Q&A: arbitration with an insolvent party

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Q&A

This article discusses some of the main considerations that arise when a party considering arbitration or already engaged in arbitration files for insolvency, or has its counterparty file for insolvency, under German insolvency law.

Q&A

Is an insolvency administrator bound by an arbitration clause agreed to by the insolvent party?

Despite earlier debates, it is now generally accepted that an insolvency administrator is in principle bound by an arbitration agreement entered into by the insolvent party. Exceptions apply, but they are rare.

One exception is if the assets of the insolvent party's estate are so limited that the insolvency administrator cannot even make the required advance payments. In such a case, the arbitration agreement may be considered inoperable due to a lack of funding. It may be argued that such inoperability does not exist if the other party offers to pay the advance for the insolvent party. However, such an offer should be made with careful consideration. Pursuing arbitration against an insolvent party is generally risky because, as explained in more detail below, creditors of an insolvent estate receive only a certain percentage of their claim – often as little as 5% (or in the worst case, nothing) – and the costs of the arbitration may exceed the amount that could be obtained. That will likely be the case in a scenario where an insolvent party lacks sufficient funds to pay the advance, unless that party has significant illiquid assets.

An insolvency administrator is also not bound by an arbitration agreement entered into by the debtor to the extent that an independent insolvency-specific right of the administrator is affected. Such an insolvency-specific right arises under the Insolvency Statute (InsO), not from the original contract entered into between the insolvent party and the other party.**(1)** Such insolvency-specific rights include clawback claims by an insolvency administrator.**(2)** Because the original contract and insolvency-specific rights of the insolvency administrator are often closely intertwined, in practice, it can be difficult to determine whether the arbitration clause applies. The Supreme Court has repeatedly been asked to decide such questions and – at least in recent years – has generally taken an arbitration-friendly approach (ie, relying on the connection to the original contract rather than the fact that the insolvency administrator invoked rights based on the InsO).**(3)**

What happens to an arbitration if a party files for insolvency in Germany?

In Germany, a company or its creditors may file a request with the competent court to open insolvency proceedings. That request, on its own, has no effect on pending arbitration proceedings. The crucial turning point is when the court decides to open insolvency proceedings – which always entails the appointment of an insolvency administrator – or when, prior to such decision, the court appoints a preliminary insolvency administrator.

In both cases, litigation proceedings concerning matters relating to an insolvency estate are automatically stayed by law (Section 240 of the Code of Civil Procedure (ZPO)). This can affect arbitration matters if, for example, a procedure for the enforcement of an arbitration award is pending.**(4)**

However, there is no rule corresponding to Section 240 of the ZPO in either its chapter on arbitration matters or the InsO in relation to arbitration proceedings. As a result, in divergence from the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency and US law, there is no automatic stay of arbitration proceedings if those proceedings are pending when a party enters insolvency proceedings.

While there is no automatic stay by law, the practical implications of a party's insolvency usually leads to some form of a limited stay of arbitration proceedings. Because an insolvency administrator steps into the shoes of the insolvent party as a new party to the proceedings (by virtue of their function), the right to be heard requires that the insolvency administrator be given sufficient time to familiarise themselves with the proceedings.

What actions must a claimant to a pending arbitration take if insolvency proceedings over the assets of the respondent are initiated?

Necessary actions in insolvency proceedings

Pursuant to Section 87 of the InsO, insolvency creditors can enforce their claims under the provisions governing insolvency proceedings. This means that all insolvency creditors – including claimants to pending arbitration proceedings – must notify their claims to the insolvency administrator for inclusion in the insolvency schedule pursuant to Section 174 of the InsO.**(5)** The insolvency schedule is an overview of all creditor claims that is drawn up by the insolvency administrator. The insolvency administrator also records in the schedule whether they, or another creditor, contests any of the notified claims. If a claim is contested, the insolvency creditor must initiate legal proceedings against the contesting party (ie, the insolvency administrator or another creditor) to seek a declaration that the claim be included in the insolvency schedule.**(6)** If the claim is included without contest, the creditor has been acknowledged as an insolvency creditor. At the conclusion of the insolvency proceedings, an insolvency quota is determined. This quota is a certain uniform percentage that is applied to all claims by insolvency creditors, determining what percentage of the registered claim they will receive.

