

TEMPORARY GERMAN COVID-19 INSOLVENCY REGIME EXTENDED IN MODIFIED FORM

To Our Clients and Friends:

When the COVID 19 pandemic first hit European shores in early spring 2020, the German legislator was quick to introduce wide-reaching legislative reforms to protect the German business world from unwanted consequences of an economy struggling with unprecedented upheaval, the lock-down and the ensuing social strain.¹ One key element of the overall legal reform in March 2020 was the temporary derogation from the regular mandatory German-law requirement to file for insolvency immediately whenever a company is either illiquid (*Zahlungsunfähigkeit*) or over-indebted (*Überschuldung*). This derogation has now been extended in time for over-indebted companies, but restricted in scope for illiquid companies.

I. The Temporary Insolvency Law Reform in March 2020

At the time the German Act on the Temporary Suspension of the Insolvency Filing Obligation and Liability Limitation of Corporate Body in cases of Insolvency caused by the COVID-19 Pandemic (“*Gesetz zur vorübergehenden Aussetzung der Insolvenzantragspflicht und zur Begrenzung der Organhaftung bei einer durch die COVID-19-Pandemie bedingten Insolvenz*” - **COVInsAG**)² was introduced in March 2020, it was felt that the strict insolvency filing requirement that obliges management to file for insolvency without undue delay, but in any event no later than three weeks after such insolvency reason first occurs, would (i) place undue time pressures on companies to file for insolvency in situations where this short time period did not even allow management to canvass its financial or restructuring options or access to newly introduced state funding or other financing sources, (ii) result in a wave of insolvencies of otherwise healthy entities based purely on the traumatic impact of the pandemic and (iii) result in unwanted distortions of the market by failing to differentiate appropriately between businesses facing merely temporary cash-flow problems and genuinely moribund companies with long-standing challenges or issues.

¹ In this context, see our earlier general COVID 19 alerts under: <https://www.gibsondunn.com/whatever-it-takes-german-parliament-passes-far-reaching-legal-measures-in-response-to-the-covid-19-pandemic/> as well as under: <https://www.gibsondunn.com/european-and-german-programs-counteracting-liquidity-shortfalls-and-relaxations-in-german-insolvency-law/>.

² In this context, again see: <https://www.gibsondunn.com/whatever-it-takes-german-parliament-passes-far-reaching-legal-measures-in-response-to-the-covid-19-pandemic/>, under section II.2, as well as with further analysis in this regard <https://www.gibsondunn.com/european-and-german-programs-counteracting-liquidity-shortfalls-and-relaxations-in-german-insolvency-law/>.

In a nutshell and without going into all details, the interim reform of the German Insolvency Code (*Insolvenzordnung, InsO*) via the COVInsAG introduced a temporary suspension of the mandatory insolvency filing requirement until September 30, 2020 for both the insolvency reasons of illiquidity (*Zahlungsunfähigkeit*) and of over-indebtedness (*Überschuldung*) by way of a strong legal assumption that any such insolvency was caused by the pandemic if (i) the company in question was not yet illiquid on December 31, 2019 and (ii) could show that it would (still or again) be in a position to pay all of its liabilities when due on and after September 30, 2020.

This temporary exemption from having to file for insolvency was flanked by a number of other legislative tweaks to the Insolvency Code that privileged and protected a company's continued trading during such time window against management liability risks and/or later contestation rights of the insolvency administrator in case the temporary crisis in the spring and summer of 2020 would ultimately result in a later insolvency, after all. Access to new financing was similarly privileged in this time window when the company could show that it traded under the protection of the COVID 19 exemption from the regular insolvency filing requirement.

Finally, the COVInsAG also contained a clause that allowed an extension of this protective time window beyond September 30, 2020 up to the maximum point of March 31, 2021 by way of separate legislative act.

II. The Modified Extension Adopted on September 17, 2020

While an extension of the temporary suspension of the filing requirement was consistently deemed likely by insolvency experts and in political cycles, Germany has since moved beyond the initial lock-down and has mostly opened up the country for trading again. It has also become apparent that, in particular, a continued blanket derogation from the mandatory filing requirement for companies facing severe cash-flow problems to the point of illiquidity (i) would often only delay the inevitable and (ii) create an unwanted cluster of many insolvency proceedings which are ultimately all filed for at the same time when the suspension comes to an end, rather than a steady and progressive cleansing of the market by gradually removing companies that have failed to recover from the pandemic in a reasonably short period of time.

