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German Avoidance Law and EU-Harmonization Efforts

The German regulations on avoidance claims are considered to be one of the most comprehensive and strict among the European legal systems.

Despite current mitigating measures by the legislator, business partners of a German company in crisis should take precautionary measures to reduce the risk of a later avoidance action in the event of insolvency. The following article provides an overview of the German rules on avoidance in insolvency, possible precautionary measures, the effects of the European Insolvency Regulation on avoidance claims in cross-border contractual relationships, and approaches as to how the avoidance rules could be harmonised across Europe.

I. Basics on German avoidance claims

1. *Basic prerequisite for any avoidance in insolvency: prejudice to creditors pursuant to section 129 InsO*

The basic prerequisite for any avoidance in insolvency is that the avoided legal act disadvantages the insolvency creditors, section 129 (1) German Insolvency Code ("**InsO**").

A creditor disadvantage exists if the legal act has either increased the debt estate or reduced the asset estate and thereby thwarted, impeded or delayed access to the debtor's assets, i.e. the satisfaction options of the insolvency creditors would be more favourable without the act from an economic point of view.[2]

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2. Cf. Federal Court of Justice ("BGH") judgement dated 22 October 2015 – IX ZR 248/14, NZI 2016, 35, with further references.

The simplest and most relevant case of a legal act detrimental to the creditors is a payment, as this reduces the assets and the amount paid out is no longer available to satisfy the creditors as a whole.

However, there is no creditor disadvantage if an item is surrendered that was already the property of the satisfied creditor and therefore should have been segregated in the insolvency proceedings. The same applies to the redemption of a right to segregation or separation by payment. Cases of practical relevance are in particular the redemption of a simple (segregation), extended or prolonged retention of title (separation). In the case of rights to separate satisfaction, however, their acquisition could in turn be detrimental to the creditors and thus possibly avoidable under sections 130 et seq. InsO, e.g., if goods delivered during the debtor's crisis are processed and/or resold.

If a creditors' disadvantage exists, the special prerequisites for avoidance under sections 130 et seq. InsO must also be met. The most relevant avoidance requirements in trade relations with a German insolvency debtor are presented in outline below.

2. *Conditions for avoidance pursuant to section 130 InsO*

The avoidance of congruent performances, i.e., such debtor performances to which the creditor was basically entitled, is also possible under section 130 InsO in the period of three months before filing for insolvency.

Pursuant to section 130 (1) InsO, a legal act is voidable if it granted or enabled an insolvency creditor to obtain security or satisfaction if it was performed within the last three months prior to the filing for insolvency and (i) at the time of the act the debtor was already illiquid and the creditor was aware of the illiquidity at that time or (ii) if it was performed after the filing for insolvency and the creditor was aware of the illiquidity or the filing for insolvency at the time of the act.

Pursuant to section 130 (2) InsO, knowledge of the illiquidity or the filing for insolvency is equivalent to knowledge of circumstances which necessarily indicate the illiquidity or the filing for insolvency.

3. *Conditions for avoidance pursuant to section 131 InsO*

Section 131 InsO regulates the avoidance of so-called incongruent performance (i.e., satisfactions or security) by the debtor to an insolvency creditor in the period of three months prior to filing for insolvency.

An incongruent performance exists if the creditor receives a performance from the debtor which the creditor was not entitled to, not in the manner or not at the time.

A performance not to be claimed is given, if the creditor has no claim to the performance versus the debtor at all, if a claim exists but is not enforceable or an objection exists versus the enforceability of the claim.

A performance not to be claimed in the manner is given if the creditor has in principle a claim to the performance, but this claim is fulfilled in a manner which is more disadvantageous for the other creditors than it corresponds to the agreement or the legal claim.[3] A practical example is that a customer fulfils his payment obligation by assigning claims against a third party to the creditor or by instructing the third party to pay the creditor. If the third party fulfils the obligation and pays the creditor, he has obtained a satisfaction to which there was no claim as such.

A performance not to be claimed at the time for example is rendered if a customer pays early although the due date of the claim had not yet occurred.

Within the last month prior to filing for insolvency the performances above constitute an avoidance claim without further ado. With the second and third month prior to filing for insolvency the debtor has to be illiquid already or the creditor has to have knowledge that the performance disadvantages the creditors.

