

BEDDING DOWN OF CHANGES

German Experiences after the Introduction of the New Insolvency Code

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A. Introduction

The new German Insolvency Code (henceforth: IC) entered into force on Jan.1, 1999. Thus, there is an “experience collecting period” of almost 5 years. Nevertheless, since this period coincides with quite a disastrous economic development both worldwide and – in particular – national it is not easy to keep things apart and to tell what is to blame (or to praise) for what. However, it is correct to state that the enactment of the IC did by no means stop (or even interrupt) the discussion about legislative changes. Complaints about the new Code in general were mixed with proposals and recommendations for how and what to alter within it. On the one hand, this gives comfort since it means that no legislative change will extinguish the writers’ profession; on the other hand, under such circumstances it can’t be a surprise that what follows is just a selective array of more or less important or central issues; I do not claim any strive for completeness.

I. As a Reminder – Historical Background

For those who are not completely familiar with the insolvency laws’ development within Germany it might be helpful to give a brief outline.¹ The IC’s predecessor was the so called Konkursordnung – a Code which was enacted (like so many other continental European ones) at the end of the 19th century (1879). To be sure, it was an impeccable statute but, following the standard of its times, concentrated almost completely on the liquidation track, thereby ignoring the reorganisation alternative.

Thus, in 1978 a Commission was ordered to come up with a draft of a modernized Code; the discussions went on for quite a time – so long that quite a few started to believe that this effort would fail. Surprisingly enough, the reform effort was saved through the fact that the Berlin Wall went down. Since after the official reunification, Germany had two insolvency laws – in the west the Konkursordnung and in the east a short remnant from pre-communists times. This short statute was sort of modernized with certain features from the draft IC. Thus, it became impossible to “kill” the reform effort for political reasons.

II. Main features of the new Code

When the IC, finally, was enacted it marked indeed a remarkable change in the history of German insolvency law. It brought quite a number of renovations with it – greater creditors’ powers, a special reorganisation proceeding, the concept of debtor in possession, a discharge possibility for private debtors, the one track insolvency proceeding, to name but a few.

The overall approach of the new Code was said to be a greater “market conformity” than its predecessor;² i.e., any windfall-profits for any participant should be extinguished. Moreover, since any insolvency case deals with credit given by the debtor’s (general as well as secured)

¹ For a more detailed description of this section and the following one, see Paulus, *The New German Insolvency Code*, 33 *Texas Int’l L.J.* (1998) 141 seq.

² For this, see Balz, *Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law*, 23 *Brooklyn J. Int’l L.* (1997), 167 seq.

creditors, it was argued that they should be given greater powers within the proceeding. Accordingly, it is now them who decide whether the debtor's estate is to be liquidated or whether the debtor shall be reorganized.

As a consequence (and following the French model), the former dual approach has been given up and is replaced by a unitarian proceeding. I.e., there is just one entry into insolvency proceedings and it is only decided within this proceeding into which direction the way goes. The debtor's strategy to petition for the composition proceeding just in order to gain time is thereby deleted.

Even though the traditional goal of an insolvency law was not changed – namely satisfaction of the creditors³ – sec. 1 acknowledges now explicitly that this can be reached by both liquidation and reorganisation of the debtor. For the latter purpose, sec. 217 seq. provide for a special proceeding, called plan proceeding. It is modelled after the US Chapter 11 proceeding – containing, however, various improvements.

The IC provides several tools to increase the debtor's estate. One set of rules does so by encouraging earlier filings – e.g., by introducing the opening reason of an imminent illiquidity, another set does so by giving the administrator stronger claws – e.g., with respect to its avoidance powers.

In order to facilitate reorganisations, the IC has also abolished the former right of the secured creditors to withdraw the assets which served as their security even before the proceeding was opened. Now, they have to wait a certain period of time and the sale of such assets is mainly to be done by the administrator.

It is of great national (and, therefore, in what follows neglected) importance that the IC has introduced a special proceeding for the insolvency of consumers, sec. 304 seq. Since this is an area of particular interest for the common man on the street, discussions here are quite intense and have recently led to a number of changes.

III. General (psychological) remarks

Needless to repeat that the foregoing list of innovations is by far not exhaustive. All the more it seems to me appropriate to point out that, of course, not all of these innovations were accepted by the practitioners on the next day following the enactment of the new Code. Of course, these practitioners – like any other human being when confronted with a new situation – needed (and sometimes still need) time for adjustment, and, of course, there are individual differences in to which degree those innovations are accepted and, accordingly, made use of in the daily practical life.