As a consequence, Germany has chosen not simply to extend the current provisions in unchanged form, but rather has significantly modified the wording of the COVInsAG to address the above concerns.

1. Over-Indebtedness

In particular, as of October 1, 2020 and until December 31, 2020, a continued derogation from the immediate obligation to file for insolvency henceforth only applies to companies which otherwise would only file for insolvency due to over-indebtedness (*Überschuldung*) but which are not also illiquid. Such companies remain protected from having to file for insolvency based on the above-described rules until December 31, 2020, if (i) they were not already illiquid by December 31, 2019 and will not be illiquid after September 30, 2020 and thereafter.

Unlike illiquid companies, it was felt that companies which are over-indebted, i.e. (i) whose assets based on specific insolvency-driven valuation rules are not sufficient to cover their liabilities and (ii) which do not currently have a positive continuation prognosis (*positive Fortführungsprognose*), deserve a further grace period during which they may address their underlying structural issues, provided they do not enter illiquidity during this time window.

This extension until year end for over-indebted companies also addresses the often-voiced concerns that the uncertain future effects of the pandemic on a company's medium-term prospects currently do not allow for a meaningful continuation prognosis which by general consensus has to cover the liquidity situation over the next 12 to 24 months.

2. Illiquidity

This new restriction of the interim derogation from the filing requirement to over-indebtedness only, in turn, means that companies that cannot pay their liabilities when they fall due on September 30, 2020 (and beyond) and, therefore, are illiquid under German insolvency law terms, may no longer justify such financial distress by claiming it is caused by the pandemic. Instead, they will now be obliged to file for insolvency based on illiquidity once the initial protection accorded to them by the March 2020 rules runs out at the end of September 30, 2020.

With it being mid-September 2020 already, this will give the management of any entity facing serious current cash-flow problems only another two weeks to either remedy such cash flow problems and restore full solvency or file for insolvency on or shortly after October 1, 2020 due to their illiquidity at that point in time.

3. Consequential Issues

The new, changed wording of the COVInsAG consequently restricts the other privileges connected with the temporary exemption from the filing requirement, i.e. that companies are permitted to keep trading during the extended time-window with certain protections against subsequent insolvency contestation rights, personal liability derogations or privileges and simplified access to new external or internal restructuring financing or loans, only to over-indebted companies. For them, these additional rules, which they may have already become accustomed to in the period between March 2020 and September 30, 2020, are simply extended until December 31, 2020.

III. Immediate Outlook

This law reform is of utmost importance for the management and the shareholders of any German entities that are currently in significant financial distress. The ongoing, periodic monitoring of their own financial position will need to determine in an extremely short time-frame whether or not the respective company is either illiquid or over-indebted as of September 30, 2020. If necessary such analysis should be firmed up by involving external advice or restructuring experts.

If the company is found to be over-indebted but not illiquid, the focus of any future turn-around must be December 31, 2020, i.e. the continued applicability of the COVInsAG rules may continue to provide

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some respite until then. If the company is found to be illiquid, the remaining time until September 30, 2020 must be used productively to either restore future liquidity via external or internal funding in the shortness of the available time or the filing for insolvency in early October 2020 becomes inevitable and should be prepared.

Managing directors of illiquid companies that do not file for insolvency without undue delay, but continue trading regardless of the insolvency reason, will again face the twin risks of personal civil and criminal liability based on a delayed or omitted filing. They and their trading partners and creditors, furthermore, face the full power of the far-reaching array of insolvency contestation rights (*Insolvenzanfechtungsrechte*) for a subsequent insolvency administrator of any measures now taken outside of the protective force of the COVInsAG interim rules.

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The following Gibson Dunn lawyers have prepared this client update: Lutz Englisch, Birgit Friedl, Marcus Geiss.

Gibson Dunn's lawyers in the two German offices in Munich and Frankfurt are available to assist you in addressing any questions you may have regarding the issues discussed in this update.

For further information, please feel free to contact the Gibson Dunn lawyer with whom you usually work, or the three authors:

Lutz Englisch (+49 89 189 33 150, lenglisch@gibsondunn.com)

Birgit Friedl (+49 89 189 33 122, bfriedl@gibsondunn.com)

Marcus Geiss (+49 89 189 33 115, mgeiss@gibsondunn.com)

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