

# **Bankruptcy and a fresh start: stigma on failure and legal consequences of bankruptcy**

## **Germany**

### **TITLE 1. INTRODUCTION**

On 01.01.1999 the German Insolvency Act (Insolvenzordnung), announced on 5.10.1994 (Bundesgesetzblatt 1994 I S. 2866), was put into force. The Insolvency Act eliminated the duality of the Bankruptcy Act (Konkursordnung) and the Composition Act (Vergleichsordnung) and introduced therefore a single type of insolvency proceeding. Furthermore the Insolvency Act replaced the Collective Enforcement Act (Gesamtvollstreckungsordnung), which formerly controlled all insolvencies in East Germany. These individual laws will continue to apply to bankruptcy proceedings where an application was requested prior to 01.01.1999.

The German Insolvency Act completed in that respect the insolvency law reform. The cause for the reform of the insolvency proceedings was the considerably high number of insolvency proceedings in the middle of the 70s which were rejected because of no assets. As a fatal consequence the high number of insolvency proceedings was that over 70% of all insolvency proceedings were rejected because of no assets. This was felt not only economically as unsatisfactory, but also in conformity with the law. Thus one relevant target of the new insolvency law was the removal of the insolvency's estate. A further important target of the new Insolvency Act was the creation of systematics, which set insolvency avoidance into the foreground and put for this purpose an emphasis on the introduction of reorganization instruments.

If a company has an economic crisis, there are several possibilities available. First of all the managing directors of the threatened enterprise can try to create in the running up to a crisis a concept with all creditors. To that extent this will often be the credit institutes, to achieve a surviving of the company. Secondly it can decide in the running up of the insolvency to liquidate the company (namely as a voluntary winding-up). Therefore the legal regulations of the German Commercial Code are available. Thirdly the company can avail itself of the regulations of the German Insolvency Act, where in particular the insolvency plan pursuant to Section 217 of the German Insolvency Act is supposed to ensure that the debtor is able to continue the business. Therefore the insolvency plan contains three organization possibilities, the liquidation of the company (namely the compulsory winding-up within insolvency proceedings), business continues because of reorganization (Unternehmenssanierung) and the model of transferred reorganization (asset-deal/Übertragende Sanierung). This legal framework provides considerable possibilities for a reorganization of threatened companies and will be exclusively represented with reference to companies in the following.

Notwithstanding all of the above, these rules do not apply to persons, who are not self-employed or have been self-employed (Verbraucherinsolvenzverfahren). The legislator created therefore a highly simplified insolvency procedure (Section 304 of the German Insolvency Act) for those persons. A crucial target should be therefore the clearing of the debtors debts without going through the insolvency proceedings. Furthermore Section 1 of the German Insolvency Act stated the debt release (Restschuldbefreiung) of the debtor as one of the main aims of the new insolvency law. These regulations were created to enable a fresh start for debtors (this possibility concerns again only persons) who despite their efforts failed

economically. This will be discussed in more detail in the following chapters, where only persons are concerned.

In this connection it is to be mentioned further, that with effect from December 1 2001, the German Insolvency Modification Act was put into force. The modifications are to eliminate the weaknesses, which became clear. Concerned are however only insolvent persons, who are not self-employed or have been self-employed (Verbraucherinsolvenzverfahren). The legislator was modified to the extent that the fields of application included also debtors to this procedure who worked as self-employed but whose financial circumstances are of a manageable size and no claims from employer-employee relationship exist. Furthermore the access to insolvency proceedings for debtors completely without any estate has been simplified, because costs resulting in commencement of the insolvency proceedings will be deferred until the court grants the debt release. In addition Section 1 of the German Insolvency Act contains the debt release (Restschuldbefreiung) of the debtor. This regulation gives a good possibility to the debtor to create again a possibility for a secured existence. Thus the foundation stone for a fresh start after failure could be made. However several preconditions are to be fulfilled on the part of the debtor, whereby in particular the adherence to 7 years continuing good behaviour period (Wohlverhaltensperiode) is required. These 7 years continuing good behaviour period has been felt as too long and was shortened therefore to 6 years due to the German Insolvency Modification Act.

Apart from these regulations concerning insolvent persons it is to be emphasized, that one target of the new insolvency law was to introduce systematics which improve the possibilities to continue business and to achieve higher recovery rates. This should be achieved by commencing insolvency proceedings earlier to receive in the long term a higher insolvency estate. By adapting the rules of the German Insolvency Act an improvement of the situation for entrepreneurs facing failure was also intended. Whether these national legislation objectives really lead in practice to an improvement of the position of insolvency-threatened enterprises, will be explained in the individual chapters.

## **TITLE 2. DEFINITIONS AND TERMINOLOGY**

- Bankruptcy Act (Konkursordnung), which formerly governed liquidations.
- German Insolvency Act (Insolvenzordnung), which governs all bankruptcies and judicial reorganisations in Germany.
- Composition Act (Vergleichsordnung), which formerly governed debtor/creditor arrangements completed without court involvement.
- Collective Enforcement Act (Gesamtvollstreckungsordnung), which formerly governed all insolvencies in East Germany.
- No assets (Masselosigkeit) applies to a situation in which the company has not enough assets to cover the costs of the insolvency proceedings. Therefore the court won't issue the opening judgement.
- The inability of the debtor to pay its debts as they fall due (illiquidity/Zahlungsunfähigkeit).
- In the case of a business, where it can be established that the value of its assets is less than its liabilities (overindebtedness/Überschuldung). Here it is compulsory to present a special balance sheet.
- Threatened illiquidity (drohende Zahlungsunfähigkeit), means the situation, where the debtor's liabilities exceed its assets. In this case only the debtor has the chance to initiate a reorganization or liquidation under the Insolvency Act.

- Preliminary trustee (vorläufiger Insolvenzverwalter), has to be appointed by the court. A preliminary trustee can have (but not necessarily) the same powers as a (final) trustee. The preliminary trustee's primary role is to continue the debtor's business.
- Unsecured creditor (Ungesicherter Gläubiger) means a creditor who holds no security for his debt.
- Retention of title (Eigentumsvorbehalt) means that the vendor of personal property may retain title until the purchase price has been paid.
- The fiduciary transfer of assets (Sicherungsübereignung) grants security for a debt on personal property while the debtor retains possession.
- The fiduciary transfers of receivables (Sicherungsabtretung) grants security over receivables owing to the debtor.
- Chattel pledge (Pfandrecht) is a security for a debt and requires the debtor to deliver up possession of the chattel.
- Insolvency plan (Insolvenzplan) is supposed to ensure that the debtor continues the business. The insolvency plan contains three organization possibilities, the liquidation of the company, continue business because of a reorganization plan and the model of transferred reorganization.
- Liquidation of the company (winding-up/Liquidation) means selling all remaining assets.
- Reorganization (Unternehmenssanierung) contains a strategy to continue business.
- Transferred reorganization (Asset deal/Übertragende Sanierung) is a model, which tries to transfer the debtor's company to third persons in order to let the company participate further in economic life.
- Creditors' assembly (Gläubigerversammlung) means a meeting with all creditors' in which a decision is made, if the business should be continue or if the company should be liquidated.
- Self-management (Eigenverwaltung) provides that the debtor may, under the supervision of a trustee, continue to manage the insolvency estate.
- Customer insolvency (Verbraucherinsolvenzverfahren) means insolvency proceedings of customers (insolvent persons), who are not self-employed or have been self-employed. After German Insolvency Modification Act also persons are concerned who were self-employed but whose financial circumstances have a manageable size and no claims from employer-employee relationship exist.
- Debt release (Restschuldbefreiung) means that a person will be free of debts after fulfilling several requirements and in particular after 6 years of good behaviour.
- 6 years continuing good behaviour (Wohlverhaltensperiode) means a period in which the debtor is also satisfied with his distrained (gepfändeten) earned income.
- Lower Court (Amtsgericht) is a court having jurisdiction over minor civil and criminal cases.
- State Court (Landgericht) is a court having original and appellate jurisdiction in civil and criminal cases.

