

## Post-petition financing in Germany

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### INTRODUCTION

During German insolvency proceedings, the success of the restructuring can depend on the insolvent business obtaining financing to operate as a going concern. Temporary funding of the business as a going concern may also be necessary to maximise recoveries during liquidation.

Post-petition debt financing (that is, the granting of a loan to the debtor or insolvency administrator after filing for insolvency proceedings) (Post-Petition Financing) may be provided by:

- Stakeholders of the insolvent debtor, such as existing lenders, suppliers or customers.
- Third party financiers.

However, unlike other jurisdictions such as the United States, where a sophisticated market and tested standards for debtor-in-possession financing exist, in Germany Post-Petition Financing is far less standardised, partially due to the statutory post-petition financing function of the Insolvency Compensation Scheme (*see below, Insolvency Compensation Scheme*). Therefore, engaging in Post-Petition Financing with German debtors requires an understanding of the German legal framework for Post-Petition Financing in Germany. This article will describe some of the relevant legal aspects for Post-Petition Financings in Germany.

### INSOLVENCY PROCEDURE AND THE INSOLVENCY ADMINISTRATOR (IA)

German insolvency proceedings are divided into two stages:

- The preliminary proceeding, where a preliminary insolvency administrator (PIA) is appointed and the pre-requisites for the opening of a main proceeding are reviewed and assessed by the PIA and the insolvency court.
- The main proceeding, where the (final) insolvency administrator (IA) is appointed. The main proceeding can take the form of a:
  - regular insolvency proceeding (*Regelinsolvenzverfahren*); or
  - insolvency plan proceeding (*Insolvenzplanverfahren*).

Both regular and insolvency plan proceedings can be organised as a debtor-in-possession proceeding called "self-administration" (*Eigenverwaltung*). Self-administration must be made on the application of the debtor and is subject to court approval. In this case, the debtor and its management remain in control of the business, subject to the supervision of a court-appointed trustee (*Sachwalter*).

Self-administration can also take the form of a Protective Shield Proceeding. This enables the debtor's management to remain in control of the business and agree a "pre-packed" insolvency plan with its stakeholders within a maximum period of three months from the date of approval by the court.

With the filing for the opening of regular insolvency proceedings, the debtor will usually lose its ability to dispose of its assets and to enter into transactions without the consent of the PIA/IA. However,

during self-administration the debtor retains the ability to enter into legally binding transactions with third parties.

The PIA/IA is appointed by the court, but creditors have significant influence on the person to be appointed. In most cases, the person appointed as PIA is also appointed as IA, but this is not a statutory requirement. The PIA/IA is independent and is bound to protect the assets of the insolvency estate and maximise recovery for all creditors. The IA manages the insolvency estate and has the power to:

- Enter into all types of contracts on behalf of the debtor.
- Dispose of the debtor's assets.

### INSOLVENCY COMPENSATION SCHEME

A significant instrument for financing an insolvent business as a going concern is the statutory employee compensation scheme (*Insolvenzgeld*) (Compensation Scheme). Under the Compensation Scheme, the insolvent company's employees have a claim against the Federal Employment Agency for the payment of up to three months' salary (capped at EUR6,000 per month) for the period prior to the opening of the main insolvency proceedings. Although the payments under the Compensation Scheme do not provide the debtor with fresh money, they result in a significant relief from costs for the workforce and can lead to an improvement of the debtor's overall liquidity.

As payments under the Compensation Scheme are only paid for the period prior to the opening of main insolvency proceedings, the debtor is typically kept in preliminary insolvency proceedings for a period of three months. In consideration of the payments under the Compensation Scheme, the Federal Employment Agency assumes the salary claims of the employees, which constitute ordinary unsecured insolvency claims.

Payments under the Compensation Scheme are only made once the court has decided to either:

- Open a main insolvency proceeding.
- Not to open a main insolvency proceeding (in the case that the available assets do not cover the insolvency costs).

It is therefore customary to pre-finance these payments. This is typically achieved by the employees selling and transferring (subject to the approval of the Federal Employment Agency) their salary claims against the debtor and their future statutory compensation claims against the Federal Employment Agency to a pre-financing lender. The pre-financing is usually organised by the PIA, who approaches the pre-financing lender and enters into a framework agreement between the debtor, the PIA and the pre-financing lender. The framework agreement establishes that (among other things):

- The pre-financing lender acquires the employees' respective salary claims on a non-recourse basis (including their future statutory compensation claims against the Federal Employment Agency).

- The debtor is going to pay interest and fees for the pre-financing to the pre-financing lender.

