CLIENT ALERT

Germany eases directors' duty to file for insolvency

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With effect as of November 9, 2022, Germany eases directors' duty to file for insolvency. In response to global business uncertainty and the current energy crisis, Germany enacted the Law on the Temporary Adjustment of Restructuring and Insolvency Law Provisions to Mitigate the Impact of Crises (*SanInsKG*).

With respect to the mandatory insolvency ground of over-indebtedness, the SanInsKG (i) shortens the statutory projection period for which directors must come to a 'no liquidity gap' conclusion from 12 to four months and (ii) extends the relevant maximum period for an insolvency filing from six to eight weeks. The modifications are intended to take account of current volatility and price developments on the energy and raw materials markets, the impact of which burdens companies and complicates their financial planning. Regardless of these policy considerations, the modifications apply to all companies. There is neither a requirement that the company in question be affected by current negative market developments nor one that the specific sector in which the company operates be affected in general.

In a nutshell – Germany's mandatory filing regime

Germany has a rigid liability regime for directors acting in the zone of insolvency. The directors of a limited liability company are obligated to file for insolvency without undue delay if the company becomes unable to pay its due debts (*zahlungsunfähig*)[1] or over-indebted (*überschuldet*).[2] A breach of this obligation is sanctioned by criminal law and by the

[1] Section 17 German Insolvency Code (*InsO*). A debtor is generally considered to be unable to pay its debts if the debtor cannot cover at least 90 per cent of its liabilities due within the upcoming three weeks.

[2] Section 19 InsO.

directors' personal liability under civil law. A director who delays a mandatory insolvency filing is liable for all payments made by the insolvent company, with narrow exceptions for some privileged payments (payment prohibition). The German Federal Court of Justice (*BGH*) clarified that a violation of the payment prohibition is covered as damage claim by typical D&O insurances.[3] However, indemnification claims are often contested by the D&O insurers, pointing out that directors knowingly delayed the insolvency filing.

Diligent monitoring and financial planning hence is key for directors to protect the company and its creditors, and to shield themselves from personal liability. The over-indebtedness test reformed by the SanInsKG was originally based on an assessment of a balance sheet deficit of assets vs liabilities (mathematical over-indebtedness). It was modified in the past to effectively work in practice as a mid-term liquidity test. A debtor is considered to be over-indebted if the company's assets no longer cover its existing liabilities, unless the company has a positive continuation prognosis. The over-indebtedness calculation, thus, has two elements: (i) the calculation of over-indebtedness and (ii) the continuation prognosis. The over-indebtedness calculation should not be mistaken for the company's ordinary balance sheet or annual statement. These may only indicate the company's over-indebtedness under insolvency law. Liabilities with a qualified subordination,[4] for instance, do not feature in the mathematical over-indebtedness calculation. But hidden reserves do have to be accounted for. A company generally has a positive continuation prognosis if it is more likely than not that the company is able to pay its due liabilities within the relevant projection period.

Modifications under SanInsKG

The SanInsKG targets the duration of the projection period of the continuation prognosis: The duration of the projection period was expressly defined only in 2021, with the previous reform of the restructuring (and insolvency) law (*SanInsFoG*) taking effect: Before 2021, the projection period was said to encompass the present and upcoming business year, i.e., a period of up to 24 months. With the SanInsFoG reform, the period was defined to be 12 months. The SanInsKG now shortens the 12-months projection period temporarily to four months.

Once a company is considered to be insolvent, the directors are obliged to file for insolvency without 'undue delay'. The law prescribes a maximum period within which such filing has to be made. This filing period – extended from three to six weeks in 2021 – is now extended to eight weeks for over-indebted debtors. As already the case with the SanInsFoG reform, the maximum period within which a filing due to an inability to pay debts due has to be made remains unchanged at three weeks.

The modifications apply until (and including) 31 December 2023.[5]

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[3] BGH, decision of 18 November 2020 – IV ZR 217/19.

[4] Section 19 para 2 sent 2, 39 para 2 InsO.

[5] The (modified) prognosis period of four months also applies in cases in which a company is already over-indebted as of 9 November 2022, unless the maximum period for an insolvency filing has already lapsed.

Good for directors – good for lenders?