4. *Conditions for avoidance pursuant to section 133 InsO*

The so-called avoidance for intent pursuant to section 133 InsO opens up the possibility of avoidance for the period of at least theoretically up to 10 years before filing for insolvency.

Pursuant to section 133 (1) InsO, a legal act is avoidable which the debtor performed in the 10 years preceding the filing for insolvency or after such filing with the intent to disadvantage its creditors if the other party was aware of the debtor's intent at the time of the act. Such knowledge shall be presumed if the other party knew that the debtor's illiquidity was imminent and that the act disadvantaged the creditors.

If the legal act has granted or enabled the other party security or satisfaction, the period of the voidable legal act is 4 years (cf. section 133 (2) InsO).

Intent to disadvantage within the meaning of section 133 (1) InsO is generally given if the debtor, in this case the customer, when performing the legal act, generally intended the disadvantage of the creditors as a result of his legal act or recognised and approved it as a presumed consequence - even if it is an unavoidable secondary consequence of another advantage sought *per se*.[4]

A debtor who is aware of his insolvency usually acts with intent to disadvantage; such intent is

3. Cf. BGH, judgement dated 18 November 2004 - IX ZR 299/00, NZI 2005, 329, 330.

4. Cf. BGH, judgement dated 8 January 2015 - IX ZR 203/12, NZI 2015, 369.

to be presumed even if the debtor is aware of his impending illiquidity.[5] This is because a debtor who makes further payments in the knowledge of his (impending) illiquidity necessarily expects the other creditors to be disadvantaged. Furthermore, there is an indication of an intention to disadvantage if a debtor makes an incongruent cover payment as described above.

Knowledge of the intent to prejudice creditors is presumed under section 133 (1) sentence 2 InsO if the other party knew that illiquidity was imminent or had already occurred and that the act prejudiced the creditors. In case law such knowledge was assumed if the debtor's liabilities with the creditor are constantly not settled to a considerable extent over a longer period of time,[6] payment targets and payment promises were not met, the customer declared that he cannot fulfil his obligations as owed, the customer repaid liabilities in other ways than owed, e.g. through assignment of receivables or performance by a third party (so-called incongruent cover), or (partial) satisfaction of the claims was only achieved under enforcement pressure or even only by way of compulsory enforcement and the creditor was aware that there were other creditors with uncovered claims that would not be served in the same way.[7]

With section 133 (3) sentence 1 InsO the conditions for avoidance have recently been tightened in favour of the opposing party, if congruent cover payments are made.[8] These are - as explained - cover services to which a claim existed and which were provided according to the agreement. In this case, the debtor's imminent illiquidity under section 133 (1) sentence 2 InsO is replaced by an illiquidity that has already occurred.

If the other party had entered into a payment agreement with the debtor or otherwise granted the debtor payment relief, it is now presumed under section 133 (3) sentence 2 InsO that he was not aware of the debtor's illiquidity at the time of the act.

This new version of section 133 InsO in favour of creditors contradicts partially the previous case law, which has often seen the request for an instalment payment agreement as an indication of economic difficulties and their documentation vis-à-vis the creditor. In a recent decision, the BGH took up the legislator's tendency and accordingly tightened the requirements for the intent to disadvantage the creditors also for old cases, i.e. before the introduction of section 133 (3) sentence 1 InsO.[9]

5. *Conditions for avoidance pursuant to section 134 InsO*

Furthermore, the possibility of avoidance under the aspect of gratuitousness must be emphasised. Pursuant to section 134 InsO, a gratuitous performance by the debtor is avoidable unless it was made earlier than 4 years before filing for insolvency.

In principle, a performance is gratuitous if, according to the agreement, an asset is relinquished in favour of another person without this person providing or being obliged to provide a compensatory consideration to the debtor or, with the debtor's consent, to a third party.[10]

While it is unlikely that a customer provides a gratuitous service to a creditor in business transactions (other than over-payment), it could be more likely that a third party pays the creditor on the customer's debt and that this third party subsequently becomes insolvent. In this case, the third party has repaid a third-party debt for the benefit of the creditor. This is often the case in insolvencies of groups of companies, for example when the parent company makes payments to the creditors of the subsidiary for its liabilities. The avoidance claim is then made by the insolvency administrator of the third party, in this case the parent company.

