ALLEN & OVERY

31 March 2020

Covid-19 pandemic: Temporary suspension of the obligation to file for insolvency proceedings

From announcement to law

With unprecedented speed, the legislation only proposed by the Federal Government on 16 March 2020 temporarily suspending the obligation to file for insolvency proceedings for companies affected by the Covid-19 pandemic until the end of 30 September 2020 has now passed all legislative stages. The Covid-19 Insolvency Suspension Act (*Covid-19-Insolvenzaussetzungsgesetz*; **COVInsAG**) was published in the Federal Law Gazette as part of the Act on Mitigating the Effects of the Covid-19 Pandemic in Civil, Insolvency and Criminal Procedure Law (*Gesetz zur Abmilderung der Folgen der Covid-19-Pandemie im Zivil-, Insolvenz- und Strafverfahrensrecht*) (article 1 therein) on 27 March 2020. The COVInsAG has thus entered into force with retroactive effect as of 1 March 2020.

A general overview of the Act on Mitigating the Effects of the Covid-19 Pandemic in Civil, Insolvency and Criminal Proceedings Law can be found in our separate bulletin "Access to new debt and equity during the corona crisis". Information on the establishment of the economic stabilisation fund, ie support for larger companies by means of guarantees and recapitalisation measures, which has simultaneously been initiated by the Federal Government, can be found in our bulletin "German rescue package takes effect".

Summary

The COVInsAG suspends the insolvency filing obligations for affected companies until **30 September 2020**, subject to certain requirements, which are explained below. During this period, insolvency-related payment restrictions, in particular those set out in section 64 sentence 2 of the German Limited Liability Companies Act (*GmbH-Gesetz*; **GmbHG**) and section 92 (2) sentence 2 of the German Stock Corporation Act (*Aktiengesetz*; **AktG**), are also suspended in the interests of directors and managers. In addition, creditors of a company are also not allowed to file for the commencement of insolvency proceedings for three months after the date on which the law is announced. The German Federal Ministry of Justice (*Bundesjustizministerium*; **BMJV**) is authorised to extend these suspensions until **31 March 2021**.

In order to facilitate the financing of companies affected by the Covid-19 pandemic, special regulations in favour of credit institutions and shareholders will be introduced to allow such lenders to provide new loans in

accordance with the law despite the crisis during the period for which the obligation to file for insolvency proceedings has been suspended. At the same time, certain provisions of insolvency avoidance law will be eased in order to make it easier for affected companies to participate in general economic transactions.

Suspension of the obligation to file for insolvency

The obligation to file for the commencement of insolvency proceedings is to be suspended until **30 September 2020** pursuant to section 1 COVInsAG. The BMJV is authorised to extend this period until 31 March 2021, subject to certain conditions. The suspension of the filing obligation does not apply if the company's insolvency was not triggered by the effects of the Covid-19 pandemic or if there is no prospect of eliminating any existing illiquidity. If the company in question was not illiquid on 31 December 2019, it is assumed that its insolvency was triggered by the effects of the Covid-19 pandemic and that it is possible to eliminate any existing illiquidity.

Section 1 COVInsAG thus suspends the obligation to file for the commencement of insolvency proceedings for directors and managers of companies of any legal form who would otherwise have been obliged under section 15a of the German Insolvency Code (*Insolvenzordnung*, **InsO**) to file for insolvency due to illiquidity or over-indebtedness. In order to protect registered associations (*eingetragene Vereine*) and foundations (*Stiftungen*), section 1 COVInsAG extends the suspension of these filing obligations to the executive boards of registered associations and foundations. This will also apply with retroactive effect as of 1 March 2020.

However, the suspension of the obligation to file for insolvency may only be invoked by directors or managers who succeed in proving two cumulative conditions: insolvency must, firstly, have been triggered by the effects of the Covid-19 pandemic and, secondly, there must be real prospects of eliminating any existing illiquidity.

Since it will obviously be difficult to prove that both conditions apply, the legislator has introduced an additional legal presumption in favour of directors and managers, according to which the existence of both conditions is presumed if the company concerned was not illiquid (*zahlungsunfähig*) on 31 December 2019. If the management can therefore prove that the company was not illiquid at the end of 2019, it can invoke the suspension of the obligation to file for insolvency. However, the legal presumption is rebuttable, so that the obligation to file for insolvency is not suspended if there can be no doubt that the Covid-19 pandemic was not the cause of the insolvency (ie a ground for insolvency existed before and independently of the Covid-19 pandemic) or the elimination of the illiquidity is excluded (eg because refinancing negotiations ultimately failed).

