

CORONAVIRUS: GERMAN INSOLVENCY EMERGENCY LEGISLATION

Many key features of the German legal restructuring and insolvency regime are about to be temporarily suspended in an unprecedented move by the German Federal Government which intends to protect German companies from a Corona induced insolvency. These changes to the law are accompanying the massive financial support which is set to be provided by both the government owned promotional bank Kreditanstalt für Wiederaufbau, KfW, and the European Central Bank. They have the goal to grant additional financial support to troubled German businesses in order to prevent insolvency filings which would inevitably have to be made by the management in accordance with Germany's strict insolvency filing regime.

INTRODUCTION

On 23 March 2020, the German Federal Government published a draft law on its official webpage which intends to mitigate the consequences of the Corona pandemic in civil, insolvency and criminal procedural law. The German Parliament has passed this law on 25 March 2020 and it is expected that it will pass the Federal Council on 27 March 2020. This briefing is based on the draft law published on 25 March 2020 and herein, we focus on the aspects which are related to restructuring and insolvency law (we do not discuss the provisions that deal with the holding of shareholder assemblies, or the provisions related to criminal procedural law). The changes are far-reaching and much more robust than the initial drafts circulated. It can be expected that they will effectively help to prevent a large number of insolvencies. Some features of German restructuring and insolvency law made these changes necessary, namely:

Lending to a distressed German company used to be cumbersome as lender needed to mitigate lender liability risks

When lending to a distressed German company, lenders face the risk that they will be later confronted with a liability claim by other creditors if the company eventually ends up in insolvency. In this context, the German Federal Court of Justice speaks of a "prolongation of the company's death struggle" as opposed to a sustainable restructuring. In order to mitigate that risk, it has become market standard to have the chances of a sustainable restructuring

Key issues

- Temporary suspension of insolvency filing obligations
- Facilitation of financings without a "lender-liability" risk
- Suspension of equitable subordination rules
- Suspension of certain insolvency claw-back provisions

thoroughly analysed before providing rescue financing – an exercise which is time consuming and would prove particularly difficult in the current situation given the sheer number of cases (and the limited number of experts) and uncertainties around the factual assumptions on which any analysis would have to be based.

Shareholder financings are generally subordinated in an insolvency

Shareholders are sometimes reluctant to provide funding in a crisis situation since their repayment claims would be subordinated in an insolvency by operation of law (so-called "equitable subordination").

Insolvency filing obligations are particularly strict with little room for flexibility

Under German law, the management has to file for insolvency within a maximum period of 21 days after the occurrence of illiquidity or over-indebtedness. If the management does not comply with this obligation, it faces a substantial civil and criminal liability regime – directors are regularly sued in connection with insolvency.

Insolvency claw-back is comparably easy

It sometimes hinders restructurings if there is a constant risk that any (partial) repayment of debt received by a lender might be clawed-back in the case of a later insolvency due to the German insolvency claw-back regime regarding transactions such as a repayment of debt during "hardening periods".

It is also a result of these peculiarities that under the current regime, it would not be sufficient to facilitate access to additional liquidity through KfW. The legal situation, therefore, needs to change substantially to prevent insolvency filings by a large number of companies over the coming weeks.

KEY AREAS OF IMPACT

In the following, we have summarised the key areas of change (please also refer to the table at the end of this briefing).

Facilitation of new liquidity support

Several measures have been designed to encourage the provision of liquidity support to businesses affected by the Covid 19-pandemic: Loans, including shareholder loans, can be granted to these businesses without the risk of claw-back and, in particular, lender-liability. This means that fully-fledged restructuring opinions (in Germany typically according to the IDW S 6 standard) will be the exception rather than the rule. However, businesses will still be required to demonstrate that liquidity can be restored over the long run and that the company was liquid as of 31 December 2019. It remains to be seen what lenders will expect to see to validate business plans and other information they receive from their clients. The market would certainly welcome it if the need to issue a restructuring opinion was explicitly excluded by the new law. In addition, the claw-back risk has been addressed as repayments on new loans and security for new loans are protected from claw-back for any insolvency filing until 30 September 2023.

Treatment of existing financings

It is not clear to what extent existing financing benefits from the proposed protection scheme. While the protection of repayment and security against claw-back clearly extends to new loans only, the draft law indicates that lender liability will be suspended for the prolongation of old and the granting of new financings. Prolongations or novations which occur without additional security should therefore, under the new legal situation, not expose lenders to potential liability, however, when these occur with additional security, lenders might continue to seek protection through restructuring opinions, unless this point is clearly addressed in the new legislation.

Treatment of new shareholder loans

New shareholder loans are protected from equitable subordination (during all insolvency proceedings opened at the latest on 30 September 2023) and against claw-back. Security for shareholder loans would, under the current draft, not benefit from this protection.

