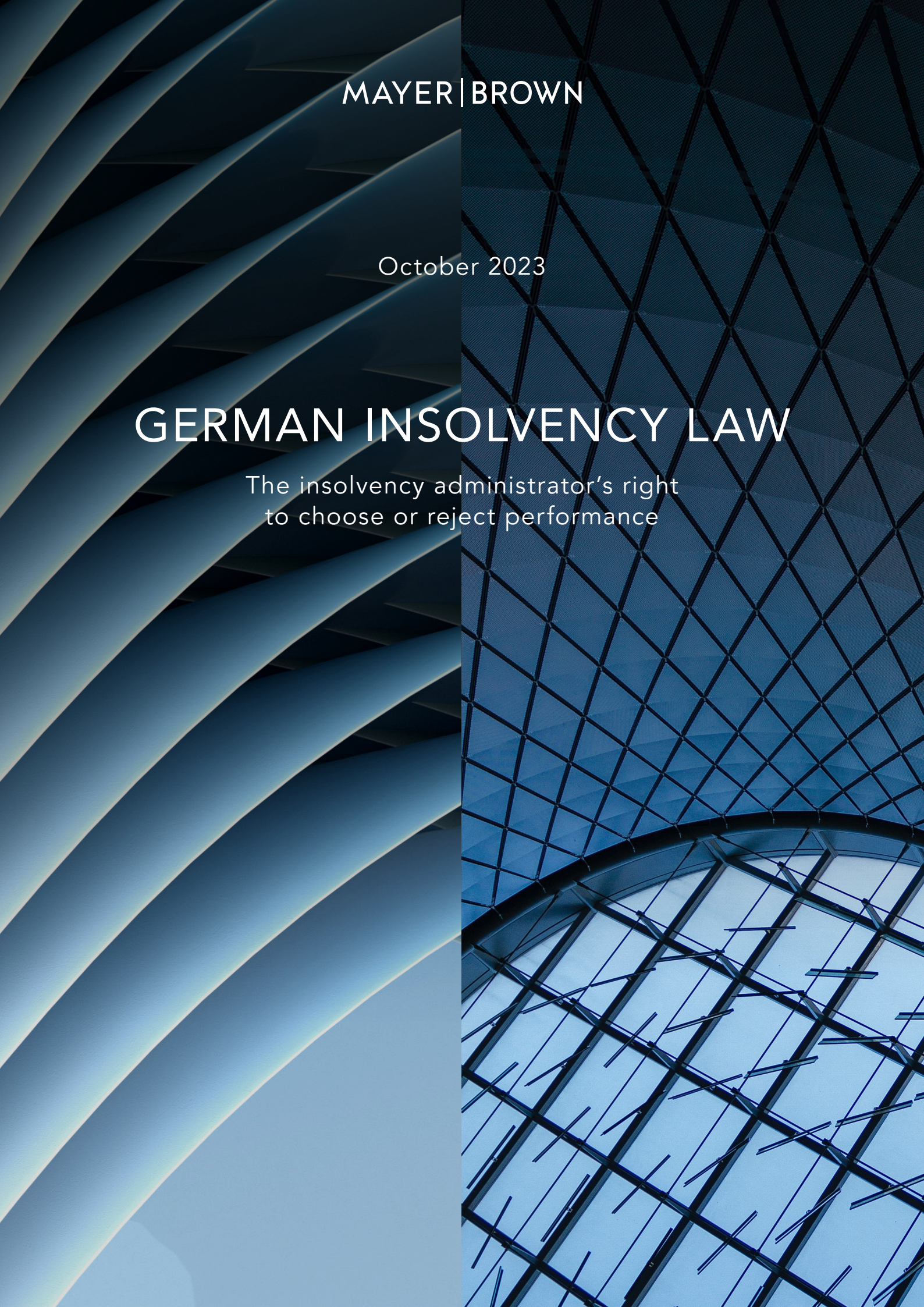

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October 2023

GERMAN INSOLVENCY LAW

The insolvency administrator's right to choose or reject performance

INTRODUCTION

Within German contract law, the principle of being bound by a contract (pacta sunt servanda) (i.e., the obligation to fulfill an agreement) applies. However, in the case of the insolvency of one of the contract parties, exceptions are made. Upon the opening of insolvency proceedings, the principle of being bound by a contract is modified.

The insolvency provisions concerning the fulfillment of mutual contracts (Section 103 et seqq. German Insolvency Code (*Insolvenzordnung InsO*)) grant the insolvency administrator an option right as to whether agreements that had been concluded prior to the opening of proceedings and that have not yet been fully performed by both parties shall still be fulfilled. While the opening of insolvency proceedings does not lead to a substantive transformation of the agreements, any outstanding claims arising from a mutually unperformed agreement are no longer enforceable. The purpose of these rules is to allow the insolvency administrator to maintain or to increase the insolvency estate, to facilitate restructuring attempts, or to discontinue agreements that are detrimental to the insolvency estate. In addition, the contractual partner of the debtor shall be prevented from terminating an agreement that was favorable for the insolvency estate due to the insolvency of the debtor.

