German Law to Contest Debtors' Transactions in Insolvency Proceedings under Critical Review

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The common understanding with regard to the Insolvency Administrator's right to contest transactions due to 'wilful disadvantaging' according to section 133 of the German Insolvency Statute (hereinafter referred to as 'InsO') has faded for a while now. The scope of transactions that are considered to be wilfully disadvantageous for creditors has been widely broadened by the applicable case law. Consequently, many parties who maintain business relationships with partners who are at the edge of insolvency suffer high losses because they have to refund received amounts to the insolvency estate. A quite controversial debate is taking place.

Background

When interpreting the provisions to contest transactions in insolvency proceedings, it has to be considered that these rules serve the purpose of equal treatment of creditors. With the right to contest transactions, this purpose is expanded in a timely manner before the filing for insolvency proceedings occurs. Experience shows that even a long time before the actual filing for insolvency proceedings takes place, those creditors who have tight business relationships with the debtor or those who have an insight into the debtor's financial status do enforce their claims against the debtor by using these advantages; the other creditors are left empty-handed.

The mean of contest therefore increases the value of the insolvency estate that can be distributed to all creditors. As a general rule, the shorter the time period between the disadvantaging transaction and the filing for insolvency proceeding, the lower the prerequisites for the contest by the insolvency administrator.

According to sections 129 and 133 InsO, a transaction disadvantaging creditors made by a debtor during the last ten years prior to the filing for insolvency proceedings, or subsequent to such filing, with the intention to disadvantage the creditors may be contested if the other party was aware of the debtor's intention on the date of such transaction. Such awareness shall be presumed if the other party knew about the debtor's imminent insolvency and that the transaction constituted a disadvantage for the creditors.

Section 142 InsO stipulates that transactions of the debtor in return for which their property benefited directly from an equitable consideration are not contestable. Thus, the need to authorise certain transactions in order to maintain the business prospects of the debtor is generally recognised by the law. However, this objection against the claim does not apply if the prerequisites of section 133 InsO are met. Accordingly, for example, those who supply goods and receive the corresponding payment are most likely not protected by this objection against a claim for contest, at least not if the debtor acted with the intention to disadvantage other creditors and if the creditor knows about this circumstance.

The claim for contest is time barred after three years, beginning at the end of the year when the opening of insolvency proceedings has been ordered by the competent court. With regard to the legal consequences of the claim, the law stipulates that any property of the debtor sold, transferred or relinquished under the transaction being subject to the contest must be restituted to the insolvency estate. This obligation for restitution covers interest rates as well. Often claims for contest are enforced just at the end of the third year after the opening of the proceeding. The other party finally has to pay interest (five per cent above the base rate) calculated from the opening of the insolvency proceedings as well. The final amount that has to be repaid to the insolvency estate is therefore significantly higher than the initial received amount.

The debatable provision, section 133 InsO

General remarks

According to the applicable case law, the term 'transaction disadvantaging creditors' has to be understood in an extensive way. It covers almost every conscious act or omission that led to an indirect economic disadvantage for the creditors. The case law reviews the act or omission from an economic viewpoint, approving whether the contested transaction has decreased the value of the insolvency estate. Counterclaims, those being fulfilled by the debtor, do not have to be considered. Therefore, the remuneration that a supplier receives for the supply of certain goods could be contested as well. As mentioned above, the equal treatment of all creditors is understood as being primarily due rather than a justified claim of one creditor.

Contest due to wilful disadvantaging

Of course, it is necessary having a mean to contest transactions that have been authorised by the debtor in order to favour one creditor only. This purpose of section 133 InsO is commonly understood and acknowledged. But nowadays, the case law regarding the prerequisites of 'wilful disadvantaging' according to section 133 InsO covers a wide range of what could be considered alike. Therefore, this provision has developed as a kind of catchall provision rather than a special means to receive payments that were authorised to intentionally disadvantage others.

The core question which has led to the current debate is mainly caused by a combination of the subjective criteria required by section 133 InsO and the distribution of the burden of proof in the respective provision.

The law stipulates that debtors' transactions which are intended to disadvantage creditors are contestable if the other party was aware of the debtor's intention on the date of such transaction. Such awareness shall be presumed if the other party has known about the debtor's imminent insolvency and that the transaction constituted a disadvantage for the creditors. Therefore, the law stipulates a presumption of knowledge if the other party knows about the debtor's imminent insolvency. The insolvency administrator needs to prove the debtor's imminent insolvency and that the creditor knew about it by applying objective criteria.

The insolvency administrator has access to the debtor's business books, records and even to their email correspondence. They can scan the material in hand for relevant payments and in many cases they find payment reminders, instalment agreements, attachment orders, debit return notes or even emails from the debtor explaining that they cannot pay at a certain time – the worst case scenario from the other parties' perspective. If this is shown to the court, it is almost impossible for the payment recipient to disprove the presumption of knowledge in many cases.

