

# Introduction to German Insolvency Law<sup>1</sup>

The insolvency law in Germany has been subject to radical changes during the last years. For almost two decades a reform of the national bankruptcy law, codified in the Bankruptcy Act of 1877, was discussed and prepared. Finally, in 1999 the new Insolvency Statute came into force. But the changes are still going on.

## A. The New Insolvency Statute (Insolvenzordnung)

Since the Bankruptcy Act of 1877 („Konkursordnung“) the Insolvency Law in Germany always had a special importance. The main purpose of insolvency proceedings in Germany was and still is the common realization of the liability of the debtor's property. The creditor loses the right to achieve a privileged satisfaction by execution. Instead a compulsory mobilization of the debtor's assets and the even distribution of the proceeds among the creditors take place<sup>2</sup>.

In 1999 an absolutely new era of insolvency law has started in Germany. After almost 20 years of discussions, hearings and negotiations the Insolvency Statute (Insolvenzordnung (InsO)) has replaced the Bankruptcy Act (Konkursordnung) and the Settlement Act (Vergleichsordnung) in the West German States and the Total Execution Act (Gesamtvollstreckungsordnung) in the East German States. The former bankruptcy law had largely proven to be unfunctioning<sup>3</sup>. Under the Insolvency Statute the preconditions for the opening of insolvency proceedings should be formed in a way that would allow to open more insolvency proceedings than under the Bankruptcy Act (under the Bankruptcy Act 84 % of the requests to open bankruptcy proceedings were dismissed because of the lack of sufficient assets). The introduction of a possible self-administration of the debtor under the supervision of a court appointed custodian by the Insolvency Statute<sup>4</sup> was supposed to facilitate the decision for a timely beginning of insolvency proceedings. The law of avoidance was intensified<sup>5</sup>. Moreover the insolvency proceedings are now much more determined by the autonomy of the creditors. Another basic change is that the secured creditors now take part in the insolvency proceedings. They join the meeting of creditors and are entitled to vote. Finally the Insolvency Statute for the first time contains proceedings by which a debtor if he is a natural person can receive a discharge (Restschuldbefreiung)<sup>6</sup>. All main court decisions are published and can be researched in the internet<sup>7</sup>.

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<sup>1</sup> This article bases on an essay which was published in the "International Company and Commercial Law Review" (publisher: Sweet & Maxwell, London) in the year 2002, page 427, by Dr. Andreas Remmert.

<sup>2</sup> For an extensive commentary on the former Bankruptcy Act see Kuhn/Uhlenbruck, Konkursordnung, 11th ed. Munich 1994

<sup>3</sup> For the legislative background and history see Balz/Landfermann, Die neuen Insolvenzgesetze, Düsseldorf 1995

<sup>4</sup> §§ 270 pp. InsO

<sup>5</sup> §§ 129 pp. InsO

<sup>6</sup> §§ 286 pp. InsO

<sup>7</sup> [www.insolvenzbekanntmachungen.de](http://www.insolvenzbekanntmachungen.de)

## **B. Survey of the typical course of insolvency proceedings**

### **I. Opening proceedings**

Insolvency proceedings can only be opened if a request is filed at the first instance court (Amtsgericht) which is competent for the debtor's place of residence respectively - if he is a businessman - for the debtor's place of business<sup>8</sup>. Further an insolvency reason is necessary<sup>9</sup>. Different to the insolvency laws of other countries the German Insolvency Statute is not confined only to merchants. Insolvency proceedings on the contrary can be opened regarding the estate of every natural person, legal entity, personal company or partnership<sup>10</sup>.

The request can either be filed by the debtor or a creditor. If it is based on the insolvency reason of imminent illiquidity only the debtor has the right to file a request. Did a creditor file a request concerning a debtor who is a natural person and runs no business (consumer), the court must give the debtor the opportunity to file an own request. If the debtor does so the opening proceedings can be suspended by the court and the judicial „Schuldenbereinigungsplanverfahren“ can take place<sup>11</sup> which can best be translated with „settlement-plan proceedings“. If the settlement-plan proceedings are successful and the creditors accept the plan, this will be confirmed by a court order and the former requests will be considered to be withdrawn.