### **TITLE 3. WARNING LIGHTS AND PREVENTION OF INSOLVENCY**

After a general view a critical development of a company is called ‘crisis’. Those ‘crises’ endanger the operational and strategic company targets, as well as basic third interests. Substantial parts of the crisis process are its fear of existence. To solve a crisis or the negative final result of an enterprise crisis – either the insolvency of the company because of inability of the debtor to pay its debts as they fall due and/or the case of a business, where it can be established that the value of its assets is less than its liabilities - it requires a crisis management, which recognizes at once the crises and means of crisis avoidance. The early recognition of company crises is an important part of the crisis management and a fundamental precondition for the avoidance of acute crises and insolvency dangers. In the following both the internal mechanisms (mechanisms from the company itself) and the external mechanisms (from third parties) are to be represented for crisis early recognition (Krisenfrüherkennung).

One internal mechanism, to prevent insolvency is to be seen in Section 91 of the German Corporate Law (Aktiengesetz). In this regard Section 91 of the German Corporate Law obligates explicitly the executive committee of a corporation to take suitable measures (such as to create an early warning system), so that developments, which could endanger the survival of the company, are detected early. The measures mentioned in Section 91 of the German Corporate Law contain on the one hand the taking of suitable measures for early recognition. Thus the executive committee is committed by company endangerment, which can arise as a result of unfavourable modifications on asset-, profit- or financial situation of the corporation, to work against this development. On the other hand it should be stated, that this has to be achieved by the establishment of an early warning system. By early warning system it is not to be understood ‘risk management’, as sections of management economics do, but rather an enterprise-internal check, in which the internal audit and the internal controlling pass on recommendations to the executive committee.

Regarding other types of companies it is to be emphasized that no such legal regulation exists. Despite the fact that no legal regulation has been embodied in the law it is to be assumed according to predominant opinions, that the regulation in Section 91 of the German Corporate Law contains a radiance to the performance of other managing directors duty. Therefore is to be assumed also for other types of companies such early warning systems should be created, as far as the society requires this from its size and complexity.

In addition every company is free to implement after general economical experience an early warning system (if necessary under consultation of external advisors) to have a better protection from unexpected crisis. Therefore the creation of liquidity plans and the creation of the statement of assets and liabilities is recommended in order to be better informed about the position of the enterprise.

In furtherance corporate governance should be mentioned as a new internal control tool. This tool should improve the transparency of an enterprise and should help to guarantee an international standard. The main objective is to achieve a higher involvement of the executive committee and supervisory board. Therefore, the successful implementation of a ‘corporate governance codex’ can lead to an earlier crisis warning.

Internal method and at the same time a good source of information of the crisis early recognition is the annual report, consisting of annual balance sheet, income statement and appendix. A basic principle is thereby the setting of certain characteristic numbers from the

numbers of the of annual balance sheet and income statement, so that a multiplicity of items of information are provided. As this tool is not specifically German it will not be described in more detail.

In particular banks which make available borrowed capital have a substantial interest in a systematic crisis early recognition. Therefore it appears appropriate to examine the (external) analysis tools of the banks, which are applied in practice.

First it is to be emphasized that the credit institutes are obliged in accordance with Section 18 of the German Credit System Law, to check if the borrower is still creditworthy, which contains not only one check before granting the credit (it means a continuous check). Therefore customer information and industry information are constantly checked regarding the industry surrounding field, the future prospects and the structure of the competition. However it must be pointed out here that despite this information the bank does not have a simple position during the assessment of the credit worthiness at the borrower. This situation is caused often through the behaviour of the borrower, who often already disguises the facts of the detected crisis, since he is afraid of the creditor reactions. By this behaviour the borrower often prevents an early, active and supporting crisis management. by the bank partners.

A crisis can be also detected in particular by business relations (bankmäßige Geschäftsbeziehung). The business relation of a credit institute to a company is extremely multilayered, whereby the starting point is always the account of the borrower and the customer consultant. Next to the customer consultant's substantial information from the balance area, he also knows important crisis-referred realizations also from account processing and settlement.

In addition strategic success factors of a company can contribute to the evaluation of a crisis early recognition as well. Regardless of the difficulty to estimate these qualitative factors, there are numerous experience-supported crisis indications like evaluating the company strategy, evaluation of the position of the company in the market or evaluating of the abilities of the management. In particular the position of a company in the market attains special meaning for the credit institutes. Therefore it requires a detailed analysis of the product policy, the selling concept, the competition, the industry surrounding field as well as to specific risk emphasis. If these criteria are detailed and thoroughly processed, the credit institutes will be able to diagnose companies crises more promptly and more accurately.

An important external procedure in practice contains furthermore the processing of an abundance of quantitative annual return data (Diskriminanzanalytisches Verfahren). It is supposed that threatened companies already significantly differ statistically some years before their failure in its annual return picture from enterprises with normal business development. By the recourse to a multiplicity of annual return the evaluation of a company should be objective and assertible. However basic doubts exist also regarding this procedure. First the danger exists that an actually healthy enterprise is represented incorrectly as ill and so a bad overhasty reaction is initiated. Furthermore one of the crucial disadvantages of this method is again that historical balance data has to be used and so that no instrument had been created for crisis early recognition.

Altogether it is to be said that these specified internal and external methods are essential to guarantee a long lasting existence of the company, so that therefore the application early warning systems is indispensable even for smaller and medium-size companies. Medium-

sized companies, the most important pillar of the German economy scarcely uses such control mechanisms rarely or not at all. As a result therefore crises of medium-sized companies are discovered much more frequently by third parties.

Despite the above mentioned early warning and control tools the last years were unfortunately characterised by new insolvency records. It remains to be feared however that without such methods the number of insolvencies in Germany would have been even higher.

#### **TITLE 4. LEGAL POSSIBILITIES TO CONTINUE ECONOMIC ACTIVITIES**

Once a company is recognised as being insolvent, or thinks it may become insolvent, there are alternatives available to the insolvent party or its creditors to continue economic activities.

First, an out-of-court settlement can be arranged between all involved parties to prevent insolvency (see the remarks made under chapter 4.1.).

Second, the threatened company can commence insolvency proceedings. Some possibilities are eligible for the company. On the one hand the trustee in insolvency can continue to run the business as such, or he can try to arrange an asset-deal. As a result, the trustee in insolvency is mainly in charge of the future development of the insolvent company. On the other hand the threatened company can avail the regulations of the German Insolvency Act, in particular the regular insolvency proceedings and the insolvency plan. Frequently the regular insolvency procedure (Regelverfahren) leads to an asset-deal, since its aim is to achieve an optimal realisation (Verwertung) of the enterprise. In contrast the insolvency plan focuses more on the reorganization of the enterprise, as the main objective is to ensure the continuation of the company as a going concern. However, especially in transferred reorganization cases an asset-deal is also feasible.

In general practice the salient alternative are the regulations of the insolvency plan, which will be discussed in more detail in the following chapters.

Especially we will stress three alternatives that try to ensure the continuation of the company as a going concern:

- out-of-court settlement,
- the reorganization based on insolvency plan
- and finally the asset-deal.

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#### **Chapter 4.1. (Out-of-court settlement)**

##### *§ 1. Comprehensive description of the regime as well as its underlying philosophy*

###### 1.1. Description

An out-of-court-settlement can be arranged without restrictions between the debtor and its creditors to give survival of the business. Therefore an out-of-court settlement can be more favourable for the creditor than the initiation of judicial insolvency proceedings. With this

possibility the prevention of the insolvency is to be achieved outside the judicial procedure, as prompt negotiations between all involved parties are started.

### 1.2. Critical analysis

An evaluation of this method is not possible, since statistics are not present and the survival of the company depends considerably on the agreements of both parties.

