Eberhard Nietzer:
German Insolvency Basics in a Thumbnail Sketch*

Introduction

Until 1999, German insolvency law was focused on liquidation and best satisfaction of the creditors.
Then, the Insolvenzordnung (Insolvency Code, hereinafter referred to as "InsO") was introduced and its first section states two additional objectives:

- Keeping the debtor business alive through a plan
- Giving the honest debtor a fresh start

The Insolvency Code includes provisions on substantive matters such as executory contracts, avoidance, and labor contracts (termination issues) and rules of procedure.
A feature that may appear strange to non-German lawyers is that the Insolvency Code also includes a provision on the criminal liability of executive officers or liquidators of business entities (InsO section 15a). It states that these persons have to file a voluntary petition within three weeks after the company has become cash insolvent or balance sheet insolvent. Failure to do so is a criminal offense carrying up to three years imprisonment or a fine.

Peculiarities of German Insolvency Law

Insolvency Event

An insolvency case may be commenced by either the debtor itself or a creditor (InsO section 13).
No petition will be admitted, however, unless it is based on an insolvency event (InsO sec. 16).
The petitioner must show that an insolvency event has occurred.
The Insolvency Code defines three different insolvency events:

- cash insolvency (InsO section 17; available basis for voluntary petitions by and involuntary petitions against any kind of debtor)
- anticipated cash insolvency (InsO section 18; only available as a basis for voluntary petitions)

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*The author is an insolvency judge at the Amtsgericht (county court) in Heilbronn, Germany, and a certified court sworn translator for English and German

- balance sheet insolvency (InsO section 19; only available as a basis for voluntary petitions by and involuntary petitions against legal entities)

No automatic stay

Unlike under section 362 of the U.S. Bankruptcy Code, the filing of an insolvency petition does not operate as an automatic stay of the enforcement of claims against the debtor or against property of the estate.
There is no stay without judicial action.
Until the insolvency proceedings are formally opened, the judge has discretion whether or not to grant a stay.

Stages of the Proceedings (Pre-Opening and Post-Opening Stage)

A judgment is required for insolvency proceedings to be opened.
Before such a judgment is rendered, the court has to investigate the facts of the case on its own motion and decide whether the requirements for opening the proceedings are satisfied.
In particular, the court needs to find out if a case is an asset case or a no asset case.
No asset cases are dismissed and no proceedings are opened because there is nothing to be liquidated for the benefit of the creditors.
The “cost coverage test” determines whether a case is an asset or no asset case.
The proceedings will be opened if there are enough assets to cover the cost of the proceedings (court fees, the remuneration of the insolvency representative and of the members of the creditors’ committee (if any), InsO section 54).
Otherwise, the party having filed the petition will be requested to make an advance payment in an amount sufficient to cover those fees and remunerations. If this request is not complied with (it hardly ever is), the petition will be dismissed as a no asset case (InsO section 26).
An individual debtor may obtain permission by the court to pay the cost of the proceedings in a later stage of the proceedings if the individual’s assets are not sufficient to cover the cost of the proceedings. Then the proceedings will be opened even if the “cost coverage test” is failed.
In business insolvency cases, the court normally does not have the means to perform the “cost coverage test” without external help, especially when the business is still operating.

This help is obtained from an expert appointed by the court.
In his/her expert opinion, the expert will tell the court if the “cost coverage test” has been passed or failed.
All judgments by which insolvency proceedings are opened or are dismissed as no asset cases are published on the internet (www.insolvenzbekanntmachungen.de).