According to the explanatory memorandum, however, the "highest demands" must be placed on any refutation of the legal presumption in order to ensure that the purpose of the law, namely to relieve liability and to protect the directors and managers, is honoured.

Further legal consequences of the suspension

The draft Act links a number of other significant consequences to the suspension of the obligation to file for the commencement of insolvency pursuant to section 1 COVInsAG.

Upon the suspension of the filing obligation, directors and managers are not liable to a company's creditors for damages under the rules of tort law set out in section 823 para. 2 of the German Civil Code (*Bürgerliches Gesetzbuch*, **BGB**) in conjunction with section 15a InsO for any loss resulting from a delay in filing for insolvency. The criminal sanctions for breaching the obligation to file for insolvency provided for in section 15a (4) and (5) InsO also cease to apply to directors and managers.

Pursuant to section 2 (1) no. 1 COVInsAG payments which are made in the ordinary course of business, in particular those payments which serve to maintain or resume business operations or to implement a

restructuring concept, shall be deemed to be compatible with the due care of a prudent and conscientious businessperson within the meaning of section 64 sentence 2 GmbHG and section 92 (2) sentence 2 AktG. These provisions significantly reduce the liability risks of directors and managers, which would otherwise exist if the so-called insolvency-related payment restrictions, which only have very limited exceptions, continued to apply.

Granting of credit significantly modified during the crisis

During the suspension period of the obligation to file for insolvency, the COVInsAG also has a significant impact on the legal provisions regarding the granting of credit during the crisis.

If a new loan is granted and secured (whether in cash or in kind) during the suspension period of the obligation to file for insolvency, such granting of credit and the provision of security shall, pursuant to section 2 (1) no. 3 COVInsAG, not be regarded as *contra bonos mores* and thus lenders are, during the crisis, placed in a privileged position in terms of liability as compared to the normal legal situation for financing arrangements. Section 2 (1) no. 2 COVInsAG also states that the repayment of such loans by 30 September 2023 and the provision of collateral to secure such loans during the suspension period shall not be deemed to be disadvantageous to creditors. The provisions of section 2 (1) nos. 3 and 2 COVInsAG are intended to exclude risks – in particular for credit institutions – pursuant to sections 138 and 826 BGB and on the basis of insolvency avoidance law in accordance with section 129 et seq. InsO. The intention is that credit institutions in particular should not, in the event of a later insolvency of a company, which may occur after the suspension of the obligation to file for insolvency has expired (after 31 March 2021 at the latest), be exposed to the accusation that they granted credit to the company during the crisis without sufficiently satisfying themselves that the company is capable of and worth restructuring. This could mean that, in particular, restructuring reports prepared according to the IDW S6 standard could become superfluous for new loans for the period up to 30 September 2020. In terms of the requirements placed on new loans, the Act distinguishes between the claw-back exemption and the liability exemption: While the claw-back exemption pursuant to section 2 (1) no. 2 COVInsAG only applies to new loans, i.e. not to prolongations, novations or other forms of back-and-forth payments, finance providers may also assert the liability exemption pursuant to section 2 (1) no. 3 COVInsAG if, for instance, no new funds are provided in the context of a prolongation or deferral. For loans granted by the state-owned *Kreditanstalt für Wiederaufbau* and its financing partners or by other institutions within the framework of state aid programmes relating to the Covid-19 pandemic, section 2 (1) nos. 3 and 2 COVInsAG also apply if the loan is granted or secured after the end of the suspension period and for an unlimited period for their repayment (cf. section 2 (3) COVInsAG); this longer term may open up additional options for new financing structures.

The legislator is breaking new ground in section 2 (1) no. 2 COVInsAG with regard to the financing of companies using shareholder loans during the suspension period, which are subordinated by law pursuant to section 39 para. 1 no. 5 InsO and therefore typically lost in full without any recovery in insolvency proceedings relating to the assets of the company. Cash injections provided by shareholders during the suspension period are to be treated on equal terms in any subsequent insolvency proceedings. Prolongations, novations or other forms of back-and-forth payments are not, however, sufficient in relation to shareholder loans either in order to be able to invoke section 2 para. 2 no. 2 COVInsAG. However, the legislator does specify a distinction from financing via bank loans: if securities are provided to the shareholder, these securities should continue to be examined for a potential violation of bonos mores principles and can be contested pursuant to section 135 para. 1 no. 1 InsO.