The various interest groups

On the one hand, many companies, or rather creditors, face these contests by insolvency administrators and suffer high losses. On the other hand, German insolvency proceedings are being financed by these claims and the creditor's rate could increase with this mean. A conflict between the different interests can be solved on a case-by-case basis only, which leaves all parties involved with legal uncertainty.

The creditors who face such contest

There is a growing resentment against this law, especially from trade unions. This mainly started with the Federal Court of Justice deciding that the knowledge of the imminent insolvency of the debtor follows generally from certain indications like significant payment arrears, delayed payments, operation of enforcement measures, instalment agreements or the like.

If the other party does not follow a strict claim management and ceases the business relationship as soon as one of the mentioned indications arise, the other party faces risks should that business partner file for insolvency proceedings. According to the law, this covers even a time period up to ten years from the relevant transaction. If the other party cannot be sure to retain the earned amount, its own financial planning is in danger. Moreover, many entrepreneurs even do not know about the financial risk for contest and do not set up respective accruals. From their perspective, they have received the debtor's payment based on a justified claim, for example, remuneration for the supply of certain goods.

The insolvency administrators' perspective

Insolvency administrators of course welcome the broadened scope of section 133 InsO. If a debtor files for insolvency proceedings, the competent court generally appoints a preliminary insolvency administrator. They have to secure the assets, approve whether the insolvency reasons apply and whether the value of the remaining insolvency estate is sufficient to cover the costs of the proceeding. The claims for contest of transactions are an important mean for financing the insolvency proceedings.

Moreover, the insolvency administrators are even obliged to challenge transactions disadvantaging (other) creditors, if the prerequisites are met. If they do not approve and enforce the respective claims, they could be held liable from the creditors of the debtor. Due to the broadened case law, they argue that they must contest transactions based on that case law to increase the value of the insolvency estate.

The debtor's view

The debtor walks on a fine line in a financial crisis. On the one hand, they need to persuade creditors to support restructuring plans (eg, negotiating instalment agreements) in case they intend to maintain business through restructuring. On the other hand, the debtor risks losing their business partners by informing them about any financial difficulties.

Status of legal amendments

In 2012, the German legislator enacted the Law for Facilitation of Company Restructuring and therewith explicitly strengthened the chances for restructuring rather than liquidation. The corresponding amendments of the InsO are designed to change the habit of the liquidation of a company being the most favoured means to satisfy the creditors. However, this would only be possible in cases where 'there is something left' and in cases that the creditors of the debtor support the restructuring. By considering the case law regarding the contestability of transactions, it seems even more difficult for the debtor to find supporters for their restructuring plan. If the plan fails and the debtor would need to file for insolvency proceedings – in Germany, this is mandatory in cases where the insolvency reasons apply – those creditors who agree upon instalment payments and who maintain the business relationship face a high risk for contest. Therefore, some argue that the right for contest in its current state contradicts the German legislator's intention to ease restructuring.

The Coalition Agreement for the 18th legislative period states the intention of the legislator to review the rights for contest according to the InsO. The purpose of the review is to prevent potential inconsistency that cannot be justified with the purpose of the law and to decrease legal uncertainty. There have been several proposals for amendments under discussion, for example, the reduction of the time period for contest or the exclusion of justified claims whereby the debtor in return benefits from an equitable consideration. On 16 March 2015, the legislator published a proposal for the amendment.

Conclusion

The objective indications acknowledged by the applicable case law that are considered to be sufficient to realise the presumption of knowledge in accordance with section 133 InsO has led to growing legal uncertainty in the application of law. Due to this, doing business with a business partner who faces a financial crisis becomes even less attractive than it already has been. Considering that the German legislator enacted the Law for Facilitation of Company Restructuring (ESUG) and therewith explicitly strengthened the chances for restructuring rather than liquidation, the broadened scope of the insolvency administrator's right to contest transactions due to wilful disadvantaging seems to defeat this purpose. One may assume that those transactions that are necessary for maintaining business prospects are safe for contest. However, this is not the case in practice, at least not with the necessary legal certainty. This lack of legal certainty increases the reluctance of business partners to grant, for instance, instalment payments, even if the financial crisis of the debtor could be overcome.

Especially within the European Union, due to Council Regulation (EC) No 1346/2000 on Insolvency Proceedings, the insolvency administrator's right to contest transactions is to be well considered in cross-border issues as well. Each entrepreneur would be well advised to consider the rights for contest before supplying goods to customers in Germany or the like. If negotiable, a request for securities when concluding a contract could be an option to secure the legitimate right for payment. In this regard there is still to mention that advance payments could be claimed by the insolvency administrator if the prerequisites of the Law for Contest Debtor's Transactions in Insolvency Proceedings are met.

It seems inconsistent if suppliers need to reimburse/refund received amounts to the insolvency estate because they have granted the debtor more time for payment in order to overcome a financial crisis and the debtor's efforts to overcome the crisis have failed. The basic principle of equal treatment of creditors as it is understood in German insolvency law should be more balanced with the debtor's efforts to maintain their business prospects. But whether the current legal uncertainty could be eliminated by the legislator with the current legislative draft remains to be seen.

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