Preservation Measures (InsO section 21)

In business insolvency cases, the pre-opening investigation stage may extend up to three months.
This period may be so long because an interim insolvency representative (vorläufiger Insolvenzverwalter) may avail himself/herself of “insolvency money” to continue the debtor’s business operations.
“Insolvency Money” is a statutory relief available for the debtor’s employees. The Federal Labor Agency will compensate the employees for any wage or salary losses suffered during a period of up to 3 months preceding the opening of the proceedings.
The interim insolvency representative can obtain a loan from a bank in the amount of three monthly salaries and use the loan funds to pay the employees for their work.
The employees’ rights to “insolvency money” are assigned to the bank to guarantee repayment of the loan.
Thus, the interim insolvency representative can motivate the employees to keep working for the debtor and generate income which will become part of the insolvency estate after the proceedings have been opened.
The court is under a statutory obligation to take all measures required for avoiding a reduction of the debtor’s assets which is adverse to the collective interests of the creditors.
Standard measures to preserve the debtor’s assets are a stay order and the appointment of an interim insolvency representative.
The powers of this interim insolvency representative are determined by the court.
In most cases, the debtor will be prohibited to dispose of any assets without the interim insolvency representative’s permission.
In some cases, the debtor is prohibited by the court to go on managing its assets and business operations. All the management rights are then transferred upon the interim insolvency representative.

Opening of the Proceedings

The judgment by which the proceedings are opened is the key event.
Its effects are manifold, the most important ones being a stay, a suspension of all current litigation; the debtor's divestment of its rights to manage its assets which are now managed by the insolvency representative.
When the judgment becomes effective, the judge is no longer in charge of the case.
The proceedings are now managed by a judicial officer called "Rechtspfleger" (literally translated: law nurse and dubbed "mini judge" by a U.S. judge in a meeting in Berlin in 2008). The Rechtspfleger is a type of junior judge who has authority to make rulings on a limited basis.
This German version of a junior judge has full independent judicial power for (almost) all decisions to be made after the proceedings have been opened by the judge.
Each German state has a college offering programs for Rechtspfleger candidates.
In Baden-Württemberg, the candidates have to go through a three year college BA program. The program includes several stages of college classes and on-the-job training.

Selection of the Insolvency Representative (InsO sections 56, 56a)

Unless the debtor is permitted to continue managing its affairs itself, the court will appoint an insolvency representative (Insolvenzverwalter) who has functions similar to a trustee in US Chapter 7 or 11 bankruptcy proceedings.

Until 2004, the judges selected the insolvency representatives from among the membership of the local bar who had shown an interest in this kind of work.
When more and more attorneys realized that this line of work may be lucrative, the situation changed.
A group of attorneys decided to apply for work with other courts than their home court.
When their applications were denied, they appealed those denials and took some of them all the way through the court system up to the Federal Constitutional Court (Bundesverfassungsgericht).

In 2004, the German Constitutional Court ruled that, provided the applicants were sufficiently qualified, these denials were unconstitutional because they violated the applicants' right of free choice of their profession.

Now each court must have a preselection list of attorneys willing and qualified to be appointed insolvency representative. From this list, the judge will choose the insolvency representative for any particular case.
This system was often criticized as non-transparent for the debtor and the creditors. Debtors and creditors complained that filing an insolvency petition included elements of gambling because nobody knew whom the court would appoint (interim) insolvency representative.
The revised law is designed to address these concerns by giving the creditors and the debtors more influence in these matters.

Since March 1, 2012, an interim creditors' committee has to be appointed if certain threshold requirements are satisfied.
This was a great step in German insolvency legislature because the creditors had no say in any matter before the judgment opening the proceedings was announced.
If an interim creditors' committee is appointed by the court and it unanimously proposes an individual to be appointed the (interim) insolvency representative, the court has no discretion to appoint someone else but is bound by the unanimous proposal unless the proposed individual is not qualified to be an insolvency representative, InsO section 56a subsection 2.

Plans

The process of reorganizing a business through a plan was designed on the basis of Chapter 11, but only fragments of the Chapter 11 provisions were eventually included in the German provisions.
InsO section 217 provides that a plan may include provisions on the satisfaction of secured creditors and distributions to unsecured creditors which are inconsistent with the provisions governing ordinary insolvency proceedings.
A plan may generally be filed by either the insolvency representative or the debtor (InsO section 218).
The plan is discussed and voted on during a court hearing (InsO section 235).
If the requirements for acceptance by the creditors (InsO sections 244-246a) are met and the debtor agrees to the plan, the court can confirm the plan (InsO section 248).

