

INSOLVENCY FILING OBLIGATIONS AND COVID-19: LIABILITY RISKS FOR MANAGING DIRECTORS

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In common with businesses globally, the ongoing Covid-19 pandemic has placed many German companies under significant pressure: in general, managing directors have not experienced a pandemic of this nature previously and, there is no precedent for identifying and dealing with the challenges it presents. Nevertheless, managing directors find themselves having to make quick and far-reaching decisions to mitigate the risks arising from unforeseeable changes to their company's business.

"When a company becomes illiquid or overindebted, managing directors must file a request for the opening of insolvency proceedings within three weeks after the occurrence of the relevant illiquidity."

However, a company's response to the Covid-19 pandemic also entails a concrete risk of personal liability risk for its managing directors. Therefore, a company's management must make informed and careful deliberative decisions considering different key factors, including the suspension of insolvency filing obligations under current German law.

INSOLVENCY FILING OBLIGATIONS

Managing directors owe a general fiduciary duty to their company and must act for its benefit. They are required to perform their duties with general care and act with the diligence of a reasonably prudent businessman. In addition, when a company becomes illiquid (*zahlungsunfähig*) or overindebted (*überschuldet*), the managing directors must file a request for the opening of insolvency proceedings without undue delay (*unverzüglich*), at the latest within three weeks after the occurrence of

the relevant illiquidity (*Zahlungsunfähigkeit*) or over-indebtedness (*Überschuldung*).

A company is considered illiquid (*zahlungsunfähig*) if it is not able to pay its debts as they fall due. In accordance with the case-law of the Federal Court of Justice (*Bundesgerichtshof*), a liquidity gap of up to 10% is tolerated, *i.e.* the company is able to pay at least 90% of its due obligations. Nevertheless, a liquidity gap of more than 10% may be tolerated under certain circumstances as well, for example if the company is able to meet at least 90% of its due obligations within three weeks. In contrast, a company is deemed over-indebted (*überschuldet*), if its existing liabilities exceed the value of its assets, unless the continuance prognosis for the company is positive (*positive Fortführungsprognose*).

TEMPORARY SUSPENSION OF INSOLVENCY FILING OBLIGATIONS

The obligation to file for insolvency was temporarily suspended until 30 September 2020 in order to give companies the possibility to pursue all available restructuring and refinancing options. Under the amendment to the Covid-19 Insolvency Suspension Act (*Gesetz zur Änderung des COVID-19-Insolvenzaussetzungsgesetzes*), the suspension of the obligation to file for insolvency has now been extended until 31 December 2020. However, the suspension of the obligation to file for insolvency only applies to business insolvencies caused by the Covid-19 pandemic and if there are prospects of eliminating an existing insolvency (*Zahlungsunfähigkeit*) which otherwise would trigger the requirement to file for insolvency proceedings. Since these two conditions are generally difficult to prove, German law provides for a (rebuttable) presumption in favour of managing directors: it is (rebuttably) presumed that the conditions are fulfilled if the company was not illiquid (*zahlungsunfähig*) on 31 December 2019.

Nevertheless, the suspension of the insolvency filing obligation does not prevent companies from making a voluntary filing for insolvency.

APPLICABLE TO OVER-INDEBTED (*ÜBERSCHULDET*) COMPANIES

In addition, the temporary suspension of the insolvency filing obligation explicitly applies to over-indebted (*überschuldet*) companies only. Managing directors of illiquid (*zahlungsfähig*) companies or companies which become illiquid (*zahlungsfähig*) are obliged to file for insolvency pursuant to the general statutory provisions, regardless of whether or not the Covid-19 pandemic was the cause of the company's illiquidity (*Zahlungsunfähigkeit*).

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RISK OF PERSONAL LIABILITY FOR MANAGING DIRECTORS

Managing directors of illiquid (*zahlungsunfähig*) or over-indebted (*überschuldet*) companies are exposed to considerable liability risks. A managing director is obliged to file for insolvency for the relevant company and failure to do so is punishable under German criminal law in the event of either intentional or negligent violation.

Furthermore, the managing director will be required to reimburse the company for payments which were made after it became illiquid (*zahlungsfähig*) or after it was deemed over-indebted (*überschuldet*). However, this does not apply to payments which were made with the due care expected of a prudent businessman. Under the Covid-19 Insolvency Suspension Act (*Gesetz zur vorübergehenden Aussetzung der Insolvenzantragspflicht und zur Begrenzung der Organhaftung bei einer durch die COVID-19-Pandemie bedingten Insolvenz*), payments which are made in the ordinary course of business, in particular those payments which serve to maintain or resume business operations or to implement a restructuring, are deemed to be consistent with the due care of a prudent businessman.

FURTHER MODIFICATIONS OF THE GERMAN INSOLVENCY REGIME

On 14 October 2020, the Federal Government presented a draft bill on the law on the further development of restructuring and insolvency law (*Referentenentwurf für das Gesetz zur Fortentwicklung des Sanierungs- und Insolvenzrechts*), completing the transposition of European Directives into German law. The draft bill provides for adjustments to German insolvency law to be developed and supplemented to take account of the special situation presented by the economic consequences of the Covid-19 pandemic.

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In particular, the managing director of an over-indebted (*überschuldet*) company will be required to file a request for the opening of insolvency proceedings at the latest six weeks after the occurrence of over-indebtedness (*Überschuldung*) of the company, whereas the time period for filing for insolvency proceedings due to illiquidity (*Zahlungsunfähigkeit*) will remain three weeks after the occurrence of over-indebtedness (*Überschuldung*).

The changes to German restructuring and insolvency law have not been implemented yet and will only become effective as from 1 January 2021 upon the approval of the German Parliament (*Bundestag*) and the German Federal Council (*Bundesrat*).

COMMENT

In these unprecedented and challenging times, managing directors are having to respond to fast changing circumstances and must consider the company's best interests in this context. Although the pandemic may present opportunities for companies as well, it is essential that managing directors are mindful and assess risk management measures to minimise their exposure to personal liability for any decisions taken. Alternatives to the usual business practice and appropriate measures will vary depending on the individual circumstances of a company such as the location of the business or cooperation of the stakeholders. Whereas insolvency proceedings are not often commenced solely based on over-indebtedness (*Überschuldung*), managing directors of businesses with liquidity issues should be aware that the provisions on the temporary suspension of insolvency filing obligations are no longer applicable to illiquid (*zahlungsfähig*) companies. Managing directors should therefore always control the liquidity of their company and, if necessary, prepare for an insolvency filing in time to avoid the risk of personal liability.

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