The most important stipulations are explained below.

THE INSOLVENCY ADMINISTRATOR'S OPTION RIGHT, SECTION 103 INSO

1. PREREQUISITES

The main prerequisite for exercising the insolvency administrator's option right (*Insolvenzverwalterwahlrecht*) is the mutuality of claims that have not yet or not yet fully been performed by both parties at the time of the opening of insolvency proceedings. Agreements that are often subject to the insolvency administrator's option right are, in particular, purchase agreements, contracts for works and services, license agreements, and loan agreements. The option right does not apply, however, in the context of mutual agreements that have already been fully performed by one party, agreements with a valid termination clause, shareholder agreements, or other agreements subject to specific provisions, such as lease agreements.

The insolvency administrator has to declare the demand for performance vis-à-vis the contracting party. For this declaration, the insolvency administrator is not bound to any time periods. However, the contracting party may request that the insolvency administrator exercise his option right and issue a corresponding declaration. In such case, the insolvency administrator has to issue his declaration "promptly", which means that he must act without undue delay. Thus, the insolvency administrator is allowed to assess the consequences of exercising his option right within a time period reasonable under the circumstances of the individual case (for example, after first obtaining the consent of the creditors' committee, after a final review of possible restructuring options, or after the first report meeting to the creditors (*Berichtstermin*)).

2. CONSEQUENCES AND EFFECTS

a) Choice of Performance:

If the insolvency administrator chooses performance with respect to a mutual, not yet or not yet fully performed agreement, he assumes the rights and obligations of the debtor arising from such agreement. The declaration of the insolvency administrator has an effect only for the future (ex nunc). As a result, the performance owed by the debtor becomes a preferential obligation (*Masseverbindlichkeit*), and the performance owed by the counterparty becomes a preferential claim (*Masseforderung*). The initially agreed contractual terms and conditions remain unchanged. Claims of the contracting party already incurred prior to the opening of the insolvency proceeding are not affected by the insolvency administrator's election to choose performance. Such claims are to be filed as ordinary, unsecured insolvency claims (*Insolvenzforderung*), which are satisfied in the amount of the insolvency dividend quota.

b) Choice of nonperformance:

In cases where the insolvency administrator rejects the performance of a contract, this is only of a declaratory nature, since, as described above, upon the opening of insolvency proceedings, the reciprocal claims are no longer enforceable. The contractual claim of the contracting party is replaced by a compensation claim for nonperformance. The contracting party may file such compensation claim as an insolvency claim with the insolvency claims schedule. The amount of the damage claim is calculated based on the principles of the so-called differential method (*Differenzmethode*). Under this theory, the mutual claims arising from the nonperformance of the agreement are netted against each other. If the result is a positive balance in favor of the contracting party, he can claim this balance as an insolvency claim, which will be subject to the insolvency dividend quota.

SEPARABLE PERFORMANCES, SECTION 105 INSO

Section 105 InsO contains special rules regarding the insolvency administrator's option right for agreements containing separable performances. In particular, this pertains to so-called agreements for continuing obligations (e.g., agreements for the continuous supply of goods or energy). In this context, and regardless of whether the insolvency administrator is opting for performance or not, all counterclaims for partial performances rendered prior to the opening of insolvency proceedings can only be filed as ordinary unsecured insolvency claims. If the insolvency administrator decides to continue the agreement, the contracting party becomes a preferential creditor for all future claims arising from the continued supplies or services. Partial performances already rendered prior to the opening of the insolvency proceeding cannot be reclaimed.

The fact that services already rendered prior to the opening of insolvency proceedings may only be asserted as ordinary unsecured insolvency claims mainly serves the purpose of avoiding an exposure of the insolvency estate. In particular, such exposure could result from the fact that the insolvency administrator would otherwise need to first reject the further performance of the contract to avoid preferential claims against the insolvency estate and might then have to conclude the same agreement under potentially worse conditions.