If the settlement plan – proceedings are not successful or if the court has decided against such proceedings<sup>12</sup> the court has to decide on the opening of the insolvency proceedings. The opening requires an insolvency reason. The Insolvency Statute in general admits two insolvency reasons:

- the illiquidity<sup>13</sup>, i.e. the inability to pay the due obligations and
- the overindebtedness<sup>14</sup>, which requires that the assets of the debtor do not cover his obligations. The overindebtedness is only an insolvency reason for legal entities and not for natural persons.

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8 In Northrhine-Westfalia the jurisdiction is concentrated at the (19) first instance courts of Aachen, Arnberg, Bielefeld, Bochum, Bonn, Detmold, Dortmund, Düsseldorf, Duisburg, Essen, Hagen, Köln, Kleve, Krefeld, Mönchengladbach, Münster, Paderborn, Siegen and Wuppertal.

9 §§ 16 pp. InsO

10 §§ 11 pp. InsO

11 §§ 305 pp. InsO

12 It is up to the discretion of the court whether settlement-plan-proceedings shall take place. The court decision depends on the chances of success of such proceedings.

13 § 17 InsO

14 § 19 InsO

It was the intention of the legislator that more proceedings can be opened. Therefore another insolvency reason was introduced: the imminent illiquidity<sup>15</sup>. By this means the opening of the proceedings was intended to be placed on an earlier date when more assets of the debtor are on hand and a rehabilitation or reorganization of his enterprise may be of more success.

During the period until the opening decision the court has to take all necessary measures to prevent any detrimental changes of the debtor's assets. Section 21 of the Insolvency Statute offers a catalogue of such measures. In particular the court can impose a general prohibition of transfers against the debtor. Any execution against the debtor can be either forbidden or stayed. And above all the court can appoint a temporary administrator. The rights and duties of such a temporary administrator differ depending on whether the court has imposed a general prohibition of transfers against the debtor or not. If it has done so the temporary administrator has the full right to manage and to transfer the debtor's assets (so-called "strong" temporary administrator)<sup>16</sup>. This means that he can take possession of the debtor's assets, continue the debtor's business and – within certain limits – sell the debtor's goods and collect the claims the debtor has against others.

If the court appoints a temporary administrator without imposing a prohibition of transfers against the debtor, the court itself can determine the single duties and rights of the temporary administrator (so-called "weak" temporary administrator). But they cannot reach as far as in the case of a prohibition of transfers.

If an insolvency reason exists the insolvency proceedings have to be opened if the assets of the debtor cover the costs of the proceedings<sup>17</sup>. The „costs of the proceedings“ include only the court fees, the remuneration and expenses of the temporary administrator, of the final administrator and of the members of the creditors' committee<sup>18</sup>. The other costs of the insolvency administration do not belong any more to the „costs of the proceedings“. Therefore they do not have to be covered by the debtor's assets as a precondition of the opening of the proceedings. Here again one can see the intention of the legislator to get more proceedings opened than under the regime of the Bankruptcy Act.

If the request to open insolvency proceedings is dismissed by the court because of a not-cost-covering bankruptcy estate this will lead to dissolution if a company is concerned, or to a registration at the court record of debtors (so-called „black list“) for five years if the debtor is a natural person.

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15 § 18 InsO

16 § 22 InsO

17 § 26 InsO

18 § 54 InsO

## II. The opened insolvency proceedings

If insolvency proceedings are opened the court will appoint an administrator and determine the date of the first meeting of creditors, the so-called „report meeting“, in which the creditors have to decide about the further development of the proceedings<sup>19</sup>. Simultaneously with the opening of the proceedings the debtor loses the right to manage and transfer his assets. This right passes over to the administrator<sup>20</sup>.

The right to manage and transfer the assets concerns the bankruptcy estate. The term „bankruptcy estate“ now encompasses much more than it did under the rule of the Bankruptcy Act. At that time it only consisted of the estate which was owned by the debtor at the time of the opening of the proceedings. Under the Insolvency Statute the acquisitions which are made by the debtor during the proceedings are also part of the bankruptcy estate<sup>21</sup>.