A visual of German plan proceedings (in German) can be found at http://www.insolvencycourts.org/DL/Trier/Frank/Frank_02_PlanverfahrenAblauf_DIN_A3.pdf.
Before a plan can be confirmed, the insolvency proceedings must be opened.

Debtor Self-Management (Debtor in Possession) Proceedings

Until 2012, debtor self-management proceedings (the German type of debtor in possession proceedings) were not common in Germany.
But the new law in force since March 1, 2012, was designed to change that.
The significantly increased number of debtor self-management proceedings permitted since then shows that the new law has served its purpose.
If a debtor requests to be granted debtor self-management proceedings in its voluntary petition, the court shall neither appoint an interim insolvency representative nor limit the debtor's rights to dispose of its assets unless the request is obviously futile.
The debtor is not without supervision, however, if debtor self-management proceedings are permitted by the court.
On the contrary, the court will appoint an (interim) curator-type supervisor (Sachwalter, hereinafter called curator).
The curator is to examine the debtor's financial situation and to monitor the business operations and the debtor's cost of living expenses.
A comparison of 28 U.S.C. 586 and InsO section 274 shows that the functions of the US Trustee in Chapter 11 proceedings and the functions of a curator in German debtor self-management proceedings are not the same.
If the curator becomes aware of circumstances which make the continuation of debtor self-management proceedings appear to be adverse to the interests of the creditors, s/he has to notify the creditors' committee and the court thereof immediately.
The court is to revoke the permission of debtor self-management proceedings if
- the majority of the creditors' committee so requests
- a secured or ordinary creditor so requests and shows that continuing the debtor in possession proceedings is adverse to the interests of the creditors
- the debtor so requests

A new subtype of debtor self-management procedure to prepare a reorganization by a plan included in the Insolvency Code is the so-called “protective umbrella procedure” (InsO section 270b).

Protective umbrella proceedings require a voluntary petition by the debtor based on anticipated cash or balance sheet insolvency (it is not available if insolvency has already occurred). The petition must include a request to grant debtor self-management proceedings and to fix a deadline for the submission of a plan. This deadline is not to exceed three months.

Unlike in ordinary debtor self-management proceedings, only the debtor is permitted to submit a plan.

The petition must be backed by the certificate of a tax consultant, auditor or attorney with considerable insolvency law experience showing that insolvency is to be anticipated but has not yet occurred and that the restructuring plans are not obviously futile.

There is considerable debate about the qualifications required for persons issuing such certificates.

The main difference between protective umbrella proceedings and ordinary debtor self-management proceedings is that the protective umbrella proceedings are primarily reorganization proceedings, not pre-opening proceedings for the purpose of investigating whether proceedings can be opened.

So the debtor will try to either settle the case with all creditors before the proceedings are opened (and then voluntarily dismiss its case) or have the plan confirmed soon after the opening of the proceedings.

The latest developments show that the popularity of the protective umbrella proceedings is decreasing because of the liability risks for the persons issuing the certificates and because some courts appoint experts to verify the accurateness and completeness of those certificates thus making the protective umbrella a too lengthy process.

I have read recommendations by insolvency professionals to stay away from protective umbrella proceedings and resort to ordinary debtor self-management proceedings instead.

