Suppliers' rights in the insolvency of a German company

BY DR VOLKER KAMMEL
partner,
Jones Day

BY ALEXANDER STRIGIN
associate,
Jones Day

A COMPANY'S INSOLVENCY USUALLY HAS A SEVERE impact on its business. Customers worry about warranty claims, future deliveries or maintenance work to which they are entitled. Key employees look for other employment opportunities. Suppliers may have delivered goods or provided services to the debtor company and are now confronted with an insolvency filing that creates uncertainty about outstanding payments and future deliveries to the debtor. This is especially true if the debtor is located in a foreign country and if that country's insolvency process is unfamiliar. This briefing provides an overview of the insolvency process in Germany and looks at important issues that suppliers to an insolvent German business should be aware of.

INSOLVENCY PROCEEDINGS IN GERMANY

Once an insolvency application has been filed, either by a company's management or by a creditor, the insolvency court is required to ascertain that the company is insolvent, and to take all measures necessary to secure the company's estate. Such measures usually include the appointment of an interim administrator. A court order determines the powers of the interim administrator. While they may range from mere advisory to full management powers, the interim administrator is, in practice, usually given a supervisory role. Management will require the administrator's consent for the disposal of any assets. The administrator is put in charge of any cash, and must give approval for payments by the debtor company. The company's debtors need to make payment to the administrator's escrow account. The administrator is the person suppliers and customers will approach, rather than management. In practice, this initial phase of the insolvency process (the opening procedure) often lasts between two and three months. The interim administrator and management will, if at all possible, continue to run business operations.

At the end of this period, the court will formally open insolvency proceedings if the company is established to be insolvent and if there are sufficient assets in the estate to cover the cost of proceedings. It will normally appoint an insolvency administrator at the same time. This administrator will take charge of the business and be responsible for its management. The court may also appoint an interim creditors' committee that supports and supervises the administrator. In practice, it is common that a representative of each of the major groups of creditors (eg banks, suppliers, employees) is chosen to serve on the committee. The creditors will be asked to file their claims with the administrator within a certain period of time.

The court will set dates for two creditors' assemblies: an information hearing and an examination hearing. The information hearing is usually within six weeks, and at the latest within three months, of the opening of insolvency proceedings. At this hearing the administrator reports on the company's business situation and the causes of insolvency. They indicate whether it is possible to continue the company's business operations and whether a restructuring by means of an insolvency plan is feasible. The creditors are called on to decide whether the court-appointed administrator should be retained or a new one elected. They will be asked to confirm the members of an interim creditors' committee or to choose a new committee. The creditors will also determine the further course that insolvency proceedings should take. Generally, creditors have the following options:

- winding-up of the business;
- sale of the business as a going concern; or
- restructuring by means of an insolvency plan.

The creditors' decision taken in the information hearing will decide whether the company's business is wound up, either by a sale of individual assets or by the sale of the business as a going concern, or whether the company will be restructured by means of a plan of restructuring. In the former case, the administrator will sell the assets and distribute the sales proceeds to the creditors; proceedings will be terminated once all of the proceeds have been distributed. In the latter case, once the plan of restructuring has been confirmed by the court, the measures it contains will be implemented and, in general, the insolvency proceedings subsequently terminated.

At the examination hearing, the ordinary claims registered by the creditors are examined by the insolvency administrator with respect to amount and rank and are either confirmed or disputed. Claims that the administrator confirms will participate in any distributions from the estate. The administrator's decision to dispute a claim can be challenged in court.

SUPPLIERS' RIGHTS

A supplier that delivered goods that were not paid for before the recipient's insolvency filing will be an ordinary creditor in insolvency proceedings and can only expect to receive a dividend, unless it has taken security for its payment claim. Generally, suppliers retain title to the goods they deliver until they have received payment. A supplier that has retained title is well-advised to establish that its goods are still in the possession of the company as soon as it learns ›

of the insolvency application and the appointment of the interim administrator. One of the first actions of newly appointed interim administrators is usually to take stock of the inventory of the company, so they are normally in a position to determine whether the goods are still there. A supplier claiming ownership will be asked to prove that it is the owner of the goods, unless this is obvious from the records of the insolvent company.

Once the supplier's ownership has been established, it will need to decide whether it wants the goods returned. Its right to demand a return of the goods will depend on the terms of the sale and purchase agreement, specifically the remedies it provides in the event of a payment default by the company, although the insolvency court can pass an order preventing such return of goods. A return of the goods is often not an attractive option for the supplier since it will probably create additional costs and make it necessary to find another buyer. Alternatively, the supplier can allow the interim administrator to process or sell the goods, as the case may be. The interim administrator will frequently only be able to pay for the goods once they have been sold to the company's customers. It is likely that the supplier will lose title to the goods in these cases, leaving it with an ordinary unsecured claim in the company's insolvency.

Once the goods have been moved into Germany, loss of ownership of the goods is, at least under German conflict rules, determined by German law, even if the original ownership of the goods was created under the provisions of the jurisdiction in which the goods were located at the time. If the goods are processed by the company and new products created as a result, under German law the company will become the owner of the new products unless the value of the processing is substantially less than that of the original goods. If goods are irreversibly mingled, the original owners will become co-owners. Similarly, if the supplier authorises the interim administrator to sell the goods to the company's customers, the customers will become the owners once the sale is consummated. To avoid being left with an ordinary payment claim in the insolvency, the supplier will need to take security for its payment claim if it permits the administrator to sell the goods.

It is common to secure a payment claim by agreeing on a prolonged retention of title with the company. This arrangement allows the supplier to retain title to the goods delivered and for the company to assign to it, well ahead of any insolvency application, its future claims against customers that arise from a sale of the goods to those customers. Effectively, the receivables created by the sale to the company's customers take the place of the actual goods as the supplier's collateral. Following the insolvency application, the insolvency court may pass an order requiring the interim administrator to collect the receivables and turn out the proceeds to the secured suppliers.

Similar considerations apply if the supplier decides to continue delivering goods to the insolvent company. If the insolvency administrator enters into a purchase agreement with the supplier after the opening of insolvency proceedings, the supplier's payment claim will be preferred in the insolvency. Depending on the circumstances, it may still be prudent to take security. If there are not sufficient assets in the estate to satisfy even the preferred creditors, the supplier's claim may not be fully satisfied if it relied only on the preferred rank of its claim.

SUPPLIERS' POOL

Secured suppliers often pool their security rights. The members of the pool usually appoint one member (or other person) as a representative who acts on behalf of all pool members and enforces their security rights, especially in negotiations with the insolvency administrator or other secured creditors, such as banks. One of the major advantages of a pool arrangement is that such negotiations are more efficient. The security pool leader is usually someone with substantial experience in insolvency situations, which benefits less experienced pool members. In addition, if it is unclear whether collateral belongs to one supplier or another, a pool allows a utilisation of such collateral for the benefit of both. However, it should be borne in mind that only existing security interests can be pooled: pooling does not create additional security interests and does not extend existing ones. Pool leaders will need to ensure that only suppliers with legally valid security rights are entitled to join the suppliers' pool. If unsecured suppliers are allowed to join, the security rights of the secured suppliers will be diluted.

CONCLUSION

From an economic perspective, a supplier's best option is frequently to continue to sell goods to an insolvent business partner. Care should be taken, however, to analyse the legal situations in the various stages of insolvency and to avoid the pitfalls that an insolvency process in Germany can entail. On the other hand, if a supplier exercises the necessary caution, there is usually no compelling legal reason why it should not continue its business relationship with the insolvent German entity.

By Dr Volker Kammel, partner, and Alexander Strigin, associate, Jones Day.

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