefore the insolvency court usually appoints a preliminary insolvency administrator (vorläufiger Insolvenzverwalter) who either takes over the insolvent entity's management or supervises the continued management by its directors. If the preliminary insolvency administrator determines that the entity is not insolvent or assets of the insolvent estate (Insolvenzmasse) are insufficient, the initiation of Insolvency Proceedings will be rejected.

Step 2: Regular Insolvency Proceeding

Upon formal initiation of the insolvency proceeding, the competent court appoints an insolvency administrator (Insolvenzverwalter). The insolvent estate essentially vests in the insolvency administrator. The insolvent entity may not dispose of any of the estate's assets. The insolvency administrator has the right to dispose of and administer the insolvent entity's assets. He owes a duty to all participants in the Insolvency Proceedings rather than to any particular category of creditors and is supervised by the court, the creditors' meeting, and the creditors' committee (if constituted). Upon the initiation of the insolvency proceedings, all unmatured claims against the insolvent entity are accelerated by operation of law. Within 3 months of his appointment the insolvency administrator is required to report to the creditors' committee, giving an overview of the insolvent entity's assets and financial situation. At that meeting, the creditors vote on whether to continue the insolvent entity's business temporarily (possibly by way of an insolvency plan) or to liquidate the insolvent entity.

What are the rights of the creditors?

1. Unsecured creditors

Unsecured creditors may not execute against the assets belonging to the insolvent estate. Set-off rights are limited due to special provisions in the GIC. Unsecured creditors are the last group of creditors to receive distribution from the insolvent estate and are bound to accept their respective portion of the surplus proceeds of the liquidation after the secured creditors (and all costs in connection with the proceeding) have been paid.

2. Secured creditors

Secured creditors may be entitled to a selection right (Aussonderung) if they can prove that title to a specific asset lies with them and not with the insolvent entity (and therefore is not part of the insolvency estate). These creditors are not considered insolvency creditors. They have an in rem-claim for return of the asset which is enforceable independently from the insolvency proceedings by means of individual enforcement. Rights giving rise to separation include: ownership, other rights in rem (reservation of title, life tenancies, heritable building rights) and intellectual property rights.

A second group of creditors who enjoy insolvency-specific privileges are creditors who may demand that a particular asset is disposed of separately (Absonderung) and that the proceeds realized are preferentially used to settle their secured claims (usually after the insolvency administrator has withheld the amount for his statutory remuneration which may be up to 9 per cent). Rights entitling to separation include transfer by way of security, liens or land charges. Such creditors, however, are considered insolvency creditors and may only conduct private enforcements on a limited basis.

3. Preferential creditors (Massegläubiger)

Creditors whose claims arise only after the opening of Insolvency Proceedings and which are caused by the insolvency administrator are treated preferentially, i.e. these creditors are paid before the insolvency creditors from the proceeds of the insolvency administrator's enforcement of the assets belonging to the insolvent estate (as long as sufficient). In most cases preferential creditors have a right to enforce their claims individually.

How are pending transactions/contracts affected?

As a general principle, the insolvency administrator can decide whether it wants to honour or terminate any bilateral contract that has not been performed completely by either party. If the insolvency administrator opts for continuation, both parties are obliged to meet their obligations; the claims of the insolvency creditors are privileged claims which are paid from the insolvent estate. Should the insolvency administrator decide to terminate, the counterparty cannot claim full payment for services already rendered. Instead, it can only seek compensatory damages due to non-performance. Such claim is to be filed as an ordinary insolvency claim.

Loan agreements may not be terminated by the insolvency administrator after the loan has been disbursed. Lease and employment contracts are in principle not affected by the initiation of an insolvency proceeding, but they may be terminated under the applicable specific termination rules and procedures (e.g. employment contracts within three months notice). However, many additional issues especially with respect to such contracts have to be evaluated in each case. Special termination provisions apply, inter alia, for financial derivatives contracts. Almost always they will be subject to the close-out netting regime. Cherry picking is therefore prevented with respect to those transactions.

How may the insolvency administrator challenge certain transactions?

The insolvency administrator is entitled to challenge transactions entered into prior to or after the filing for insolvency where the transaction in question has an adverse effect on creditors. As a rule of thumb, the crucial period which is examined by the insolvency administrator is three months prior to the filing for insolvency proceedings. In addition, gifts or transactions entered into by an insolvent entity with the intention of wilfully prejudicing other creditors are challengeable unless they are made four years (in case of gifts) or ten years (in the case of transactions entered into with the intention of wilfully prejudicing creditors) prior to the filing for insolvency. Arm's length cash transactions can only be challenged if creditors were intentionally prejudiced.

How does the insolvency proceeding end?

In Liquidation Proceedings, after the proceeds have been distributed, the insolvent entity will be dissolved and the residual claims of the creditors are essentially of no value. The effect of an insolvency plan, however, is to finally settle the rights of all creditors. The insolvency plan, inter alios, describes if and to what extent the unsubordinated creditors' rights may be reduced, deferred, secured or subjected to other rules which may have been agreed. If there is no specific rule or regulation provided for in the insolvency plan, claims of subordinated creditors are deemed to be waived. Once the insolvency plan has been agreed on by the creditors it is legally valid and binding on all creditors.

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