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ARTICLE

Taking down the Sword of Damocles: Definition of Illiquidity According to the German Federal Court of Justice

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Introduction

> 'Damocles was an excessively flattering courtier in the court of Dionysius II of Syracuse, a 4th Century BC tyrant of Syracuse, Italy. He exclaimed that, as a great man of power and authority, Dionysius was truly fortunate. Dionysius offered to switch places with him for a day, so he could taste first hand that fortune. In the evening a banquet was held, where Damocles very much enjoyed being waited upon like a king. Only at the end of the meal did he look up and notice a sharpened sword hanging by a single piece of horsehair directly above his head. Immediately, he lost all taste for the fine foods and beautiful boys and asked leave of the tyrant, saying he no longer wanted to be so fortunate.'[1]

Even if the German bankruptcy law nowadays does not represent imminent danger for the life and livelihood of managing directors and boards of directors, it does contain peculiarities which both domestic companies as well as foreign companies with German holdings must take into consideration and the ignorance of which may result in unpleasant fines for the management.

One of the main issues is that the debtor's management is often faced with Hobson's choice when it comes to their duty to file for insolvency (i.e. in case of illiquidity or over-indebtedness): if they file too early, shareholders will sue them for ruining the company, and if they file too late, they will become liable to the creditors for the undue decrease of the insolvency assets. This dilemma was even amplified in the past due to the lack of a detailed legal definition of illiquidity, which is by far the most common reason for the opening of insolvency proceedings.

The following article intends to give a brief description of how to determine illiquidity according to German insolvency law, and what management needs to do in this event.

Definition of illiquidity according to German Federal Court of Justice

According to the law, a debtor is illiquid if he is unable to meet his due obligations (sec. 17 Insolvency Code, InsO). This definition sounds concise and easy, but due to a lack of high court precedents it was unclear for a long time under which conditions a debtor is regarded as being illiquid.

Discussion has frequently centered around whether even the smallest or shortest shortage was to be viewed as illiquidity or if small, temporary bottlenecks in payments should not be included. There were a number of opinions in this regard. In some cases – literal interpretations of the law – the opinion was that liquidity shortages, even if they only existed for one day, were sufficient for meeting the requirements of insolvency.[2] According to this interpretation '*very slight*' shortages – whereby 'very slight' shortages could be from 5%,[3] to 20%[4] or even up to 25%[5] – were not hazardous.

The period of time granted to the debtor to overcome the illiquidity before he is obligated to file for bankruptcy was also disputed and ranged from one week[6] to 3 months.[7]

Notes

1 Legend of Damocles according to <www.wikipedia.org>.
2 Temme, *Die Eröffnungsgründe der Insolvenzordnung* 1997 p. 35 et seq.; Bieneck, *Strafverteidiger* 1999, p. 43 et seq.; Uhlenbruck, *Insolvenzordnung* (12th edn) § 17, side note 10; Kübler/Prütting/Pape, *Insolvenzordnung*, § 17, side note 13.
3 Amtsgericht Cologne, NZI 2000, 89, 91; Hess/Weis/Wienberg, *Insolvenzordnung*, 2nd edn, § 17 side note 17; Smid, *Grundzüge des Insolvenzrechts*, 4th edn, p. 71.
4 Haarmeyer/Wutzke/Förster, *Handbuch zur Insolvenzordnung* 3rd edn, chapter 1 side note 85.
5 Landgericht Augsburg, DZWIR 2003, p. 304; Harz, ZInsO 2001, p. 196.
6 Haarmeyer/Wutzke/Förster, *Handbuch zur Insolvenzordnung* 3rd edn, chapter 1 side note 86.
7 Harz, ZInsO 2001, p. 197.

This unpleasant uncertainty in the interpretation of law was only ended in 2005 when the BGH (German Federal Court of Justice) established precise criteria which have since been applied for the determination of insolvency.

In its ruling dated 24 May 2005, the German Federal Court of Justice (*Bundesgerichtshof*, BGH, judgment as of 24 May 2005, file no. IX ZR 123/04) ruled as follows:

> 'A mere stagnation of payment – and therefore no illiquidity – exists if the debtor can secure the necessary liquidity within a period of three weeks.
>
> If the liquidity gap cannot be eliminated within three weeks and is smaller than 10% of all due payables, the debtor is deemed to be not illiquid unless it can be expected that the gap will become larger than 10%.
>
> If the liquidity gap that cannot be eliminated within three weeks is larger than 10% of all due payables, the debtor is deemed to be illiquid unless it is virtually certain that, due to exceptional circumstances, the liquidity gap can be eliminated almost completely in the near future and it can be demanded of the creditors to wait for their payment under the special circumstances of the case.'

The decision therefore contains two important limitations, a) a funding gap that is closed within three weeks by securing the necessary funds does not lead to illiquidity and b) if the debtor cannot close the gap within three weeks and therefore has an ongoing contingent of payables that are not covered with sufficient means of payment ('bow wash'), the question of illiquidity largely depends on whether the percentage of liabilities that are covered is above or under 90% of all due payables. Under 90%, a reversal of the burden of proof takes effect, resulting in a strong but refutable presumption of illiquidity, i.e. the debtor has to prove that this funding gap can be closed almost completely in the foreseeable future. It should be emphasized that in this case a mere reduction to under the 10% barrier of uncovered liabilities is not sufficient but only an almost entire elimination of the gap.

Practical implications for an illiquidity audit

As there are no official instructions on how to apply the aforementioned decision in practice, the manner of assessing illiquidity is largely determined by the applicable professional standard IDW PS 800 of the Institute of Chartered Accountants in Germany (*Institut der Wirtschaftsprüfer in Deutschland e.V.*, IDW). Although not a formal law, this standard is in fact binding due to its wide acceptance. According to IDW PS 800, an illiquidity audit requires two steps: (i) a financial status of all liquidity-related items and (ii) a financial plan based thereon.