Failing to register a claim for inclusion in the insolvency schedule jeopardises the enforceability of an award. In 2009 the Supreme Court held that the enforcement of a domestic arbitration award that establishes an insolvency claim not previously registered with the insolvency schedule violates German public policy and should thus be annulled.**(7)** Section 87 of the InsO is part of German public policy because the requirement to register a claim is part of the core principle of German insolvency law, which is the even and common satisfaction of all insolvency creditors on the basis of the insolvency quota from the proceeds of the insolvency estate. Without the registration of the claim, that core objective would be jeopardised because a claimant may seek to receive more than the *pro rata* satisfaction to which it is entitled.

The situation may be different in the case of foreign arbitral awards. While the Supreme Court has yet to decide this question, in 2012 the Karlsruhe Higher Regional Court held that a foreign award that determines a claim that has not been filed for inclusion in an insolvency estate may be enforced in Germany because it does not violate the less stringent international public policy.**(8)**

Necessary actions in arbitration
The necessary actions in the arbitration depend on whether the insolvency administrator contests the claim that the claimant files for inclusion in the insolvency schedule.

If the insolvency administrator contests the claim – as is typically the case if the claim concerns a pending arbitration – the claimant has grounds to continue the arbitration. To account for the fact that the claimant can no longer claim payment from the debtor but rather only *pro rata* satisfaction from the insolvency estate, the claimant should amend its request for relief from a payment claim to declaratory relief, seeking determination that the claim be included in the insolvency schedule. However, based on Supreme Court case law,**(9)** failing to amend a request for relief on this basis is unlikely to be fatal because a payment claim can generally be interpreted to mean a claim for declaration that the claim be included in the insolvency schedule.

In the unlikely event that an insolvency administrator does not contest a claim, the claimant has already achieved all that it could hope to in respect of the arbitration (ie, the registration of its claim in the insolvency schedule). As explained before, this registration allows the claimant to be satisfied from the proceeds of the insolvency estate on a *pro rata* basis when the insolvency proceedings are concluded.

Can a new arbitration proceeding be commenced against a party after insolvency proceedings over its assets have been initiated in Germany?
Yes, it is possible to commence an arbitration against a party after the opening of insolvency proceedings over that party's assets. The considerations are the same as those described under the third question above (ie, before filing for arbitration, a potential claimant should register the claim with the insolvency administrator for inclusion in the insolvency schedule).

Can an arbitration clause in an executory contract be enforced against a debtor?
Similar to executory contracts under US law, in Germany, insolvency administrators have powers to assume or reject claims that relate to contracts which impose mutual obligations that have not been performed in full by both parties when insolvency proceedings are opened (Section 103 of the InsO).

If the insolvency administrator elects to perform the contract, the claim becomes a preferential claim, which must be satisfied in full – rather than on a *pro rata* basis – from the insolvency estate. If the claims are rejected, they are unenforceable and a claim for compensation for non-performance can be filed for inclusion in the insolvency schedule. Compensation claims are unsecured claims and will thus be subject to the insolvency quota. If no compensation claim is filed, the claim to performance is retained and can be asserted against the debtor if and once the debtor emerges from insolvency.

While the insolvency administrator is generally bound by arbitration agreements between the creditor and debtor (see above), this does not apply to the insolvency administrator's option right according to Section 103 of the InsO, as this is an insolvency-specific right.**(10)** However, a dispute as to whether the right to choose exists still falls under the arbitration clause.**(11)**

If a party to an ongoing or pending arbitration receives payments relating to that arbitration from a debtor which then files for insolvency, can the party be ordered to return those payments?
Yes. Sections 129 *et seqq* of the InsO provide that an insolvency administrator can recover certain payments and property transfers made to any creditor before the opening of insolvency proceedings. In

particular, an insolvency administrator may claw back payments made in the 90 days prior to the filing of the request to open insolvency proceedings if they can show that the debtor was already insolvent when the transfer was made and that the creditor to whom payment was made knew about the insolvency.