The repayment of a third-party debt in a three-person relationship is generally gratuitous if the recipient of the service, in this case the creditor, does not provide any compensatory counter-performance.[11] In this respect, it is irrelevant for the assessment of the (non-)gratuitousness whether the rendering party itself has received compensation for its performance. Rather, it is decisive whether the recipient of the service has to provide a consideration.[12] In the case of the repayment of a third party's debt, such consideration is usually already the fact that the recipient of the service (in this case the creditors) loses its claim against the third party.[13] However, the redeemed claim must have been of value at the time of the receipt of the service. If the creditor's claim against the customer was already worthless at the time of the receipt of the service because the customer was already illiquid (and thus no satisfaction could be obtained from him anyway), there is gratuitousness in the aforementioned sense.

If a third party pays for the customer, the avoidance pursuant to section 134 InsO therefore applies if the creditors could not have enforced their claim against the customer for economic reasons.

6. *Conditions for avoidance pursuant to section 135 InsO*

Finally, a rescission provision that is not too common in other jurisdictions is the avoidance of repayments of shareholder loans under section 135 InsO.

According to section 135 (1) no. 2 InsO a legal act is avoidable that granted a satisfaction for a repayment claim on a shareholder loan or for an equivalent claim if granted within the last year prior to filing for insolvency. The granting of security for such a claim is even avoidable within the last ten years, section 135 (1) no. 1 InsO.

5. Cf. BGH, judgement dated 8 January 2015 – IX ZR 203/12, NZI 2015, 369.

6. Cf. BGH, judgement dated 25 February 2016 – IX ZR 109/15, NZI 2016, 266 nos.13 and 18; BGH, judgement dated 24 May 2007 - IX ZR 97/06 NZI 2007, 512; BGH, judgement dated 17 February 2004 - IX ZR 318/01, NZI 2005, 690.

7. Cf. BGH judgement dated 25 February 2016 – IX ZR 109/15, NZI 2016, 266 no. 30.

8. Act to Improve Legal Certainty in Respect of Rescission under the Insolvency Code and the Rescission Act dated 29 March 2017 (BGBl. I S. 654), in force since 5 April 2017.

9. Cf. BGH, judgement dated 6 May 2021 – IX ZR 72/20, NZI 2021, 720.

10. Cf. BGH, judgement dated 1 March 2018 – IX ZR 207/15, ZInsO 2018, 1039; BGH, judgement dated 4 March 1999 - IX ZR 63–98, BGHZ 141, 96, 99.

11. Cf. BGH, judgement dated 1 June 2006 - IX ZR 159/04, NZI 2006, 524; BGH, judgement dated 4 February 2016 – IX ZR 42/14, NZI 2016, 307.

12. Cf. BGH, judgement dated 4 February 2016 – IX ZR 42/14, NZI 2016, 307.

13. Cf. BGH, judgement dated 4 February 2016 – IX ZR 42/14, NZI 2016, 307.

It is also avoidable if a shareholder is freed from a security he has provided to a lender of the debtor (e.g., when the debtor repays the loan) within the last year prior to filing for insolvency. The avoidance claim then exists in the form of a payment claim against the shareholder in the amount in which he was released from his security deposit.

Interest payments are not avoidable under section 135 (1) InsO as long as they are not above the market standard.[14] How such a market standard is to be determined and whether the debtor's default risk (especially since shareholder loans are often granted when the debtor is no longer creditworthy for a bank loan) may be included in the calculation is left to future case law.

7. *Ineffectiveness of set-offs pursuant to section 96 (1) no. 3 in conjunction with sections 129 et seq. InsO*

Parallel to the avoidance claims, set-offs may also be challenged by the insolvency administrator if the receipt of the set-off position was obtained in an avoidable manner within the meaning of sections 129 *et seq.* InsO. In this case, a declared set-off is invalid and the insolvency administrator may continue to collect the claim against which the creditor has set-off in the opened insolvency proceedings.

