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Germany: Invalidity of Insolvency-Related Termination Clauses in Long-Term Contracts

In international commercial transactions, clauses enabling one party to terminate the contract (e. g. a long-term supply agreement) if the other party should fall into insolvency are widely used. However, under new case law by the German Federal Supreme Court, such clauses tying a termination right to an insolvency filing or an opening of insolvency proceedings may be invalid.

In a recent decision dated 15 November 2012 (file no.: IX ZR 169/11), the German Federal Supreme Court (*Bundesgerichtshof* or *BGH*) ruled on a fact pattern highly relevant for anyone engaging in business in Germany.

Facts of the case

An electric power company entered into a contract for the supply of electricity to its corporate customer on the basis of a long-term energy-supply contract, which contained, inter alia, a clause stating that "*the contract shall terminate automatically without notice if the customer files for insolvency or if preliminary insolvency proceedings are initiated or opened due to a filing by creditors.*" Several months later, an insolvency proceeding was initiated against the assets of the customer. After his appointment, the preliminary administrator and the power company discussed about the survival of the contract. The power company took the position that the previous supply contract had automatically terminated due to the insolvency and offered to conclude a new supply agreement with the administrator – at higher prices. The administrator took opposite stand and accepted the new agreement only under the condition of a legal examination and without prejudice. After having received further supplies of electricity for quite some time, the administrator refused to balance the invoices to the extent that the prices of the new contract exceeded the rates of the old contract. The power company eventually filed suit. After having gone through two instances, the BGH held that the old energy-supply agreement was not terminated due to the insolvency of the customer, but remained valid and binding upon the parties. For that reason, the BGH held that the administrator was not obligated to pay the higher fees of the new agreement and dismissed the action.

Definition of insolvency-related termination clauses

The BGH classified the contractual term in question as an insolvency-related termination clause. Such a clause is present where one of the parties has the right to disen-

gage from the contract in the case of suspension of payments, of insolvency filing or of opening of insolvency proceedings, or if the contract shall automatically be terminated in the case of such insolvency-related circumstances. The BGH further specified the scope stating that such an insolvency-related termination clause would not exist if it were not tied to insolvency-specific circumstances, e. g. default or other violations of contract.

Invalidity of the insolvency-related termination clause

The court then considered the termination clause against the backdrop of the German Insolvency Act (*Insolvenzordnung* or *InsO*).

The court examined the insolvency administrator's right of choice to fulfill a pending contract or to refuse fulfillment of such a contract. Under § 103 InsO, if a mutual contract was not or not completely fulfilled by the debtor and the other party at the date when the insolvency proceedings were opened, the insolvency administrator may fulfill such contract and claim the other party's consideration. However, the administrator may also refuse to fulfill the contract, in which case the other party is entitled to any claims for non-performance only as an insolvency creditor. The purpose of this right of choice is to protect the insolvent's estate and to reach an equal satisfaction of the creditors. The court found that this purpose could be defeated if the supplier of the debtor could undermine the administrator's right of choice by terminating a contract which is favorable for the insolvent's estate.

The court further referred to the purpose of an insolvency proceeding which includes the continuation and restructuring of the insolvent company. It held that this purpose is facilitated if the administrator can continue existing long-term agreements for supply of goods or energy at unchanged conditions. The court pointed out that this would not be detrimental for the supplier because he would receive full contractual consideration for his supplies from the insolvent's estate.

Finally, the BGH disproved conflicting arguments that had been raised by courts and legal literature previously on this issue. It found that the invalidity of insolvency-related termination clauses was not in conflict with the intention of the "historic legislator" and that it does not have a detrimental impact on restructurings for any other commercial reasons. It also mentioned possible "disadvantages in international trade" which it obviously considered as negligible.

In conclusion, the BGH found that the insolvency-related termination clause would impede the application of § 103 InsO, unless such contractual termination should correspond with a statutory termination right. It therefore found the clause null and void in accordance with the specific statutory rule of § 119 InsO. The court clarified that the relevant fact pattern for such finding is not only the opening of insolvency proceedings, but also an earlier point in time when an insolvency proceeding can be expected due to a filing for insolvency.

Key aspects

Insolvency-related termination clauses are common practice in international business. At least for contracts for the continuing supply of goods or electricity, the BGH has explicitly found them to be invalid and unenforceable. It can be expected that other long-term contracts, such as distribution agreements, service- and maintenance agreements, license agreements, continuing contracts for works and construction agreements will also be affected by this jurisdiction. It is possible that this subject will also be relevant for loan- and financing agreements, which would affect banks and investors.

When drafting long-term contracts under German law, i. e. going beyond a one-time exchange of goods or services, it is imperative to take this issue into account. In

its decision, the BGH has indeed suggested a solution for the parties to secure their interests. It has indicated that an invalid insolvency-related termination clause is not present where the clause is based on circumstances that are not "insolvency-specific". It has specified two such examples, these being default or other violations of contract. In the future, contracting parties will have to resort to such more general causes for termination.

Companies engaging in long-term agreements under German law can also attempt to base a termination right on the deterioration of the other party's financial position. Specifically, such a clause could provide that the termination right can be exercised if the financial circumstances of the other party should materially deteriorate or threaten to deteriorate to the effect that the fulfillment of contractual obligations is jeopardized. While it ca be assumed that such a clause would be considered as not insolvency-related, it is not free of legal risk. It remains to be seen where exactly future jurisdiction will draw the line between permitted clauses and invalid insolvency-related clauses.

How we can help?

Please contact Kai Graf v. der Recke at HAVER & MAILÄNDER who can help you with any queries on this topic.

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