However it is possible to connect the free agreement of reorganization plan with the advantages of the insolvency proceedings, by creating a 'pre-packaged plan' solution. In practice the method often applied, that the out-of-court settlement is submitted to the insolvency court in conjunction with the petition for the commencement of insolvency proceedings (the 'pre-packaged plan'). The background of this procedure is that a concept for the rescue of the company prepared in the running up to insolvency proceedings is often easier to accomplish within insolvency proceedings. For example, the dismissal of employees is not immediately possible under the German Dismissal Protection Act (Kündigungsschutzgesetz) and other provisions, the dismissal will therefore lead to severance payments for the dismissed employees. The submitted pre-packaged plan, within the insolvency proceedings can lead to the application of the regulations of the social plan (Section 123 of the German Insolvency Act). These regulations contain in detail procedures concerning the dismissals and compensations of the employees.

*§ 2. Classification of the procedure among branches of law, competent jurisdictions, overview of the procedure followed before these jurisdictions, implications of international private law*

#### 2.1. Description

The out-of-court settlement is not legally regulated. Therefore the principle of freedom of contract applies to it, with the consequence that the parties may even agree to deviate from statutory rules. A judicial supervision does not take place.

#### 2.2. Critical analysis

Since no legal regulations exist, it must be noted that such reorganization represents a corresponding solution between all parties. Therefore all creditors must agree to the reorganization contract.

*§ 3. Criteria to benefit for the regime (the origin of the criteria (legal, case-law, practice) must be specified)*

#### 3.1. Description

The main advantage of an out-of-court settlement can be seen in a faster execution as no legal basis needs to be established. In furtherance disadvantageous disclosure effects are reduced and less court fees occur.

#### 3.2. Critical analysis

A settlement out-of-court contains the risk that the managing directors circumvent the principle of creditor equal treatment (Gläubigergleichbehandlung), by granting advantages to individual creditors. Not rarely claims of 'annoying creditors' are also bought up by the company or a front man, in order to attain 100% agreement to the out-of-court settlement. As already mentioned above the settlement must be agreed upon all parties involved. Therefore difficulties are to be expected with the negotiations due to the numerous and different positions. The out-of-court settlement often contains in the long term the disadvantage that its

processing is not correctly supervised. The creditors should therefore make certain, that the reorganization out of court is supervised by a person the creditors can trust.

#### *§ 4. Specification of the possible initiators of the procedure*

##### 4.1. Description

Basically the introduction of an out-of-court settlement can be aimed at all involved parties. In practice it is however often the case that the creditors (in this case the credit institutes) give the impulse for negotiations in case of an possible insolvency of their debtors.

##### 4.2. Critical analysis

To be mentioned in particular here is the emphasized position of the credit institutes, which are offered several courses of action within an possible insolvency of their borrower. One possibility is to support the borrower, in order to save its company and their credits. For such support several possibilities are made available to the credit institutes, so e.g. capital increase by transfer of new shares, debt-equity-swap, remission of claims or giving new loans to the borrower. On the other side the bank can also quit their loans and probably take the borrowers last chance for reorganization. The latter follows particularly from the strict demands, which the jurisdiction places on the bank, if they want to give new loans in view of a possible insolvency.

#### *§ 5. Administration of the procedure (who manages the assets of the individual or the company, the role of the different actors in the proceedings (creditors, debtor, State appointed manager, court, etc.))*

##### 5.1. Description

After negotiations with all parties are initiated it is up to them to take measures for recovering the occurred failure. Which type of reorganization measure for the threatened company is in each individual case to be preferred, cannot be said generally and theoretically. Regardless of the taken measures, as for e.g. giving new loans to the company, it is to be noted that the settlement out of court fails, if not all creditors agree to this arrangement. Not rarely the lack of agreement of one or a few creditors forces the company into the judicial insolvency procedure. To that extent creditors cannot be forced to a settlement out of court.

Furthermore no trustee in insolvency has to be ordered, so that the managing director of the company keeps its power of disposition further. In addition an inclusion of the insolvency courts does not take place. Usually the old management remains in the company, but also the creditors often demand that external consultants are placed into the management.

##### 5.2. Critical analysis

The legal obligation for the managing directors to file a petition without undue delay, and in every case, at the latest within three weeks of the date on which the company became insolvent, still exists. Therefore promising out-of-court negotiations do not entitle the managing director to omit the required insolvency proceedings.

#### *§ 6. Restructuring plan (if applicable, who must file it, how, where, must it be voted by creditors, is there a court intervention, etc.))*

##### 6.1. Description

A restructuring plan, developed by the negotiating parties and later accepted by the insolvency court, is for the out-of-court settlement not necessary.

The agreement of the involved parties must lead to the elimination of the legal basis for the commencement of the insolvency proceedings or to their prevention, because the managing directors are still obliged to file a petition for the commencement of insolvency proceedings without undue delay, and in any event, at the latest within three weeks of the date on which the company became insolvent.

The 'pre-packaged plan' differs from this, since the regular insolvency proceeding is used here and therefore controlling by the insolvency court.

## 6.2. Critical analysis

The latter requires the agreement of all creditors involved, since there are (different to the judicial settlement) no majority decisions, by which minorities can be outvoted.

*§ 7. The degree of protection of the actors implied in the procedure: public investors, creditors (secured and unsecured, preferential or not), shareholders, stakeholders,...), as well as the way to carry out this protection*

### 7.1. Description

The security of the creditors will not be touched by the out-of-court settlement. To that extent the realisation rights of the secured creditor is not concerned, otherwise the settlement contains other regulation. Additionally the principle of the equal treatment of all creditors applies, so that a preference of individual creditors is not admissible.

### 7.2. Critical analysis

The fact, that the realisation rights of the secured creditor are not concerned, contains a substantial danger for the company concerned. Secured debtors are not be prevented to execute (as in the case after opening the insolvency proceedings) in the corporate assets.

*§ 8. Termination of the procedure*

### 8.1. Description

Both the debtor and the creditor have the option to stop the free negotiations and to put the procedure into the legal insolvency proceedings.

### 8.2. Critical analysis

The German Insolvency Act gives this option in any case to the debtor, who can present his petition on the legal basis of threatened illiquidity for the commencement of the insolvency proceedings. Whether this option is also open to the creditors, depends on whether they can establish legal basis such as the inability of the debtor to pay its debts as they fall due and/or, in the case of a business, where it can be established that the value of its assets is less than its liabilities.

*§ 9. Degree of information on the development of the procedure towards creditors (e.g. access to (court) files, etc.)*

### 9.1. Description

There is no obligation to hold a creditor's meeting within an out-of-court settlement. All information concerning the creditors is to be indicated in the negotiations, so long as it can be ensured that in particular the managing director does not hide important details for the position of the company.

## 9.2. Critical analysis

A probable important agreement-obstacle for the out-of-court settlement has to be seen in the different information level of the involved parties. These differences exist on the one hand between debtors and creditors and exist in addition on the other hand, between different groups of creditors. The credit institutes will usually be better informed than suppliers of the entrepreneur. This different information level make a financial economical solution more difficult and must therefore be avoided by a consistent disclosure of all details.

*§ 10. Costs related to the procedure, if applicable (e.g. fees trustee, receiver etc.)*

### 10.1. Description

Due to the fact that no trustee in insolvency has to be appointed within an out-of-court settlement and no court fees arise, it is possible to keep the costs low. Costs result to that extent only for lawyers or external consultants.

Within 'pre-packaged plan' solution, the normal court fees arise.

### 10.2. Critical analysis

The out-of-court settlement does not have to be in every case more reasonable for the creditors than the regular insolvency proceedings. Costs result, if the creditor had already initiated the insolvency procedure and agreed within the out-of-court settlement to take back the petition. Therefore the creditor concerned should make the taking back of the petition and the agreement to the settlement out of court, dependent on the payment of the costs of proceedings by the company.

*§ 11. Competence, knowledge and functioning of insolvency (bankruptcy) courts*

Not applicable.

*§ 12. Publicity conditions, if applicable (e.g. newspaper, official gazette)*

Not applicable.

