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KIRKLAND **ALERT**

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Landmark Court Opinion Increases Liability Risk Profile for German Portfolio Company Management

The German Supreme Court,[1] in an opinion published January 31, 2018, has tightened the rules for determining when a company is "cash flow insolvent" and by extension for determining when a director of a German company has a civil and criminal law obligation to file the company for bankruptcy.

Failure to file a company for bankruptcy promptly or, at the latest, within 21 days of the occurrence of cash flow insolvency can subject directors to civil liability to harmed creditors, civil and criminal fines and, in worst cases, jail time.

I. What is "Cash Flow Insolvency"?

Section 17 of the German Insolvency Code (the "German Code") defines "cash flow insolvency" as having occurred if a company is not in a position to fulfil its due and payable obligations. Current Supreme Court case law interprets that to mean that a company generally is "cash flow insolvent" if it has a payment shortfall of 10% or more and is "cash flow solvent" if the payment shortfall does not exceed that amount (the "10% Rule").[2]

Further, § 17 creates a rebuttable presumption that a company is "cash flow insolvent" if it generally has ceased making payments. A finding of "cessation of payments" (*Zahlungseinstellung*) is not a formulaic rules-based determination: It can be demonstrated by circumstances, largely based on the company's own behavior,[3] that cause third parties to have the impression that the company has discontinued payments generally.[4] The company and its directors can rebut the presumption of "cash flow insolvency" created by a "cessation of payments" only by showing that the company was in fact "cash flow solvent" under the 10% Rule.

II. Why Does "Cash Flow Insolvency" Matter to Directors?

Pursuant to § 15a of the German Code, directors of a German company have an obligation to file a company for bankruptcy if the company is, *inter alia*, cash flow insolvent.[5] Failure to file a company for bankruptcy promptly or, at the latest, within 21 days of the occurrence of cash flow insolvency can subject directors to civil liability to harmed creditors,[6] civil and criminal fines and, in worst cases, jail time.[7] In addition, German imposes a "wrongful trading" regime[8] on directors under which directors are personally liable to the company (or its bankruptcy estate) for payments made after incurrence of insolvency to the extent such payments are not made with "due care," which is a high bar to achieve under German corporate law.[9]

III. What Did the German Supreme Court Decide?

To date, the Supreme Court had left a critical interpretational issue unresolved with respect to the cash flow insolvency determination, namely, which liabilities should a court consider in determining whether the company has breached the 10% Rule? When assessing the payment shortfall, directors are required to determine the amount of the company's liquid assets and those assets that the company easily can

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liquidate within three weeks.[10] This view is settled law.[11] Prior to the court's opinion however, it was unclear whether directors were required to compare the amount of liquid assets to (a) only those liabilities that were due and payable on the relevant liquidity testing date[12] or (b) ***all*** liabilities coming due and payable during the following ***three-week period***.[13]

Ultimately, the German Supreme Court took the latter, more expansive view, thus extending the scope of potentially relevant liabilities that could cause a breach of the 10% Rule, and thereby trigger a bankruptcy filing duty.

Ultimately, the German Supreme Court took the latter, more expansive view, thus extending the scope of potentially relevant liabilities that could cause a breach of the 10% Rule, and thereby trigger a bankruptcy filing duty.[14] Specifically in the case at bar, a bankruptcy trustee had sued a director for damages of EUR 4.7 million on account of payments that the director had made subsequent to alleged occurrence of "cash flow insolvency." In his defense, the director argued, among other things, that the company had EUR 4.5 million of aggregate liquid assets and only EUR 3.5 million in liabilities due ***on the liquidity testing date***. Contesting that defense, the bankruptcy trustee argued that an additional EUR 2.9 million in liabilities ***coming due in the three weeks subsequent to the liquidity testing date*** needed to be considered. The Frankfurt appellate court ruled for the director. The Supreme Court reversed and remanded, holding that the EUR 2.9 million in liabilities coming due during the subsequent three-week period needed to be included for purposes of the 10% Rule. Inclusion of those liabilities would cause a payment shortfall of over 30%.

The result is a harsh one for the director: Assuming the lower courts find that the EUR 4.7 million in payments were not made with "due care" (which is a high bar under German law, as noted above) the director could be held liable for those amounts.

IV. What is the Practical Impact of the Court's Decision?

The result of the German Supreme Court's decision is that, in future, directors will need to monitor daily, on a go-forward basis, the liabilities due on the relevant testing date ***plus*** those liabilities coming due in the three weeks following that date and compare those liabilities to the company's available cash and cash equivalents on that date.