The pre-financing lender pays, as purchase price and consideration for the transfer of the employee's claims, an amount equal to the net salary (to the extent covered under the Insolvency Compensation Scheme) and is repaid directly by the Federal Employment Agency after the main insolvency proceeding is opened. Since the interest/fees for the pre-financing loan is owed by the debtor, it is of utmost importance for the pre-financing lender to ensure that such claims are qualified as post-petition administrative claims, which rank ahead of all other unsecured claims in the statutory order of repayment (*see below, Legal Issues, Requirement for administrative claim*).

However, from a lender's perspective the pre-financing of payments under the Compensation Scheme is not completely risk free. For example, there is a risk that the main insolvency proceeding is not opened by the court because either:

- It turns out that the statutory insolvency reasons are not given.
- The application for the opening of proceedings is withdrawn.

In such circumstances, the employees' claims against the Federal Employment Agency will not arise and the pre-financing lender is therefore left with an ordinary unsecured repayment claim against the debtor.

## STAGES AND TYPES OF POST-PETITION FINANCING

Due to the nature of the German insolvency procedure as a two-stage process, the Post-Petition Financing can be provided during either:

- The preliminary insolvency proceeding.
- The main insolvency proceeding.

The stage at which the Post-Petition Financing is provided affects the ranking of the lender's claims and the availability of security, and is also relevant in relation to claw-back risks. Furthermore there are, broadly speaking, two types of Post-Petition Financings:

- The actual advance of new money by the lender (*echter Massekredit*).
- The realisation of certain secured assets (such as trade receivables or stock) by the debtor with the consent of the secured party to fund the debtor's liquidity needs during the insolvency procedure (*unechter Massekredit*).

From an insolvency law perspective, both types of Post-Petition Financing are broadly subject to similar principles. Accordingly, the considerations set out below apply to both types of financings.

## LEGAL ISSUES

### Available security

Unlike in the United States and some other jurisdictions, existing security interests cannot be adversely affected under German law. Therefore, a Post-Petition Financing can only be secured by the free assets of the debtor.

If the debtor has already granted security to secure existing pre-petition debt, this security interest will not (without the consent of the secured parties) be affected by the Post-Petition Financing. To the extent that the IA (or in the case of self-administration, the court-appointed trustee) has been able to successfully claw back assets that have been granted as security to a creditor, such assets may be used to secure the Post-Petition Financing. However, in practice collateralisation of the Post-Petition Financing through clawed-back assets is scarce, due to:

- Uncertainty surrounding the outcome of claw-back litigation.
- The duration of any claw-back litigation.

- In the case of a Post-Petition Financing made during preliminary insolvency proceedings, uncertainty surrounding the opening of the main insolvency proceeding.

In addition, under the German Insolvency Code, the pre-insolvency assignment of receivables that come into existence after the opening of insolvency proceedings is invalid. Therefore, trade receivables that come into existence after the opening of insolvency proceedings are free assets which can be used to secure a Post-Petition Financing.

### Ranking

Given that in most cases there will not be sufficient free assets available to satisfactorily secure a Post-Petition Financing, the ranking of such Post-Petition Financing within the statutory order or repayment in the insolvency procedure becomes fundamental.

Broadly speaking, the German Insolvency Code provides the following priority order of repayment:

- Costs of the insolvency proceedings. This includes the costs of the court and the fees and expenses of the administrators.
- Administrative claims (*Masseverbindlichkeiten*). This includes claims resulting from new contracts entered into by the insolvency administrators and third parties (including certain debtor-in-possession type financings and tax claims (such as VAT claims) which are triggered by the administrator).
- Segregation rights (*Aussonderungsrechte*). This includes property that does not form part of the insolvency estate which must be released by the IA (for example, retention of title claims).
- Certain fees, property-related claims, expenses and tax claims in connection with mortgages and land charges.
- Secured creditors. These claims rank among themselves according to their time of creation.
- Ordinary insolvency claims (*Insolvenzforderung*). This includes all unsecured claims, to the extent included in the insolvency table. These claims rank *pari passu* among themselves and are entitled to pro rata distribution of the remaining insolvency proceeds.
- Statutorily subordinated claims under shareholder loans.
- Contractually subordinated claims.
- Equity claims of shareholders.

### Requirement for administrative claim

Considering the statutory order of repayment (*see above*), a lender will only be prepared to provide Post-Petition Financing if it receives the status of an administrative claim. This will mean that the lender will benefit from ranking directly behind the insolvency costs but ahead of all other unsecured claims.

In the case of an insolvency plan proceeding, further advantages of administrative claim status are as follows:

- Due and payable administrative claims must be settled before the insolvency proceeding ends.
- Administrative claims which are not due and payable must be either collateralised, or there must be sufficient evidence that such claims will be repaid on their due date.

