Protection of Employees in their Employer’s Insolvency —  
The German Way

Stephan Madaus

I. INTRODUCTION

Whenever a business fails and insolvency proceedings are commenced, employees comprise a special group of stakeholders. On the one hand, they are contractually connected to the debtor — their employer — and may even take the legal position of creditors if salaries are left unpaid. Here, employees are a peculiar group of creditors because their livelihood typically depends on their salary, which gives them little space for a write-off in rescue negotiations. Still, despite their dire interest in protecting their salary, employees are usually not in a position to negotiate any collateralization of their salary claims ex ante, which is why they remain in the vulnerable position of unsecured creditors in insolvency proceedings. On the other hand, employees can also be considered as investors in the business, as they adapt their skills, as well as their career plan, to the specific conditions and opportunities of “their” business and their individual workplace. Such an individual skill set may not be easily transferable to new employers.

This very specific connection to the firm leads to employees occupying a peculiar position in their employer’s insolvency, one widely held to be worth statutory protection. In Europe, the European Union (“EU”) has picked up this task and provided for a minimum standard of harmonized protection across EU member states that addresses two issues: guaranteeing the
payment of outstanding salary claims, discussed in Part II, and protecting employment contracts in the event of a business transfer, as discussed in Part III.

For Germany, the importance of employee protection in insolvency can be illustrated by empirical data. In 2014, 164,000 employees received payment from the guarantee scheme on their unpaid salary claims while insolvency proceedings were pending. The overall annual payments by the guarantee fund in the years 2011 through 2015 amount to €875,000,000.

II. THE PROTECTION OF UNPAID SALARY CLAIMS

Following a European Council ("EC") directive from 20 October 1980 (Council Directive 80/987/EEC),1 EU member states have introduced an insurance-type mechanism that guarantees the payment of outstanding salary claims. The mechanism that was promoted by this directive followed previously used German and Dutch protection schemes. For example, in 1974 German legislators introduced a statutory claim of the employee against a fund organized by a public authority if the employer becomes insolvent, called "Konkursausfallgeld".2

A directive is a legal EU act under article 288 of the Treaty on the Functioning of the European Union (TFEU) that is binding, as concerns the result, on each member state to which it is addressed, but the directive leaves the choice of form and methods to respective national authorities.3 A directive is a frequently used tool in European law-making that initiates national legislation with similar content in all the applicable member states, thus harmonizing the law across the EU on a

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2 Gesetz über das Konkursausfallgeld, 17 July 1974, BGBl. I 1974, 1481 (Germany).
specific topic. Regarding unpaid salary claims, the *Council Directive 80/987/EEC* prompted all member states to establish guarantee schemes. Since 1980, it has been updated twice.4

1. Organization and Contributions

*Council Directive 80/987/EEC* requires all member states to establish a body that guarantees the payment of outstanding claims to the employees concerned.5 Article 5 mandates that all member states lay down detailed rules for the organization, financing and operation of the guarantee institutions, complying with the following minimum standards:

- **Bankruptcy remoteness:** The assets of the institutions must be independent of the employers’ operating capital and be inaccessible to insolvency proceedings.

- **Financed by employers’ contributions:** Unless it is fully covered by public authorities, employers must contribute to its financing.

- **Guarantee regardless of the payment of contributions:** Though an insurance-like mechanism, payments to employees may not depend on the prior employer’s fulfillment of their duty to contribute.

The German version of the guarantee scheme has been re-enacted a couple of times and is now laid down in sections 165

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to 175 and sections 358 to 361 in Part III of the Social Security Code (*Sozialgesetzbuch III (SGB III)*). The scheme is sponsored solely by the contributions of all German employers. The amount payable relates to the amount of an individual salary claim and is currently set to 0.15 percent. The contribution is to be paid by the employer as part of the social security contributions of the employer, and the employee, that are connected to the salary claim; for example, contributions for statutory health, unemployment and pension insurance, to a public authority. From here, all contributions for the guarantee scheme are transferred to the government authority administering the funds, the “Bundesagentur für Arbeit”.

2. Distributions to Employees

Article 3 of Directive 2008/94/EC provides that member states shall take the measures necessary to ensure that guarantee institutions secure the payment of employees’ outstanding claims resulting from contracts of employment or employment relationships, including severance pay on termination of employment relationships, where provided for by national law. Based on this mandate, national legislators enacted provisions which gave employees a direct claim against the local guarantee institution. An employee under Directive 2008/94/EC is defined as anyone with an employment contract, regardless of the employment being part-time or temporary.