Suspension of insolvency filing obligation for businesses affected by the coronavirus until 30 September 2020

The management's insolvency filing obligation for both mandatory filing reasons (illiquidity and over-indebtedness) are suspended until 30 September 2020, unless the insolvency reasons are not related to the Covid 19-pandemic or if there is no prospect of resolving the existing illiquidity. It will be assumed that the insolvency reasons are related to the Covid 19-pandemic situation unless the business was illiquid on 31 December 2019 already. Equally, the (most common) director liability provisions relating to payments made after the occurrence of mandatory insolvency reasons will be suspended in the same way as the insolvency filing obligation (fraudulent behaviour will continue to be punishable). Moreover, the right of third-party creditors to file a petition for the initiation of insolvency proceedings will also be suspended for a period of three months.

Ban on the termination of lease contracts

Lease contracts for real estate and for living/office space must not be terminated as a result of the tenant failing to pay due rent in the period from 1 April to 30 June 2020, insofar as the non-payment is caused by the impact of the Covid 19-pandemic. This can be extended by ordinance to lease payments due between 1 July and 30 September 2019.

Consumer rights on long-term contracts (other than in respect of leases or loans)

As proposed, a consumer shall have the right to refuse performance until 30 June 2020 of any obligation related to a consumer contract which contains continuing obligations (*Dauerschuldverhältnis*) (other than lease and loan contracts) concluded before 8 March 2020 if due to circumstances resulting from the Covid-19 pandemic, the performance would not be possible without endangering the consumer's reasonable subsistence or the reasonable subsistence of the consumer's dependants. The consumer's right to refuse performance is limited to material continuing obligations (*wesentliche Dauerschuldverhältnisse*), which are defined as such obligations which provide the consumer with essential goods and services required to maintain an adequate livelihood.

Micro-enterprises (*Kleinstunternehmen*) within the meaning of Recommendation 2003/361/EC of 6 May 2003 of the Commission concerning the definition of micro, small and medium-sized enterprises have a right to refuse performance until 30 June 2020 of any obligation related to a contract which contains continuing obligations concluded before 8 March 2020 if, as a result of circumstances relating to the Covid-19 pandemic, the micro-enterprise is unable to perform or would not be able to perform without endangering the economic basis of its business operations. This right to refuse performance can be extended by ordinance to 30 September 2019.

Loans

The measures described below will initially only apply to consumer loans. However, they can be widened by simple ordinance to loans extended to in particular micro-enterprises, but also other corporates.

To avoid termination of loan agreements for payment default or deterioration of financial conditions as well as to enable borrowers to apply for support measures and make use of support offers, the draft law contains in Article 240 section 3 EGBGB-E substantial measures applicable to loan agreements with consumers concluded before 15 March 2020. These comprise a statutory payment deferral for initially 3 months. If during those 3 months no agreement can be negotiated, another deferral by 3 months will apply as a matter of law (each subject to deviating agreement by the parties). During the period, lender's termination rights based on payment default and deterioration of financial conditions will be excluded by mandatory law.

For loan agreements with consumers concluded before 15 March 2020, claims of the lender for repayment, interest or principal payments due between 1 April 2020 and 30 June 2020 are automatically deferred by law for a period of three months from the due date if the consumer has lost income due to the extraordinary circumstances caused by the spread of the Covid-19 pandemic, which make it unreasonable to expect the consumer to meet the obligations (Article 240 section 3 para. 1 sent. 1 EGBGB-E). The consumer is entitled to continue making contractual payments during the period between 1 April 2020 and 30 June 2020 at the performance dates originally agreed. To the extent the consumer continues to make the payments in line with the contract, the deferral is deemed to not have occurred. Parties to the loan agreement may by agreement deviate from the deferral as imposed by the law, in particular regarding possible partial payments, interest and repayment adjustments or debt rescheduling. The law can, by ordinance, be expanded to apply to payments due until 30 September 2020.

Article 240 section 3 para. 3 EGBGB-E excludes termination by the lender due to payment default, significant deterioration of the financial circumstances of the consumer or the value of collateral provided for the loan until the end of the deferral. The parties must not deviate therefrom to the detriment of the consumer.

If no mutual agreement is reached for the period after 30 June 2020, Article 240 section 3 para. 5 EGBGB-E extends the term of the contract by three months. The respective due dates of the contractual obligations are postponed by this period. By ordinance, the postponement can be prolonged to 12 months.

Pursuant to Article 240 section 3 para. 6 EGBGB-E the aforementioned paragraphs 1 to 5 of Article 240 section 3 EGBGB-E shall not apply if the deferral or exclusion of termination is unreasonable for the lender taking into account all circumstances of the individual case including the changes in general living conditions caused by the Covid-19 pandemic.

Article 240 section 3 para. 8 EGBGB-E entitles the German Federal Government to change by ordinance the personal scope of application of Article 240 section 3 para. 1 to 6 EGBGB-E and to extend it, in particular but without limitation, to micro enterprises within the meaning of the Annex to Article 2 para. 3 of the Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.

