COVID-19: Germany Update – Suspension of Obligation To File an Insolvency Application and Certain Effects

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With the intention of mitigating the effects of the COVID-19 pandemic, the obligation of companies in Germany to file insolvency applications was suspended by legislative act dated March 27, 2020. Thus, the respective board members will, in many cases, no longer be obligated to file an application for the initiation of insolvency proceedings if their company is illiquid or over-indebted. The suspension applies until September 30, 2020, and may be extended until March 31, 2021, by the German Federal Ministry of Justice and Consumer Protection.

This article will discuss the requirements and certain significant consequences of this act.

Illiquidity and Over-Indebtedness No Longer Necessarily Leads to Insolvency Proceedings

The obligation to file an insolvency application only applies to companies that are no longer able to settle their due obligations, so companies that are illiquid or companies that no longer have any equity capital and are therefore over-indebted. The new legislation serves to suspend this obligation for an initial period of approximately five months and, if extended, for up to an entire year. Therefore, companies will be able to continue their business for a significant time, even if they are unable to meet their obligations or have negative equity capital. The aim is to give them time to apply for grants, aid or credit and to maintain their business for an interim period.

At the same time, the suspension of the obligation to file an insolvency application is subject to substantial risks: If the affected companies do not receive the required grants, aids or credits during this interim period or if these prove to be insufficient, they will be compelled to discontinue their business in spite of the new legislation and, perhaps, to apply for the initiation of insolvency proceedings. With the suspension for a period of up to one year, this scenario is likely to arise in many cases. The business partners of those companies will then be at risk of seeing their receivables largely or even fully in default because, in these cases, the insolvent company will have continued its illiquid or over-indebted business longer than is normally permitted, and its assets are much more likely to have been further depleted over the suspension period. Business partners also will not be able to file a creditor application for the initiation of insolvency proceedings with the hope of saving at least a small portion of the assets, because creditor applications also have been strongly restricted until June 28, 2020, also extendable until March 31, 2021.

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Any company currently entering into agreements that will result in a significant credit exposure to the counterparty is therefore urged more than ever to carefully review the solvency of their contract partners prior to signing. At the same time, a delay in the order inflow may be experienced if their own solvency is subject to extensive review. For this reason, it is also recommended that companies prepare confirmations of their own financial situation in order to avoid delays in business operations.

New Legislation Only Intended To Apply to COVID-19 Cases

The obligation to file an insolvency application in principle has been suspended. However, this does not apply in cases where the illiquidity or over-indebtedness is not based on the effects of the COVID-19 pandemic or in cases where there are no prospects of remedying the insolvency. The suspension is only available where these conditions are fulfilled. In cases of uncertainty, the decision as to whether the conditions are satisfied will be made in favor of the company and its respective board member, and the burden of proving that the conditions have not been met is upon third parties who may wish to question the decision of the respective board member. Board members are provided with additional safeguards. It is assumed that the conditions for the suspension are met and that there is no obligation to file an insolvency application, if the company was not iliquid on December 31, 2019. This statutory assumption may be disproven, but the threshold is high. If the company was still solvent on December 31, 2019, then at the current time an insolvency application only will be required if the negative conditions (illiquidity or over-indebtedness not resulting from the COVID-19 pandemic or no prospects of remedying the insolvency) are met without any doubt.

This means that during the early stages of the suspension, risks for respective board members deciding not to file an insolvency application are greatly reduced. Such risks only should exist in specific cases and in cases where the company was already illiquid on December 31, 2019. In order to rely on the favorable assumption rule, companies are urged to review their solvency as per December 31, 2019, and document the results of this review.

During Suspension the Company's Situation Should Be Monitored Closely

The new legislation does not stipulate under which circumstances the obligation to file insolvency applications will resume and which risks the respective board members will be exposed to with the passage of time. It is likely that the negative exceptions to the suspension must be monitored not only during the early stages of the suspension period, but also over the entire course of the suspension period. In this respect, it is likely that the risks will increase. Circumstances may arise that might lead to illiquidity or over-indebtedness even without the COVID-19 pandemic. In addition, the remediation of the illiquidity may become impossible, such as where expected aid does not materialize or prove to be insufficient. The favorable assumption rule may not be helpful in those cases, because it is undoubtedly disproven. In these cases, an insolvency application must be filed.

It already has been stated in many cases that the actual granting of restructuring loans and aids by the German Development Bank (KfW) takes a long time, among other things, because principal banks are required to conduct their own credit review. In this way, loans and aids may materialize too late to prevent the discontinuation of business operations. Many things depend on the specifics of the given company, but this may be one of the cases where the obligation to file an insolvency application, with all its effects, may be reinstated. However, the prospects of remedying illiquidity should be considered as realistic until the time of the discontinuation of business operations, and companies should be allowed to give themselves time to maximize their chances.

Currently, respective board members will have to anticipate claims questioning their decisions only in rare cases. Whether this will hold true for the retrospective assessment and for the coming months remains to be seen. At any rate, it appears prudent to continually monitor and document the financial situation of the company as well as to perform a regular analysis as to whether an insolvency application must be filed in spite of the new rule. In this respect, respective board members also may consider applying for the initiation of insolvency proceedings as a precaution. The new rule only suspends the obligation to file an insolvency application; insolvency proceedings will remain available on a voluntary basis.

Strict Regime Will Be Resumed After the Suspension Period Ends

Upon expiry of the suspension period, the normal rules concerning the obligation to file an insolvency application will be reinstated. In cases of illiquidity or over-indebtedness, an application may have to be filed immediately upon expiry of the suspension period. In practice, this situation will create many challenges, because the effects of the pandemic will almost certainly still be reflected in company balance sheets after the expiry of the suspension period. Therefore, companies should consider now their likely financial situation at the time of the expiry of the suspension period in their financial planning. In all other respects, legislators are called upon to consider enacting an additional suspension period for the obligation to file an insolvency application for situations of over-indebtedness.

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Conclusion

The suspension of the obligation to file an insolvency application appears to be a balanced instrument in order to protect companies against insolvency proceedings, at least for a limited time. The conditions of the suspension should be reviewed and documented at the outset and continually over the course of the suspension period. In addition, the ongoing financial planning undertaken by companies should consider now the period after the expiry of the suspension and the legal situation at that time. Finally, it appears prudent for companies to review the solvency of their business partners for larger transactions in detail.

If these requirements are observed, many should be able to manage the present difficult situation as well as possible.

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