## **Chapter 4.2. (Reorganization based on insolvency plan)**

*§ 1. Comprehensive description of the regime as well as its underlying philosophy*

### 1.1. Description

The new German insolvency law provides, as a key innovation, for the reorganization of insolvent businesses on the basis of a reorganization plan, the so called 'Insolvenzplan' pursuant to Section 217 of the German Insolvency Act which is supposed to ensure that the debtor is to continue his business.

Perhaps the most important objective of the new German Insolvency Act was the introduction of systematics, which put insolvency avoidance into the foreground and for this purpose an emphasis on the introduction of reorganization instruments. Therefore the new legal instrument of the insolvency plan was created to be made available for the involved one's a

functional legal framework for the reorganization of distressed companies. However not the plan as such, but rather the determined implementation of the individual concepts and their execution will bring the success of reorganization to the threatened company.

## 1.2. Critical analysis

Practice has shown so far that the rule of the reorganization is not that the debtor continues his business, but rather that the company will be liquidated by selling all the remaining assets. Liquidation is, with only a very few exceptions, the end of the road for the company and it will then be removed from the companies register (Handelsregister).

*§ 2. Classification of the procedure among branches of law, competent jurisdictions, overview of the procedure followed before these jurisdictions, implications of international private law*

### 2.1. Description

Prior to the commencement of insolvency proceedings, restructuring could be carried out informally. Very often restructuring will be based on a voluntary settlement agreement between the debtor and its creditors following negotiations between them.

### 2.2. Critical analysis

A proposed reorganization plan must first be considered by the insolvency court. The insolvency court will reject the plan if a plan submitted by the debtor clearly has no chance of being accepted by the creditors or confirmed by the court, or the claims to which the participants are entitled by the plan can obviously not be satisfied. If the plan is not rejected on any of these grounds, the insolvency court will set a date for a hearing at which the reorganisation plan and the creditors' voting rights are to be discussed and the plan is to be voted on.

Also important is the influence of German Corporate Law, which provides certain procedures for the dissolution and liquidation of a corporation which cannot easily be summarised. The cases in which a company may or must be dissolved are set out in the relevant laws and, without limiting the articles, specify additional reasons for the dissolution of the company. At any time, the shareholders' meeting can resolve, with a qualified majority of usually 75 per cent of the votes cast, to dissolve the company.

*§ 3. Criteria to benefit for the regime (the origin of the criteria (legal, case-law, practice) must be specified)*

### 3.1. Description

This new legal instrument try to use the assets of the debtor in an economically effective way for the creditors. Within the last years experience was made, that the creditors satisfaction (Gläubigerbefriedigung) can be often attained by a continuation of the enterprise.

### 3.2. Critical analysis

The aim of reorganization is to maximise benefits to the company's creditors, this usually means saving jobs and businesses too.

*§ 4. Specification of the possible initiators of the procedure*

### 4.1. Description

An individual creditor does not have authority to submit an reorganization plan, however the creditors' assembly (Gläubigerversammlung) may instruct the trustee in insolvency to

produce a plan. If the creditors' assembly accepts the plan, and if the plan is confirmed by the insolvency court, it will then come into force.

Notwithstanding all of the above, both the trustee in insolvency and the debtor have the authority to submit a reorganizations plan (pursuant to Section 218 of the German Insolvency Act).

#### 4.2. Critical analysis

In general insolvency proceedings may be commenced by a creditor on presentation of a petition if it can establish a legal basis for doing so. Therefore it also naturally requires the fulfilment of this requirement to be able to initiate a reorganization plan.

*§ 5. Administration of the procedure (who manages the assets of the individual or the company, the role of the different actors in the proceedings (creditors, debtor, State appointed manager, court, etc.)*

##### 5.1. Description

The trustee in insolvency who is in charge of verifying that the interests of the various parties involved are adequately protected sets up a list of all property and debts after he has cleared up the insolvency estate. Having prepared that list, the trustee has to make a report for the creditors' assembly about the financial situation of the company and he has to state, whether it is possible to continue the business or not. The creditors' assembly decide, if business should be continued or if the company should be liquidated by selling all the remaining assets. If the creditors assembly accepts the plan, the plan has to be confirmed by the insolvency court.

The decision to carry on the business for a certain time, enables the trustee to make further examinations regarding a reorganization or to start with measures for the turn around. Mainly, this decision will be made, if the creditors are of the opinion, that they will achieve better satisfaction after that reorganization. In the case of liquidation the company will be extinguished after the partial allotment of the liquidity to the creditors. Prior to the allotment to the creditors the trustee in insolvency has to pay the cost of the insolvency proceedings, including the costs which arose from legal transactions carried out by him during the proceedings. Only the remaining part of the liquidity will be used for the satisfaction of the insolvency creditors. Each insolvency creditor should get the same percentage portion of his original claim against the debtor.

Section 270 of the German Insolvency Act provides that the debtor may, under the supervision of a trustee in insolvency, continue to manage the insolvency estate and to dispose of assets if the insolvency court orders self-management (Eigenverwaltung) at the commencement of the insolvency proceeding. In this regard the debtor has to apply for the order, or, where the petition has been presented by a creditor, that the creditor has consented to such an application. Likewise it has to be ensured, that the making of such an order will not delay the proceedings or otherwise disadvantage creditors.

##### 5.2. Critical analysis

Regarding the order of self-management it has to be emphasized that insolvency courts are reluctant to order such self-management, because due to the fact that they do not expect the debtor to be seriously interested in fulfilling obligations to the creditors, which is still the main objective of the German Insolvency Law even though it provides for a reorganization procedure. Furthermore the courts are often concerned, that the debtor could use the self-management to remove some assets of his remaining estate. This reluctance is particularly not

justified in the cases, in which the company through no fault of its own went into the crisis. As a rule in such a case the managing directors of a company were already replaced, so that the argument of insolvency court, they do not expect these persons to be seriously interested in fulfilling obligations to the creditors, so that these arguments are no longer valid.

*§ 6. Restructuring plan (if applicable, who must file it, how, where, must it be voted by creditors, is there a court intervention, etc.)*

#### 6.1. Description

Remarkable is, that the German Insolvency Act places very few restrictions on what may or not be included in a reorganization plan. By approving a plan, the parties may even agree to deviate from the statutory rules on the disposition of the debtor's assets and the distribution of proceeds. Notwithstanding the plan must separate creditors into classes. In particular, it must distinguish between secured and unsecured creditors, and list the various classes of subordinated creditors. The plan must be approved by each impaired class of creditors. A class of creditors accepts the plan if a majority in number and value in that class vote in favour. Then it is up to the insolvency court to decide whether or not to confirm the plan.

#### 6.2. Critical analysis

Even if statutory rules may be deviated from, the plan must describe the proposed measures for reorganizing the debtor and how the plan effects the rights of creditors. Typically, a plan has to contain provisions for a partial waiver of claims or for deferred payment.

Also to be emphasized is the strong position of the insolvency court, which has to ratify the plan, even if the plan has already been accepted by the creditors and debtor. Decisive for it are however the reasons already specified above.

*§ 7. The degree of protection of the actors implied in the procedure: public investors, creditors (secured and unsecured, preferential or not), shareholders, stakeholders,...), as well as the way to carry out this protection*

#### 7.1. Description

All creditors of the insolvent company will be requested after initial judgment, to register their claims in the table of claims. The trustee will then check all the claims which are submitted by creditors. The registration in the table of claims has an effect on the claims as a final verdict towards the trustee and all creditors.

Of special importance is now, whether the concerned creditor has security devices or not. There are principal types of security devices which are taken on immovable property and principal types of security devices which are taken on moveable property. An unsecured creditor is in the worse initial position that he must first sue the debtor if he is in breach of his obligations. After obtaining judgment, he can initiate a judicial execution of the debtor's personal or real property. However these procedures can be very difficult and time-consuming, especially if the debtor contests the creditor's claim.

Foreign creditors in possession of a foreign judgment would have to apply to a German court for recognition of their judgment before bringing steps to enforce it.

