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German Insolvency Law

Overview on Insolvency Challenge Rights

The most important principle of the German insolvency law is the equal treatment of the creditors of the insolvency debtor. To satisfy their claims, the creditors are entitled to receive satisfaction from the debtor's insolvency estate. The insolvency estate consists of the entire assets of the debtor belonging to it at the time the insolvency proceeding is opened and the ones obtained during the proceeding.

In order to increase the insolvency estate, insolvency challenge rights enable the insolvency administrator or – in case of self-administration proceedings – the insolvency trustee (*Sachwalter*) to have certain transfers of assets, which have reduced the insolvency estate to the detriment of individual or all creditors, reversed. The challenge of transactions therefore in particular takes into account that it is often attempted in pre-insolvency phases to deprive the creditors of access to the debtor's assets by way of objectively unjustified transfers of assets or to put individual creditors in a better position.

BASIC PRINCIPLES

The insolvency administrator is in general entitled to challenge all legal acts taken prior to the filing for insolvency and which place the creditors at a disadvantage.

1. Legal Act

The term "legal act" has to be interpreted broadly, in order to expose as far as possible all disadvantageous measures, with the exception of mere accidental changes in assets, to challenge rights. It includes any action which has a legal effect, e.g., promissory contracts, contractual obligations, real acts (*Realakte*), acts of legal procedure, resolutions taken by corporate bodies, but also omissions. It is not necessary for an asset of the debtor to be permanently removed from his assets by a legal act. Rather, temporary sacrifices of assets, such as the provision of collateral, are also sufficient.

2. Placing Creditors at a Disadvantage

The placement of creditors at a disadvantage must be assumed if the challenged legal act has limited the creditors' possibilities to satisfy their claims. A disadvantage can be given in case of a decrease in assets, an increase of liabilities, an aggravation of access possibilities or an aggravation or a delay of enforceability. The challenge rights partly differentiate between direct and indirect disadvantages. A direct disadvantage is given where the disadvantages relating to a transaction occur in the debtor's assets without further circumstances, e.g., the sale of an asset below value. In contrast, an indirect disadvantage exists if, besides the transaction itself, additional circumstances arise that cause the adverse effect on the creditors. For example, this is the case where the debtor in fact receives an equivalent consideration which, however, is irrecoverable.

3. Privilege of Cash Transaction

a) General

The exchange of equivalent values in form of a so-called cash transaction (*Bargeschäft*) is privileged (Section 142 German Insolvency Code (InsO)). Thus, the InsO in general excludes challenge rights in the case of a cash transaction.

Such a cash transaction exists if the debtor's assets directly receive an equivalent consideration for the debtor's performance.

In case of employee salaries, such close connection in time shall, e.g., be given, if the time between work performance and payment of the remuneration does not exceed three months.

The burden of proof for the existence of a cash transaction lies with the addressee of the challenge right.

b) Exceptions to the Privilege of Cash Transaction

Exceptions to the privilege of cash transaction apply with respect to a challenge due to willful disadvantages and, according to settled case law, in case of a challenge due to incongruent coverage.

In case of a challenge due to willful disadvantages, the privilege for cash transactions is not excluded in general, but only if the debtor has acted unfairly and the addressee has realized such unfairness. Therefore, a challenge of cash transactions is only possible in case of a targeted disadvantaging of creditors.

The assumption of unfairness may only be drawn considering high requirements. Examples are the intent of the debtor to cause damage, the dissipation of assets or the unload of company assets required for continuation of the business.

The burden of proof for any placement of the creditors at a disadvantage as well as the unfairness lies with the insolvency administrator. In this regard, however, the law provides for several alleviations of the burden of proof.

