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Insolvency legislation and COVID-19 pandemic

by Dr Hans Janus

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The German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Georgia and Uzbekistan regarding the design of economic policy reform processes and a sustainable development of the economic framework. As part of the project we also work in other countries on selected topics.

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In addition, GET supports German institutions in the political, administrative and business sectors with its know-how and detailed knowledge of the region's economies.

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1 Background

“No healthy company should go bankrupt due to Corona!” With this statement Germany’s Federal Economic Affairs Minister Peter Altmaier announced on 13 March 2020 multi-billion rescue measures for German companies and private entrepreneurs¹, including a hint to the possibility of capital injections from state sources.² Since in the European Union state aid is in principal not permitted, such measures can be implemented only with a respective approval of the European Commission. This approval for the Member States has been given in the form of a “Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak”.³ On the national level in Germany various legal acts have been temporarily amended in order to adapt civil, criminal and insolvency legislation to the needs to fight and mitigate the economic impacts of the coronavirus outbreak.⁴ Avoiding insolvencies due to Corona is one of the central objectives of these rescue measures. In a historically unprecedented way, the German government has also agreed with private Credit Insurance companies on a specific protection shield enabling these insurers to keep their credit lines open and to digest much higher levels of indemnification payments, thus preventing insolvencies or knock-on (domino) insolvencies.

There are serious worries that even healthy companies will not survive the current crisis. In a very recent forecast Euler Hermes, the world’s leading credit insurance company, predicts an increase in insolvencies in 2020 on global level of minimum +20%, resulting from increases in the USA of 25%, in China of 15% and in Europe of 19%.⁵ This demonstrates undoubtedly clear, how important all efforts are to help companies and entrepreneurs to survive the crisis, to rescue jobs and to avoid unnecessary insolvencies.

2 Objectives of possible emergency measures in the area of insolvency legislation

The objectives for measures to slowing-down insolvency proceedings are the same in all countries having established similar legal regulations, e.g.:

- Protect companies temporarily from insolvency proceedings initiated by creditors if the reasons of economic problems is the COVID-19 pandemic;

¹ <https://www.bmwi.de/Redaktion/EN/Pressemitteilungen/2020/20200313-protective-shield-for-employees-and-companies.html>. For the various measures taken in Germany see: German Economic Team GET, Policy Briefing 1/2020: Measures of the German Federal Government to ease the economic consequences of the Corona crisis, <https://www.german-economic-team.com/de/blog/2020/04/30/policy-briefing-01-2020/>

² A substantial state capital injection in Germany’s “Lufthansa AG” has been agreed upon. Similar is a bail-out for Air France-KLM by France and The Netherlands.

³ Communication from the Commission “Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak”, OJ 2020/C 91 I/01 dated 19.03.2020 with later amendments in April and May 2020.

⁴ See: Gesetz zur Abmilderung der Folgen der COVID-19-Pandemie im Zivil-, Insolvenz- und Strafverfahrensrecht vom 27.03.2020, BGBl. 2020 I, S. 569 ff (in the following: “COVID-19 Law”). Austria, France, Russia, Spain, UK and other European countries have adopted comparable legislative measures. For Russia see Federalniy Zakon N 98-FZ of 01.04.2020 and Government Regulation No. 428 of 03.04.2020 and Д. Садыкова, Влияние коронавируса на обязанность по подаче заявления о банкротстве: право или обязанность, https://zakon.ru/blog/2020/04/15/vliyanie_koronovirusa_na_obyazannost_po_podache_zayavleniya_o_bankrotstve_pravo_ili_obyazannost_83238. See also: Buying Time, The Economist, 16. May 2020, p. 51.

⁵ Reopening the world: Beware of false starts, Euler Hermes / Allianz, 23.04.2020, https://www.eulerhermes.com/content/dam/onemarketing/ehndbx/eulerhermes_com/en_gl/erd/publications/pdf/New2020_04_23_COVID19.pdf.