The claim against the public fund requires outstanding claims resulting from contracts of employment or employment relationships and may include severance pay on termination of

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6 *Sozialgesetzbuch III*, Employment Promotion, 1 January 1998 (Germany) [SGB III].
7 Ibid, s 358(1).
8 Ibid, s 360.
9 Ibid, s 359(1).
10 Ibid, s 359(2).
11 For Germany, see *ibid*, s 165(1).
employment relationships if provided for by national law, which is not the case in German law. In addition, the employer must be in a state of insolvency, which is defined as the time following a request to open insolvency proceedings or other types of proceedings that refer to the inability of the employer to pay.

Where these preconditions are met, unpaid salary claims are not guaranteed without a time limit and a cap, as Article 4 of Directive 2008/94/EC allows member states to limit the liability of the guarantee institutions by:

- specifying the length of the period for which outstanding claims are to be met by the guarantee institution, and by
- setting ceilings on the payments made by the guarantee institution.

Referring to the social objective of Directive 2008/94/EC, the ceilings set by national legislators must not fall below a level which is socially compatible with this objective, and the time limit may not be shorter than a minimum period of three months in a reference period with a duration of not less than six months.

German legislators took advantage of both provisions and set the time limit according to the minimum requirement, three months, and a ceiling at the amount set annually by the government to be the maximum reference for the calculation of social security contributions (“Beitragsbemessungsgrenze”). In 2015, this ceiling was allocated at a salary of €6,050 per

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13 Ibid, art 3.
14 SGB III, supra note 6, s 166 (1) No 1.
15 See Directive 2008/94/EC, supra note 4, art 2(1).
16 Ibid, art 2(4).
17 Ibid, art 4(2).
18 Ibid, art 4(3).
19 Ibid, art 4(3)2.
20 Ibid, art 4(2) at para 2.
21 SGB III, supra note 6, s 165(1).
22 Ibid, ss 167(1), 341(4).
month. It is worth noting that in (most) other member states, the ceiling is not nearly as high, for example, in England, the ceiling is set to £22.20 per day (approximately £660 per month). 23

These remarkable disparities arise from different fundamental opinions about how to protect employee claims in insolvency proceedings across Europe. In Germany, such claims are only protected by the guarantee scheme, meaning that these claims do not receive any preferential status in the ranking of unsecured creditor claims under insolvency law. The only exception is a salary claim that arises in consideration of any post-commencement work performance, which takes the priority of an administrative expense. Pre-commencement claims are general unsecured claims only. In such cases, German legal protection differs significantly from regimes in many other EU member states like France or England, where pre-commencement employee claims usually have preferential status. Under such regimes, the protection of employees is primarily assigned to the distribution in insolvency proceedings. The guarantee scheme only works as an additional tool within narrow statutory limits, consequently being of limited relevance in practice.

3. Limited Recovery from the Estate

The guarantee institution, having paid a claim to an employee, is then subrogated to the rights of the employee against the employer. At this stage, insolvency proceedings are usually commenced, and the guarantee institution is now entitled to file all subrogated salary claims. In principle, the subrogated claim will not enjoy any special treatment. If employee claims are ranked as preferential under national insolvency law, the subrogated claim will also rank as preferential. 24 Under German insolvency law, however, section 55(3) of the Insolvency Code (Insolvenzordnung

23 Employment Rights Act 1996, c 18, s 31(1) [Employment Rights Act].
24 See, eg, Employment Rights Act, ibid, ss 167(3), 167(4), 189.


(InsO) provides that a subrogated claim will always be treated as a general unsecured claim. As these claims usually receive a payoff of 0 to 10 percent, the German guarantee institution (“Bundesagentur”) cannot expect a significant recovery in insolvency proceedings on behalf of subrogated employees’ claims. As a result, guarantee payments to employees are mostly covered by permanent contributions of all employers to the public fund.

4. Representing Employees Collectively

The guarantee scheme causes a significant side effect for rescue negotiations in German insolvency plan proceedings. By way of subrogating all employee claims against an insolvent employer to the government agency, all these claims are pooled for the course of the insolvency proceedings. Because the guarantee institution is a creditor, it holds all creditor rights, such as the right to participate and vote in creditors’ meetings or to vote on a rescue plan. This introduction of a professional player can sometimes enhance rescue negotiations. In practice, however, the involvement of the guarantee institution is not very significant because the amount of claims represented is rather small compared to claims of financial creditors or suppliers.

5. Using the Fund for Post-Petition Financing

The structure of the European guarantee scheme for unpaid salaries does not intend to give financial support to a failing business. However, German insolvency practice has mastered a use of the scheme that allows for an essential relief for business finances in the very crucial period after the filing but before the opening of insolvency proceedings, called “Insolvenzgeldvorfinanzierung”. Under German law, insolvency proceedings are not commenced on the very day of a petition being filed. Instead, interim proceedings are initiated by the court in order to investigate whether the debtor is actually insolvent and whether there are sufficient assets to
cover the costs of formal insolvency proceedings. An interim insolvency administrator is usually appointed to investigate the debtor’s financial status and to secure all assets from being dispersed or diminished.

