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RECOGNIZING INSOLVENCY – KEY WARNING SIGNS AND RECOMMENDATIONS
FOR MANAGING DIRECTORS

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RECOGNIZING INSOLVENCY – KEY WARNING SIGNS AND RECOMMENDATIONS FOR MANAGING DIRECTORS

I. WHY THIS TOPIC IS IMPORTANT

Timely recognition of impending or actual insolvency is critical for managing directors. Under Section 15a of the German Insolvency Code (*Insolvenzordnung*, InsO), executive body members of a legal entity—or of a partnership without legal personality where no personally liable partner is a natural person—must file for insolvency proceedings when the company becomes illiquid (*zahlungsunfähig*) or overindebted (*überschuldet*). The statutory deadlines are strict: the filing must be made without undue delay but no later than three weeks after the onset of illiquidity (*Zahlungsunfähigkeit*) or six weeks after the onset of over-indebtedness (*Überschuldung*). Importantly, this obligation applies to each managing director individually, regardless of (i) actual knowledge of insolvency grounds, (ii) internal allocation of duties, or (iii) the scope of representation authority. Failure to comply exposes managing directors to personal civil liability (Section 15b InsO), criminal sanctions (Section 15a para. 4 InsO), and tax liability under Section 69 of the German Fiscal Code (*Abgabenordnung*) for unpaid taxes.

II. DEFINITION OF INSOLVENCY

A company is illiquid if it is unable to pay its due debt (Section 17 para. 2 InsO). Cessation of payments (*Zahlungseinstellung*) creates a rebuttable presumption of illiquidity.

The Federal Court of Justice (*Bundesgerichtshof*, BGH) has established that illiquidity must be determined through a systematic comparison of due accounts payable against available liquid assets, typically in the form of a liquidity balance sheet. Pursuant to standing case law, a liquidity gap of 10% or more triggers a rebuttable presumption of illiquidity—unless it is virtually certain that the gap will be closed completely or almost completely in the near term and creditors can reasonably be expected to wait under the circumstances. Conversely, a payment suspension is deemed merely temporary (and, thus, may not constitute illiquidity) if the company can procure the necessary funds to settle due claims and reduce the liquidity gap below 10% within three weeks. This assessment is based exclusively upon objective circumstances, not on the debtor's subjective assessment.

III. TYPICAL WARNING SIGNS IN PRACTICE

Warning signs typically manifest across several categories. At the operational level, indicators include repeated overdrafts of credit facilities, returned payments (*Rücklastschriften*) from suppliers or insurers, dunning notices (*Mahnbescheide*), enforcement actions (*Vollstreckungsmaßnahmen*), and loss of trade discounts due to liquidity constraints. Regarding

liabilities, critical red flags include arrears in social security contributions (*Sozialversicherungsbeiträge*), wage tax, or VAT; unpaid wages and salaries; and termination or restriction of credit lines by banks. In supplier and customer relations, warning signs include demands for advance payment or cash-on-delivery terms, termination of contracts by key suppliers, and unusually high levels of bad debt or customer defaults.

IV. RECOMMENDATIONS

- **Institutionalize liquidity planning:** Establish a rolling 13-week liquidity forecast and update it weekly. Designate a responsible person (e.g., CFO or Head of Finance) to maintain the projections and report material deviations to management immediately.
- **Implement an early warning system:** Define specific trigger thresholds that automatically alert management—for example, when available liquidity falls below a defined minimum or when payables exceed a specified aging threshold (e.g., more than 14 days past due).
- **Maintain thorough documentation:** Document all crisis detection and management measures in writing. In any subsequent liability lawsuit, managing directors bear the burden of proving compliance with their monitoring obligations (*Überwachungspflichten*).
- **Engage banks proactively:** At the first signs of liquidity constraints, initiate dialogue with your principal financing banks. Transparent, early communication increases the likelihood of obtaining support measures (e.g., covenant waivers, payment deferrals) and reduces the risk of unexpected credit terminations.
- **Prioritize payments strategically:** During cash flow constraints, certain obligations must be paid with priority, particularly the employee portion of social security contributions (*Arbeitnehmeranteil der Sozialversicherungsbeiträge*). Nonpayment constitutes a criminal offense under Section 266a of the German Criminal Code (*Strafgesetzbuch*) and cannot be excused by financial difficulties.
- **Act immediately upon warning signs:** If multiple warning signs emerge, seek expert advice without delay. An experienced restructuring advisor or insolvency lawyer can objectively assess available options—whether out-of-court restructuring, preventive restructuring proceedings under the Corporate Stabilization and Restructuring Act (*Unternehmensstabilisierungs- und -restrukturierungsgesetz*, StaRUG), or preparation of an orderly insolvency filing. Early action expands strategic options and can significantly mitigate personal liability exposure.

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