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KNOWLEDGE NUGGETS

THE INSOLVENCY ADMINISTRATOR'S LONG MEMORY – WHEN GRATUITOUS
BENEFITS ARE RECLAIMED

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I. WHY THIS TOPIC IS IMPORTANT

When someone receives a gift, the recipient rarely considers the possibility of the donor's insolvency. Yet, this is precisely where a significant claw-back risk arises: Under section 134 of the German Insolvency Code (*Insolvenzordnung*, InsO), the insolvency administrator may challenge gratuitous transfers made by the debtor within the four years preceding the filing of the insolvency petition—without having to prove that the recipient acted in bad faith or was aware of the debtor's financial distress. In practice, this primarily affects shareholders, managing directors, and their relatives who have received assets from a company that later became insolvent. Because the four-year challenge period also covers transactions carried out long before the onset of financial difficulty, the risk exposure for recipients is substantial.

II. PREREQUISITES FOR AVOIDANCE UNDER SECTION 134 INSO

The insolvency administrator may challenge gratuitous transfers that prejudice creditors and were made within the four years preceding the filing of the insolvency petition. Prejudice to creditors only needs to exist at the time of the last oral hearing, meaning that subsequent changes in value after the gift was made may also be relevant. This comparatively long look-back period is justified by the principle that the recipient of a gratuitous transfer is less deserving of protection than the debtor's creditors: The recipient has given nothing in exchange for the benefit and, upon restitution, loses only an unmerited financial advantage.

A benefit is considered gratuitous if it is not accompanied by any consideration or by consideration of non-equivalent value. In a corporate context, the following scenarios are particularly relevant:

- **Distributions and withdrawals:** Distributions to shareholders not supported by corresponding distributable profits or withdrawals from company assets without adequate consideration.
- **Asset transfers:** Transfers of business assets, real estate, or other company property to shareholders, managing directors, their family members, or other third parties without arm's-length consideration.
- **Intra-group waivers of claims:** Waivers of repayment of shareholder loans, forgiveness of claims against affiliated companies, or releases of compensation claims.
- **Security for third-party debt:** Granting security interests (e.g., guarantees or mortgages) for liabilities of shareholders or affiliated companies without a direct economic benefit to the grantor (so-called upstream or cross-stream security). An indirect benefit—such as maintaining group financing—may, under certain circumstances, constitute a sufficient own-interest and preclude the transaction from being characterized as gratuitous.

- **Mixed gifts:** Transactions in which consideration is agreed but does not equal the value of the performance (e.g., purchase of real property at a price substantially below market value). In such cases, only the gratuitous portion is voidable, provided the performance can be divided into gratuitous and consideration-based components based on value.

Customary gifts of minor value (e.g., business gifts) are exempt from challenge. According to case law issued by the Federal Court of Justice (*Bundesgerichtshof*), the threshold values are EUR 200 for a single gift and a cumulative total of EUR 500 per calendar year per recipient.

If the challenge is successful, the recipient must, as a general rule, return the asset or benefit received in kind to the insolvency estate; if return in kind is not possible, the recipient owes monetary compensation for its value. Importantly, as long as the recipient was unaware of the prejudice to creditors, liability is limited to the extent of any remaining enrichment—however, liability becomes unlimited once the recipient gains such knowledge.

III. RECOMMENDATIONS

- **Scrutinize transactions within the corporate group and with related parties:** Before entering into transactions between the company and shareholders, managing directors, or their relatives, verify whether adequate consideration has been provided. The same applies to intra-group transactions such as shareholder loans, transfer pricing arrangements, cash pooling, and the provision of collateral for liabilities of shareholders or sister companies—if the company making the payment or providing the collateral lacks a direct economic interest in the transaction, it may be subject to challenge.
- **Factor in the risk of claw-back for distributions:** Shareholders should be aware that distributions received may be reclaimed for up to four years following receipt if the company becomes insolvent. Liability is limited to any remaining enrichment—but only so long as the recipient has no knowledge of the prejudice to creditors. Also bear in mind that the reversal of a challenged transaction may have gift tax implications.
- **Document arm's-length terms:** Carefully document the arm's-length nature of terms for transactions between the company and related parties or third parties. An independent valuation report or market comparison can be decisive in defending against a challenge. This applies to both the donor and the recipient.
- **Seek legal advice early:** Engage advisors specializing in insolvency law at an early stage to review which transactions from the preceding four years could be subject to challenge in the event of insolvency. A timely analysis enables identification of risks and implementation of countermeasures where necessary.

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