WHITE & CASE

Insight: Financial Restructuring & Insolvency

March 2012

The new German laws governing the restructuring of companies

German Insolvency Law – a Leap Forward

Creditors have often complained that German insolvency law does not give them sufficient influence in insolvency proceedings. On 1 March 2012 new amendments to the German bankruptcy code came into force which go some way towards ameliorating this concern and make a host of changes which should improve German insolvency law to facilitate an insolvency culture which facilitates reorganisation rather than liquidation of assets.

In brief, the law, referred to below as "ESUG", or more formally, the Act for Further Facilitation of the Reorganisation of Enterprises (the "Reorganisation Law") makes the following key changes:

- creditors will obtain a greater influence over the identity of the preliminary insolvency administrator;
- certain corporate formalities which formerly required shareholder approval are now able to be incorporated into an insolvency plan thus eliminating the need for shareholder approval;
- certain risks for lenders where they participate in debt-equity swaps are being mitigated through the amended legislation;
- special appeals by shareholders to challenge an insolvency plan are going to be made harder;
- debtors will find it easier to obtain 'debtor in possession' status; and
- a new procedure – the 'Protected Reorganisation' – will be available which will allow debtors to obtain protections from their creditors where debtors are facing impending illiquidity or balance sheet insolvency.

Enhancing the influence of creditors

By the time of the onset of a full administration, which often takes 2 to 3 months following the request to open insolvency proceedings (referred to as "preliminary insolvency"), many key decisions have been taken. Prior to 1 March, the preliminary insolvency administrator who was appointed by the court, often without reference to the creditors, took many of the key decisions. Therefore, the ability of the creditors to dismiss the administrator (who is invariably the same person who ran the preliminary administration) was of limited practical benefit. Recognizing this, the new Reorganization Law will enhance the influence of creditors in the early phase of the insolvency filing procedure. For this purpose, the revised legislation incorporates a role for a preliminary creditors' committee;

For more information please contact:

Leïla M. Röder
Partner, Munich
+ 49 89 206043 775
lroeder@whitecase.com

Dr. Tom Oliver Schorling
Partner, Franfurt
+ 49 69 29994 1569
tschorling@whitecase.com

Dr. Sven-Holger Undritz
Partner, Hamburg
+ 49 40 35005 212
shundritz@whitecase.com

Stephen Phillips
Partner, London
+ 44 20 7532 1221
sphillips@whitecase.com

This publication is prepared for the general information of our clients and other interested persons. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice.

a committee which will be able to influence the court in its selection of the preliminary administrator and whether the debtor can obtain debtor in possession status. The latter order may include permission to dispose of the assets (under the supervision of a custodian) and, in this context, the identity of the (temporary) custodian.

The court shall establish a preliminary creditors' committee at the debtor's or creditors' request. However, in urgent cases the insolvency court retains the right to appoint a preliminary insolvency administrator without first establishing a preliminary creditors' committee. In this case, a preliminary insolvency administrator also retains the right to request the creation of a preliminary creditors' committee, if he or she wants to work together with the creditors closely right from the outset to ensure a constant exchange of information.

Companies of a specific size are under an obligation to organize a preliminary creditors committee which will be appointed by the court. This will be obligatory wherever two of the following three tests are met: a minimum balance sheet total of €4.84 million; minimum sales revenue of €9.68 million in the last twelve months prior to the balance sheet date; or a minimum average of 50 employees in the preceding year. Upon corresponding instructions being issued by the court, the debtor or the preliminary insolvency administrator is to provide the names of persons who might be considered for appointment to the preliminary creditors' committee. The intention is that this committee should include a mix of creditors including secured creditors and unsecured creditors (be they major or minor creditors) employees and contingent creditors who first become creditors when proceedings are opened, e.g. guarantee and bond insurers ("Kredit- und Kautionsversicherer") and German Mutual Pension Assurance Association ("PSVaG"). Obtaining a seat on the preliminary creditors' committee should be an ambition for creditors who want to play, from the outset, an active part in the restructuring process.

Selection of the (preliminary) insolvency administrator

The insolvency court shall select and appoint as (preliminary) insolvency administrator an individual who is independent of the creditors and of the debtor. The preliminary creditors' committee is entitled to formulate a general requirement profile based on which the (preliminary) administrator is to be selected, or may also specifically nominate an administrator. The court may refuse to appoint the nominee which the preliminary creditors' committee has unanimously proposed only if such nominee is unfit to take office. In this context, the required independence of the nominee is not ruled out simply because it was nominated by the debtor (along with others), or by virtue of having provided general consultancy services to the debtor, prior to the insolvency filing, on general matters of reorganization and insolvency. There remains the question of what constitutes general advice, (which is permissible) and specific advice (which disqualifies a person from the office) and we expect this issue to be determined by the insolvency courts in the future. If the vote of the preliminary creditors' committee is not unanimous the decision is not fundamentally binding for the court but a clear expression of the wishes of the creditors may be persuasive.