The insolvency of a corporation does not deviate basically from other corporate bodies insolvency. The legal basis for the commencement of insolvency proceedings are the same as other corporate bodies. In Section 35 of the German Insolvency Act is stated that to insolvency estate belongs the entire estate which belongs to the corporation by initiating the commencement of the insolvency proceedings.

## 7.2. Critical analysis

Any rights over the debtor's assets obtained by execution of a judgment within a one month period ending with the filing of an insolvency case will be automatically set aside. These regulations reduce the security of the creditors on the one hand drastically, on the other hand it is one of the main duties of the trustee in insolvency to secure the assets of the debtor in order to supply for all creditors an insolvency estate as high as possible.

## *§ 8. Termination of the procedure*

### 8.1. Description

The preliminary trustee has to examine, if the company has enough assets to cover the costs of the insolvency proceedings. If this requirement is not fulfilled, the insolvency court will dismiss the insolvency proceedings and therefore no reorganization plan will come into force.

Insolvency proceedings may only be commenced by the presentation of a petition. Therefore a creditor who has presented a petition is able to take this petition back (Section 13 II of the German Insolvency Act). However the creditor can only do this, before the insolvency proceedings were opened or the petition was rejected.

### 8.2. Critical analysis

If the petition is effectively taken back, the creditor who is taking it back, is obliged to pay the costs and expenses of insolvency proceedings (Section 4 of the German Insolvency Act and Section 269 III of the Code of the Civil Procedure).

## *§ 9. Degree of information on the development of the procedure towards creditors (e.g. access to (court) files, etc.)*

### 9.1. Description

There are several important creditors' meetings, where the creditors assembly receive the necessary information to be kept informed. For this purpose there is first an information hearing in which the creditors mainly decide if the business should be continued or if the company should be liquidated. In addition there is an examination hearing where the registered claims are examined. Likewise there exists a hearing for discussion and voting, where a reorganization plan and the creditors' voting rights are discussed and the plan is voted on.

### 9.2. Critical analysis

In principle, all decisions of the insolvency court require notice to all persons affected. Notwithstanding this, public notes are sufficient for proof of service on all parties, even where the Insolvency Act provides for personal service. Thus, the creditors should pay attention to all public notices from the insolvency court and keep in contact with it.

## *§ 10. Costs related to the procedure, if applicable (e.g. fees trustee, receiver etc.)*

### 10.1. Description

Section 54 of the German Insolvency Act provides costs relating to the insolvency proceedings. Those arising costs are in particular to be settled from the estate.

#### 10.2. Critical analysis

Section 63 to 65 of the German Insolvency Act regulates the remuneration and display refunding of the trustee in insolvency. These regulations refer to the trustee in insolvency remuneration order (Insolvenzrechtliche Vergütungsverordnung).

### *§ 11. Competence, knowledge and functioning of insolvency (bankruptcy) courts*

#### 11.1. Description

The Lower Court of the district in which a State Court (Landgericht) is located has exclusive insolvency jurisdiction for that district.

#### 11.2. Critical analysis

The insolvency court has jurisdiction to deal with all matters connected with the insolvency proceedings. The court can suspend the secured creditor's attempt to execute in immovables, if the trustee in insolvency requested, in order to be able to use the real estate for further continuation of the company.

### *§ 12. Publicity conditions, if applicable (e.g. newspaper, official gazette)*

#### 12.1. Description

Independent of the reorganization plan the court resolution over the initialization of the insolvency proceedings (according to Section 30 of the German Insolvency Act) is to be made publicly by the office of the insolvency court in the German Federal Gazette (Bundesanzeiger). The public announcement takes place in accordance with Section 9 of the German Insolvency Act by the publication intended for official notices of the court.

#### 12.2. Critical analysis

Pursuant to Section 9 II of the German Insolvency Act the insolvency court can arrange further and repeated publications. The court resolution has to particularly serve the creditors and debtors of the debtor and the debtor itself after Section 30 II of the German Insolvency Act. Furthermore the initialization of insolvency proceedings is to be recorded in the land register (Grundbuch) in accordance with Section of 32 of the German Insolvency Act.

## **Chapter 4.3. (Asset-deal)**

### § 1. Comprehensive description of the regime as well as its underlying philosophy

#### 1.1. Description

By the formulation of Section 1 of the German Insolvency Act the legislator made clear that the targets of the insolvency proceedings can also be carried out by keeping the business operating. Therefore an asset-deal means that the threatened company sells all or some of its assets to a purchaser, who is generally willing to continue the business.

#### 1.2. Critical analysis

The parties to an asset-deal have to decide which assets should be transferred to the purchaser. Having sold assets and liabilities of the company to another person or legal entity, the company itself as a legal entity still exists.

The creditors are satisfied either from sale revenue or from the future surplus achieved by the enterprise.

*§ 2. Classification of the procedure among branches of law, competent jurisdictions, overview of the procedure followed before these jurisdictions, implications of international private law*

### 2.1. Description

The transferred reorganization is an enterprise sale via an asset-deal, i.e. functional units of the company will be sold to the purchaser. Thus the designation 'reorganization' may not obscure the fact that it concerns a type of realisation within insolvency proceedings.

### 2.2. Critical Analysis

The transferred reorganization in insolvency proceedings can be executed after the German Insolvency Act within an insolvency plan. It is to be assumed that the transferred reorganization within an insolvency plan is mainly for such cases, in which the enterprise will be transferred to a rescue company (Auffanggesellschaft).

As there is no real estate which would be bought by the purchaser, a written agreement – without notarial recording – is sufficient for the parties for an asset-deal.

*§ 3. Criteria to benefit for the regime (the origin of the criteria (legal, case-law, practice) must be specified)*

### 3.1. Description

The possibility of an asset-deal contains several advantages. First a continuation of the still running business is usually economically meaningful, since by a continuation of production substantial assets can be taken to the estate. Furthermore the completion of products is worthwhile to generate cash for the buyer. By the processing of existing contracts arising claims of damages can be avoided.

### 3.2. Critical Analysis

In most asset-deals only selected assets of the company are transferred to another person or legal entity, all contractual relationships between the company and third persons remain unchanged in principle.

As a substantial obstacle in insolvency practice the regulation of Section 613 a of the German Civil Code appeared. Pursuant to Section 613 a of the German Civil Code in general the acquisition of important and material assets of a running business leads to a transfer of ownership of a firm (so-called 'Betriebsübergang'). As statutory legal consequence of this transfer of ownership, the purchaser of the assets has to join the employment agreements. He and the seller of the assets are jointly and severally liable debtors for the employees and their demands and claims. A termination of the employment agreement for the cause of the transfer of ownership of the firm is prohibited by Section 613 a IV of the German Civil Code.

In contrast to these effects the trustee in insolvency can get rid of contracts under simplified conditions and dismiss employees at short notice (see in addition the remarks made under 4.2. § 1.2.). Thus the trustee in insolvency can protect the company or parts of the company of disadvantageous contracts for the potential purchaser.

In general the asset-deal is often reasonable for the seller and the purchaser, because of the fact, that a potential purchaser will not be obliged to buy the whole company with all its

liabilities and other obligations. The purchaser is able to select the assets which are required to continue the business. He is not obliged to take over running agreements he does not want. Therefore a higher purchase price seems to be possible. On the other hand, the purchaser has to deal with Section 613 a of the German Civil Code which could be an argument for a reduction of the purchase price.

#### *§ 4. Specification of the possible initiators of the procedure*

##### 4.1. Description

In accordance with Section 157 of the German Insolvency Act the creditors' assembly decides, based upon a report by the trustee in insolvency, whether the business of the debtor is to be continued or partially or completely shut down. Therefore it is up to the creditors whether or not to confirm the asset-deal.

##### 4.2. Critical analysis

This regulation forbids, that the trustee in insolvency will carry out an asset-deal with another person or legal entity without hearing and agreement of the creditors.

