Germany: Start-ups in a crisis - what to watch out for? Evaluation of recent German court decisions

Introduction

German start-ups quite rightly promote an improved culture of failure, as exemplified in the US start-up environment. In fact, most start-ups fail: depending on the statistics, there is talk of a failure-rate of between 80% and 90% in the first five years after founding the company. The implementation of an innovative idea in one's own company is necessarily risky - but nothing ventured, nothing gained.

However, the risk of the founders should ideally be limited to the invested equity and the work expended, which are often irretrievably lost in the event of failure. Founders are aware of this risk and consciously accept it. What many people are less aware of is that in Germany there are very strict legal obligations to file for insolvency, the violation of which may lead to a personal liability of the managing directors - a late filing for insolvency is even punishable under criminal law. It is particularly problematic that German law - unlike other legal systems - not only requires the managing directors to check that the company is solvent at all times and, if this is no longer the case (i.e. in the event of illiquidity), to "pull the plug" in good time. Rather, due to the second existing mandatory insolvency reason of over-indebtedness (in addition to illiquidity), the management must assess in the form of a forecast whether the company is likely to be "financed through" for the next 12 months, which means: whether it will remain liquid during that timeframe. Such a liquidity forecast is naturally more difficult for start-ups than it is for other companies.

Accordingly, there are some calls for the concept of over-indebtedness, and in particular its component of the so-called "going concern forecast", to be interpreted differently in the case of start-ups than in the case of established companies. "Different" meaning "milder", namely in the sense that the uncertainties inherent to a start-up do not become a permanent threat of liability due to insolvency delay for the managing directors. Most recently, important German courts have ruled on this issue in a number of decisions, which is reason for us to summarize the status quo to hopefully shed some light for interested founders or managers of start-ups. To anticipate the essential result: Contrary to a promising decision of the Higher Regional Court of Duesseldorf (an important regional court), the yet more important Federal Court of Justice ("**BGH**") has (unfortunately) not decided on a relief for start-ups.

Risks in a crisis situation: obligation to file for insolvecy / liability for made payments after insolvency has occured

Obligation to file for insolvency

If a company becomes illiquid or over-indebted, the managing directors are obliged to file for insolvency without undue delay (section 15a of the German Insolvency Code, "**InsO**"). "Without undue delay" can sometimes mean "immediately", but the law generally provides for (maximum) deadlines in order to give the management some time for last promising rescue attempts and the preparation of an insolvency application.

In the event of illiquidity, the insolvency petition must be filed by the managing directors within three weeks of its occurrence at the latest; in the event of over-indebtedness, after six weeks at the latest. A

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breach of the obligation to file for insolvency may give rise to personal liability (for damages) on the part of the managing director and, in the worst case, may even lead to criminal liability.

The obligation to file for insolvency must be taken very seriously. If there are signs that the company will soon run out of money, decisive and swift action is required. This does not mean that an insolvency petition must be filed in haste as soon as there are signs of a crisis - every case is different. In any case, however, the assumptions made in connection with the efforts to eliminate the crisis and the progress of negotiations should be very closely documented.

Liability for payments made after insolvency has occurred

Once a mandatory insolvency reason materialises, i.e. illiquidity and over-indebtedness, the managing directors of a company must generally reduce the company's business activities to the bare minimum. If they do not do so, they risk personal liability for payments made after that date (section 15b InsO).

Despite the general prohibition, payments are permissible by way of exception provided that they are consistent with the due care and diligence of a prudent and conscientious business man. This is particularly the case if the managing director makes the payments in the ordinary course of business, they serve to maintain business operations and the management either deals with promising sustainable rescue attempts or prepares an insolvency application - and above all the insolvency application deadlines are met.

Interim summary

It is important for managing directors of (ailing) companies to be aware of the above-mentioned liability risks. A basic understanding and a certain sensitivity for the mandatory insolvency reasons of illiquidity and over-indebtedness are indispensable. These are briefly explained below.

Mandantory insolvency reasons

In view of the above-mentioned liability risks and reasons for insolvency, the main focus is on liquidity - thus, in the case of illiquidity, the current liquidity of the company is of particular importance, while in the case of over-indebtedness, the (likely) future liquidity of the company becomes relevant.

Illiquidity

By far the most important reason for insolvency in practice is illiquidity (section 17 InsO). A company is illiquid if it is no longer able to meet its current liabilities. This is a cut-off date test. To determine illiquidity, the company's available cash and cash equivalents are compared with the payment obligations due in a so-called "liquidity balance sheet", also known as "liquidity status". In principle, the company must have so many liquid assets that it is able to service all its due liabilities (immediately); and this every day. Only in exceptional cases can a due liability be excluded from this test, for example if it is deferred by the creditor or "not seriously claimed".