4. Related Parties

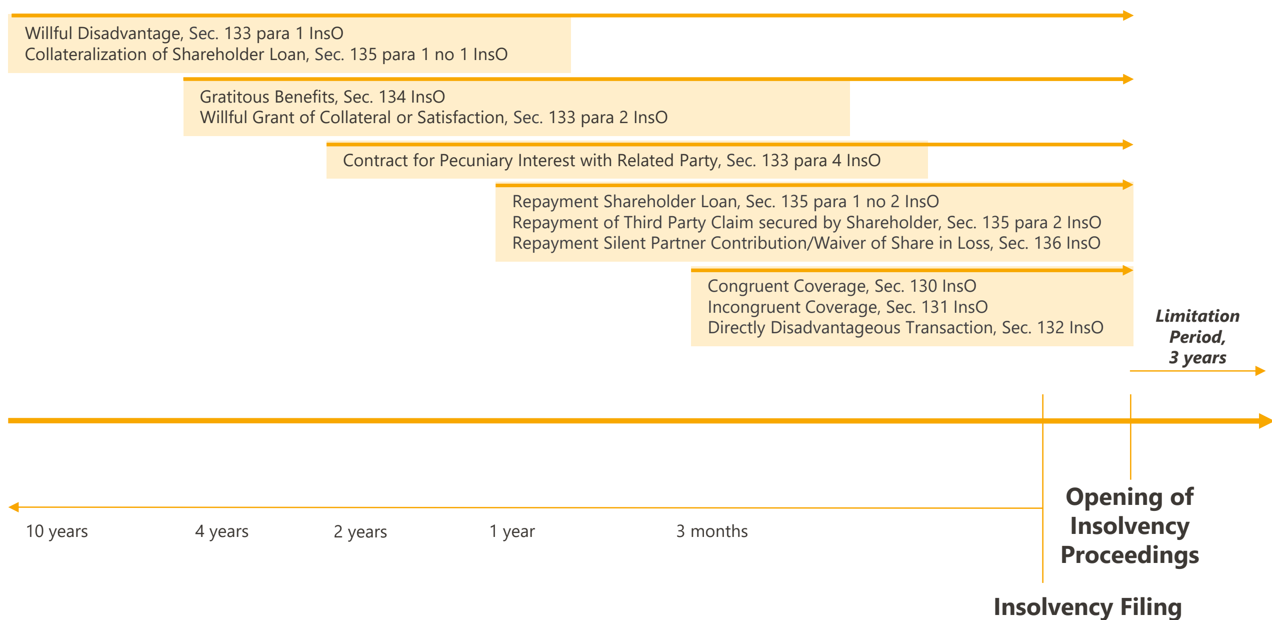
In the event that the transaction was concluded between the debtor and one of its related parties (*nahestehende Person*), less stringent requirements for a challenge apply. These parties normally have better opportunities to be informed about the financial circumstances of the debtor and are, by experience, more likely willing to collaborate with the latter to the detriment of the creditors. If the debtor is a natural person, related parties are, inter alia, spouses or relatives. Related parties of a corporate entity are, in particular, members of the management or supervisory board and personally liable shareholders. Furthermore, persons who have the opportunity to inform themselves about the financial circumstances of the debtor due to a relation under corporate law or a service contract are related parties to the respective corporate entity, as well as to the debtor.

5. Challenge against Legal Successors

A transaction may also be challenged and enforced against legal successors (Section 145 InsO). This challenge right applies to universal succession (*Gesamtrechtsnachfolge*) as well as to singular legal succession (*Einzelrechtsnachfolge*). Hence, a transaction may be contested against the heir or another universal successor, and also against any other legal successor, if such legal successor (i) was, at the time of his acquisition, aware of the circumstances giving rise to the contestability of his predecessor's acquisition, or (ii) was, at the time of his acquisition, a related party, unless he was at that time unaware of the circumstances giving rise to the contestability of his predecessor's acquisition, or (iii) obtained the object of contestability by way of a gratuitous transfer.

THE INDIVIDUAL CHALLENGE RIGHTS AND THEIR PREREQUISITES

The challenge rights can in particular be ordered according to the time periods during which the challengeable transaction took place prior to the insolvency filing.



As a rule, the shorter the time period between the transaction and the insolvency filing, the lower are the prerequisites for the challenge. The period of the last three months prior to the insolvency filing is generally viewed as particularly critical.

