

Security Interests in German Insolvency Proceedings

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Recent German insolvency proceedings (such as BenQ Mobile GmbH & Co. OHG, Munich) addressed the treatment of security interests in mobile phone parts, software and other tangible and intangible property under German law. Security interests are of vital importance for creditors facing the possibility of a deficiency, particularly when the debtor is insolvent or on the brink of insolvency. Almost every legal system regulates security interests in such circumstances. This article focuses on the treatment of security interests in German insolvency proceedings and provides a brief outline of issues that are especially relevant to many foreign suppliers.

The treatment of security interests in German insolvency cases is regulated in the German Insolvency Code (*Insolvenzordnung*, InsO), in §47 *et seq.* InsO. The Insolvency Code differentiates between the right to separation from the estate (*Aussonderung*) and the right to separate satisfaction (*Absonderung*), which is a permissible preferential treatment of creditors. In order to enforce their rights to separation from the estate or to separate satisfaction, creditors also often enter into pool agreements, which do not have an equivalent in U.S. bankruptcy proceedings.

1. Right to separation (*Aussonderung*)

Generally, only the assets of the debtor are available to the debtor's insolvency creditors (§35 InsO). Third party's property must be separated from the assets that the debtor had at the outset of the insolvency proceedings. In other words, individuals and entities entitled to separation are not insolvency creditors (§47 s. 1 InsO). The claims in exercise of a creditor's right to separation are not being asserted as insolvency claims (*i.e.*, by filing a proof of claim with the insolvency administrator who, upon the claim's allowance, would enter it into the schedule), but pursuant to noninsolvency laws (§47 s. 2 InsO) in regular civil proceedings.

The Insolvency Code does not stipulate who is entitled to separation from the estate. Section 47 s. 1 of the Insolvency Code only provides that a creditor has the right to separation based on an underlying *in rem*, or personal right, which entitles such creditor to claim that the collateral does not belong to the debtor's insolvency estate. If the property subject to a creditor's right to separation is personalty, the owner can request its return. If it is real property, the creditor could also potentially request correction of the land register. Any one of these claims has to be asserted in regular civil proceedings against the insolvency administrator. In addition, the creditor has the burden to prove the facts, which establish its right to separation.

Certain other *in rem* rights also give rise to a right to separation, for instance, the right of pre-emption of real estate. The seller can also separate its retention of title in the collateral when the administrator decides to reject the purchase contract between the creditor-seller and the debtor-purchaser. However, this applies only to *simple retention of title* (*einfacher Eigen-*

tumsvorbehalt), which secures only the debtor's payment of the purchase price for the sold object or collateral. In sum, in an insolvency proceeding, the right to separation is a superior security interest to any other security interest.

2. Separate Satisfaction (*Absonderung*)

Creditors with a security interest in property of the debtor have no right in the collateral itself, but only in its value and only up to the amount of their secured claims. Such creditors can only request preferential or separate satisfaction from the security collateral prior to all other creditors of the debtor. Separate satisfaction requires "realization" or reduction to monetary value of the collateral, which is subject to the creditor's right to separate satisfaction. The creditor is entitled to the resulting proceeds up to the amount of its secured claim.

If the collateral is real estate, creditors are entitled to separate satisfaction when, for example, they have a lien or mortgage on the property, which is subject to the judicial execution of immovable assets (§49 InsO). With respect to personal property, creditors are entitled to separate satisfaction if they hold a contractual pledge, a pledge acquired by attachment, or a legal lien on the collateral. (§50 InsO).

A transfer by way of security (*Sicherungsübereignung*) and an assignment for security (*Sicherungscession*) (§51 No. 1 InsO) are treated similarly to pledges. Although the recipient of the security is the formal-legal owner or creditor, he or she cannot separate the collateral from the debtor's insolvency estate. Such creditor transferor or assignor can only demand separate satisfaction since it only has an interest in the value that would be realized from the collateral and not in the collateral itself.

Pursuant to §51 No. 1 of the Insolvency Code, extended and expanded retentions of titles are also grounds for a creditor's right to separate satisfaction. If the debtor has sold an item and has assigned the subsequent claims in advance to the seller/supplier (*extended ROT, verlängerteter Eigentumsvorbehalt*), the seller can only demand separate satisfaction. Hence, the insolvency administrator will collect the claims (or will otherwise realize their monetary value) (§166 para 2 InsO) and will satisfy the seller out of the net realized proceeds after deducting costs (§170 para 1 InsO). If the sale item is still in debtor's possession, however, the seller has a right to separation.

The same rules apply to an agreement, which provides that title to the sale item will transfer only when all claims resulting from the business relationship between seller and purchaser are fulfilled (*expanded ROT, erweiterter Eigentumsvorbehalt*). As long as the debtor-purchaser has not paid the purchase price for the property that the creditor-seller had delivered, the seller has the right to separate it from the estate. Thereafter, the seller has only a right to separate satisfaction on account of an expanded retention of title.

Who has authority to liquidate personal property or to realize its monetary value depends on whether or not the insolvency administrator has possession of it. An insolvency administrator in possession of personal property collateral is also authorized to realize or liquidate the same (§166 InsO). Otherwise, the creditor can realize or liquidate the collateral (§173 para 1 InsO), provided that the creditor also has the right to separate satisfaction pursuant to applicable sub-

stantive law. If more than one creditor is entitled to separate satisfaction, the creditors' ranking order follows the general principles of priority under substantive law.

3. Pool Agreements

Pool agreements are of significant importance in German practice. Although such arrangements are not directly regulated by legislation, they are generally accepted and subject to the general civil law rules. In many cases, pools are established due to a potential or existing insolvency of the debtor. They are even possible during ongoing insolvency proceedings.

The purpose of a typical pool agreement is to avoid or prevent factual and legal difficulties that may arise if separate creditors assert potentially conflicting and uncertain security interests in the same collateral by bundling the interests and rights of all creditors entitled to separation. The pool is authorised to facilitate the resolution of all creditor rights in particular property. By comparison, a creditor who does not join a pool agreement would have to prove its right to separation of a specific item, which may turn out to be very difficult, if not impossible. One example would be a creditor's attempt to establish its rights in software or parts installed in hundreds or thousands of cellular phones. It is significantly less costly and more practical for all creditors who assert rights in the collateral to have only one pool trustee rather than each single creditor negotiate with the insolvency administrator regarding all affected items and rights.

Due to the creditors' different needs and rights, there are many types of pool agreements. Pool agreements may differ depending on the time the creditors enter into them (either prior or subsequent to the commencement of the insolvency proceedings), and on whether the insolvency administrator is a party to the pool agreement or not. Further, pool agreements can be divided into pools servicing the security interest claims of creditors that participate in the pool (security interests pools) or servicing the liquidation of collateral subject to such security interests (realization pools). Finally, pools can be differentiated based on their participants: bank pools, supplier pools or mixed pools.

Conclusion

The rights to separation and separate satisfaction, which German law grants to secured creditors when the debtor is in insolvency, provide different yet sufficient protection against deficiency. In order to further improve the successful assertion of their right to separation, creditors in Germany often participate in pool agreements. Understanding these fundamental rights and arrangements is of critical importance to any party that has business relations with German entities, including in the technology and telecommunications sectors.