Financial status

The financial status is an inventory of all liquid financial resources such as cash, cash equivalents, and accounts receivable on the one hand and all payable liabilities on the other hand. The receivables have to be adjusted with regard to necessary write-offs for irrecoverable amounts. Consequently, all items should be structured according to their respective due date or anticipated date of payment.

Contractually agreed deferrals can be considered and have to be documented in a sufficient manner. However, mere inactivity on the part of a creditor without an underlying deferral agreement must not be taken into account. All agreements and assumptions made with regard to the time of payment and/or the respective risk of default must be documented in a proper manner in order to allow reconciliation.

It should be pointed out that the above rules also apply with regard to affiliated companies, i.e. any deferral of a payment has to be agreed upon with the respective affiliated company before a due date later than the original one can be considered in the financial status. However, due to the general principle of prudence, all incoming payments have to be planned with their realistic date of payment, even if this date is later than the contracted due date. Thus, a failure of affiliated companies to pay in a timely manner reduces the aforementioned cover ratio at least temporarily and might therefore result in the firm's exceeding the limit values of the BGH (i.e. a gap of more than 10% uncovered liabilities that cannot be closed within three weeks). As the latter leads to the aforementioned assumption of illiquidity (and the necessity to be able to close the gap almost completely in the foreseeable future), a delay of payment from affiliated companies contains the same risk of causing illiquidity as any delayed payment from a third party does.

Financial plan

In a second step, the financial status is extended into a financial plan on a weekly (or even daily basis, if the liquidity situation is particularly strained). The planning horizon should cover approximately three months.

Planned or already initiated measures to improve liquidity can be accounted for if – and as far as – these measures are sufficiently measurable and plausible.

In order to continuously improve the assumptions made, past deviations from the planning should be monitored and accounted for in future forecasts. Again, all underlying assumptions must be documented consistently and comprehensibly.

The table below shows different possible scenarios according to the BGH ruling:

Scenario	*Liquidity gap in % of all due liabilities*	*Duration of liquidity gap*	*Comment*	*Illiquidity Yes / No*
1	No specifications	≤ 3 weeks	Example of a mere stagnation of payment; the liquidity gap can be closed completely within three weeks	No
2	< 10%	> 3 weeks	The current funding gap cannot be closed within three weeks, but will not exceed 10% in the foreseeable future	No
3	< 10%	> 3 weeks	The current funding gap cannot be closed within three weeks and will further increase to over 10% in the foreseeable future.	Yes
4	> 10%	> 3 weeks	The current funding gap cannot be closed within three weeks, but can be eliminated completely in the foreseeable future. It can be demanded of creditors to wait for their payments under the special circumstances of the case.	No
5	> 10%	> 3 weeks	The current funding gap cannot be closed within three weeks, but can be eliminated completely in the foreseeable future. It cannot be demanded of creditors to wait for their payments under the special circumstances of the case.	Yes
6	> 10%	> 3 weeks	If the gap cannot be closed within three weeks and will not be eliminated in the foreseeable future, the company is deemed to be illiquid.	Yes

Management's duties in case of illiquidity

In case of illiquidity, the managing directors have to file for insolvency without delay to avoid culpability and at the latest within three weeks after beginning of the illiquidity (sec. 64 no. 1 Limited Liability Corporation Act, GmbHG; sec. 92 no. 2 Stock Corporations Act, AktG). This obligation to apply for insolvency in connection with the general duty of care requires the managing directors to closely monitor the liquidity on an ongoing basis. The BGH ruled that the prognosis of the development of the future liquidity has to be updated with every single payment [sic!] if necessary.

The law also requires the managing directors to document properly all decisions and assumptions made and the data upon which they are based. This is particularly important in a potential crisis of the firm as such a crisis significantly increases the risk of a personal liability. As the burden of proof is with the directors in this regard, it is highly recommended to adhere closely to the obligations regarding the documentation.

In case of a breach of their duties, the managing directors can become personally liable for any payment after the beginning of illiquidity if these payments are not within the duty of care of an orderly and diligent manager, irrespective of whether those payments were made towards affiliated companies or third parties (sec. 64 no. 2 GmbHG, sec. 93 no. 3 AktG). In addition, a culpably committed delay in the submission of the application for insolvency is a criminal offense (sec. 84 no. 1.2 GmbHG, sec. 401 no. 1 AktG), and any neglect of duties can trigger further penalties and liability for damages.

In addition to the debtor, a creditor is entitled to apply for insolvency, too, if he is able to show his claim and the reason why insolvency proceedings should be opened (sec. 14 InsO). Thus, a 'bow wash' of unpaid liabilities bears the inherent risk of a request for insolvency proceedings from one of the creditors. As the right for application is not dependent on the amount of the obligation due, the risk actually rises with the number of creditors, even if the individual outstanding payment is relatively low. Even if the criteria of illiquidity are not fulfilled, an application for insolvency proceedings from a creditor always binds valuable resources in order to provide evidence of sufficient funding before court.

Summary

According to the ruling of the BGH as of 2005, a debtor is deemed to be illiquid if a liquidity gap of at least 10% cannot be closed within three weeks. While this judgment on the one hand clarified the qualifications of illiquidity and disposed of a long-lasting uncertainty, it also demands diligent efforts by the management to monitor and document the company's liquidity. Management need to obey these requirements to avoid personal liability, and shareholders need to understand that their management acts under these conditions.

While the sword of Damocles of the threat of personal liability still hangs over the head of management despite the BGH ruling, it is at least hanging with somewhat more than a single strand of horsehair.

International Corporate Rescue

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