

## **Reform of Insolvency Law – Greater Legal Certainty for Suppliers of Business Partners in Insolvency**

The reform of the insolvency law focusses on changes regarding the avoidance law – a more supplier-friendly law might come.

### **1. Introduction**

In recent years the business community, social insurance companies and various associations, especially the Chamber of Auditors and Tax Consultants, have been calling for a reform of the insolvency based rescission rights (Avoidance Law – Insolvenzanfechtungsrecht). Politicians have now acted on such requests with a first bill from the German Federal Ministry of Justice and Consumer Protection. Said bill will be explained below from the perspective of a supplier.

### **2. Background**

According to the explanatory notes of the new bill, it aims at removing legal uncertainties from business transactions where such uncertainties result from the current (mis-) use of the right to rescind actions (contracts) by insolvency administrators. The use of the avoidance rights conferred by Sec. 133 para. 1 (so called willful / deliberate avoidance) of the German Insolvency Code (Insolvenzordnung – InsO) constitutes an encumbrance with disproportionate and incalculable risks. The encumbrance on business transactions can generally be seen from the question whether and under which circumstances payment relief which is customary in the industry justifies the risk of the received payments being subsequently contested as willfully disadvantageous. The bill ascertains that pursuant to currently established court practice a request by the debtor for payment relief (such as deferment of payments or instalment payments), form sufficient ground upon which the court adjudicating on the facts can affirm the existence of the required intention to disadvantage the creditors. Although the German Federal Court of Justice (Bundesgerichtshof – BGH) also developed “counter” evidence and “counter” indications which allow the party with the burden of proof to assert that a payment was integrated in an exchange similar to a cash transaction or that it was an integral part of a serious restructuring attempt, the such not subject to the rescission rights. In practice, the counter evidence can hardly be offered without a detailed disclosure of the debtor’s assets and therefore the court based relief efforts in practice very rarely play any significant role.

The new regulations therefore aim at achieving an appropriate balance between the insolvency creditors’ prospects of satisfaction which are protected by the Avoidance Law and the legitimate expectations and interests of those who see themselves exposed to claims based on the Avoidance Law. In this sense the bill aims at attaching the insolvency administrator’s right to rescind an action to facts which can be acknowledged and understood by the parties concerned and which offer a guarantee together with their legal consequences that the parties are not encumbered in a disproportionate manner.

Pursuant to currently established court practice the suppliers’ problem (facing avoidance actions) can be described as follows: every supplier initially has an outstanding balance when it makes a delivery; however, it will then be held responsible for any concessions made to the customer with respect to payment (based on the wide scope of indicative evidence), even if such concessions are customary in the business. If the supplier accepts an agreement for instalments or a deferment of payment, such agreement also documents the supplier’s awareness of the imminent insolvency of the customer and subsequent insolvency debtor. This also assumes that the supplier was aware of the debtor’s intention to disadvantage its creditors based on the statutory assumption in Sec. 133 para. 1 sent. 2 InsO. Every agreement to pay instalments and/or defer payment therefore makes it easier for the subsequent insolvency administrator to contest the insolvency.

### **3. Willful / Deliberate Avoidance (Sec. 133 InsO)**

#### **a) New Regulation based on the Ministerial Draft**

The new regulation of or addition to the willful / deliberate avoidance rules is particularly

relevant from the supplier's perspective. In future Sec. 133 InsO will read as follows (convenience translation):

*Subsection 1 (partially supplemented, partially new): "A transaction made by the debtor within the last ten years prior to the request to open insolvency proceedings, or subsequent to such request, with the intention to disadvantage his creditors inappropriately may be avoided if the other party was aware of the debtor's intention on the date of such transaction. An inappropriate disadvantages does not exist if*

- 1. an equivalent payment for the debtor's payment is directly made to the debtor's assets which is necessary for the debtor's company to continue or secure the debtor's living requirements, or*
- 2. the transaction is an integral part of a serious restructuring attempt.*

*It shall be presumed that the other party was aware of the debtor's intention if it knew at the time of the transaction of the debtor's imminent insolvency, and that the transaction constituted an inappropriate disadvantage for the creditors."*

*Subsection 2 (new): "If the transaction granted or facilitated the other party with a security or satisfaction, the period pursuant to Subsection 1 Sentence 1 shall amount to four years."*

*Subsection 3 (new): "If the transaction granted or facilitated the other party with a security or satisfaction which it could use in the kind or on the date, then the debtor incurred insolvency instead of the presumption of the debtor's imminent insolvency pursuant to Subsection 1 Sentence 3. That the other party was aware of the debtor's intention cannot alone be derived from the fact that*

- 1. the other party concluded a payment agreement with the debtor pursuant to § 802b Subsection 2 Sentence 1 of the German Code of Civil Procedure (Zivilprozessordnung – ZPO) or*
- 2. the debtor requested payment relief from the other party as is customary within the business."*

A significant amendment in Subsection 1 is that emphasis is placed on inappropriate disadvantage (Sentence 1). Exceptions to such disadvantage which are envisaged by legislation have now been regulated as payments for a company to continue (Sentence 2, No. 1) and payments as integral parts of a serious restructuring attempt (Sentence 2, No. 2). The period for contesting a payment which satisfied a supplier's claim (as a creditor) is reduced from ten to four years by Subsection 2. Finally Subsection 3 regulates a restriction of the presumption regulation in Subsection 1 whereby it is explicit that payment relief shall not be sufficient to derive an awareness of the debtor's intention.