The following challenge rights basically have an equal, independent status, i.e., they do not exclude each other and can be fulfilled simultaneously.

1. Congruent Coverage

Legal acts of the debtor or a third party to which the opposing party (creditor) has a claim at that time in that form and which granted or enabled it to secure or satisfy its claim (congruent coverage) may be challenged by the insolvency administrator under the prerequisites of Section 130 InsO.

Accordingly, a challenge is possible if (i) the legal act to be challenged was performed in the last three months before the application for commencement of insolvency proceedings, (ii) the debtor was illiquid at the time of the act and (iii) the creditor knew of the illiquidity at that time. For the period after the request for commencement of insolvency proceedings, knowledge of the illiquidity or the request for commencement of insolvency proceedings is alternatively sufficient for the challenge right.

From a subjective point of view, the knowledge of the creditor of the illiquidity of the debtor is required. Illiquidity is given when the debtor is not able to pay his debt when due. The addressee of the challenge is deemed to have knowledge of such illiquidity if he has knowledge of the circumstances underlying the illiquidity and in light of common experience had to assume that the debtor will not be able to pay a material portion of his debt. With regard to related parties, there is a rebuttable presumption that they were aware of the illiquidity.

It should be noted that with regard to transactions taking place after the insolvency filing, a challenge is generally even possible if the legal act took place with the knowledge or even the consent of the preliminary insolvency administrator. In such case, however, a challenge by the later insolvency administrator may be precluded for reasons of legitimate expectation and legal certainty.

2. Incongruent Coverage

A challenge according to Section 131 InsO is possible, if the creditor obtains security or satisfaction of his claim without being entitled to such security or satisfaction, or to a security or satisfaction of this kind or at that time (incongruent coverage).

An incongruent coverage exists, for example, in case of the fulfilment of a time-barred claim, in case of the satisfaction of a claim in a manner that deviates from the performance owed pursuant to the underlying contractual obligation or if a creditor receives satisfaction of his claim at that time when it is not yet due. An incongruent coverage, however, is also present where the debtor non-voluntarily satisfies a due claim, such as in case of pressure or threat, in order to prevent the filing for insolvency or the initiation of enforcement proceedings.

In case the legal act to be challenged was performed within the last month prior to the filing for insolvency, there are no further subjective prerequisites for a challenge.

If the transaction occurs in the second or third month prior to the insolvency filing, then the transaction can be challenged if the debtor was illiquid at the time the transaction was effected, or if the creditor was aware at that time that the transaction places the other insolvency creditors at a disadvantage. The creditor is deemed to have such knowledge if, the creditor knew at the time of the transaction, that the transaction will diminish the debtor´s assets, with the result that the debtor's assets will probably no longer be sufficient to pay off all creditors in the foreseeable future. Knowledge of the disadvantage to the insolvency creditors shall also be deemed equivalent to knowledge of circumstances which necessarily indicate the disadvantage. It is rebuttably assumed that related parties have knowledge of the placement of creditors at a disadvantage.

3. Directly Disadvantageous Transaction

A transaction entered into by the debtor that places the insolvency creditors at a direct disadvantage can be challenged, if (i) it was transacted within three months prior to the insolvency filing and if, at the time the transaction was made, the debtor was illiquid and the other party to the transaction had knowledge thereof or (ii) if it was made after the insolvency filing, and if, at the time the transaction was made, the debtor was illiquid and the other party to the transaction had knowledge thereof or of the insolvency filing (Section 132 InsO).

A direct disadvantage is in particular to be assumed if the debtor enters into a legal transaction in which rights are waived or can no longer be asserted, or if a pecuniary claim against the debtor is facilitated or becomes enforceable. The creditor's knowledge of the debtor's illiquidity is presumed if he has knowledge of circumstances that necessarily imply the debtor's illiquidity. With regard to related parties, there is a rebuttable presumption that they were aware of the illiquidity.

