

## **Basic Provisions of German Insolvency Law**

1. **Effective Date of New Law.** A new German insolvency law became effective on January 1, 1999.
2. **Commencement of Proceedings.** A German insolvency proceeding may be commenced for a business debtor only (a) if the debtor has a continuing inability (or, in the case of a proceeding commenced by a debtor, a threatened inability) to pay any of its debts as they become due; or (b) if the going-concern value of the debtor's assets is less than the aggregate amount of the debtor's liabilities. Under German corporate law, a board of directors may be liable for damages (and perhaps subject to criminal liability) if it does not commence an insolvency proceeding within three weeks following the date when the corporation's liabilities exceed the value of its assets.
3. **Immediate Effects of Commencement of Proceedings.** Upon the filing of an application for insolvency by a debtor or a creditor, there is no "automatic stay" to prevent creditors from exercising rights against the debtor's assets. However, the court may enter any order appropriate to protect the debtor's assets. The court will appoint an interim trustee (a professional administrator), who is charged with operating the debtor's business and, if necessary, disposing of the debtor's assets. Unless exigent circumstances warrant (for example, the imminent loss of value of the debtor's assets), the interim trustee may not sell the debtor's business or substantially all of its assets. The interim trustee's primary role is the preservation of the status quo and to evaluate whether there is a prospect for reorganization of the debtor's business. The interim period (3 months in length) coincides with the period during which employees are entitled to payment of wages from social security.
4. **Opening Hearing and Order.** The next step in a German insolvency proceeding is a hearing at which the court determines whether there is a basis for commencing the proceeding and whether there are sufficient unencumbered assets to fund the costs of administering the proceeding. If the court is satisfied with the basis for the proceeding and the assets available for administrative expenses, then the court enters an order opening the proceeding and appointing a permanent trustee. The order opening the proceeding acts as a stay against creditor actions, although the stay only prevents formal legal proceedings against the debtor, not informal collection actions.
5. **Liquidation versus Reorganization.** All German insolvency proceedings are commenced as liquidation proceedings but may be converted to reorganization proceedings following the first meeting of the creditors, which typically occurs between six weeks and three months after the order opening the proceeding.
6. **Meeting of the Creditors.** At the creditors' meeting, the creditors decide whether the case should proceed as a liquidation or as a reorganization—whether the debtor's business should be closed, operated by the trustee pending sale, or operated by the debtor-in-possession pending sale or reorganization. A date is usually set for the resolution of any claims disputes. The amount of control given to creditors is unique even among European governments, where, unlike the United States, debtor-controlled proceedings are the exception.



7. Power of the Debtor-In-Possession. The debtor-in-possession is not automatically empowered to administer its estate, but courts may allow the debtor-in-possession to do so. In the case of an insolvency application filed by a creditor, the creditor's consent is required for the debtor-in-possession's estate administration. In any event, a German trustee exercises a great deal of oversight of the debtor-in-possession, as compared to the lesser oversight of a debtor-in-possession under United States law.
8. Avoidance Powers. German law provides an estate with preference and fraudulent transfer avoidance powers. As compared with prior German law, the new avoidance powers make it easier for an estate to recover assets, and the prospect of recovery may provide an incentive and a cost structure for investigating and pursuing the actions.
9. Assumption and Rejection of Contracts and Leases. A trustee or debtor-in-possession pursuing a reorganization may assume and agree to be bound by contracts and leases or reject contracts and leases. Pending a decision to reorganize, and pending reorganization, the trustee or debtor-in-possession must honor its obligations under contracts and leases that have not been rejected, as a cost of estate administration.
10. Asset Sales. Sales of the debtor's assets may occur at any time during the insolvency proceedings, although different approvals and standards apply depending on the stage of the proceedings. As a general matter, sales of the debtor's business or substantially all of its assets before the entry of the order opening the proceedings, or even before the creditors' meeting, are permissible only to avoid substantial harm to the estate and its creditors. Sales after the creditors' meeting are more generally permissible with the consent of the creditors. Specific creditor approval must be obtained for sales to insiders or if the debtor. Specific creditor approval must also be obtained upon request of the creditors or the debtor. The general standard is that the sale must be more beneficial to the estate than any other available sale options, the price and other terms of the sale must be fair and reasonable, and the negotiations must have been in good faith and at arm's length. As compared with United States law, which generally puts the final decision to approve a sale in the control of a bankruptcy judge, German law provides that control to the creditors.
11. Plan Proposal. A plan of reorganization may be proposed by the debtor-in-possession or the trustee at or at any time after the meeting of the creditors. The trustee may propose a plan on its own, but the trustee is obligated to propose a plan if the creditors request the trustee to do so. The plan may be a "liquidating plan" or a "reorganizing plan."
12. Plan Structure. Although the prior law in Germany imposed a 35% minimum dividend requirement, the new German law has no minimum dividend. A plan must divide creditors into classes—secured creditors, prioritized creditors, general unsecured creditors, and subordinated creditors. There is a general rule favoring equal treatment among creditors in the same class, although deviation from the rule is permitted if disparate treatment benefits the debtor's creditors overall.
13. Plan Approval by Creditors. A plan must be approved by impaired classes of creditors, each voting as a class. A simple majority in number of creditors and amount of claims will constitute approval of the class. If a majority of the creditor classes voted to approve the plan,



the plan may be approved over the objection of the dissenting classes so long as the creditors in the dissenting classes are given an “adequate share” that is better than they would have received without the plan. An “adequate share” means that no other creditor is paid 100% of its claim, no subordinate creditor receives any value, and no other creditor with equal rights outside of the insolvency receives more than the creditors in the dissenting classes.

14. Plan Confirmation. The court will confirm a plan that has been approved by the creditors unless the plan is unfair or detrimental to the debtor’s creditors overall. There is no “feasibility” test, and German law disfavors any economically-based decisions by the court. Individual creditors may challenge confirmation on the basis that the creditor would have received more value without the plan, and this type of challenge may lead to lengthy litigation regarding the value of the debtor’s assets.

15. Director Liability. Managing directors are required to file insolvency proceedings within three weeks after learning that the company is insolvent under a cash flow or balance sheet test. Failure to file is punishable by imprisonment, and the director can be personally liable for all payments made by the company after it becomes insolvent (unless the payments are considered to be proper in the ordinary course of the business). A director may also be personally liable for social security payments, withholding tax, and VAT.

16. Equitable Remedies. German law does permit equitable remedies such as equitable subordination of debt held by affiliates and, to a limited extent, substantive consolidation.

17. Recognition of Foreign Judgments and Cooperation with Foreign Courts. Although as a general matter German courts will recognize insolvency proceedings commenced in foreign countries, assets located in Germany may be subject to the German-law rights of local creditors. As among EU nations, the new EU Insolvency Regulation governs.