- Release the management temporarily from the obligation to file for bankruptcy if the economic problems are only due to the COVID-19 pandemic;
- Help companies to survive economically intact from the COVID-19 pandemic;
- Help companies which need to undergo a financial rescue or restructuring process to keep trading;
- Maintain access to raw materials and other supplies in order to ensure continuation of production;
- Ensure that creditors get through survival of the company the best return possible in the current circumstances;
- Protect company's directors from prosecution under insolvency and/or criminal law:

Very important is a clear deadline for the legal measures to protect companies from insolvency proceedings and that not all companies are protected, but only those who suffer from direct impacts of the COVID-19 pandemic. Furthermore, there must be a realistic chance that the respective company can overcome its financial problems. In § 1 of the German COVID-19 law it is clearly stated that only companies benefit from the new specific rules whose payment problems are a consequence of the impacts of the COVID-19 pandemic and realistically can be overcome. For companies which have not been insolvent until 31.12.2019 it is assumed that the insolvency emerging in 2020 is a COVID-19 based insolvency. In this case the debtor is not obliged to file for insolvency until 30.09.2020. If the creditor(s) file for insolvency in the period between 28.03. and 28.06.2020, the insolvency proceedings cannot be opened unless the cause of insolvency materialised prior to 01.03.2020.

3 Possible measures to achieve a.m. objectives

The measures implemented to achieve the a.m. objectives are manifold and differ from country to country. There is, however, a certain set of rescue measures which have been implemented in a large number of countries in a more or less similar way.

- Temporary suspension of the obligation of directors/board members to file for insolvency until [30.09.2020]⁶, provided the reason of the [factual] insolvency is COVID-19 based;
- Insolvency applications made by creditors between [28.03.2020 and 28.06.2020]⁷ shall be possible only for insolvencies that had already materialised prior to [01.03.2020];
- Temporary suspension of the “wrongful trading liability” of directors/board members in the case of continued payments despite occurrence of [factual] insolvency in response to the COVID-19 pandemic;
- Fresh money, including from shareholders, in the form of new loans or guarantees for such new loans during the insolvency slow-down period are not treated as an immoral act of delaying bankruptcy. Repayments on these loans until [30.09.2023] are treated as not-disadvantageous vis-à-vis other creditors;
- Repayments on shareholder loans shall be treated in possible future insolvency proceedings applied for until [30.09.2023] as regular debts and not as subordinated loans;
- The “claw-back” of repayments made until [30.09.2023] on new loans issued during the insolvency slow-down period is excluded. Such repayments are treated as not-disadvantageous vis-à-vis other creditors

⁶ Insolvency slow-down period.

⁷ Dates and thresholds mentioned in square brackets refer, as an example, to the German COVID-19 law.

- General suspension of “claw back” procedures for regular payments made or securities provided in the period until [30.09.2020] if the obligation to file for insolvency was suspended. Not applicable if contractual partner knew that the financing or restructuring measures were not suitable to eliminate the insolvency that had occurred.

All these possible measures have the primary objective to gain time for the company concerned, time necessary for rehabilitation and negotiations with creditors.⁸ Such measures can be carried out during this time without the risk of insolvency proceedings being opened. However, these temporary amendments of insolvency legislation are economically efficient only in combination with other official support programmes.⁹

4 Other instruments to protect and rescue companies

One of the most serious problems for companies during the COVID-19 pandemic is the sudden shortage of liquidity. Many rescue measures are particularly focused on the stabilisation or improvement of the liquidity situation of companies, thus securing employment and continuation of business. These measures can protect companies from going bankrupt, or, if [factual] insolvency due to the COVID-19 pandemic has already materialised, help companies to restructure making use of insolvency slow down measures. Some examples for measures activated in various countries are:

- Grants from federal, regional or municipal budget means for self-employed and micro enterprises;
- Bank loans for small, medium sized or large enterprises with no or less strict assessment of creditworthiness, partly or wholly guaranteed by the state;
- State intervention to become shareholder of very large and/or systemic relevant corporations by equity purchase;
- Temporary, interest-free deferral of tax payments due in 2020 if their collection would lead to significant hardship;
- Adjustment (reduction) of current year’s tax prepayments and retroactive reduction of tax prepayments effected in 2019;
- Carry back of assumed losses in tax year 2020 into the preceding business (tax) year 2019;
- Suspension of tax enforcement measures until the end of 2020. Late-payment penalties falling due during this period will be waived as well;
- Reduction or suspension of social security contributions;
- Modification of employment treaties, “short-time allowance” with partial compensation¹⁰ for a loss of earnings caused by a temporary cut in working hours;
- Ban on the termination of lease contracts. Lease contracts for real estate or living/office space must not be terminated as a result of the tenant failing to pay due rent in the period [from 01.04.2020 until 30.06.2020] if the non-payment is caused by the COVID-19 pandemic.

⁸ Buying Time. The Economist, 16.05.2020, p. 51.

⁹ In Germany in the first instance through loans of state-owned development bank KfW or its lending partners.

¹⁰ German: “Kurzarbeit”. In Germany compensation paid from Federal Employment Agency. This reduces the costs faced by employers in the context of employing workers, and enables companies to continue to employ their workforce even in the event of a loss of orders. The short-time allowance helps to prevent job losses.