Other relevant aspects that directors will need to consider in connection with the opinion are:

First, the obligation to test "cash flow solvency" kicks in only on the date that a payment shortfall occurs.[15] In other words, even where the company anticipates that it may experience a payment shortfall in future, until that payment shortfall date has arrived and the company is continuing to perform its obligations, it is not required to test whether the 10% Rule has been exceeded. Nothing in the court's opinion changes that result. However, where a company knows that, ultimately, it is unlikely going to be in a position to satisfy that payment, it potentially may lack a "going concern," and thus, be required to file for bankruptcy.[16]

Second, a company can redress "cash flow insolvency," once it has occurred, only by resuming payments again, as a general matter. This means specifically, that the company must be in a position to pay new obligations that have arisen in the interim, in addition to those that caused its payment shortfall to exceed 10%.[17]

Finally, matters such as those that came before the court often occur while a company is engaging in restructuring negotiations with its creditors. The mere fact that these negotiations are occurring and even in instances where the success of those negotiations is likely will ***not*** relieve directors of their obligation to file to the extent "cash flow insolvency" has occurred under the 10% Rule described above. Unless the relevant creditors, factually or pursuant to binding agreements, have agreed to waive their otherwise due and payable claims or unless the company has obtained committed financing that can and is nearly certain to be funded during the relevant period or in the "near term", the bankruptcy filing duty will still trigger. Notably, the German Supreme Court repeated its settled jurisprudence on this issue, holding that directors seeking to show that a creditor has not earnestly demanded payment (*ernsthaftes Einfordern*) is a high bar to meet, essentially requiring a legally binding or *de facto* payment deferral or waiver.

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1 *See* Sp. Ct. Judgment (*Bundesgerichtshof*), Case No. II ZR 88/16 (Dec. 19, 2017).

2 *See* Sp. Ct. Judgment, Case No. IX ZR 123/04 (May 24, 2005). Even if the payment shortfall is less than 10%, a court will find a company to be "cash flow insolvent" if it's likely that the payment shortfall will exceed 10% in the near term. *Id.* In turn, if the payment shortfall exceeds 10%, but it's nearly certain that the company will be able to close the payment gap in the near term, a court will find that the company is "cash flow solvent"; as long as it's reasonable under the circumstances for creditors to wait for repayment. *Id.* What constitutes "near term" depends on the circumstances, including seasonal liquidity impacts in certain industries and macroeconomic events, all of which go into a determination of whether the company can show it has a positive economic forecast. *Id.* Generally, however, near term means no more than three months and, at the very most, six months. *See* Mock in: Uhlenbruck German Insolvency Code § 17 ¶ 28. To the extent the 10% Rule is not triggered and, based on these principles, the company is not "cash flow insolvent," a court will find that the company is undergoing temporary "payment difficulties" (*Zahlungsstockung*).

3 *See* Sp. Ct. Judgment, Case No. IX ZR 242/13 (March 24, 2016).

4 *See* Sp. Ct. Judgment, Case No. IX ZR 134/10 (June 30, 2011). Even the nonpayment of a single non-immaterial invoice can suffice to show "cessation of payments" and thus trigger the presumption of "cash flow insolvency." *Id.* Moreover, a single creditor's cognizance of the alleged "cessation of payments" likewise can suffice; it is not necessary that creditors generally are aware. *See* Sp. Ct. Judgment, Case No. IX ZR 4/84 (Jan. 10, 1985). And the company's satisfaction of other, even material, obligations, does not suffice to rebut a finding that a "cessation of payments" has occurred. *See* Sp. Ct. Judgment, Case No. IX ZR 134/10 (June 30, 2011).

Further, importantly, other indicia can be relied on to find that a "cessation of payments" has occurred. These include: payment only after threat of delivery stop or foreclosure; months'-long failure to respond to payment demands; payment delays; sudden increases in due and payable arrears; non-payment of claims held by critical vendors; requests for uncustomary or non-market payment deferrals and alternative payment plans; closure of operations; providing declaratory statements implying cessation of payments; surrendering of goods that are subject to retention of title claims. *See* Schröder in: Hamburg Commentaries § 17 (2017) ¶¶ 29a et seq. (collecting sources).

