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Insolvency & Restructuring - Germany

Three-week payment period permitted for crisis-ridden limited liability company

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Introduction

Under German insolvency law, the managing directors of a crisis-shaken limited liability company are obliged to file for the opening of insolvency proceedings within three weeks of an insolvency event (ie, either over-indebtedness or illiquidity) occuring. If insolvency reasons are given, the managing directors are, in principle, personally liable in relation to the company for any payments which they make out of the company's assets during that three-week period and beyond. Moreover, managing directors who intentionally violate their duty to file for the opening of insolvency proceedings may also be exposed to liability with regards to third-party creditors (in addition to criminal liability, which might also apply).

However, notwithstanding the financial situation of the company, managing directors of a limited liability company are permitted to make payments to creditors without being held personally liable, provided that they have exercised due care and diligence in making such payments. Such payments may particularly relate to operating costs which need to be paid in order to enable the business to continue to operate during the three-week period (ie, electricity, water, heating and social contributions).

It is obvious that the three-week period pertaining to an insolvency event puts the managing directors under a certain degree of pressure, especially if restructuring negotiations are still ongoing. The managing directors must find a balance between protecting their own interests (ie, filing for insolvency as soon as possible in order to avoid any personal liability) and the interests of the company and the creditors to achieve (potentially) a successful out-of-court restructuring which depends on the final outcome of the ongoing restructuring negotiations.

Viewed from a different perspective, creditors of a company in financial difficulty which are asked for a restructuring contribution would normally expect the prospects of the envisaged restructuring measures to have been carefully considered by all parties involved. Such assessment can prove to be time consuming and can potentially result in financial deterioration if negotiations are initiated too late. Taking the three-week period into consideration, it is obvious that the short period of time which applies under German law may hamper a successful restructuring.

Hamburg Higher Regional Court ruling

On June 25 2010 the Hamburg Higher Regional Court held that payments made by managing directors with a view to an intended restructuring are permissible. In the case at hand, the insolvency administrator asserted a repayment claim against the company's managing director for the repayment of amounts which were paid to creditors after the three-week period had elapsed. The payments were apparently made with the erroneous expectation that a restructuring concept would be adopted by the shareholders.

What is particularly striking about this court ruling is the intention to create an exception which allows for an extension of the three-week period. In the case at hand, the exception was established on the grounds of the *bona fide* expectation of the management, which believed in the implementation of the restructuring. Whereas the Federal Court of Justice (which is the highest court in Germany) has consistently held that payments to creditors must not be made after the expiration of the three-week period – whether or not made in compliance with the proper professional care – the

regional court's ruling is innovative in its attempt to introduce more flexibility for the benefit of managing directors acting in good faith, in particular in cases where the company's shareholders hold out hopes of a successful restructuring. This anomaly is attributable to the fact that, in the case at hand, the restructuring efforts did not fail due to a lack of a sustainable restructuring concept or the unwillingness of the creditors to cooperate, but rather due to the shareholders' sudden rejection of a previously adopted restructuring plan.

Comment

Taken at face value, the Hamburg Higher Regional Court's ruling would seem to introduce a modification of the personal liability of managing directors for payments made to creditors after grounds for insolvency have arisen. This could constitute the beginning of a trend which could well culminate in more flexibility during the planning phase of a restructuring. If these principles are confirmed by the Federal Court of Justice, this development could facilitate the implementation of restructuring measures by providing reassurance to managing directors. Such managing directors would be enabled to put their best efforts into to realising a restructuring concept without being exposed to the risk of being held liable by the company.

However, on closer analysis, the decision has unfortunately failed to improve clarity and legal certainty. First, the decision lacks confirmation by the Federal Court of Justice, which in other cases has taken a different view on the same issue. Therefore, it is questionable whether a prudent managing director can rely on this line of argument. Second, the decision was rendered in view of the insolvent company's claim against its own managing directors. It remains to be seen whether the exception applied by the Hamburg Higher Regional Court would also be applied by German courts to other personal liabilities which might be triggered by the violation of duties within the three-week period (ie, in context of the potential criminal liability and/or liability relating to third parties). At present, there are no indications that such a development is likely. In fact, quite the opposite is the case; German courts continue to apply the limitation of the three-week period strictly, without allowing for any exceptions.

Ultimately, the decision may merely provide for an additional layer of defence which could be utilised by management in individual cases. The ruling must not be taken as an invitation for managing directors to neglect their duties which apply within the three-week period and/or thereafter, because the risk of personal liability remains unchanged.

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