SUMMARY OF KEY PROVISIONS IN THE DRAFT LAW

A. Corona Insolvency Suspension Act ("CorInsAG")

| CorInsAG | Subject | Content |
|---|--|--|
| Section 1 | Suspension of the insolvency filing obligation | <p>Suspension of the insolvency filing obligation with a reversed rule-exception relationship in such a way that filing is only required if:</p> <ol style="list-style-type: none"> 1. the factual insolvency is (exceptionally) not based on the Covid-19 pandemic; or 2. (exceptionally) there is no prospect of the existing insolvency being resolved. <p>If the debtor was not insolvent on 31st December 2019, it is assumed that the factual insolvency is the result of the Covid-19 pandemic and that there are prospects of eliminating the existing insolvency.</p> |
| Section 2 paragraph 1 number 1 | Liability of the management / the board | No liability of the management / the board in accordance with section 64 of the German Limited Liability Companies Act (<i>GmbHG</i>), section 92 paragraph 2 of the German Stock Corporation Act (<i>AktG</i>), section 130a of the German Commercial Code (<i>HGB</i>), etc. for payments made after the occurrence of factual insolvency subject to the conditions of section 1 CorInsAG. |
| Section 2 paragraph 1 number 2 | Treatment of (shareholder) loans and security | <p>The repayment of new loans (until 30 September 2020) including shareholder loans (section 135 of the German Insolvency Code ("InsO")) cannot be subjected to claw-back in any insolvency filings opened on the basis of insolvency filing made before 30 September 2023.</p> <p>Claw-back of new security for new (bridge/restructuring) loans according to sections 129 et seqq. InsO is de facto suspended until 30 September 2020.</p> <p>Claw-back of security for shareholder loans is excluded here but is probably subject to the general suspension of claw-back for congruent legal acts pursuant to section 2 paragraph 1 number 4 CorInsAG.</p> |
| Section 2 paragraph 1 number 2 sentence 3 | Treatment of shareholder loans | New shareholder loans do not have a subordinated status in insolvency proceedings which were opened on the basis of insolvency filings made before 30 September 2023 (section 39 paragraph 1 number 5 InsO is not applicable). Similarly, security for shareholder loans is not subordinated (section 44a InsO is not applicable). |
| Section 2 paragraph 1 number 3 | Lender liability | Lender liability (liability on the basis of an insolvency filing delay according to section 826 BGB) is suspended until 30 th September 2020. |
| Section 2 paragraph 1 number 4 | Claw-back (congruent legal acts) | Claw-back for all congruent legal acts in the period until 30 th September 2020 is generally suspended. This does not apply if the contractual partner was aware that the efforts made were not suitable for eliminating the insolvency that had occurred. |

| CorInsAG | Subject | Content |
|-----------------------|----------------------|--|
| Section 2 paragraph 2 | Other companies | Relief also applies to companies that are not subject to a filing obligation and to debtors that are neither insolvent nor overindebted. |
| Section 3 | Creditor application | Creditors can now only file for insolvency if the factual insolvency occurred before 1 March 2020. |

B. Article 240 of the Introductory Act to the German Civil Code ("EGBGB")

| Article 240 EGBGB | Subject | Content |
|-----------------------|--|--|
| Section 1 | Right to refuse services for consumers and micro-enterprises | <p>Corona-related right to refuse performance of services for consumers and micro-enterprises until 30 September 2020 in the case of continuing obligations concluded before 8 March 2020 and if the consumer/micro-enterprise is unable to provide the service without jeopardising the reasonable livelihood/economic basis of the business due to circumstances attributable to the corona pandemic.</p> <p>Exception for employment contracts, travel contracts and transport. Special regulations for leases and consumer loan agreements (see below).</p> <p>Exception, if the exercise of the right to refuse performance is unreasonable for the creditor on his part, since failure to perform would jeopardise the economic basis of his business. In this case, however, the debtor may withdraw from the contract.</p> |
| Section 2 | Termination block for tenancies | Termination block for tenancies of land and premises and for leases in the event of non-payment of the rent/lease in the period from 1 April 2020 to 30 September 2020, if the non-performance is corona related. |
| Section 3 paragraph 1 | Deferral of loans and interest on consumer loan | To the extent the Covid-19 pandemic resulted in an extraordinary loss of revenue and it borrower cannot be expected under the circumstances to meet its contractual obligations, interest and amortization payments for consumer loan due between 1 April and 30 June 2020 will be deferred for 3 months from the due date (in the case of monthly payments, the deferral will therefore extend beyond 30 June 2020). Different solutions are possible by mutual agreement. |
| Section 3 paragraph 3 | Protection against termination of consumer loans | Termination of the consumer loan due to late payment or deterioration of financial circumstances is excluded until 30 June 2020. This is part of German mandatory law. |
| Section 3 paragraph 6 | Further deferral for consumer loans | If no amicable solution is found for the period after 30 June 2020, all payments due under the consumer loan are automatically extended by 3 months. |

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