*§ 5. Administration of the procedure (who manages the assets of the individual or the company, the role of the different actors in the proceedings (creditors, debtor, State appointed manager, court, etc.)*

##### 5.1. Description

Usually an asset-deal will be executed within insolvency proceedings, by creating a rescue company on which assets have to be transferred. In this case the procedure will therefore be controlled by the trustee in insolvency.

##### 5.2. Critical analysis

Up to the day of the creditors' assembly, in which the decision is made whether the company is to be continued or not, basically the trustee in insolvency has to continue the business of the company. Therefore the company is generally not allowed to dispose of any of its assets without the consent of the trustee in insolvency. The trustee in insolvency is obliged to check periodically whether the continuation of the business still agrees with the financial interests of the creditors.

*§ 6. Restructuring plan (if applicable, who must file it, how, where, must it be voted by creditors, is there a court intervention, etc.)*

The remarks (made already under the appropriate chapter: Chapter 4.2., § 6) also applies here.

*§ 7. The degree of protection of the actors implied in the procedure: public investors, creditors (secured and unsecured, preferential or not), shareholders, stakeholders,...), as well as the way to carry out this protection*

##### 7.1. Description

Basically the principle types of security devices of the individual creditors are not impaired by an asset-deal.

##### 7.2. Critical analysis

However a potential buyer is mostly interested in a charge-free acquisition of property. Therefore an individual contract between the involved parties has to be signed to decide, whether the purchaser receives charge-free or charged property.

### *§ 8. Termination of the procedure*

#### 8.1. Description

The creditors' assembly can reject the trustee in insolvency's proposal to agree to the asset-deal.

#### 8.2. Critical analysis

It is noteworthy that often during a continuation of business further losses result, so that the trustee in insolvency is obliged to close the company. Therefore the rule applies, that if the current incomes do not cover the outputs any longer, a further continuation of business is basically only justified if it is to be assumed that the enterprise can be sold later at a price, which exceeds the market value of the enterprise.

### *§ 9. Degree of information on the development of the procedure towards creditors (e.g. access to (court) files, etc.)*

#### 9.1. Description

The creditors receive the necessary information to be kept informed by attending the information hearing in which the creditors mainly decide if the business shall be continued by making an asset-deal.

#### 9.2. Critical analysis

Because of the importance of being well informed the legislator first creates the creditors' assembly. Furthermore all creditors should pay attention to all public notices from the insolvency court or keep in contact with it. Within the time-period up to the creditors' assembly the creditors can also obtain the necessary information from the trustee in insolvency.

### *§ 10. Costs related to the procedure, if applicable (e.g. fees trustee, receiver etc.)*

Here it is to be referred to the remarks under chapter 4.2., § 10.

### *§ 11. Competence, knowledge and functioning of insolvency (bankruptcy) courts*

See the remarks made under chapter 4.2., § 11.

### *§ 12. Publicity conditions, if applicable (e.g. newspaper, official gazette)*

Because the transferring reorganization or rather asset-deal was represented within the insolvency proceedings, the remarks made above under chapter 4.2. § 12 apply also here.

## **TITLE 5. LEGAL CONSEQUENCES OF BANKRUPTCY AND POSSIBILITIES FOR A FRESH START**

## Chapter 5.1. Bankruptcy procedure

In principle, insolvency proceedings may be commenced by or against any person or juristic person. Insolvency proceedings cannot, however, be commenced against the Federal Government or a State Government, or any legal entity that is subject to the supervision of a federal or state activity, if the law of the respective state so provides.

Insolvency proceedings have to be commenced by a creditor or the debtor. A petition may be presented by a creditor if the creditor can establish a legal basis for the commencement of the insolvency proceedings.

Under German insolvency law, the legal basis would be the inability of the debtor to pay its debts as they fall due (Zahlungsunfähigkeit) and/or, in the case of a business, where it can be established that the value of its assets is less than its liabilities (overindebtedness/Überschuldung). Remarkable is, that under the German Insolvency Act, the definition of Zahlungsunfähigkeit has been expanded in such a way that even the inability to balance minor outstanding payments can justify the commencement of insolvency proceedings. As of January 1 1999, the Insolvency Act has, in addition, introduced the concept of 'threatened illiquidity' (drohende Zahlungsunfähigkeit) to give the debtor itself the chance to initiate a reorganization or liquidation under the Insolvency Act when insolvency threatens. The latter was to achieve a more significant move towards a rescue by relaxing the criteria for companies to enter the insolvency proceedings.

As stated above the Lower Court of the district in which a State Court (Landgericht) is located has exclusive insolvency jurisdiction for that district. Furthermore to be mentioned is that the Lower Court in the district which would normally have jurisdiction over the debtor will have exclusive local jurisdiction. If the centre of the debtor's business activity is located in another district, the insolvency court of that district will have exclusive local jurisdiction.

After the petition is filed, the court will order preliminary measures to secure the property of the debtor. For this purpose, generally a preliminary trustee in insolvency will be nominated. If a preliminary trustee in insolvency is nominated, generally the debtor is not allowed to dispose any of its assets without the consent of the preliminary trustee in insolvency (Section 21 II 2 of the German Insolvency Act). To that extent the insolvency court usually imposes a restraint on disposition, so that only the preliminary trustee is authorised to dispose of the assets. The preliminary trustee is further authorised to enter business premises and commercial facilities. The debtor has to allow him to look at the books and business papers and to hand them to him by request until the decision of the opening of the proceeding has been made. Moreover, the debtor's right to information about the business can be curtailed; for example its mail can be blocked and its management will be under a positive duty to provide information. The main duties of the preliminary trustee in insolvency are securing the assets of the debtor, carrying on the running business of the company, until the decision of the court of opening the insolvency proceeding and examining, if the company has enough assets to cover the costs of the insolvency proceedings.

If the company has enough assets to cover the costs of the proceedings, the court will check if an admissible application was placed and if an initialization reason exists. If these requirements are fulfilled, the court will issue the opening judgement for the insolvency proceedings. The time period after the petition has been made until the opening judgement can take two or three months.

In its opening judgement, the court appoints the (final) trustee in insolvency. Often the preliminary and final trustee in insolvency are identical.

## **Chapter 5.2. Legal effects of the initiation of bankruptcy procedures**

The issue of the above named opening judgement contains main legal consequences. Therefore the company will lose the authority to manage and dispose the business. The power of disposal will be transferred by the order of the judge to the trustee in the business. For this reason dispositions after the proceedings are opened made by the company, these dispositions will be ineffective.

Another main legal consequence of the opening judgement is, that the trustee in insolvency has to take all properties of the debtor in his possession and has to adjust and clear up the insolvency's estate. In order to be able to do the latter, the trustee in insolvency has to collect all debts of the debtors of the insolvent company. Besides this the trustee – within the still running business – has to segregate those assets out of the insolvency's estate to those creditors, who have a right of ownership against the insolvent estate. A right of ownership is for example the retention of title (Eigentumsvorbehalt) pursuant to Section 455 of the German Civil Code or the claims for return of the landlord (Vermieter) pursuant to Section 556 of the German Civil Code, the lessor (Verpächter) pursuant to Sections 581 II, 596 of the German Civil Code and the lender (Verleiher) pursuant to Section 604 I of the German Civil Code. In contrast to this no right of ownership contains the fiduciary transfer of assets (Sicherungsübereignung), the fiduciary transfers of receivables (Sicherungsabtretung) or the chattel pledge (Pfandrecht). However those creditors without a right of ownership have a privileged claim against the insolvent estate in the case of a later realisation.

Apart from these security advice which is taken on movable property there are also principal types of security devices which are taken on immovable property (e.g. Hypothek, Grundschuld). The execution against the debtor's immovable property remains unaffected.

After the opening judgement, all creditors of the insolvent company will be requested to register their claims in the table of claims. The trustee will check all the claims which are submitted by creditors. He must also prepare a list of all creditors whose names appear in the books and records of the debtor, whose identity is revealed by other statements of the debtor, or who assert their claims in the course of the proceedings. The list of assets and the list of creditors should be deposited in the court clerk's office for inspection. If creditors fail to register their claims in the directed time period, they will not be part of the insolvency proceedings, however they still have the possibility to determine judicially their claim by an action against the trustee in insolvency (pursuant to Section 179 of the German Insolvency Act). The period for the registration can be from two weeks to three months.