The determination of illiquidity is comparatively easy compared to over- indebtedness. Even if you don't know the legal term, it's more of an "*'I'll recognize it, when I see it*" insolvency reason - you usually notice it when liquidity runs out and you have to ask creditors for payment deferrals. At that point, at the latest, all alarm bells should ring.

Over-indebtedness

The liquidity of the company also plays a decisive role in determining over-indebtedness (section 19 InsO); however, the time horizon is significantly longer here than in the case of illiquidity.

Over-indebtedness exists if the assets of the company no longer cover its existing liabilities (so-called "mathematical over-indebtedness", which is to be determined by way of an over-indebtedness balance sheet on the basis of liquidation values), unless the continuation of the debtor company is predominantly likely under the circumstances (so-called "positive continuation forecast"). Over the years, German courts have worked out that the going concern forecast to be established in the over-indebtedness test is in essence also a liquidity forecast. In practice, it was unclear for a long time what the relevant time horizon was (it was predominantly argued that it was the current and subsequent financial year). At the beginning of 2021, the German legislator clarified that the relevant forecast period for over-indebtedness is 12 months. Thus, a company is not over-indebted if it is "financed through" with an more than likely probability (i.e. at least 50% + 1) for the next 12 months and is able to meet its liabilities as they fall due or become due during this period.

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In the case of start-ups, however, both (i) the assessment of mathematical over-indebtedness and (ii) the affirmation of a positive going concern prognosis are often not easy in practice.

As far as the mathematical over-indebtedness is concerned, this is often given in the case of start-ups in crisis for reasons of prudence even if positive equity can still be shown in the general commercial balance sheet. This is because in the over-indebtedness balance sheet "hidden burdens" of the commercial balance sheet have to be corrected, which regularly leads to a lower valuation of the start-up's assets than in the commercial balance sheet (especially in connection with IP). The real asset of most start-ups - the inventive idea or the know-how - does typically not remedy an arithmetical over-indebtedness, as these values are often not allowed from being considered in the balance sheet. It is true that, with regard to the liabilities side of the balance sheet, start-ups are often primarily equity financed and do not have high external liabilities. However, if there are external liabilities or if provisions for impending/potential losses have to be built, the asset side of the balance sheet will often not be sufficient to offset these in an assumed liquidation scenario in the company crisis.

Against this background, the affirmation of a positive continuation forecast for start-ups is of central importance. However, since most start-ups are economically unprofitable and loss-making in the initial phase - and this often over longer periods of time - the question arises as to how this can be reconciled with the required "financing through" for the next 12 months. An "unreflective" application of this yardstick could spell immediate doom for many start-ups. Therefore, when determining the positive going concern forecast for start-ups, should the same standard be applied as for established companies? Two German courts recently dealt with this question - one directly and the other indirectly.

Higher Regional Court of Duesseldorf of 20 July 2021 - 12 W 7/21

In a recent decision, the Higher Regional Court of Duesseldorf, with reference to the previous case law of the Federal Court of Justice and contrary to individual commentators in the German legal literature, first clarifies that the positive going concern forecast is not a "profitability forecast". This means that it is not necessary for the company to be able to finance itself ("self-financing capacity") for a positive going concern forecast to be affirmed. The only decisive factor is that the company is financed through for at least 12 months, whereby the necessary funds can also be made available to the company by third parties in the short, medium or long term (external financing). This view of the Higher Regional Court of Duesseldorf is to be agreed with without reservation. In particular with regard to start-ups, a different view would also be fatal, since it is inherent in these that they are loss-making, at least in the initial phase.

In a further step, the Higher Regional Court of Duesseldorf then deals with the question of which requirements have to be met in order to demonstrate an "overwhelming probability" of being financed. In the specific case, the former shareholder and investor of the start-up had regularly provided recurring financial services in the form of loans to the start-up in the past. According to the investor's own statements, the managing directors of the start-up were able to rely on the fact that he would continue to provide funding upon the delivery of a "comprehensible business plan" (commitment subject to reservation). In the specific case, this ultimately did not happen.

Nevertheless, the Higher Regional Court of Duesseldorf affirmed - until the final refusal by the investor - the existence of a positive going concern prognosis. According to the court, a positive going concern prognosis can always be (further) affirmed "*as long as it is not concretely probable that the financier will not continue to finance the start-up company*". In this context, the Higher Regional Court of Duesseldorf emphasises that, in particular, a legally secured and enforceable claim to a financing contribution is not required.