I do say that with an eye to the following context: sometimes institutions and persons tend to be too impatient when it comes to the transformation of the letter of an (more often than not more or less) imposed insolvency law into reality. When, e.g., World Bank or IMF or whosoever recommend or urge the transition country X to adopt a new insolvency law it should be accepted that it is one thing to enact such legislation and another thing to have the respective “actors” playing in accordance with these rules. This may last quite a long time.

B. Rescuing the debtor – Plan Proceeding

I. General Acceptance

³ Thus, insolvency law was always seen, taught and described in close connection with the law of enforcement and, thus, with civil procedure law.

A good example for such necessary adjustment period is the introduction of a debtor rescue option – i.e. the abovementioned plan proceeding. After literally millennia of mistreatment of a bankruptcy debtor – for centuries the debtor was punished like a thief since he was said to have stolen his creditors’ goods; sometimes such punishment was capital punishment, e.g. in England – it just cannot be expected that the idea to “help” the debtor is throughout welcomed.

Thus, it took some times before the new instrument was used. It started with a few smaller cases before a “big fish” – Küppersbusch (manufacturer of kitchen machines) – was reorganized. This was a sort of success story which helped the plan proceeding to receive the practitioners’ serious attention and to become applied more often. This development continues and it is my observance that primarily the younger administrators are the ones who are eager to make use of this type of proceeding.

As indicated supra, there are, of course, complaints about the details of the plan proceeding –e.g., there are too many remedies, too complicated, and thus too long lasting. However, practice and judiciary is about to cut off the edges and to bring this tool in an appropriate and workable shape.

II. Debtor in Possession

The biggest problem in the context of the plan proceeding, however, seemed to be the concept of “Eigenverwaltung”, i.e. debtor in possession, sec. 270 seq. Needless to say, that both features belong more or less together. A predominant argument against this new instrument is that it cannot be done that the one who has ruined the business is now rescuing it. Here, again one can observe the strength of time honoured ideas in the heads of people (– as an aside: part of these people are the corporation and business lawyers and those who make a big thing out of Corporate Governance; they all fail to recognize that insolvency and Corporate Governance have close ties – especially in the context of the dip⁴). It should be noted that debtor in possession is a somewhat misleading translation because the IC provides in any case for a surveilling person, called “Sachwalter” (trustee).

But this sort of mental obstacle, too, is about to be pushed aside by means of something what might be called the German type of debtor in possession. In the eve of an upcoming insolvency, the debtor’s management (or just its CEO or the “bad guy” in there) is replaced by insolvency practitioners or administrators. They then file the petition and act as the debtor in possession – controlled by the said trustee. The most prominent case where this solution was applied is the break-down of the KirchMedia AG; but see also Babcock/Borsig, and (initially) Grundig.

Under such a constellation, judges are less reluctant and sceptical in granting “Eigenverwaltung”; the reason for that is quite the same as it is for creditors: they trust this person whereas the old management has lost any trust. Workers, too, are said to prefer this sort of management exchange for the same reason. To be sure, not any “Eigenverwaltung” will be done this way – there are many (however smaller, e.g. medical doctors) cases where one has the so to speak clear-cut debtor in possession. But from a certain economic and financial dimension on, it seems as if the German debtor in possession will predominantly be the new and administration-experienced and fresh appointed boss.

C. Increase of opened cases

⁴ For this, see Paulus, *Verbindungslinien des modernen Insolvenzrechts*, ZIP 2000, 2189 seq.

During the last 25 (or so) years of the old Code's "life" – ever since the oil price shocks in the early 70ies –, only 25 % of insolvency cases were opened. Thus, it was one of the utmost endeavours of the legislators to increase the amount of opened cases. At this point it is not really clear if it is the Code which succeeded or if it is the desolate economic situation in Germany which causes the tremendous increase of opened cases. As an aside, it is interesting to see in what short terms the general public (and politics) are used to think: In 1999, when the IC was enacted everybody expressed the hope that from now on more proceedings would be opened and, thus, be subjected to the insolvency regime. Only a few years later, again everybody is shouting for remedies to reduce the number of opened cases.

Nevertheless, one way of reaching this goal was the introduction of the new reason to open – the imminent illiquidity, sec. 18 IC. This, however, is not really a successful tool when there are almost no real advantages connected with such early opening. Another change within the Code was more efficient in this respect – namely the abolition of the tax authorities' privilege (or, as England has it now through its Enterprise Act 2002, the disappearance of the Crown's privilege). This forces these authorities nowadays to react much faster than they used to do in former times. Finally, the new Code reduced the amount of money (procedural costs) which must be guaranteed by the estate in order to open the case.

