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Insolvency avoidance rules re-loaded?

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Introduction

German insolvency law is regularly criticised for having relatively extensive insolvency clawback provisions compared to the provisions in other jurisdictions. These provisions allow insolvency administrators to challenge transactions which occurred during suspect periods (or hardening periods) before filing for insolvency. German insolvency administrators have the statutory duty and monetary incentive to maximise the value of the estate, including by way of clawback, which is why they make frequently use of this right.

Clawback is a means to implement practically the principle of equal treatment of creditors – the overriding idea of insolvency proceedings. The proceedings guarantee that the insolvency debtor's few remaining assets are shared equally among its creditors. Little would be left of this principle if there was no limitation for the transfer of assets before the opening of insolvency proceedings.

On the other hand, it is equally important from an economic standpoint that at some point creditors can rely on the fact that they can retain what they have received, even if the debtor becomes insolvent at a later point in time. Moreover, the legislature and the courts must offer a safe harbour in terms of dealing with a company in financial difficulties. Courts must find a middle ground between the justified demand for transaction security and the equal treatment principle, which favours a far-reaching cancellation of suspect antecedent transactions.

Unusual circumstances aside (eg, gratuitous transactions or repayment of shareholder loans), creditors generally do not face justified clawback claims if three months has passed since the transaction without an insolvency filing by or against the debtor. Even transactions which take place within this three-month period cannot be challenged by insolvency administrators if they qualify as "cash transactions"(1) and if the creditor received only what it was owed (known as congruent satisfaction). Cash transactions are characterised by the immediate exchange of equivalent performances and considerations. Such transactions can be challenged only if they were made with the intention of the debtor to disadvantage its creditors.(2)

At first glance, this appears as a balanced system. However, transactions made with the intention to prejudice creditors – which are subject to a hardening period of 10 years – are legally presumed under certain conditions. The Federal Court of Justice had interpreted these legal presumptions extensively in the past. As a result, in order to prove that a transaction was intentionally disadvantageous, insolvency administrators have previously had to provide only evidence that the insolvency debtor was in a state of impending illiquidity at the time that the transaction was made and that the other party knew of this. What was paid or otherwise contributed by the creditor to the insolvency estate in return is irrelevant. It became difficult to defend against clawback actions on this basis.

Facts

In a recent decision, the Federal Court of Justice (BGH IX ZR 192/13, July 10 2014) ruled that the presumption of an intentionally disadvantageous transaction based on awareness of impending illiquidity can be rebutted if the debtor has made a congruent payment against a fair and immediate consideration which was essential for the continuation of the business and beneficial to the creditors.

The case was brought by the insolvency administrator of a company. The insolvency administrator challenged the payments of salaries to a manager of the insolvent debtor. He argued that the payment was made in times of financial crisis with the intention to prejudice the company creditors, and that this intention was known by the defendant.

Decision

The court held that there was no legal basis for the insolvency administrator's claim and thereby re-defined the conditions for the assumption of a (generally) unavoidable cash transaction.

The presumption of the intention to disadvantage creditors is rebutted in cases where a debtor makes a congruent payment in exchange for a consideration which is indispensable for the continuation of the business and beneficial to the creditors of the company. The Federal Court of Justice has stated that the performance of the workforce (including the management) typically qualifies as such essential contribution. In the case at hand, the court held that the commercial manager's work was essential for the continuation of the business and valuable for the creditors. It was privileged because it was awarded by means of a cash transaction (eg, by direct payment to the manager).

The Federal Court of Justice confirmed that the maximum period in which the payment of wages qualifies as a direct cash transaction is 30 days. In contrast, the Federal Labour Court considered a three-month period sufficient for direct consideration within the meaning of cash privilege.

Comment

After a long series of court decisions lowering the requirements for a successful clawback, this decision offers a positive signal on the way to an increasingly diversified German clawback regime. Despite the clear wording of the cash-consideration provision in the Insolvency Code – which provides that the privilege does not apply in case of an intentionally disadvantageous transaction – the courts are getting closer to minimising insolvency claw-back risks for essential services and supplies. This decision is the insolvency-related equivalent to the possibility under corporation law of managing directors continuing to make payments for services and supplies (eg, electricity and water) which are essential for the continuation of the business, notwithstanding entry into a financial crisis (Section 64 of the Limited Liability Companies Act).

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Endnotes

(1) Section 142 of the Insolvency Code.

(2) Section 133(1) of the Insolvency Code.