The new insolvency act assigns a multiplicity of functions and obligations to the trustee in insolvency. In this regard it is to be mentioned first, that with the issue of the opening judgment the nominated trustee in insolvency can set aside certain legal transactions (apart from leases, employment – and tenancy contracts) carried out by the insolvent company prior to the judgement of the court, if these transactions have led to a reduction of the insolvency's estate and the parties knew this or intended to prejudice other creditors of the company. With regards to contracts which are not fulfilled by both sides, the trustee in insolvency has the opportunity to choose, whether he will fulfil the part of the insolvent company or not. If the trustee in insolvency chooses to fulfil, he has a claim against the opposing party for the agreed

performance. If the trustee in insolvency denies fulfilment, the creditor has only a claim for compensation against the insolvency's estate. Special features apply in particular by contracts which are not fulfilled by one side. As legal consequences arise therefore, that if the debtor does not fulfil his obligation to the creditor, the creditor has a claim on his consideration (Gegenleistung) against the insolvency's estate. Otherwise, if the creditor did not fulfil but the debtor, the trustee in insolvency has a claim for the agreed consideration against the creditor. If the trustee in insolvency signs contracts with new creditors, this effects the position of the insolvent company negatively. As a result the estate will be also negatively affected.

In particular it has to be further emphasized that the trustee in insolvency can challenge the repayment of a shareholder's loan if the loan was granted or not withdrawn during a crisis of the company. This means a prudent businessman would have contributed equity instead of a loan (as no one would have granted a loan), so that the loan is deemed to be quasi-equity of the company (eigenkapitalersetzendes Gesellschafterdarlehen). The result being that this has to be used primarily for the payment of the outstanding claims of the creditors.

The avoidance provisions in the German Insolvency Act are set out in Sections 129 – 146. Basically, the trustee in insolvency may set aside transactions where they prefer one creditor over another or where there has been a fraudulent conveyance. The necessity of showing actual intent on the part of the debtor has been watered down by the extension of the provisions to situations of gross negligence and by the introduction of presumptions, particularly where the recipient is an insider. An insider now has the onus of proving that the transfer was not preferential or fraudulent. Anything that was transferred, disposed of or realised from the assets of the debtor by means of a voidable transaction must be restored to the insolvency estate.

Furthermore the right to set off his liability (Aufrechnung) can be restricted (Section 96 of the German Insolvency Act) within insolvency proceedings.

Due to the above specified legal effects it is demonstrated that obstacles for the managing directors of the insolvent company occur. Due to the main fact that the power of disposal will be transferred by the order of the judge to the trustee in the business, the debtor is incapable of leading the company further. As a consequence therefore the debtor is neither able to generate new investments for the company nor to sell assets of his enterprise. The debtor's only possibility to determine further the fate of his company, is found in Section 270 of the German Insolvency Act (Eigenverwaltung). This section provides that the debtor may, under the supervision of a trustee in insolvency, continue to manage the insolvency estate and to dispose of assets if the insolvency court orders self-management at the commencement of the insolvency proceedings.

In contrast to this, it must also be seen, that the initiation of the insolvency proceedings contains the possibility for a turn around, due to the fact, that the past company strategy, which led to the crises, is turned away and offers a chance for keeping the business operating. Furthermore all company's assets are protected by the fact that all creditors of the insolvent company are requested to register their claims in the table of claims. Thus a single execution of the creditors in the debtors estate is not any longer possible and a 'race of the creditors' will be prevented. Not least therefore this legal protection prevent a breaking down of the entire company.

A chance for a survival of the threatened company is offered in particular by the fact that an insolvent enterprise is basically interesting for other investors. If the trustee in insolvency

represents the view, that the company can continue business to operate and generate cash for the creditors, there will probably be some potential investors who would possibly agree to a purchase. The sales of the company can thereby be achieved through the model of transferred reorganization (Asset-deal/Übertragende Sanierung), which often contains the transfer of the company through asset-deals to a third person. At this point financing is often central to prospects for a successful transferred reorganization, because banks are not often willing to advance monies, without adequate security. Nevertheless it is then up to the investors and the trustee in insolvency to convince the lender of purchasing a business, which is viable in the long-term and will therefore survive its crisis. However it must be emphasized that the lenders often encourage negotiations between all parties to ensure the company's business operation, because this will be the best chance for the credit institutes to get their money back.

Finally it is to be noted that a fresh start in the sense of clearing-up crisis symptoms and causes to benefit the insolvent company is not supported by German law.

### Chapter 5.3. Legal effects of bankruptcy as such

<b>Legal obstacles to a fresh start after bankruptcy</b>
<ul style="list-style-type: none"> <li>➤ As a legal obstacle for a fresh start is to be seen in Section 613 a of the German Civil Code. This legal regulation states that a company or a part of the company transferred over by legal transaction to another owner, that the rights and obligations from the existing employer-employee relationships transfer to the new investor. To that extent the consequences of Section 613 a of the German Civil Code prevents the willingness for an investment in the threatened company, because from the view of the investor unnecessary contracts and obligations must be taken over.</li> <li>➤ A further typical 'German' obstacle for a restart has to be seen in the unclear and time-costing bureaucracy-procedure after a failure in business. To that extent innumerable forms must be filled out which lead to the fact that the unclear procedure is made even more complicated.</li> <li>➤ The managing directors of a German limited liability company who committed a criminal offence according to Section 6 of the German Law pertaining to Companies with limited liability are prohibited to practice for the duration of five years. The same applies to the executive committee of a German stock corporation pursuant to Section 76 of the German Corporate Law.</li> <li>➤ The representatives of a German stock corporation are required to call a shareholders' meeting if it appears to be in the best interests of the company (Section 92 of the German Corporate Law). A special meeting is required to be called without undue delay if it appears from the annual balance sheet, or from a balance sheet prepared during the fiscal year, that half or more of the share capital has been eroded. The representatives who fail to notify the shareholders in these circumstances, may be liable to a prison term of up to three years or a fine.</li> <li>➤ According to the previous point it has to be stated that the German Penal Code contains its own paragraph for insolvency criminal offences. Therefore managing directors or other representatives who fail to exercise the diligence expected of responsible businessman or further committed a fraudulent insolvency may be liable to a prison term.</li> <li>➤ As further disadvantage for a fresh start the taxation from reorganization gains is to be</li> </ul>

seen. This taxation prevents the preservation of operational and legal units in all cases, in those no sufficient losses brought exist. It is obvious that the taxation of a reorganization gain represents an enormous financial load to an even reorganized company which will often lead again to financial difficulties.

**Legal incentives to a fresh start after bankruptcy**

- As stated already above, the German Insolvency Act considers especially insolvent customers. Therefore the customer insolvency procedure and the possibility to receive a debt release has been created and embodied by the legislator to enable a foundation stone for a fresh start after business failure.
- Legislation introduced the concept of the threatened illiquidity to give the debtor itself the chance to initiate insolvency proceedings when insolvency threatens the debtors business. Therefore the desired improvement should be the early initiating of insolvency proceedings in order to prevent the fact that the threatened enterprises wait too long and, as a result, reorganization becomes even more difficult.

#### **Chapter 5.4. ‘Excusability’ following bankruptcy**

Remarkable is the reluctance of directors and managers to consider alerting interested parties, such as banks or to take professional advice from, say, insolvency experts, at an early stage of distress. This may be due to a lack of understanding of what options other than reorganization or liquidation are available, or a desire to maintain their own positions (and income) for as long as possible or even a reluctance to accept how bad the position really is. These directors and managers may also be reluctant to alert creditors at an early stage because this might result in them using their early knowledge to take action that might hinder rather than help in any rescue. For example, a creditor might enforce its security at an early stage knowing that it will get full recovery of its debt whereas a rescue might result in higher recovery rates in general, and be a more efficient outcome, but introduces a risk that the secured creditor recovers less.