4.Willful Disadvantage

A legal act undertaken by the debtor within ten years prior to the insolvency filing with the intention to disadvantage his creditors can be challenged if the other party to the transaction has knowledge of such intent at the time of the act (Section 133 para. 1 InsO).

Such knowledge of the debtor's intent to disadvantage his creditors is presumed if the other party knows at that time about the debtor's (imminent) illiquidity and the placement of creditors at a disadvantage. For instance, any conduct leading to an incongruent coverage is a strong sign of evidence for the other party's knowledge of the debtor's intent, if the effects of the transaction occur at a time when there was, at least from the perspective of the addressee, reason to doubt the debtor's liquidity.

If the addressee of the challenge is aware of the (imminent) illiquidity of the debtor, it is refutably presumed that he also has knowledge of the intent to disadvantage the creditor. However, this alleviation of proof is restricted by a legal presumption according to which the creditor in case of an agreement to pay in installments or any other accommodation for payment granted to the debtor had no knowledge of the debtor's illiquidity.

In deviation from the above mentioned time period, transactions which grant the other party collateral or satisfaction of his claims, may only be challenged within a period of four years (Section 133 para. 2 InsO).

A contract for pecuniary interest between the debtor and a related party can be challenged (Section 133 para. 4 InsO) if it is directly disadvantageous to the insolvency creditors. This is to be assumed if the legal transaction reduces the insolvency estate. In terms of timing, all contracts concluded within two years prior to the filing for insolvency are included. Although the debtor must also act with intent to disadvantage the creditor and the related person must be aware of this intent, both the intent and the knowledge of the related person of the debtor's intent to disadvantage are presumed.

5. Gratuitous Benefits

Gratuitous transactions are challengeable by means of the so-called gift challenge (Section 134 InsO). Captured are gratuitous transactions (including partially gratuitous transactions) entered into during the last four years prior to the filing for insolvency proceedings. So-called occasional gifts, which are customary for certain occasions and of low value, are not included.

6. Shareholder Loans

The insolvency administrator can also challenge the repayment or the collateralization of a shareholder loan or an equivalent claim (Section 135 InsO).

A challenge period of one year applies in case of a repayment, whereas the collateralization of a shareholder loan can be challenged for a much longer period of up to ten years.

A challenge is also possible if the company has satisfied the repayment claim of a third party relating to a loan or an economically comparable claim, if such claim was secured with collateral granted by a shareholder. The challenge period in such case concerns the last year before the filing for insolvency.

7. Contributions by Silent Partners

Finally, a transaction can be challenged, by which within one year prior to the insolvency filing a silent partner is paid back his contribution in full or in part, or by which his share in the loss incurred is waived in full or in part (Section 136 InsO).

LEGAL CONSEQUENCES

The insolvency challenge gives rise to a restitution claim for payment to the insolvency estate. The claim for restitution becomes due when the insolvency proceedings are opened and is interest-bearing from the time of delay or pendency. The restitution has to be made in kind. Only where a restitution is not possible, compensation of value has to be paid.

1. Claims of the Addressee of a Challenge

If the creditor restitutes to the insolvency estate what he had obtained, his original claim will revive. Due to the principle that a challenge must not result in an unjustified enrichment of the insolvency estate, the creditor's consideration has to be refunded from the insolvency estate as far as it is still a distinguishable part of the insolvency estate. Otherwise, the recipient of a challengeable benefit can only assert his refund claim as an ordinary unsecured insolvency claim against the insolvency estate, which is the usual case.

2. Limitation Period

The limitation period for challenge rights is three years. The objective criterion for the beginning of the limitation period is the end of the year, in which the opening of the insolvency proceedings takes place; the subjective criterion is the insolvency administrator's knowledge of the circumstances on which the respective challenge right is based and of the person of the addressee of the challenge. Upon the insolvency administrator initiating legal proceedings regarding the challenged transaction or during negotiations between the insolvency administrator and the addressee of a challenge regarding a certain avoidance claim, the period of limitation is suspended.

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