Thus, an insolvency administrator can avoid voluntary payments made in satisfaction of arbitration awards or the settlement of an arbitration. However, insolvency administrators' clawback rights relate only to legal acts by the insolvent party. If an arbitration award was satisfied through enforcement measures rather than voluntary payment, the insolvency administrator has no legal basis to claw back such payments.**(12)**

What happens to a German-seated arbitration if a foreign party to the arbitration becomes subject to insolvency proceedings in another country?

If the insolvent party is seated in an EU member state, the situation is relatively straightforward. Since its 2018 amendment, Article 18 of the EU Insolvency Regulation provides that the effects of insolvency proceedings on pending arbitral proceedings concerning an asset or a right that forms part of a debtor's insolvency estate will be governed solely by the law of the member state in which the arbitral tribunal is seated. Therefore, German law would apply in a German-seated arbitration in which an EU-seated party becomes insolvent and the effects would be as explained under the second question above.

If a non-EU seated party becomes insolvent, the outcome is less clear. Pursuant to Section 352 of the InsO, a legal action will generally be stayed if foreign insolvency proceedings are opened and will continue until:

- it is resumed by a person who – in accordance with the law of the state of the insolvency proceedings – is entitled to continue the action; or
- the insolvency proceedings are terminated.

It is an open question in German legal literature whether arbitration proceedings qualify as a 'legal action' within the meaning of Section 352 of the InsO, and no guiding court decision has been rendered to date. As a result, there is some uncertainty as to how an arbitral tribunal may respond to the insolvency of a non-EU seated party.

What happens to a non-German seated arbitration if one of the parties files for insolvency in Germany?

How an arbitral tribunal will react to a German party's insolvency largely depends on:

- the tribunal;
- the agreed procedural rules; and
- the law of the seat of the arbitration.

However, with a view to the enforceability of an award, German law should be respected in the sense that the insolvency administrator will become a party to the proceedings and, as such, should be granted sufficient time to familiarise themselves with the proceedings. As indicated above,**(13)** if the insolvent party is the respondent, it is also highly advisable to register the claim for inclusion in the insolvency schedule and to amend the request for relief accordingly.

For further information on this topic please contact Anke C Sessler or Max Stein at Skadden Arps Slate Meagher & Flom LLP by telephone (+49 69 742 200) or email (anke.sessler@skadden.com or max.stein@skadden.com). The Skadden Arps Slate Meagher & Flom LLP website can be accessed at www.skadden.com.

Endnotes

(1) See, for example, BGH, SchiedsVZ 2018, 127.

(2) Also see the sixth question above.

(3) See Kuhli/Köppel, SchiedsVZ 2020, 2.

(4) See BGH, SchiedsVZ 2017, pp 266 *et seqq*.

(5) An exception is if the creditor has a claim in relation to a specific asset of the insolvent company (eg, a claim for the return of rented goods). In such a case, the claim would be to separate the specific assets from the insolvency estate and the creditor would not be an 'insolvency creditor' for the purposes of German insolvency law.

(6) If the claim is contested by another creditor, an arbitration agreement concluded between the creditor and the insolvent party will not apply.

(7) BGH, NJW 2009, pp 1747 *et seqq*.

(8) OLG Karlsruhe, SchiedsVZ 2012, pp 101 *et seqq*.

(9) BGH, NJW 2009, pp 1747 *et seqq*.

(10) See the first question above; BGH, NZI 2018, pp 106 *et seqq*.

(11) BGH, NZI 2018, pp 106 *et seqq* at para 22.

(12) See BGH NJW 2005, pp. 1121 *et seqq*.

(13) See "Necessary actions in insolvency proceedings" under the third question above.


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