D. Increase of the estate

I. Avoidance powers

As indicated supra, it is fair to say that the attempt failed to get proceedings earlier initiated and, thereby, having increased the estate. However, the IC has also brought with it a sharper avoidance power for the administrator, sec. 129 seq. In many cases where it was doubtful under the old law whether or not a claim for recovery would be acknowledged it is nowadays clear that it will be. This was done, i.a., by clarifying former uncertainties, by shifting the burden of proof, by extending many of the suspect periods, and by extending the reach of this tool to certain third parties.

At this point, it might be appropriate to hint at another German peculiarity which cannot easily be transferred into other surroundings: The fact that the avoidance powers are such a powerful tool in the hands of administrators is, as far as I can see it, not just a consequence of the changed wording of the Code but also of a stricter interpretation. And here comes the typical German "flavour". The by far most important literary genre for practitioners is what we call "Kommentare" and Americans probably "Annotations"; there you have the Code with all its sections and under each section you find a description of its purpose and what courts and other writers have decided or reasoned about it. Coming back to the avoidance power and its strength: two judges from that Chamber of the Supreme Court (BGH) which is responsible for all insolvency cases are commentators in two main commentaries for the IC. It is, thus, no big surprise that they have created something like a self-referential system – quoting in their commentaries their own decisions and in their decisions their own commentaries. This, too, leads to an increase of the estate because both judges are known to be very administration friendly.

II. Participation of the secured creditors

It has already been indicated that the new Code forbids (most of) the secured creditors to withdraw the assets which serve them as securities right at the beginning of the proceeding. Instead, they have to wait for the reporting meeting, sec. 29 (1) No. 1 – i.e. that meeting something between six and twelve weeks after the opening of the case where the administrator reports about the debtor's affairs based on which the creditors then decide which way to go. And since it is now the administrator who realises the securities by selling them, the se-

cured creditors are now bound to contribute to these realization costs by paying a proportional sum of four to nine percent of the proceeds, sec. 171. These payments increase the estate – however, whether this is really a progress compared with the old law which was silent in this respect is subject to some practitioners’ doubt. They claim that under the old law they always bargained with the secured creditors for individual contributions when they sold such assets – and then always for more than nine percent.

III. Others

There are more estate increasing mechanisms – suffice it here to mention the general abolition of privileges and the limitation of the sum to be paid to workers under the so called Social Plan, sec. 123.

E. Protective measures

Under the old law, it was an often heard complaint that the preliminary administrator had not enough powers – it was said to be wishful to have a position like a preliminary administrator. The new Code took care of that and presented the possibility of such preliminary administrator which is nowadays called a “strong administrator”. However, practice very rarely applies it. Since there is a tremendous draw-back connected with such strength. Sec. 55 (2) provides that all obligations entered into or created by such strong preliminary administrator are insolvency estate liabilities! Sec. 61, dealing with the administrator’s personal liability, goes a decisive step further: This liability extends to all insolvency estate liabilities which cannot be satisfied by the estate. Under these circumstances it is no big surprise that no administrator is ever eager to be put into the position of a “strong preliminary administrator”.

Instead (and almost explicitly in order to circumvent the abovementioned statutory mechanism), practice invented the so called “half-strong administrator” – here, not all rights and legal powers are taken away from the debtor and consequently transferred to the preliminary administrator but only selected ones.

It was also one (a minor one, to be sure) goal of the new Code to abbreviate the period of preliminary administration in order to get quickly into the proceeding itself and have its mechanisms develop. However, there is a strong tendency to have this period not shorter than three months. The reason for this is Labour Law and its insolvency peculiarities: The Federal Bureau of Labour pays the workers’ unpaid salary in case of an insolvency proceeding under certain conditions – and for three months! This has been developed to the probably most effective financing tool for insolvent debtors in their attempt to recover or just for finishing their production before liquidation.

F. Increase of creditors’ private autonomy

The increased creditors’ autonomy is best reflected in both deciding which way to make use of the debtor’s estate, sec. 156 seq., and in the right to give strict instructions to the administrator as to how to draft an insolvency plan, sec. 157, 218 (2). To my knowledge, this has been welcomed throughout and may be deemed to be fully accepted. Minor disturbances such as ongoing obstruction attempts by competitors within a plan proceeding (as in the case of “Küppersbusch”, e.g.) are of no substantial importance. Discussions arose only in the context of the selection of an administrator, for this see below.

G. Critical issues

Needless to say that here, too, the selection is quite artificial and completely dependent on the more or less accidental and selective knowledge of the present author. Keeping that in mind,

two issues shall be mentioned here – one being a “best seller” the other one being a kind of dormant giant:

I. Selection of the administrator

In German law, there is – and never has been – an official administrators’ supervision institution like in so many other jurisdictions.⁵ Control is exercised by the peers, by an unofficial code of good conduct – an ethical measure rod, so to speak. A few cases of misuse, an increased constitutionalization of the sub-constitutional law, and the begrudging of non-administrators have lead to an intense and still ongoing debate about the selection process of the administrators.