What the Higher Regional Court of Duesseldorf understands by "concretely probable" and which indications can be of importance here (except of course the explicit refusal of further financing) remains open. Overall, however, the approach of the Higher Regional Court of Duesseldorf is likely to be start-up friendly, as it initially establishes a kind of "rebuttable presumption" for continued financing by the previous investor. Whether this view is justifiable in practice, however, is questionable, especially in view of a decision of the BGH issued shortly before (1 week) in a different case.

Federal Court of Justice of 13 July 2021 - II ZR 84/20

In line with the Higher Regional Court of Duesseldorf, the BGH (in another case) has also confirmed in a recent decision that legally binding assurances about necessary financing contributions by third parties are not mandatory for the affirmation of a positive going concern prognosis (para. 78). The specific case concerned an internal "comfort letter" issued by the shareholder of the company. It was not clear whether the comfort letter was to be understood as "hard" or "soft". In the former case, there would be a legally binding

claim for the provision of liquidity by the shareholder. In the case of a soft letter of comfort, on the other hand, this would not be the case.

The BGH clarified that in the case of a "soft" letter of comfort, i.e. where there is no enforceable legal claim to the support payment, there are, however, narrow limits to the discretion of the management with regard to the (continued) existence of a positive going concern prognosis against the background of the interests of the company's creditors (para. 80).

In this context, the BGH states that non-binding financing promises (by third parties) can only be taken into account in the company's earnings and financial planning in exceptional cases (para. 81). If it becomes apparent that liquidity is not assured in the relevant forecast period without support measures from third parties and, for example, a shareholder is no longer prepared to cover the necessary financial requirements while accepting a (considerable) risk of loss in the event of insolvency, for example by providing additional equity capital, subordinated debt capital, etc., an prudent managing director cannot as a rule assume that the necessary funds will be made available to him (paras. 81, 82). Something else should only apply in absolutely exceptional cases, for example if the shareholder is active without the intention of making a profit or, for example, in the area of services of general interest. However, such exceptional circumstances must be substantiated and proven by the management of the company (marginal no. 82). For this purpose, the indication that the third party/shareholder has already provided financial resources in the past, even if these may have been substantial, is not sufficient in itself (marginal no. 83).

Thus, the BGH takes a much more restrictive, if not contrary, view than the Higher Regional Court of Duesseldorf. In particular, the BGH does not make an exception for start-ups at any point in its decision.

Conclusion / Recommendation for action

Most start-ups do not have their own earning power in the sense that they can finance themselves through their sales, at least in the early days. This presents start-ups and their managers with considerable legal challenges, especially if necessary financing commitments from third parties fail to materialise or are no longer provided without hesitation. In these situations, the managing directors have to observe increased due diligence obligations, in particular with regard to insolvency-related liability risks (such as a liability for a belated filing for insolvency etc.).

While the illiquidity of the start-up can be monitored relatively easily on the basis of a 13-week liquidity plan (i.e. taking into account the planned cash inflows and outflows according to accounting), this is much more difficult in the case of insolvency due to over-indebtedness. In this case, it must be regularly determined whether the start-up is "financed through" for the next 12 months with an overwhelming probability (i.e. at least 50 % + 1) (positive continuation forecast). Under which circumstances financing contributions from third parties (e.g. shareholders) may be taken into account in the context of the required income planning is not easy to answer in some cases. Case law is also - as has been shown - inconsistent here, with the BGH taking a rather "conservative" stance, especially when it comes to (as yet) non-binding commitments. According to the BGH, these are generally not to be taken into account, even if the third party/shareholder has already provided substantial financial resources in the past. There is no exception to this principle for start-ups. In view of the unclear legal situation and the considerable insolvency-related liability risks, the managing directors of start-ups in crisis are therefore urgently recommended to pay attention to clean (written) documentation. All indications that speak for a future provision of necessary funds by third parties should be recorded in writing and re-evaluated at regular intervals; if necessary, with the help of experienced advisors.

Finally, it remains to refer to section 1 of the new German restructuring law ("**StaRUG**") in this context. The provision was introduced by the StaRUG ("Act on the Stabilisation and Restructuring Framework for Enterprises"), which came into force in Germany on 1 January 2021. Section 1 StaRUG provides for a generally applicable duty of managing directors to identify risks at an early stage and to manage crises, an obligation which is not restricted to StaRUG constellations. This also applies to start-ups.

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