**Main insolvency proceedings.** If Post-Petition Financing is granted to the IA within main insolvency proceedings, the financing automatically receives the status of an administrative claim, as any claims resulting from actions of the IA receive administrative claim status.

**Preliminary insolvency proceedings.** If, as it is usually the case, the Post-Petition Financing is granted within preliminary

insolvency proceedings, the situation is more complicated. In principle, only the IA or the insolvency court can create administrative claims. However, there are two explicit exceptions to this principle:

- The first exception is if the PIA is a "strong PIA" (that is, where the insolvency court has issued a general ban on the debtor to dispose of its assets and has exclusively appointed the PIA to do so).
- The second exception is in the case of a Protective Shield Proceeding. In this case the insolvency court, at the request of the debtor, is obliged to authorise the debtor to create administrative claims (*see below, Protective Shield Proceeding*).

However, in practice the appointment of a "strong PIA" is uncommon, as the insolvency court usually allows the debtor to dispose of its assets with the consent of the PIA (in which case, the PIA is called a "weak PIA").

Generally, any claim created through a "weak PIA" will only have the status of an ordinary insolvency claim and will therefore rank *pari passu* with other unsecured creditors in the statutory order of repayment. To secure administrative claim status for Post-Petition Financing granted in an ordinary preliminary insolvency procedure where only a "weak PIA" has been appointed, it is necessary to have the competent insolvency court sanction the Post-Petition Financing and explicitly authorise the debtor to conclude such financing. According to the Federal Supreme Court, the authorisation must specify the exact claims that will be subject to elevation as administrative claims.

**Protective Shield Proceeding.** In a Protective Shield Proceeding the insolvency court must, at the request of the debtor, be authorised to create administrative claims. Other than the authorisation granted to a "weak PIA", the authorisation granted to the debtor in a Protective Shield Proceeding can be generic and does not have to specify the exact claims in order for the claims to be elevated to administrative claims. However, if the debtor abuses its authorisation by extensively creating administrative claims which unjustifiably dilute the ordinary insolvency creditors, the Protective Shield Proceeding may be stopped by the insolvency court on the request of either:

- The creditor's committee.
- Under certain circumstances, a secured or an ordinary insolvency creditor.

**Ordinary self-administration proceeding.** Under the German Insolvency Code, the extent to which the debtor is entitled to require an authorisation to create administrative claims in an ordinary self-administration proceeding (that is, a self-

administration proceeding which is not a Protective Shield Proceeding) is unclear. The majority of legal literature is of the view that the insolvency court may well also authorise the debtor in an ordinary self-administration proceeding to create administrative claims.

However, unlike Protective Shield Proceedings, the insolvency court may not be entitled to grant a generic and wide authorisation to create administrative claims, but may have to exclusively provide concrete authorisations in relation to specific pre-determined claims (similar to the authorisation granted to a "weak PIA" in an ordinary preliminary insolvency proceeding).

#### Claw-back of collateral

Assuming there are assets available to collateralise the Post-Petition Financing, the lender must mitigate the risk of the collateral subject to claw-back by the IA or trustee. As a main principle, any legal actions (*Rechtshandlungen*) which occurred before insolvency proceedings were opened, which diminish the value of the insolvency estate to the detriment of the creditors, can be challenged by the IA or trustee, subject to certain hardening periods and other conditions.

If the collateral securing the Post-Petition Financing is granted after the opening of main insolvency proceedings, it is not subject to claw-back. The same applies to the extent that the collateral secures a claim which qualifies as an administrative claim.

A claw-back risk can occur if the Post-Petition Financing is granted in the preliminary insolvency proceeding and either:

- A "weak PIA" has been appointed.
- The debtor has applied for ordinary self-administration without a Protective Shield Proceeding, and has not been authorised by the insolvency court to elevate the claims to administrative claims.

The fact that the PIA (who will most likely also become the IA) has consented to the Post-Petition Financing does not automatically avoid a claw-back after the opening of the main insolvency proceedings. Security granted after filing for the opening of insolvency proceedings is subject to claw-back if the creditor knew of the filing or that the debtor was illiquid, which is most likely the case when collateral is granted to secure a Post-Petition Financing.

However, the German Insolvency Code provides an exemption from claw-back if the collateral is granted in connection with the advance of fresh money, which should therefore practically exclude a claw-back risk where the Post-Petition Financing has been provided through the advance of fresh money.

## Practical Law Contributor profiles



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#### Recent transactions

- Advised bondholders, hedge funds, institutional lenders and creditor committees on a wide range of complex cross-border restructurings and workouts in Germany, Europe and the US.
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