As a matter of principle, two steps must be kept apart. Step 1 is the formation of a pool of potential administrators – this can be very selective (like, e.g., in England, Canada, Australia) or can include each lawyer (Finland) or even each interested person (Austria). Step 2 is the selection of the administrator for an individual case from that pool. Here the critical question is: who selects? The German answer to these problems is to be found in sec. 56. There it is stated that administrator may become “a natural person who is qualified for the respective case and particularly experienced in business and independent from both creditors and debtor”. That’s all!

According to sec. 27, it is the insolvency judge who appoints the administrator in the opening order. The pool from which (s)he is drawing was until recently a list of candidates which the judge himself had created. More often than once, new candidates for such list were rejected – with the argument that the list were closed – and, as a further argument, that the high running costs of the accepted administrators does not allow an extension of that list. This so called “closed shop” mentality and practice has no been forbidden by a recent amendment of sec. 56.

Whereas this relates to the aforementioned step 1, step 2 has also its own big discussion: Even though it is the judge who selects the administrator for the case at hand, sec. 57 allows the creditors assembly to replace this administrator in its first meeting. As a matter of fact, general creditors are rarely seen at such creditors’ assemblies – except the big ones, the institutionalised one. i.e. primarily the banks. By making use of the right given to them through sec. 57, they were accused – rightly or wrongly need not worry in the present context – of appointing administrators who are suspect of being “bank-friendly”, to put it mildly. The following discussion, too, lead to an amendment of the Code – namely in sec. 76 which deals with the voting requirements of the creditors’ assembly. The originally required simple head-majority is now replaced by a combined head- and sum-majority.

II. Subjection under the insolvency regime

The second issue has not yet reached the legal community of insolvency experts – namely the insolvency of municipalities and Länder (here, I am particularly speaking as someone coming from Berlin – a completely broke city!). Economists and politicians know perfectly well what I am referring to, but they still do not even allude – let alone talk about – insolvency and insolvency law. However, after the introduction of a reorganisation track and after an international debate about an appropriate proceeding for insolvent states after Argentina’s break-

⁵ An interesting variance of such institutionalized supervision is to be found in Finland. There, recently an Ombudsman with far-reaching investigation powers has been installed.

down,⁶ this topic cannot any longer be excluded from serious professional discussion among insolvency lawyers. Here, much remains to be done.⁷

H. Consumer Insolvency

As indicated supra, in the present context I skip this part of the IC, sec. 304 seq., completely. It must suffice to say that here most amendments have been enacted – irrespective of the so far only short life of that proceeding. However, this does not really surprise because it is a completely new invention with many interesting features which had not been tested before enactment. The acceptance of this proceeding, however, is constantly increasing.

I. International Insolvency Law

Only a couple of months ago, the IC was amended by new rules for transborder-insolvency cases. There are now two sets of rules: one represents the autonomous German international insolvency law, i.e. the law which is to be applied in cases where the other country(ies) is not a member state of the EU Regulation; the other one brings details for the application of this very Regulation.

For reasons of up-to-dateness, shall it suffice here to mention just one rule out of the latter set: In cases of an potential cross-border-effect, sec. 2 of Art. 102 of the Introductory Statute for the IC obliges the judge to mention “the facts and his legal considerations” which lead him to the assumption that he has jurisdiction under Art. 3 of the Regulation. This is meant to be a trust creating measure for the (primarily foreign) recipients of a German opening order (be it a main proceeding or a secondary one). And trust is, according to consideration 22, the fundament of the Regulation.

I personally deem this German rule as highly recommendable to all other member states. It prevents antipathy and counter-reactions (like in France) against orders which just state: “After having heard evidence and in recognition of the international dimension of the case, I herewith open a main proceeding”.⁸ This was roughly the wording of an English order with respect to three German companies the center of main interests of which was assumed to be in England – even though this is highly disputable (particularly with respect to two of these companies). Orders like that should be reserved for national cases! In European cross-border cases, a judge should always take into consideration that addressees of his decisions are people who have not the same deep-rooted and long lasting trust in this judiciary as the domestic recipients.

⁶ For this, see e.g. Paulus, A Statutory Proceeding for Restructuring Debts of Sovereign States, *Recht der Internationalen Wirtschaft (RIW)* 2003, 401 ff.

⁷ Cf: Paulus, Überlegungen zur Insolvenzfähigkeit von Gemeinden, *ZInsO* 2003, 869 ff.

⁸ For this, see Paulus, Zuständigkeitsfragen nach der Europäischen ,Insolvenzverordnung, *ZIP* 2003, 1725 ff.