Alternatives to Formal Insolvency / Bankruptcy Proceedings

In Germany

1. Obligation to apply for Insolvency

The key difference between the German insolvency regime and the insolvency regimes of common law jurisdictions and indeed of many other continental European jurisdictions is that a German managing director *(Geschäftsführer)* of a German corporation is under a general obligation to apply for (formal) insolvency proceedings in the event that the company is

- over-indebted (i. e. the bookable value of the liabilities exceeds the assets); and / or
- insolvent (i. e. unable to pay its due debts).

The law therefore requires any managing director of a German corporation to be aware of and watch the balance sheet situation of its company on a daily basis and to initiate immediately insolvency proceedings upon occurrence of at least one of the abovementioned circumstances.

In view of the financial and economic crisis of 2008, the German legislature eased the requirement for actions to be taken in case of over-indebtedness up until the end of 2013. Until that time, no insolvency application is necessary if the managing directors have substantiated reason to believe that the company has a "positive continuation forecast" (*positive Fortführungsprognose*"). This applies if it is probable that the company will continue its regular operations and that it will exit the financial crisis in the foreseeable future.

It is to be noted though that this temporary exception to the general rule does not apply in cases of a company's inability to pay due debts.

2. Sanctions

The sanctions imposed against a managing director are drastic: Failing to apply for insolvency when required leads to personal civil liability of each managing director for any payment made or asset transferred by the company after the point in time when an

insolvency ground arose.

Further, the delay of applying for mandatory insolvency proceedings is a criminal offence. It is also to be noted that other persons such as representatives of creditors or advisors could be seen to have participated in the criminal offence if they induced or urged the managing director not to apply for insolvency when required.

3. Extension to foreign entities

This strict requirement to apply for insolvency was recently extended to managers of foreign entities which have their center of main interest in Germany.

The background to this rule is that in many areas it is now commonplace (mostly for tax reasons) to incorporate entities abroad, even if they mainly or exclusively hold assets in Germany.

In order to avoid civil and criminal liability in Germany, the management of such foreign entity must ensure that it observes the strict requirement to apply for German insolvency proceedings when required.

4. Consequences for out-of-insolvency restructurings

As a result of this very onerous rule, out-of-insolvency restructurings of companies in financial difficulties are rare in Germany.

The main reason for this is the time restraint. Once the management of a company takes notice of financial difficulties, the time period within which one of the two abovementioned situations of insolvency occurs is often too short to try and negotiate an acceptable settlement with creditors.

Further, particularly companies in which the management is not identical with the shareholders but consists of employed managers tend not to risk personal civil or criminal liability. Instead, insolvency is applied for at a very early stage.

However, the main reason for the absence of significant restructurings outside the insolvency procedure is that once an operational company approaches its creditors, banks, suppliers, workers etc. in an attempt to restructure its debts, the company will likely itself bring about the insolvency. Openly addressing this issue towards creditors is normally a self-fulfilling process because suppliers will not deliver any longer and banks will accelerate their loans.

5. Alternative restructurings

Despite the obvious lack of a much-needed out-of-insolvency procedure to restructure the

debts of a company, German legislature does not provide for any such procedure. Except for certain cases in the foreclosure procedure of real estate, the law does not provide for any form of receivership or comparable procedures.

Therefore, out-of-court restructurings tend to be possible only when there is merely one creditor or at least a very small group of creditors, such as in cases involving real estate property companies. For these types of non-producing, asset-holding companies alternative routes of restructuring are being discussed and are sometimes agreed.

Given the managing directors' obligations to apply for insolvency, such negotiations in out-of-court restructurings will only be possible if the creditor(s) at a very early stage conclude a standstill agreement and thereby allow the managers to negotiate the restructuring without the threat of illegal delay of the insolvency application.

6. Outlook

The German legislator has for quite some time been aware of the urgent need for a more effective regime on restructuring companies. Unfortunately, the legislator is not opting for ways to avoid formal insolvency proceedings, but instead assumes that the formal insolvency procedure is still the adequate framework within which to effect settlements.

In a recent effort to introduce new legislation, a comprehensive review of German insolvency law is being discussed *("Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen (ESUG), roughly translated as the "Law for the further simplification of the restructuring of companies").*

A completely new structure of formal bankruptcy proceedings is being proposed. The changes would include, for example, mechanisms whereby creditors will be able to decide who to appoint as insolvency administrator, and whereby creditor can largely influence the restructuring process and overcome minority opinions within the creditors committee.

Whether ESUG will become law is becoming increasingly unclear. The further legislative steps required in order to create a final draft bill have repeatedly been postponed.

Therefore, the bad news is that to date in Germany there does not yet exist an alternative to the old-fashioned, costly and drawn-out insolvency procedure.

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