Of particular practical relevance are cases in which mutual and, in principle, offsettable claims arise in the last three months before filing for insolvency, but according to the contractual relationship of the creditor with his customer there was no entitlement to obtain the offsetting option. Then the possibility of set-off would be incongruent within the meaning of section 131 InsO with the above-mentioned lesser prerequisites for avoidance. Typical cases of incongruent cover are, for example, that the creditor acquires its claim against the customer by assignment or that the creditor buys an object from the insolvency debtor and thus becomes its debtor.

II. Cash transaction objection

Even if the conditions for avoidance are met, the risk of avoidance in insolvency can be greatly reduced by a timely and congruent exchange of equivalent performances in the sense of a cash transaction.

From the point of view of a cash transaction pursuant to section 142 InsO, a performance is exempt from avoidance if it is countered by an equivalent consideration which has reached the debtor's assets in temporal proximity to the performance and directly.

Contestability remains if and to the extent that the requirements of section 133 (1) InsO are met and if the other party has recognised that the debtor acted unfairly. High demands are to be made on the proof of unfairness. Examples of unfair conduct are to be assumed in cases of deliberate disadvantaging of creditors, in the case of squandering assets for ephemeral luxury goods without benefit to creditors or in the case of disposing of business assets necessary for the continuation of the business. Since this is an indeterminate legal concept on which there is no case law yet, the courts still have to work out on the basis of individual cases when unfair action is to be assumed.

The existence of a cash transaction precludes avoidance under section 130 InsO and must also be considered in the context of avoidance under section 133 InsO. In the case of an incongruent cover within the meaning of section 131 InsO, on the other hand, a cash transaction cannot exist, since in these cases there is always a significant deviation from the original agreement and thus no reason to favour legal acts of the debtor that are settled differently than agreed.[15]

The "immediacy" of the exchange of performance requires a close temporal connection between performance and consideration. According to section 142 (2) sentence 1 InsO, the customs of business transactions are decisive. In a cash transaction, performance and consideration do not have to be concurrent. There may be a certain period of time between performance and consideration. This time span must not be so long that the legal transaction takes on the character of a credit transaction. As a rule, the legal concept of section 286 (3) BGB, according to which the default period is 30 days, can be used to determine the proximity in time. Hence, in general the immediacy requirement is fulfilled if the respective performance and consideration were rendered within 30 days.

If there is a cash transaction, this exchange of services regularly stands in the way of a successful avoidance. Thus, the cash transaction is the most effective protection against an avoidance of performances received during the debtor's crisis.

III. Art. 16 European Insolvency Regulation objection

An important objection against an avoidance claim regarding a cross-border transaction may arise in accordance to Art. 16 European Insolvency Regulation. Generally, the law of the state of the opening of proceedings – here, Germany – shall determine the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to the general body of creditors, see Art. 7 (2) point (m) European Insolvency Regulation.

According to Art. 16 European Insolvency Regulation this shall not apply where the person who benefited from an act detrimental to all the creditors provides proof that (a) the act is subject to the law of a Member State other than that of the State of the opening of proceedings; and (b) the law of that Member State does not allow any means of challenging that act in the relevant case.

14. Cf. BGH, judgement dated 6 May 2021 - IX ZR 72/20, NZI 2021, 720.

15. Settled case law since BGH, judgement dated 30 September 1999 – IX ZR 227/92, BGHZ 123, 320, 324.

Hence, if the transaction is subject to a different Member State law and if such transaction would not be avoidable or by other means challengeable under such law, then, this objection blocks any avoidance claim of a German insolvency administrator.

However, it is a controversial topic as to how the applicable law (the *lex causae*) for a transaction is assessed. In general, if a contractual duty is fulfilled and the contract is subject to the other Member State's law, the statute of debt would lead to the Member State's law to be applicable. The result may differ for example in case of a repayment of a shareholder loan as this legal act can be assessed under several statutes. It affects the standing of the shareholder in the insolvency proceedings as his loan repayment claims by German law (sec. 39 (1) no. 5 InsO) are subordinated in German insolvency proceedings as well as the capital contributions of the shareholder to its subsidiary. Hence, the insolvency statute (German law) or even the company statute (within Member States the incorporation statue would decide the applicable law) could be decisive for the *lex causae*.