5 Avoiding insolvencies by protecting supply chains

In addition to relief in legal conditions for insolvency proceedings and liquidity support, there is a very important additional element to protect the industry from very negative consequences of the COVID-19 pandemic. The protection of the uninterrupted flow of supplier credits can reduce or mitigate the great risk of disruption of supply chains with the frequently unavoidable consequence of a company's or an entrepreneur's insolvency. Supplier credits or working capital credit lines are frequently reduced or even withdrawn if the creditworthiness or financial solidity of the debtor is in question.

Credit insurance providers (private or officially supported)¹¹ are specialists in credit risk management and by offering credit insurance they shift the risk of non-payment due to commercial or political risks from the suppliers' balance sheet to their own or their reinsurers' ones. They play by nature an important countercyclical role with their *raison d'être* to guarantee trade credit flows also in difficult times or with companies of yet unknown or knowingly second best creditworthiness.

The major difference between private insurers and state supported Export credit agencies (ECA) is that the latter ones have a clear political mandate and can even in very high risk periods maintain their cover open when private insurers have to protect their balance sheets by reducing their cover or, with other words, "closing the umbrella". Various European governments have increased the offer of their national ECAs in the time of the COVID-19 pandemic, particularly in the area of working capital finance for export production.¹² The European Union has permitted state supported ECAs to cover short term credit risks until the end of 2020 also in the OECD markets, what before has been allowed only to private insurers.¹³ The German government has even gone a step further and established a protection shield of EUR 30 bn for the private credit insurance companies to enable those to continue to provide insurance cover for domestic and export transactions in times of higher credit risk due to the COVID-19 pandemic.¹⁴

By maintaining or increasing credit insurance cover and by keeping working capital lines open, most probably a significant number of insolvency cases can be avoided.

6 Recommendations for insolvency proceedings during the COVID-19 pandemic

Experience from many countries shows that insolvency legislation should be temporarily adjusted in order to increase the chance of companies to survive the difficult economic times under the COVID-19 pandemic. International best practice is still emerging. But the following measures are being introduced in most countries. It can therefore be recommended to:

- protect companies if insolvencies are caused by the COVID-19 pandemic;
- take measures to support uninterrupted supplies of raw materials and other components for maintaining production;

¹¹ Export credit insurance industry response to the COVID-19 pandemic, Berne Union, 20.04.2020.

¹² A. Klasen, Who delivers? European support measures for exporters in times of corona crisis, Global Policy, 22.03.2020, <https://www.globalpolicyjournal.com/blog/22/03/2020/who-delivers-european-support-measures-exporters-times-corona-crisis>.

¹³ Communication from the Commission "Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak", OJ 2020/C 91 I/01 dated 19.03.2020 with later amendments in April and May 2020, paragraphs 32-33.

¹⁴ Press release dated 16.04.2020, „Bundesregierung sichert Warenverkehr ab“, <https://www.bundesfinanzministerium.de/Content/DE/Pressemitteilungen/Finanzpolitik/2020/04/2020-04-16-GPM-Warenverkehr.html>.

- encourage shareholders, banks and other creditors to support companies in financial difficulties due to the COVID-19 pandemic if there is a good chance for survival after the end of the pandemic;
- suspend temporarily the obligation of directors and/or board members to file for insolvency for a period to be defined and only for COVID-19 pandemic caused insolvencies;
- suspend temporarily the insolvency or criminal law responsibility of directors/board members to file for insolvency during the insolvency slow-down period;
- suspend temporarily the filing for insolvency by creditors during the insolvency slow-down period for insolvencies which occurred during that period;
- suspend temporarily the claw-back procedures for defined types of payments or provision of securities and for defined periods.

Every country has to define and implement the measures most appropriate for the national economy and structure of the industry. There is no one blueprint for all countries. Following the modern philosophy of insolvency law, rehabilitation is the much better option than liquidation. Protecting companies which suffer under the COVID-19 pandemic consequences but which are not insolvent due to other economic reasons, deserve to be rescued, even if the costs for such rescue measures are high. Slowing-down insolvency proceedings means buying time. This additional time makes it possible for the debtor to negotiate with creditors about rehabilitation measures. Reduction of tax burden, reduction of labour costs, liquidity support, maintaining credit insurance available and various other measures will prove to be necessary as well. But with the whole range of these measures it should be possible to prevent a significant number of companies from going bankrupt. Jobs will be saved and the economic recovery has a good chance to materialise much faster than without softening the insolvency proceedings.