Where a company would not be required to file for the commencement of insolvency proceedings despite the Covid-19 pandemic, and if it would therefore not matter to the managers of this company whether the obligation to file for insolvency has been suspended pursuant to section 1 COVInsAG, the draft also extends

the above-mentioned exemptions for credit financing under section 2 para. 2 COVInsAG to financing for companies which are either not subject to an obligation to file for insolvency or companies which are neither insolvent nor over-indebted. Therefore, credit institutions and shareholders do not have to first ascertain whether a company is subject to the obligation to file for insolvency or whether it is to be deemed insolvent before they can invoke the exemptions of section 2 para. 1 nos. 2 and 3 COVInsAG.

Further relief in insolvency avoidance law

In order to make it easier for companies in crisis to participate in general legal transactions, the possibilities for contesting transactions on the grounds of congruent and certain incongruent acts pursuant to sections 129 et seq. InsO are to be modified.

If, for example, the company pays its instalments under an instalment payment agreement on time, it shall not be possible to reclaim these payments in later insolvency proceedings by contesting the transaction unless the creditor had positive knowledge that restructuring and financing efforts of the company making the payments had failed (section 2 para. 1 no. 4 sentence 1 COVInsAG).

The same shall apply if the creditor receives payments or security (eg from third parties) which would otherwise be classified as incongruent under insolvency avoidance law. Without section 2 (1) no. 4 sentence 2 COVInsAG, such payments could be contestable and would thus make it more difficult for a company to participate in general economic transactions during the crisis, since its contractual partners might be inclined to terminate economic relations with that company as quickly as possible due to future insolvency avoidance risks.

The provisions of section 2 para. 1 no. 4 COVInsAG also apply to companies that are not subject to a filing obligation and to debtors that are neither insolvent nor over-indebted.

Suspension of creditor insolvency applications for three months

The right of creditors to apply for the commencement of insolvency proceedings relating to the assets of their debtor is to be suspended for three months, provided the reason for initiating insolvency proceedings did not already exist on 1 March 2020. The three-month period set out in section 3 COVInsAG begins on the day after the COVInsAG is formally published in the Federal Law Gazette. The BMJV can also extend the validity of this provision – subject to certain requirements – until 31 March 2021.

Outlook

Upon the COVInsAG taking effect, significant relief under insolvency law will be implemented to mitigate the effects of the Covid-19 pandemic.

Besides the discussion on whether the obligation to file for insolvency is actually suspended for a company in the individual case, a key question will be which diligence requirements must be applied by directors and managers (for example with regard to payments in the ordinary course of business) despite these relief measures.

From the point of view of credit institutions willing to provide financing, the main question to be answered is under what conditions they will grant new loan facilities, even if a classic IDW S6 restructuring report might be dispensable for the time being (at least until the end of September 2020).

The period of stabilisation must be used to quickly develop a restructuring plan; as soon as a company is rendered illiquid (because state support is not provided (in time), for instance), the situation becomes more

critical, since the suspension of the obligation to file for insolvency (and the exemptions that are then triggered) ends once there are no more prospects of the company returning to liquidity.

Going forward, a positive going-concern prognosis will again have to be established from 1 October 2020 onwards. An (at least temporary) suspension of over-indebtedness within the meaning of section 19 InsO as a criterion triggering an obligation to file for insolvency, as during the 2008/2009 financial crisis, has so far not been implemented by the legislator.

Our restructuring and insolvency team

Peter Hoegen
Partner – Frankfurt
Banking & Finance / Restructuring

Tel +49 69 2648 5905
peter.hoegen@allenovery.com

Dr. Sven Prüfer
Partner – Frankfurt
Corporate / Restructuring

Tel +49 69 2648 5381
sven.pruefer@allenovery.com

Dr. Franz Bernhard Herding
Partner – Frankfurt
Banking & Finance / Restructuring

Tel +49 69 2648 5712
franz-bernhard.herding@allenovery.com

Dr. Walter Uebelhoer
Partner – München
Banking & Finance / Restructuring

Tel +49 89 71043 3113
walter.uebelhoer@allenovery.com

Dr. Christopher Kranz, LL.M.
Senior Associate – Frankfurt
Banking & Finance / Restructuring

Tel +49 69 2648 5744
christopher.kranz@allenovery.com

Oliver Köhler
Associate – Frankfurt
Banking & Finance / Restructuring

Tel +49 69 2648 5968
oliver.koehler@allenovery.com

Moritz Probst
Associate – Frankfurt
Banking & Finance / Restructuring

Tel +49 69 2648 5522
moritz.probst@allenovery.com

Wencke Rusbüldt
Associate – Frankfurt
Corporate / Restructuring

Tel +49 69 2648 5484
wencke.rusbueldt@allenovery.com

Dr. Joerg Weber
Associate – München
Banking & Finance / Restructuring

Tel +49 89 71043 3957
joerg.weber@allenovery.com