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IV. Recommendations for action to minimise the risk of avoidance in insolvency

Besides the objections described above, a creditor can optimise his business relationship with a German debtor to minimise the risk of avoidance in insolvency as follows.

1. For deliveries of goods: Retention of title

Protection against insolvency avoidance can initially be achieved by agreeing on a reservation of title for deliveries of goods. With the agreement of a retention of title, ownership is only transferred to the buyer subject to the condition precedent of payment of the purchase price. If the debtor becomes insolvent before payment has been made, the creditors can then in principle segregate (i.e. demand the return of) their delivered goods in accordance with section 47 InsO in opened insolvency proceedings. In addition, the transfer of ownership by payment of the purchase price is a consideration that falls under the cash transaction pursuant to section 142 InsO, so that payments to

redeem a simple reservation of title are not subject to avoidance as a rule.

Furthermore, extended and expanded reservations of title may be beneficial. In the case of extended retention of title, it is agreed that in the event of processing of the delivered goods, the right in rem, i.e. the ownership, continues in the object that is newly created by the delivered goods. In addition, it can be agreed that in the event of resale of the delivered or processed goods, a security interest is created in the purchase price claim against the further purchaser. The extended retention of title is an agreement that in addition to the purchase price claim for the delivered goods, further claims of the creditor must be satisfied by the customer in order to transfer ownership of the goods. However, at least the extended retention of title does not fall under the cash transaction, as there is regularly a lack of equivalence of the exchanged performances.[16]

2. *Trade credit insurance and avoidance insurance*

Parallel to the retention of title, it may also be advisable to take out trade credit insurance. In the meantime, insurers also offer avoidance insurances, which provide insurance cover for cases of incongruent and congruent cover (including intentional avoidance).

3. *Enforcement of a claim in the crisis of a debtor*

When enforcing a claim against a debtor in crisis the following actions may minimise the avoidance risk:

- No acceptance of a satisfaction by (third-party) benefits to which there was no claim as such (e.g. assignment of claims instead of payment).
- If despite a crisis of a debtor the business relationship shall be continued, it should be ensured that an exchange of services is guaranteed within the meaning of the cash transaction privilege which does not exceed the period of generally 30 days. Fixed payment targets that fall within this period should be agreed and compliance with them should be monitored.
- Performance only after advance payment constitutes a cash transaction if the service is rendered by the creditor within the period of generally 30 days after receipt of the advance payment.
- If mutual claims exist regularly, it may make sense to agree on offsetting the creditor's against the customer's claims as an alternative means of satisfaction. This would make a later set-off in the crisis at least congruent and thus more difficult for the insolvency administrator to contest.
- If the creditor has an enforceable title for its claims (i.e. payment obligations established by enforcement order, judgement or notarial acknowledgement of debt with submission to compulsory enforcement), within the enforcement the creditor should not accept payment by instalments or deferral and the bailiff should also be instructed accordingly. It is then already documented that the debtor cannot pay and voluntary payments by the debtor would in all likelihood be contestable in subsequent insolvency proceedings. However, if the insolvency petition is filed later than 3 months after receipt of a foreclosure proceeding, it cannot be contested, as outside the 3-month only an act of the debtor could be avoided. An actual enforcement, for example by seizure of the debtor's account, cash or claims, is not an act of the debtor.

V. Harmonization Efforts within the EU

On September 24th, 2020, the European Commission introduced an action plan for a Capital Markets Union.[17] Part of said plan is to make the outcomes of insolvency proceedings more predictable. For this reason, "*the Commission will take a legislative or non-legislative initiative for minimum harmonisation or increased convergence in targeted areas of core non-bank insolvency by mid-2022*".[18] Avoidance actions in insolvency proceedings was defined as one of the core elements.

In a next step, a working group, led by Prof. Reinhard Bork (Hamburg University) and Prof. Michael Veder (Radboud University) reviewed the various national insolvency laws of the EU-member states and the UK and drafted a "Model Law on Transactions Avoidance Law"[19] (Model Law) as a harmonization template. This regulatory proposal is currently being reviewed by a group of experts on restructuring and insolvency law appointed by the European Commission. This group of experts is expected to submit a recommendation for action to the European Commission by mid-March 2022. The European Commission must then decide by the end of June 2022 whether to recommend the harmonization of Transactions Avoidance Law to the EU legislative bodies and whether harmonization should take the form of a recommendation, a directive or a regulation.[20]

1. *The approach of the Working Group*

In a first step, the working group identified the actual need for harmonization. Since national insolvency laws differ considerably in the EU, it is undisputed that harmonization of insolvency avoidance rights is necessary. The differences significantly hinder cross-border legal transactions in the EU, as well as the handling of insolvency proceedings including cross-border restructuring efforts.