If the business of an insolvent debtor is still running after a petition has been filed, workers will have to be paid during interim proceedings in order to keep the business going. To meet their post-petition salary claims, the interim insolvency administrator usually contacts a bank and negotiates a collective purchase of all post-petition employee claims by the bank as far as those claims are covered by the guarantee scheme. In consideration of the collective subrogation of their salary claims, the bank pays the employees an amount equal to that claim as it falls due. In addition, the debtor pays a premium to the bank. After insolvency proceedings are opened, the bank turns to the guarantee scheme for payment because all acquired salary claims are still unpaid by the debtor and covered by the guarantee. The German guarantee institution would accept this request and pay if it had agreed to the transaction when it was negotiated. German law permits a subrogation only if it finds that the intended transaction would help to secure a “significant number of jobs” with such a business. This provision is usually interpreted in a rather generous way. For example, the requirement to save a “significant number of jobs” is held to be met where about 10 percent of the workforce is expected to stay with the business.

Bearing in mind the very limited recovery from the estate that the guarantee institution would usually receive, this practice outlines a form of support for business rescues in insolvency by means of publicly administered funds. The usage of such funds, however, could prompt legal issues because state aid is forbidden under European law. It is easy

26 Ibid, s 22.
27 SGB III, supra note 6, s 170(4).
28 See TFEU, supra note 3, art 107.
to imagine that in 2009, German legislators and insolvency practitioners were relieved to learn that the European Commission did not find a form of forbidden state aid when evaluating the German practice.\footnote{European Commission, Decision of 19 November 2009 — K(2009)8707.} Today, the tool is essential in the eyes of most experts for preserving a rescue option for insolvent German businesses.

### III. THE (LIMITED) PROTECTION OF EMPLOYMENT CONTRACTS IN A BUSINESS RESCUE

In the event of the insolvency of their employer, employees do not only need to worry about whether salaries will be paid on time, but should also be concerned about the continuation of their employment contract.

#### 1. Little Labour Law Protection in Insolvency Liquidation

As a basic rule, the filing or later commencement of insolvency proceedings does not automatically terminate employment contracts of the insolvent employer because such contracts are still pending performance from both sides at that moment. For that reason, they are executory contracts, and the legal regime governing such contracts in a respective jurisdiction applies.

Most European insolvency laws, including German insolvency law,\footnote{See InsO, supra note 25, s 108(1).} provide for the initial continuation of employment contracts. At the same time, insolvency practitioners are authorized, as part of their power to administer the debtor’s estate, to release employees from work and to terminate employment contracts. This authority is thus an essential tool when winding up an insolvent business. It can, however, also be used to sell or restructure a business and continue it by doing so. In an attempt to strike a balance between the interests of a business rescue and dismissed
employees, most European jurisdictions, including the German one, suspend their labour law protection rules to a certain extent whenever an employment contract is being terminated by an insolvency practitioner.

Under German law, statutory protection against unfair dismissal is applicable in principle, but insolvency law allows for a sharply shortened cancellation period with a maximum of three months.\(^{31}\) It also contains a cap for collective agreements with unions on severance payments to a third of the estate to be distributed to unsecured creditors.\(^{32}\) In case of a piecemeal liquidation, such agreements are hardly ever seen. When all jobs are lost, any protection against unfair dismissal is irrelevant, and employees are released from work immediately after the business is shut down. Employment contracts are terminated and conclude after the cancellation period has expired. Any salary claim that accrues within the cancellation period is an administrative expense and, thus, paid in full.

2. Limited Labour Law Protection in a Restructuring under Insolvency Law

If the business of the insolvent debtor is viable and restructured in the course of insolvency proceedings, a reduction of the workforce is a common tool to achieve such a restructuring. In such cases, the limited protection of labour law proves effective in limiting the costs of collective dismissals. Employment contracts can be terminated within a far shorter period than outside of insolvency proceedings, and the costs of litigation on the grounds of unlawful termination can be limited by agreeing collectively on a list of dismissed workers and a small severance payment. Such collective agreements are negotiated between the insolvency practitioner and workers’ representatives. These instruments have proven their efficiency, resulting in a number of companies that have

\(^{31}\) Ibid, s 113.
\(^{32}\) Ibid, s 123(2).
made strategic use of insolvency proceedings to restructure their workforce in times of a crisis.