INVALIDITY OF TERMINATION CLAUSES, SECTION 119 INSO

Contractual agreements excluding or limiting the applicability of the insolvency administrator's option right under Sections 103 et seqq. InsO are invalid. With respect to agreements regarding continuing obligations, the Federal Court of Justice (*Bundesgerichtshof, BGH*) clarified in a landmark ruling of 15 November 2012 (case no. IX ZR 169/11) that termination clauses linked to an insolvency event (*insolvenzabhängige Lösungsklausel*) jeopardize the insolvency administrator's right to choose performance or nonperformance and are therefore invalid. This applies in particular to clauses that grant the parties the right to terminate an agreement for cause if the respective other party has filed for insolvency or if (preliminary) insolvency proceedings have been opened over such party's assets. In a more recent ruling of 27 October 2022 (case no. IX ZR 213/21), the BGH concretized these general regulations to the effect that, in cases in which the statutory law also provides for a termination right for cause (e.g., in the law on contracts for works and services), insolvency-dependent termination clauses mentioning the opening of insolvency proceedings as cause may be valid. However, this requires that the clause be justified by objective reasons at the time the contract is concluded and that the exercise of such termination right in the specific case not be contradictory to good faith (e.g., termination solely with the intention of demanding higher prices).

With respect to creditors of cash payments, insolvency-related termination clauses continue to be generally inadmissible, as these creditors have other protective mechanisms at their disposal, such as the defense of contract nonperformance. Furthermore, termination clauses that are not linked to an insolvency but to other events are usually deemed to be in line with legal regulations. Such events can be, for example, the default of obligations, the initiation of enforcement measures into the assets of the other party, the breach of essential contractual obligations, or the occurrence of a significant deterioration of the financial situation of the other party.

SPECIAL PROVISIONS FOR INDIVIDUAL TYPES OF AGREEMENTS

The insolvency laws provide for special provisions regarding certain types of agreements, which supersede or modify the insolvency administrator's option right:

1. EXPIRY OF AGREEMENTS, SECTIONS 115 – 117 INSO

Save for very limited exceptions, assignments, agency agreements, or powers of attorney relating to the insolvency estate terminate upon the opening of insolvency proceedings by operation of law. Claims regarding a remuneration or reimbursement of expenses agreed in connection with such agreements can only be filed as ordinary, unsecured claims with the insolvency schedule.

2. INAPPLICABILITY OF OPTION RIGHT, SECTIONS 106, 107 INSO

Subject to any avoidance rights, the insolvency administrator's option right does not apply with respect to priority notices (*Vormerkung*) registered in the land register prior to the opening of insolvency proceedings, Section 106 InsO. Hence, such priority notices are insolvency-proof (*insolvenzfest*). Any claims secured by a priority notice must therefore be fully compensated from the insolvency estate.

The same further applies to the purchaser's expectancy right (*Anwartschaftsrecht*) in the event of the insolvency of the seller if the seller has sold a movable item (*bewegliche Sache)* under retention of title and has already granted possession to the purchaser, Section 107 InsO.

3. CONTINUANCE OF CERTAIN CONTRACTUAL OBLIGATIONS – SPECIAL WITHDRAWAL AND TERMINATION RIGHTS, SECTIONS 108 ET SEQ. INSO

Lease agreements on immovable property, as well as employment and service agreements of the debtor, are continued by operation of law, despite the opening of insolvency proceedings, Section 108 InsO. Any claims from such agreements that arose prior to the opening of insolvency proceedings must be filed with the insolvency claims schedule as ordinary unsecured insolvency claims; claims arising after the opening of insolvency proceedings, however, constitute preferential claims. Instead of the insolvency administrator's option right, special termination and withdrawal rights apply for these types of agreements.

a) Lease Agreements

The law on lease agreements grants the insolvency administrator a special termination right with no more than a three-month notice to the end of the month, irrespective of the contractually agreed provisions. This enables the insolvency administrator to avoid a continuation of agreements that are detrimental to the insolvency estate. In case of the insolvency of the lessee, both the insolvency administrator and the lessor may withdraw from the agreement if the rental property has not already been handed over to the lessee at the time of the opening of the proceedings. If the administrator withdraws from the agreement, the lessor may request damage claims for the premature termination as an ordinary unsecured creditor. In case of the lessee's insolvency, the lessor cannot terminate the lease agreement based on the default of rental payments prior to the filing for the opening of insolvency proceedings or because of a deterioration in the financial situation of the lessee (so-called termination stay (*Kündigungssperre*), Section 112 InsO. A termination for other reasons generally remains possible.

b) Employment and Service Agreements

With regard to the laws on employment and service agreements, the insolvency administrator also has the right to terminate the underlying agreement with no more than three month notice to the end of the month, regardless of any contractually agreed or applicable statutory notice period. Employees who would enjoy longer notice periods or are irredeemable under their employment or labor agreements may assert damage claims as ordinary unsecured creditors in the amount of the remuneration and fringe benefits they would have received if regular notice periods had been applicable. For employees whose employment agreements are irredeemable, the amount of the damage claim is, however, limited to the amount calculated on the basis of the longest notice period applicable under statutory law.

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