#### b) Evaluation

The desire of the legislative reform is on the one hand to curb the rampant use of the Avoidance Law and therefore on the other hand to grant greater security and planning ability to legal transactions. In view of the numerous undefined legal terms (e.g. "serious restructuring attempt", "inappropriate disadvantage" or "customary within the business") it is to be feared, however, that established court practice will only manage to fill said terms with life and content in years to come. The desired legal certainty will therefore not occur at least in the near future. Moreover, it is doubtful whether such aim will ever be achieved (considering the dynamics of established court practice regarding the Avoidance Law). From a supplier's (and other market participants') point of view, it would be desirable if the legislator develops itself clear and unambiguous wording, leaven less room for courts (as far too often the case) to fill any legislative gaps.

#### **4. Contestation Based on So-Called Incongruent Coverage (Sec. 131 InsO)**

##### a) New Regulation based on the Ministerial Draft

The proposed modification of Sec. 131 InsO also has much practical relevance for suppliers. In future the regulation is to be supplemented as follows (convenience translation):

*"A transaction may not alone be contested pursuant to Sentence 1 because the creditor obtained the security or satisfaction by means of a foreclosure proceeding on the basis of an executory title obtained in a court proceeding."*

Previous the practice of the BGH foresaw that a payment in a foreclosure proceeding or on a foreclosure title was considered incongruent and was therefore subject to the Avoidance Law. This resulted for suppliers in the fact that conduct which was completely socially acceptable and desirable per se, namely securing a claim through recovery by means of foreclosure proceedings, turned into an obligation for the supplier to return the payment if the customer became insolvent at a later stage.

#### b) Evaluation

The bill attempts to alleviate the problem with the fact that payments on court titles will no longer lead to incongruence and therefore contestability. In future the supplier can therefore rely on the fact that a judicial dunning procedure or legal action is not conducted in vain and the payment which is then made can be kept even if insolvency proceedings are subsequently opened upon the customer's assets. It is also positive here that attempts by public authorities, namely fiscal authorities and social insurance companies, were resisted to grant similar privileges, i.e. a "special fiscal right", to titles of these authorities (who can even issue such titles themselves). The proposed new regulation is, however, problematic in the fact that it creates different "qualities" of titles. In future a title would not enjoy any protection from contestation by virtue of a notarial deed (typically subjection to immediate foreclosure proceedings in loan agreements), whereas a title which was obtained in court would enjoy such protection. It also appears problematic that it is precisely social insurance companies and fiscal authorities who, even if they wanted to, could not obtain a title in court in many cases since they will not usually have a legitimate interest in filing legal action (since they are themselves responsible for issuing titles – see above).

## **5. Interest (Sec. 143 InsO)**

### **a) New Regulation based on the Ministerial Draft**

Another new regulation which is very important for suppliers is the interest obligation of (re)payments which result from a successful avoidance action. In future Sec. 143 InsO is to be supplemented as follows (convenience translation):

*"Interest must only be paid on a debt if the conditions for the default of the debtor or Sec. 291 of the German Civil Code are fulfilled."*

The previous regulation led to the fact that interest was to be paid on the successfully contested amount not just from the time of contestation but instead from the legal transaction (i.e. the payment of the supplied goods, for example). The statutory interest rate which is currently much higher than is customary in the market applied (and applies) here. This at least sometimes led in turn to unwelcome extremes on the part of the insolvency administrators. Since the obligation to pay interest ran independently from the time of the declared contestation (retroactively), some observers of the industry believed that insolvency administrators deliberately asserted a claim for contestation very late in the proceedings since it was certain that they would receive interest on their claims and declaring contestation as late as possible ultimately led to an increase in assets.

### **b) Evaluation**

In future the proposed link to the general preconditions for execution, i.e. to Sec. 291 BGB, will pull the rug out from under this unwanted practice. In future this means for all parties opposing contestation that interest will only be paid on their claims when they are asserted by the insolvency administrator (and not retroactively even for several years). Without exception this is certainly a welcome regulation from the perspective of suppliers as usual defendants of avoidance actions.

## **6. Previous Discussions and Outlook**

The bill is currently being widely discussed in academic publications and within business circles; it was also recently a subject at the Restructuring Forum in Düsseldorf on April 14, 2015. The need for a reform of the Avoidance Law was particularly discussed here. Against the background of recent court decisions this can certainly appear doubtful. A recent ruling by the BGH (ruling dated April 16, 2015; Case No.: IX ZR 6/14) went in favor of the creditors. The BGH decided that merely the debtor's request to conclude an agreement for payment instalments as such is not an indication that the debtor will stop payments or is insolvent if it is customary within the business. Concluding an agreement for payment instalments is often seen as an indication that the party opposing contestation was aware of the intention to disadvantage creditors so that the insolvency administrator can successfully contest intention pursuant to Sec. 133 InsO. The agreed payment instalments must be returned to the insolvency assets. According to the current ruling that does not apply if the conclusion of an agreement to pay instalments is customary in the business. Even if the ruling only concerns an individual case, the question can certainly be asked on this basis whether a new statutory regulation is necessary.

As an answer to the question posed at the beginning it can be ascertained that greater legal certainty for suppliers is to be expected from crisis-ridden and perhaps subsequently insolvent customers if the ministerial draft is implemented. However, first assessments of the continued discussions among legal academics and politicians allow modifications to be expected in the legislative process. Suppliers can therefore watch with suspense how great the legal certainty achieved by the legislative reform will actually be. We hope to be able to

inform you about a final and hopefully supplier-friendly version of the law in one of the next issues of this newsletter.

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