Regardless of these or other reasons and regardless of whether these reasons can be comprehended, managers and directors who fail to file a petition for the commencement of insolvency proceedings when a company reaches the stage where insolvency proceedings must be initiated, will be personally liable for the resulting losses incurred by the company. However they are not prohibited to practise a comparable position in a new company. Should directors and managers have however committed fraudulent insolvency according to Sections 283 to 283 d of the German Penal Code they are prohibited to enter business for a period of five years.

Usually the former managing directors are made responsible for the failure of the enterprise, even if the failure is due to external causes and therefore no reproach could be made on the managing director’s behaviour. Thus a fresh start with the old managing directors is mostly inconceivable since particular credit institutes demand very frequently a replacement of the managing directors, before they agree to a reorganization concept.

#### **Chapter 5.5. Responsibility of the Company’s management in case of bankruptcy of a limited liability company**

The managing directors of a German limited liability company, who are members of the management board of the company, are required to exercise the diligence expected of a responsible businessman in their conduct of the affairs of the company. If they fail to do so, they will be jointly and severally liable to the company for any damage resulting. The obligation to exercise the diligence expected of a responsible businessman also includes the duty, if a crisis threatens, to consider all possible remedial steps and, as far as possible, to initiate such measures.

A company which is unable to pay its debts as they fall due with its liquid assets or which is over-indebted according to its financial statements for insolvency purpose (special balance sheet (Überschuldungsbilanz) must file a petition for the commencement of insolvency proceedings without undue delay, and in any event, at the latest within three weeks of the date on which the company became insolvent (Section 64 of the German Law pertaining to Companies with limited liability). In this special balance sheet the real value of assets and liabilities will be entered, not book value, but the valuation depends on a prognosis, whether the business can be continued or not. If the company respectively its representatives fail to file the petition, criminal and personal liabilities of the managing directors arise.

As already mentioned above managing directors of a German limited liability company who committed a criminal offence according to Section 6 of the German Law pertaining to Companies with limited liability are prohibited to practice in a new company for the period of five years.

The liability of the managing directors for the delay in filing the petition for the commencement of insolvency proceedings is not rare, because often the companies don't have the necessary assets at their disposal so the managing directors are the only ones with remaining estate.

## **TITLE 6. PROSPECTS AND RECOMMENDATIONS**

During preparing the preceding points it is remarkable that the German Insolvency Law requires two elements. The first is a legal framework that sets forth the rights and obligations of participants, both substantively and procedurally. The second is an institutional framework that will implement these rights and obligations. Both requirements were embodied into the German Insolvency Act. Therefore the question arises, why the German Insolvency Act contains a tidy legal framework but although the restart for failed entrepreneurs is substantially difficult. One reason for this scenario is the fact that Germany has still not developed a reorganization culture for failed enterprises and entrepreneurs. The latter is to be attributed to the fact that the fear of the failure and the stigma on failure are very common in Germany as well as the fear of financial ruin. This is one of the reasons why people in Germany tend to be risk averse, because they see the financial and social costs of failure as outweighing the benefits of success. These factors negatively influence entrepreneurship in Germany.

Attitudes take a long time to change and the psychology of stigmatisation is unlikely to be directly susceptible to legislation. What legislation can do is to seek to send a signal that it recognises the risks inherent in a modern enterprise and credit-based economy and is concerned to provide mechanisms for dealing with financial failure, which give effect to that recognition. Thus the legislation must take a lead in helping to tackle the low level of

motivation to start and grow new businesses because motivation correlates directly with entrepreneurial activity. Thereby of enormous importance is also to give the failed entrepreneurs a possibility for a fresh start, because they have already had experience as founders of an enterprise and should therefore receive the chance to learn from their errors.

Questionable is, with which means society and legislation can achieve these objectives. From the legislative view in particular the introduction of the threatened illiquidity is to be mentioned, which already work considerably in the running up to an economic crisis toward the punctual initialization of insolvency proceedings. However it may be seen despite these legal reorganizations that the insolvent companies do not become healthier alone. Thus the introduction of the threatened illiquidity does not lead automatically to the fact that the executive body of the threatened company will place earlier a commencement of insolvency proceedings. To that extent the executive body will also have to consider before a commencement of the insolvency proceedings is stated, whether such a request released negative consequences which are counter productive and harmful to the company. Finally it has to be noted from the view of practice that the threatened illiquidity was in no way accepted.

Further it must be referred to again that the reorganization based on the insolvency plan pursuant to Section 217 of the German Insolvency Act which is suppose to ensure that the debtor is to continue the business. This new legal instrument was created to make available for the involved ones a functional legal framework for the reorganization of distressed companies. However the experience of the previous years shows the fact that this instrument is too complicated and too bureaucratic for the threatened enterprises. To be emphasized is also the taxation from reorganization gains, which often lead to failure of a fresh start.

The new German Insolvency Act is also an attempt to enable customers a release from their indebtedness. This great possibility, to be released from debts towards their creditors, reveals a large chance to participate again in economic life later. Nevertheless, despite the above mentioned possibilities these embodied proceedings are in not enough to enable a fresh start for the persons concerned. In short the costs relating to commencement of the insolvency proceedings are still too high for insolvent private households and the 6 years continuing good behaviour period is enormously discouraging. Moreover the proceedings have been felt as too complicated and lengthy. Also it is not to be reconstructed why the legislator modified Section 304 of the German Insolvency Act in the direction, that basically only debtors can pass through the customer insolvency, who are self-employed. Thus as a consequence small businesses and former small businesses, which requested customer insolvency are pushed into the normal insolvency proceedings. The latter however did not contain the possibility for a debt release like the customer insolvency, so that the chances for a fresh start after a business failure are reduced.

Regardless of these points of criticism it must be seen that the primary objective has to be to keep the company's business operating, because then the business can continue to operate and generate cash for the creditors and furthermore save the jobs of the employees. Thus in addition to such objectives there is a growing sense that, in many cases, rescue or reconstruction, whether informal or moderated through formal insolvency procedures, probably benefits everyone involved with the company and its business more than liquidation. Latter insight results also from the fact, that in a modern economy the degree to which an enterprise's value can be maximized through liquidation of its assets has been significantly reduced, because in circumstances where the value of a company is increasingly based on

technical know-how and goodwill rather than on its physical assets, preservation of the enterprise's human resources and business relations is in the first priority.

On the other hand is also to be stressed, that it is easy to sympathise with such motives but it should be emphasised that not all companies should be or are capable of being rescued. That follows that a right on the part of a company's management to insist that a rescue be attempted, no matter what the state of the company's affairs, would be undesirable. The failure, insolvency and liquidation of some companies and business are inevitable in a market economy and provide a valuable discipline on those who manage such companies and on their use of the resources within those enterprises.

Finally it is to be stated that Germany's social dealings with failed entrepreneurs must change, because a person is only likely to start a business if success brings social recognition and failure does not mean public humiliation. Especially as the German legal framework encourages entrepreneurs and does not punish failure.

## **TITLE 7. STATE OF KNOWLEDGE**

The report is based on the following sources:

### Legislation

- The German Insolvency Act (Insolvenzordnung)
- The German Commercial Code (Handelsgesetzbuch)
- The German Credit System Law (Gesetz über das Kreditwesen)
- The German Code of the Civil Procedure (Zivilprozessordnung)
- The German Civil Code (Bürgerliches Gesetzbuch)
- The German Corporate Law (Aktiengesetz)
- The German Law pertaining to Companies with limited liability (Gesetz betreffend die Gesellschaften mit beschränkter Haftung)
- The German Penal Code (Strafgesetzbuch)

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| ➤ Grub, Volker  | „Insolvenzplan und Eigenverwaltung“<br>in AnwBl 2000, p. 580 ff.   |
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| ➤ Lutter, Marcus  | „Zahlungseinstellung und Überschuldung unter der Neuen Insolvenzordnung“<br>in ZIP 1999, p. 641 ff.                                |
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