When the proceedings are opened the creditors can file their claims with the administrator<sup>22</sup>. The rights of the creditors were totally rearranged by the Insolvency Statute. The law now only knows three groups of claims/obligations:

- the estate obligations,
- the normal insolvency claims and
- lower-ranking claims.

„Estate obligations“<sup>23</sup> are

- the costs of the proceedings,
- those obligations created by activities of the administrator or the temporary administrator to whom the debtor's right to transfer was vested,
- obligations under mutual contracts, if their performance either is claimed by the administrator or has to take place after the opening of the proceedings and
- obligations due to unjust enrichment of the estate.

In comparison to the Bankruptcy Act the catalogue of the estate obligations was reduced. Furthermore the costs of the liquidation of the estate are not “proceedings costs” anymore. This has led to a higher number of openings of insolvency proceedings because it is a precondition of the opening that the proceedings costs are covered.

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19 §§ 27 pp. InsO

20 § 80 InsO

21 § 35 InsO

22 § 28 InsO

23 §§ 54 pp. InsO

The estate claims still have to be fully satisfied before anything can be paid on insolvency claims<sup>24</sup>. But as the catalogue of the estate claims was reduced there are more proceedings in which usual insolvency creditors can receive at least some satisfaction. There are no priorities within the group of normal insolvency claims anymore. If the estate is not sufficient to fully satisfy all of them - which is usually the case - an equal percentage will be paid on each claim.

Lower-ranking claims<sup>25</sup> are

- the interest accruing on the insolvency claims from the opening of the proceedings,
- costs incurred by creditors due to their participation in the proceedings,
- fines and similar claims,
- claims to the debtor's gratuitous performance and
- certain claims of partners of insolvent companies.

Corresponding to the aim of the reform to strengthen the autonomy of the creditors, the highest organ of the insolvency proceedings is the meeting of creditors<sup>26</sup>. During their first meeting the creditors can for example replace the court appointed administrator and elect another one<sup>27</sup>. All other essential decisions concerning the proceedings are either made by the meeting of creditors or by the creditors' committee<sup>28</sup>. The meeting of creditors particularly decides whether the debtor's enterprise shall be closed or continued<sup>29</sup>. The administrator has to ask for the consent of the creditors' committee or – if no committee is appointed – for the consent of the meeting of the creditors concerning all transactions which are of particular importance<sup>30</sup>. This of course includes the decision whether an enterprise shall be sold or not.

The task of the creditors' committee is to support and to monitor the administrator<sup>31</sup>. It can be established by the court before the first meeting of creditors<sup>32</sup>. Later the meeting of creditors will decide whether the committee shall be maintained, changed in its composition or established, if no committee was established by the court<sup>33</sup>.

The claims of the creditors have to be filed with the administrator<sup>34</sup>. He has to enter them in an insolvency schedule<sup>35</sup>. During the so-called verification meeting the

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24 § 53 InsO

25 § 39 InsO

26 §§ 74 pp. InsO: "creditors' assembly"

27 § 57 InsO

28 For the creditors' committee see §§ 67 pp. InsO

29 § 157 InsO

30 § 160 InsO

31 § 69 InsO

32 § 67 InsO

33 § 68 InsO

34 § 28 InsO

35 § 175 InsO

amount and the rank of the filed claims are verified<sup>36</sup>. If there are no denials of the administrator or any creditor the claims are deemed to have been determined<sup>37</sup>. Denials and determinations are entered into the insolvency schedule. Concerning the determined claims the entry in the table has – concerning amount and rank - the same effect as a final judgement with respect to the administrator and the creditors<sup>38</sup>. Has a claim been denied by the administrator or a creditor it is up to the creditor of the denied claim to initiate proceedings to determine such claim against the denying party<sup>39</sup>.

After the verification meeting the distribution can start<sup>40</sup>. It follows a distribution record which is established by the administrator<sup>41</sup>. As soon as the distribution of the debtor's assets is carried out, the court decides on the termination of the insolvency proceedings<sup>42</sup>.