16. Cf. BGH, judgement dated 12 February 2015 – IX ZR 180/12, NJW 2015, 1756.

17. EUR-Lex Document 52020DC0590.

18. EUR-Lex Document 52020DC0590, Annex, Action 11.

19. https://www.intersentiaonline.com/library/model-law-on-transactions-avoidance-law.

20. Bork, ZRI 2021, p873 *et seq.*

In a next step, the working group defined the scope of the research project. The aim was to formulate standards which could be transposed into national law, thereby creating legal certainty as to which legal acts should be voidable in all Member States under the same conditions and which should not. The project was limited to transaction contestation claims and a *"minimal harmonization"* was sought. It should be regulated what should at least be contestable in all member states under the same conditions and what should not. There is no objection to deviating stricter, national rights.

Methodology-wise, the expert group drafted the model law according to pre-defined principles rather than using a combination of the existing national laws as a template for the model law. It defined general principles of insolvency law in general and those of avoidance law in particular. According to the working group the principles supporting avoidance claims are:

- best possible creditor satisfaction;
- equal treatment of creditors;
- collective principle;
- fixation principle; and
- effectiveness principle.

Principles that set limits to avoidance claims were defined as:

- protection of legitimate expectations;
- predictability (legal certainty); and
- proportionality.

The working group found these principles to be generally accepted and internationally acknowledged.[21] Hence, it used these principles as the defining cornerstones of the Model Law.

Members of the working group have researched the potential impact of the Model Law for the national laws of the member states. The working group will publish these assessments in the near future.[22]

2. *The systematics of the Model Law*

For reasons of legal certainty and transparency, the working group decided to separate the prerequisites for contestation, the grounds for contestation and the legal consequences within the Model Law.[23] The General Prerequisites are laid out in § 1 of the Model Law. Accordingly, legal acts – including forbearance – which have been perfected prior to the opening of the proceedings to the detriment of the general body of creditors are voidable provided the prerequisites of an avoidance ground (§§ 2-5) are met.[24]

According to this broad definition, in principle all legal acts (and omissions) are voidable - i.e. not only legal acts of the debtor but also legal acts of third parties. The decisive factor is the nature of the legal act that is detrimental to the creditors.

The specific grounds for avoidance claims are defined in §§ 2-5 Model Law.

§ 2 Model Law states the grounds for voiding preferential actions including congruent coverages. § 3 Model Law declares certain congruent coverages as not voidable – noteably legal acts performed directly against fair consideration to the benefit of the estate. § 4 Model Law declares legal acts against no or inadequate consideration to be voidable. § 5 Model Law declares legal acts as voidable provided the debtor intentionally disadvantages the general body of creditors.

The legal consequences of voiding a legal act are described in §§ 7, 8 Model Law.

Conclusion

As described above, German avoidance law is relatively complex in relation to the legal systems of other member states. In the case of cross-border insolvencies, this leads to legal consequences that are not always comprehensible for the parties to the proceedings and provide little legal certainty. Against this background, the intended harmonization of avoidance law by defining minimum standards is to be welcomed.

With the introduction of the Restructuring Framework, the EU has shown, that with the appropriate political will, relatively rapid implementation of new legislature is possible.

By using standard legal principles, which are at least recognized by most legislatures within the EU, the working group successfully avoided the otherwise inevitable discussion of whether the Model Law favors one jurisdiction over another. This certainly increased the chances of the Model Law being implemented. However, it remains to be seen whether the EU Commission will put the ball that the working group has set rolling into the goal. ■

21. Bork, ZRI 2021, p873, 876.

22. Bork, ZRI 2021, p873, 879.

23. Bork, ZRI 2021, p873, 876.

24. https://www.intersentiaonline.com/publication/model-law-on-transactions-avoidance-law/2.