5 *See* § 15a German Insolvency Code. For a German limited, the persons subject to the obligation are all members of management (*Geschäftsführung*); for a German stock corporation, all manage-

ment board members (*Vorstand*). *See* § 15a para. 1 German Insolvency Code. If management (for a limited) or the management board (for the stock corporation) have resigned, the shareholders (for a limited) or the supervisory board (*Aufsichtsrat*) (for a stock corporation) have the obligation to file to the extent they have knowledge of the insolvency. *See* § 15a para. 3 German Insolvency Code.

6 *See* § 15a German Insolvency Code; § 823 German Civil Code. Civil damages are assessed on the basis of the measurement of harm suffered by creditors of an entity caused by the directors' failure to file (or delay in filing) the entity for insolvency. German remedies law differentiates between so-called "old creditors" (*Altgläubiger*) and "new creditors." (*Neugläubiger*). "Old creditors" are those whose claims arose prior to an entity's insolvency (and thus, director's filing duties) having arisen and are limited to the recovery in insolvency that they *would have* received had the directors timely filed for insolvency. *See* H.-F. Müller in: Munich Commentaries German Limited Company Act (2016) § 64 ¶ 206 Fn. 596 (*citing* Sp. Ct. Judgment, Case No. II ZR 146/96 (March 30, 1998). "New creditors" are those whose claims arose after an entity's insolvency (and thus, director's filing duties) have arisen (i.e., those who entered into new or continued to do business with the debtor subsequent to occurrence of insolvency but prior to the filing) and can assert their entire loss against directors. *See* Hirte in: Uhlenbruck German Insolvency Code (2015) § 15a ¶ 40.

7 § 15a para. 4 German Insolvency Code.

8 *See* § 64 sent. 1 German Limited Company Act. These rules apply both to a German limited liability company as well as a German stock corporation. *See* § 93 para. 2 German Stock Company Act. Further, the supervisory board of a German stock corporation as well as that of a German limited liability company (to the extent it is required by law to have one), can be held liable for its failure to undertake measures to prevent management from making payments after occurrence of "cash flow insolvency." *See* §§ 116, 93 para. 2 & 3 German Stock Corporation Act; Sp. Ct. Judgment, Case No. II ZR 280/07 (March 16, 2009); Sp. Ct. Judgement, Case No. II ZR 78/09 (Sept. 20, 2010).

9 Payments not made with due care include: acceptance of payments to an overdrawn bank account (Sp. Ct. Judgment, Case No. II ZR 310/05 (Mar. 26, 2007) unless the receivables had been assigned as collateral (Sp. Ct. Judgment, Case No. II ZR 394/13 (Jan. 26, 2016); payments of the employers' portion of social security contributions (Sp. Ct. Judgment, Case No. II ZR 147/08 (Jun. 8, 2009); payment for services (i.e., not hard assets) including employee services (Sp. Ct. Judgment, Case No. II ZR 319/15 (Jul. 4, 2017); payment for goods with little value, such as consumer goods (Sp. Ct. Judgment, Case No. II ZR 319/15 (Jul. 4, 2017).

10 *See e.g.* Sp. Ct. Judgment, Case No. IX ZR 123/04 (May 24, 2005). These assets can include credit commitments and trade receivables sufficiently likely to be recovered during the three weeks. *See* Sp. Ct. Judgment, Case No. IX ZR 313/97 (Dec. 3, 1998).

11 Mock in: Uhlenbruck German Insolvency Code § 17 ¶ 39 (collecting sources).

12 *See* Hamburg Appellate Court Judgment, Case No. 11 U 48/08; G. Fischer, Ganter Comm. Publ. 2010 at 153, 158; Becker/Jansen/Müller DStR 2009, 1660, 1661; Bruns EWiR 2006, 767, 768.

13 *See* Sp. Ct. Judgment, Case No. II ZR 88/16 (Dec. 19, 2017) ¶ 40 (collecting sources).

14 *See* Sp. Ct. Judgment, Case No. II ZR 88/16 (Dec. 19, 2017).

15 IDW S11 ¶ 24, ZInsO 2015, 1136.

16 Specifically, §§ 19 and 15a of the German Code require directors to file a company for bankruptcy

if the company is "balance sheet insolvent." A company is "balance sheet insolvent" if its liabilities exceed its assets *unless* it is likely that it has a going concern. It has a going concern, generally, if it is more likely than not to remain cash flow solvent over the current and following fiscal year. *See* Fischer NZI 2016, 665, 666; Bitter/Kresser ZIP 2012, 1733, 1737 Fn. 31 (collecting sources).

[17] Sp. Ct. Judgment, Case No. IX ZR 93/06 (Dec. 20, 2007).

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