Creditor Participation in German Insolvency Proceedings

Traditionally, creditor participation was only provided for during the post-opening stage of the proceedings (InsO sections 156 et seq.).
The problem with this tradition was that the creditors had no influence on the development of the case until some time after the opening of the proceedings.
The course of the proceedings had, however, often been set during the pre-opening stage already.
For example, the creditors have the right to elect another person than the individual appointed by the court as insolvency representative in the first creditors' meeting after the opening of the proceedings (InsO section 57).
By that time, the appointed insolvency representative (who is almost always identical with the interim insolvency representative used during the pre-opening stage of the proceedings) has invested considerable time in investigating the facts of the case, often entered into intitial negotiations with prosepctive investors, etc. All these efforts may become useless if the key person (the insolvency representative) is replaced by someone else. Moreover, the remuneration earned by the appointed insolvency representative will have to be paid without the insolvency estate receiving the benefits of the appointed insolvency representative's work.
Therefore, the legislator thought it wise to let the creditors participate in the process of selecting the insolvency representative during an early stage of the proceedings.
Other responsibilities the interim creditors' committee has are to keep themselves up-to-date on the debtor's business operations, inspect the debtor's books and business documents, check the available funds and the monetary transactions made by the debtor, et. al.
If the (interim) insolvency representative plans to enter into transactions of particular importance for the development of the case, such as selling all the inventories or selling real estate, s/he needs to obtain the (interim) creditors' committee's permission (InsO section 160).

Have the New Provisions Improved the Quality of Insolvency Proceedings?

Recently, there has been much debate on whether or not the new provisions on increased creditor participation and on making debtor self-management more easily available have improved the quality of business insolvency proceedings.

The insolvency professionals counseling debtor companies emphasize that reorganization proceedings are likely to be successful if the managers obtain expert advice well before the crisis of the companies they manage actually begins.
Quite a number of courts doubt that insolvency cases will benefit from having the same people who led the company into crisis in the driver's seat.
There has been praise that early creditor involvement in the proceedings facilitates reorganization because the debtor and the creditors have more time to cooperate in finding solutions which keep the debtor alive.
Courts and insolvency professionals have feared that insolvency representatives appointed by the courts will be less impartial and independent than before. These fears are based on the assumption that large entities which are often parties to insolvency proceedings as creditors, such as banks, will tend to only propose interim insolvency representatives to the courts which will respect those creditors' interests to the maximum possible extent and possibly to the disadvantage of other creditors.
My experience has shown that an interim creditor committee can be a valuable source of expert advice for the interim insolvency representative if sufficiently qualified members have been selected to serve on the interim creditor committee.

Effects of the New Law on Shareholders

Until the new law took effect on March 1, 2012, the shareholders of a debtor company could not be divested of their ownership interest in the debtor without their agreement. They could not prevent asset deals entered into by the insolvency representative. But when the insolvency representative wanted to assign shareholder interests or certain other rights, such as licenses or favorable long term agreements, to third parties, s/he might have needed the shareholders' cooperation to avoid difficult and costly processes for becoming able to do so. Shareholders who were aware of this situation tried to exploit it for the purpose of receiving special benefits in exchange for their cooperation.

The new InsO section 225a is designed to prevent such negotiation tactics by the shareholders.

Under this new provision, a plan may provide that creditor claims be converted into shares in the debtor if the affected creditor agrees to the conversion of the claim even if the affected shareholders disagree.

Additional Information Online

If you are interested in more information on German insolvency law in English or in the work of German and international judicial workgroups, please visit my website at www.insolvencycourts.org or contact me at postmaster@insolvencycourts.org.

Reading Recommendations

I am not aware of any comprehensive book on German insolvency law in English.

A summary of 51 pages ("National Report for Germany" by Christoph G. Paulus and Matthias Berberich) which can very well be used as an introduction into German insolvency law is included in "Commencement of Insolvency Proceedings" (Oxford International and Comparative Insolvency Law).

Information on different individual aspects of German insolvency law can be found in INSOL Europe's Technical Series.
This series includes the following publications by INSOL Europe's Judicial Wing:

- Regulations and Measures of Protection in National Legislations Within the European Union, Papers from the INSOL Europe Judicial Wing Meeting, Vienna, Austria 14 October 2010
- The Remuneration of the Insolvency Representative in Europe
- The Role of the Judge in the Restructuring of Companies Within Insolvency
- The Role of the Judge in Nomination, Supervision and Removal of the Insolvency Representative

All of the above publications include chapters on Germany.