### III. The insolvency plan proceedings

The insolvency plan is one of the cores of the new German insolvency law. The autonomous mastering of the insolvency by the creditors and the debtor is not any more subject to separate proceedings but part of uniform insolvency proceedings. Within these proceedings it is one of several courses which can be followed on the search for the best opportunity to satisfy the creditors' claims<sup>43</sup>. This uniform system is different from other insolvency laws like for example the U.S. Bankruptcy Code which demands a decision between the liquidation proceedings of Chapter 7 and the plan proceedings of Chapter 11. Nevertheless there are also many similarities between the insolvency plan proceedings of the German Insolvency Statute and the provisions of Chapter 11.

The law does not define the purpose of the insolvency plan. The parties are allowed to diverge from the provisions of the Insolvency Statute and to find a different solution. Therefore the insolvency plan can even provide a liquidation although it was introduced mainly to preserve, to rehabilitate and to reorganize the enterprise of the debtor.

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36 § 176 InsO

37 § 178 InsO

38 § 178 InsO

39 § 179 InsO

40 §§ 187 pp. InsO

41 § 188 InsO

42 § 200 InsO

43 Provisions concerning the plan proceeding can be found in §§ 217 pp. InsO

An insolvency plan can be set up and submitted to the court only by the debtor or the administrator<sup>44</sup>. The plan has to consist of a declaratory and a constructive part<sup>45</sup>. In the declaratory part the rehabilitation concept is described. The constructive part determines the impacts of the rehabilitation on the single rights and claims of the creditors. One of the most important principles of the insolvency plan is that the creditors are divided into groups<sup>46</sup>. The creditor groups can be treated differently by the plan if a justifying reason exists. The plan for example can form different groups for secured creditors, for normal insolvency creditors, for those creditors whose claims rank behind the claims of the normal insolvency creditors and for the employees. The number of groups is not limited. It is up to the fantasy of the person who is setting up the plan. The only demand is that there has to be a justifying reason if two creditors are put into two different groups.

The insolvency plan needs the consent of the creditors<sup>47</sup>. It has to be presented to them in a meeting during which the plan is discussed. At the end of that meeting the creditors decide on the adoption of the plan. They vote by groups. The plan is adopted if in each group the majority of the voting creditors backs the plan and if the sum of the claims of the creditors backing the plan exceeds half of the sum of all claims of the voting creditors<sup>48</sup>. There is however a prohibition of obstruction, which shall prevent that an economically sensible plan fails because of the opposition of a single or a few creditors: If in one group the majority is not achieved that group is deemed to have consented if the creditors of that group are not treated worse by the plan than they would be without the plan. Moreover the majority of the groups must have backed the plan<sup>49</sup>.

The debtor has to back the plan, too. He is deemed to have consented if he has not opposed the plan until the voting of the creditors. If he is not treated worse than he would be without the plan his opposition to the plan is irrelevant<sup>50</sup>.

Finally the plan has to be confirmed by the court<sup>51</sup>. After the decision of the court has got legally binding, the plan gets effective, the insolvency proceedings are terminated and the debtor recovers the power to transfer his assets. The constructive part of the insolvency plan may provide for surveillance of implementation of the plan by the administrator<sup>52</sup>.

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44 § 218 InsO

45 §§ 219 pp. InsO

46 § 222 InsO

47 §§ 235 pp. InsO

48 § 244 InsO

49 § 245 InsO

50 § 247 InsO

51 § 248 InsO

<sup>52</sup> §§ 260, 261 InsO

## IV. Consumer insolvency proceedings and discharge of debts

The Insolvency Statute provides a special insolvency proceedings for consumers<sup>53</sup>. The provisions include three steps: the attempt of an extra-judicial settlement of debts, the judicial settlement plan–proceedings and the simplified insolvency proceedings with the subsequent discharge proceedings.