The modifications of the insolvency trigger ease the pressure on directors in a situation of financial distress. While the illiquidity test with a projection period of just three weeks is quite straightforward, a solvency prediction for the over-indebtedness test over a period of 12 months is challenging. This is especially the case when a large maturity looms and negotiations with stakeholders are ongoing in times of highly volatile costs and capital markets. Restricting the projection period for the over-indebtedness test to four months reduces the risk of insufficient or incorrect solvency assessments by directors.

From a lender’s perspective, the benefits of the reform may be viewed with ambiguity: The former 12-months testing period incentivized directors to start negotiations with creditors well ahead when the outlook of a regular market refinancing became uncertain. In times of lax covenants, the statutory test was seen as one among few, if any, early-bird triggers for entering into a meaningful restructuring discussion with negotiation leverage on the creditor side. The limited test period of only four months may take away some of this benefit.

However, the relaxed filing duty should ultimately benefit all stakeholders as it gives directors more comfort and more stability to search for out-of-court solutions in agreement with the company’s stakeholders. Under the new as under the old regime, directors are continuously incentivized to properly pursue restructuring efforts when in the best interest of the company:

- The modification of the prognosis period does not change the directors’ general duties under corporate law primarily owed towards the company. Directors are obliged to continuously monitor developments that may jeopardize the continued existence of the company, establish risk management strategies and structures, and take appropriate countermeasures, not only in the zone of insolvency.

- The SanInsKG has not changed the character of the (modified) eight-weeks’ filing period as a maximum period. Because the filing, as was the case before, has to be made without undue delay directors may not want to exploit the maximum filing period, unless *e.g.*, a restructuring solution is on the horizon.

- Because as of now the modifications are time-limited until the end of 2023, the effects of the expiry are not fully clear yet: Companies may need to prepare that the full 12 months test is being reinstated by the end of 2023 unless further legislative action is taken. We expect further clarification on whether such reinstatement may need to be taken into account for 2024 maturities ahead of time.

Walking the line on directors' duties – the start-up example

Directors typically are sitting between the chairs if the going-concern prognosis is doubtful for lack of legally binding commitment for financing. In such situation, directors have to balance liability risk both for a breach of the filing obligation and for a voluntary[6] premature filing which may potentially damage the shareholders' interest.[7]

Looking at the example of start-ups, the positive continuation prognosis may often depend on the injection of new equity capital either from existing shareholders or from new investors. Whether or not the prognosis is continuously positive will then depend on the level of certainty of such new funds' being provided on time. The picture of the relevant criteria is not fully clear yet: The BGH ruled in its 2021 *Air Berlin* decision that non-binding commitments be sufficient only in exceptional cases; the decision did not address the particular situation of start-ups.[8] The Higher Regional Court of Dusseldorf ruled[9] in 2021 and 2022 that the positive continuation prognosis of a start-up can be based on a shareholder's non-binding financing commitment. The Dusseldorf court is willing to accept non-binding financing commitments of financially potent investors if (i) these investors had already supported the company in the past and (ii) the provision of further funds depended on the presentation of up-to-date, comprehensible and realistic financial planning. It remains to be seen to what extent the BGH will apply the exception established by the Dusseldorf court.

The case of start-ups exemplifies some challenges but also highlights opportunities that may come with the modified projection period. Directors can continue trading provided they expect sufficient resources for the upcoming four months. Continuous diligent planning and close communication with the relevant stakeholders are key to navigate a challenging market environment.

Conclusion

The modifications of German insolvency law made by the SanInsKG bring some important relief regarding directors' filing duties. The shortening of the projection period to four months and the extension of the filing period to eight weeks with respect to the insolvency ground of over-indebtedness bring some breathing space for all stakeholders to search for consensual solutions. Still, directors should monitor the company's future financial health diligently and enter into meaningful negotiations with the relevant stakeholders at an early point in time so as to have all options available when needed.

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[6] A voluntary filings only requires the debtor to be imminent insolvent, section 18 InsO, i.e. a liquidity gap to occur within the next 24 months.

[7] OLG Munich, decision of 21 March 2013 – 23 U 3344/12.

[8] BGH, decision of 13 July 2021 – II ZR 84/20.

[9] OLG Dusseldorf, decision of 20 July 2021 – 12 W 7/21 and decision of 9 February 2022 – 12 U 54/21.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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