3. Limited Labour Law Protection against a Transfer of Business in Insolvency Liquidation

If the business of an insolvent debtor is neither wound up nor restructured by an insolvency practitioner but instead transferred to a new owner, employment contracts are, in principle, protected by the Acquired Rights Directive 2001/23/EC.33 As this directive applies to any transfer of a business,34 Article 3(1) mandates that the transferor’s rights and obligations arising from a contract of employment existing on the date of a transfer shall, on the basis of such a transfer, be transferred to the transferee. At the same time, Article 4(1) bans any termination of such a contract on the grounds of the transfer. Under German law, these regulations were enacted in section 613a of the Civil Code (Bürgerliches Gesetzbuch (BGB)).35 The transfer of a business as an on-going concern will therefore always lead to the transfer of all employment contracts connected to the business. This is, however, obviously a problem for insolvent companies that might only find a buyer with a reduced number of employees.

European legislators responded to the special needs of insolvent businesses in the mergers and acquisitions market by enacting an exemption option in Article 5(1) of the Acquired Rights Directive 2001/23/EC which authorized member states to choose whether the protection under Articles 3 and 4 shall

34 Ibid, art 1.
35 Civil Code (Bürgerliches Gesetzbuch (BGB) (Germany), (Federal Law Gazette [Bundesgesetzblatt] 1 42, 2909; 2003 I 738), last amended by Article 4 para. 5 of the Act of 1 October 2013 (Federal Law Gazette I 3719).
apply to a transfer of a business where the transferor is the subject of insolvency proceedings which have been instituted with a view to the liquidation of the assets of the transferor and are under the supervision of a competent public authority. That authority may be an insolvency practitioner authorized by a competent public authority. If member states choose to protect their employees, they may limit the amount of transferred liabilities and allow for the consensual alteration of transferred contracts.36

Member states have used the option under Art 5 in a rather non-uniform way. While some jurisdictions like Belgium, Sweden, Austria or the Netherlands exempted all transfers by an insolvency practitioner from the protection under Arts 3 and 4, others like Italy, Greece or (for administrations) England, only limited the liabilities transferred. In Germany, the issue was not expressively addressed by the legislator, which led to a decision by the Federal Supreme Court, (Bundesgerichtshof (BGH)), affirming that employment contracts are protected in a business transfer in the course of insolvency proceedings.37 Later the Federal Labour Court, (Bundesarbeitsgericht (BAG)), held that the transferee is not liable for any employment claims payable before the transfer.38 The resulting protection of employment contracts in a business transfer led to a common practice that aims at terminating employment contracts prior to a transfer of the business. In such cases, an insolvency administrator can make use of the privilege of limited labour law protection under insolvency law, as discussed above.

36 Ibid, art 5(2).
38 BAG, 9 December 2009 (2010), BAGE 132, 333 (Germany) BAG, 19 October 2004 (2004), BAGE 112, 214 (Germany).
Alternatively, a consensual solution has become a common strategy in bigger cases. In many cases, the insolvency practitioner is able to negotiate a collective and consensual transfer of all employment contracts to a company that is set up by unions and financed by the estate, with some public funding, specifically for the purpose of absorbing the employees of an insolvent business in order to allow the transfer of a business without any employment contracts. Employees agree to such a solution for two reasons: first, the transferee is allowed to re-hire former employees from the transitional company. Employees therefore hope that their contribution to the survival of the business will eventually save their job under the new owner of the old business. Second, employees are not yet unemployed when they had left the business for the transitional company. As such a transitional company is usually set up for a year, it offers employees a timeframe where they do not yet receive unemployment insurance payments. At the same time, the objective of such a company is to re-orient the employees for new jobs and thus minimize the number of employees that would eventually be unemployed after the transitional period ends.

IV. CONCLUSION

The protection of employees during their employer’s insolvency has been harmonized by European law, to some extent setting a common minimum standard of protection in EU member states. The key principles are as follows: on the one hand, ensuring the payment of unpaid salary claims by establishing guarantee institutions, and on the other hand, transferring employment contracts and obligations to the transferee in the case of a business transfer. In Germany, both principles work as intended. An additional preferential status of employment-related claims in insolvency proceedings is part of most EU member states’ law; in Germany, however, only post-commencement claims are qualified as administrative expenses. Pre-commencement claims are widely covered by the
guarantee fund, which has led to a peculiar way to cover employment costs in interim proceedings in Germany, one that is unique across Europe and which has become a vital tool for rescue efforts today.

At the moment, the EU is discussing the further harmonization of substantive insolvency law as part of the initiative on building a capital markets union.\(^{39}\) However, the further harmonization of employee protection instruments, eg, towards the German way, is not yet part of that initiative. Other issues like the introduction of harmonized pre-insolvency proceedings or a prompter discharge for honest entrepreneurs dominate the debate. From a German perspective, there is also little need to further harmonized employee protection provisions in the near future.