### 1. Step: Attempt of extra-judicial settlement

Before the consumer debtor can file an insolvency request, he first has to attempt to achieve an extra-judicial settlement with his creditors<sup>54</sup>. One of the reasons of this obligation is that the courts shall not be charged with too many insolvency proceedings which usually require very high efforts of all who are concerned with them. The law demands that the debtor has to present a certificate of a so-called „suitable person or agency“. The certificate has to state that within the last six months an attempt to reach an extra-judicial agreement with the creditors on the basis of a settlement plan has failed. The federal states can determine which preconditions an agency or person has to meet to be regarded as „suitable“ according to the law. Suitable agencies are for example the debtor advisory agencies of the welfare organisations. Suitable persons are mainly the lawyers.

### 2. Step: The judicial settlement plan – proceedings

If the extra-judicial attempt to reach a settlement with the creditors fails, the debtor can file a request to open insolvency proceedings<sup>55</sup>. Besides the certificate of the suitable agency or person he has to submit a settlement plan and records of his assets and his income, his creditors and his debts. The settlement plan has to contain all provisions which are suited for an appropriate settlement of the debts. It can be identical with the plan on which the debtor' s extra-judicial settlement attempts were based. The courts accept even a so-called „zero-plan“. These are settlement plans of debtors with no income and no assets which provide no payments to the creditors. The effect of the acceptance of the „zero-plans“ by the courts is that debtors either in the settlement plan - proceedings or at the latest after the six years of the discharge proceedings can be freed of their debts even if they cannot pay anything to their creditors.

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53 §§ 304 pp. InsO

54 See § 305 Paragraph 1 Nr. 1 InsO

55 § 305 InsO

After reviewing the documents submitted by the debtor the court decides whether a court guided second attempt to reach a settlement between the debtor and the creditors could be successful<sup>56</sup>. If it decides in favour of settlement-plan-proceedings, it serves the plan and an overview over the assets and the income of the debtor on all creditors who are named by the debtor. The creditors have the opportunity to comment on the settlement plan and the other documents submitted by the debtor. If all creditors consent to or do not object to the plan within a month the plan is deemed to be approved<sup>57</sup>. If the majority of the creditors has approved the plan and if the sum of their claims exceeds half of the total sum of the claims of the named creditors, the court can replace the objections of the other creditors under certain preconditions<sup>58</sup>.

If the majority of the creditors object to the plan, the settlement plan - proceedings end and the insolvency proceedings will be opened.

### 3. Step: Insolvency and discharge proceedings

After the failure of judicial settlement plan – proceedings and if the bankruptcy estate covers the costs of the proceedings, the insolvency proceedings will be opened<sup>59</sup>. The court appoints a trustee who liquidates the estate of the debtor and distributes the proceeds among the creditors. After that a period of 5 - 6 years<sup>60</sup> starts during which the debtor has to transfer all his attachable wage claims to a trustee to be appointed by the court<sup>61</sup>. The trustee distributes the collected money among the creditors once in a year. Wage assignments or wage pledges of the debtor remain valid for a period of two years after the opening of the insolvency proceedings<sup>62</sup>. Only after this period the trustee can seize the attachable part of the wages.

After six years the court will decide on the discharge of debts. The discharge shall only be for the benefit of honest debtors. Therefore - on request of a creditor - the discharge will be refused if the debtor for example<sup>63</sup>:

- is convicted for a bankruptcy crime,
- within the last three years before the opening of the proceedings,

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56 § 306 InsO

57 § 308 InsO

58 § 309 InsO

59 See above and § 26 InsO

60 § 287 InsO: The period lasts six years, but it starts already with the opening of the proceeding.

61 §§ 286, 287 InsO: The provisions are not only valid for consumers but for all natural persons who apply for a discharge.

62 § 114 InsO

63 in detail see § 290 InsO

- made false statements to obtain a loan or grants from public funds or to avoid making payments to public funds,
- obtained discharge of debts within the last ten years or
- neglected his information and co-operation duties during the proceedings.

The discharge has the effect that the debtor is freed from all debts except

- from claims to maintenance which arose during the insolvency proceedings<sup>64</sup>,
- from obligations of the debtor incumbent on him under a tort by wanton act, insofar as the creditor has stated this legal reason when filing the corresponding claim with the administrator,
- from fines and
- from interest-free loans granted to the debtor to pay the costs of the insolvency proceedings<sup>65</sup>.

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64 § 40 InsO

65 § 302 InsO