It remains to be seen whether the courts will seek to apply the ESUG provisions to companies which are special purpose vehicles ("SPVs") used in structured finance or leverage finance transactions. The law is primarily aimed at operational/ conventional businesses and SPVs are unlikely to employ 50 employees or be involved in sales (two of the key tests) and, in the context of a CMBS transaction, may only have one large creditor. Where only one creditor is involved, the courts will be reluctant to create a "committee of creditors" in this case.

Introducing shareholders' rights to the procedure of establishing an insolvency plan

It is sometimes preferable for an insolvent corporate entity to be restructured through an insolvency process rather than for there to be a sale of the assets of the corporate entity (if, for example, a sale of the assets of a debtor may lead to the loss of valuable tax losses or the loss of a licence). The Reorganisation Law will accordingly abolish the strict separation of insolvency law and corporate law in the procedure which establishes an insolvency plan. Therefore, any arrangement can be made which is permissible under German corporate law, in particular debt-equity swaps may be included in insolvency plans. Shareholders are, however, to be taken into account when creditor voting groups are formed, although they will vote separately to the other creditor groups. Each group of creditors and shareholders shall vote on the plan separately. Even if each group does not vote in favour of the plan, a voting group shall be deemed to have consented (by court order) if it can be demonstrated that the relevant dissenting group suffers no loss under the insolvency plan compared with its situation without a plan. However, in the rare cases where shareholders are viewed as still being in the money, it is imperative that the shareholders participate to a reasonable extent in the economic value under the plan.

The fiscal and corporate law restructuring measures set out in the plan prepared cannot trigger any rescission or termination rights of the borrower's contractual partners on the basis of contractual change-of-control clauses. This ensures that the restructuring process is protected against the negative consequence of contractual change-of-control clauses, when a change in the ownership structure occurs as a result of a debt-equity swap. If a departing shareholder is entitled to a compensation claim against the company, such claim will be restricted to the liquidation value of the shares (which is frequently nothing in these circumstances) and the payment of this amount may be deferred for up to three years.

Accordingly a shareholder can no longer block a restructuring in an administration process. Instead, the measures under corporate law provided for by the insolvency plan will be deemed to have occurred on confirmation of the insolvency plan. Specifically reductions or increases of capital will not require a resolution to be passed by the annual general meeting. This provision significantly reduces the means by which a shareholder can obstruct a restructuring. On the other hand the general protection accorded to minorities of creditors (Section 251 InsO) is also granted to shareholders. At the request of a shareholder or creditor the insolvency plan shall be refused if the requesting party can demonstrate that it has been placed at a disadvantage by the plan compared with his situation without a plan. Notwithstanding this, an individual shareholder will not be able to prevent the confirmation of the insolvency plan on the basis of an objection against the creation of a "cash reserve fund" which will be used as a 'fighting fund' to be drawn in the event of a dispute with shareholders who object to the implementation of an insolvency plan. Whether the shareholder receives compensation out of the "cash reserves" shall be decided in regular court proceedings outside the insolvency proceedings.

Conversion of creditor claims to shares in the company ("debt-equity swap")

By including the shareholders' interests in the process, it is even easier now to provide for debt-equity swaps in the procedure which establishes the insolvency plan, in other words to convert outside capital into equity. In fact, wherever the participation interests have no economic value, which is the norm in an insolvency context, such debt-equity swap can even be performed even if shareholders object to the plan. In contrast, no creditors may be pressured, against their will, to become a shareholder.

Debt-equity swaps have often been impeded in the past not only because of a lack of shareholder consent, but as a consequence of possible lender liability risks owing to the strict tests that any contribution of capital had to meet in German corporate law. Where claims were over-valued at the time of their being contributed, the creditors in a subsequent insolvency ran the risk of being held liable to the debtor for the difference between the value of the contribution in kind and the initial contribution (Differenzhaftung). However, the Reorganisation Law has, for the most part, mitigated this liability risk; the evaluation of a claim by the lender (and future shareholder) as a contribution in kind may only be contested by the debtor and in particular the other shareholders in the context of an insolvency plan procedure. Should it become apparent later that the claims were overstated, this cannot (any longer) result in the contributor being liable vis-à-vis the debtor for the difference between the value of the contribution in kind and the initial contribution.

Reorganization plan cannot be obstructed by legal remedies

Shareholders have frequently been able to impede the speed of the implementation of an insolvency plan and provisions have been included in the Reorganisation Law to mitigate possible delay. The possibility of challenging an insolvency plan by pursuing the legal remedy of a special appeal subject to a time limit (sofortige Beschwerde), which had the consequence of suspending the plan's impact, had the ability to enormously disrupt reorganization processes. This is a frequently used tactic by shareholders, and even served as a means of extortion in some where shareholders were "out of the money". It was not an infrequent occurrence to see the entire reorganization called into question.

In future, any special appeal will be admissible only where a formal complaint has been filed by a claimant, subject to the proviso that this claimant has previously exhausted the procedural options available. The claimant must have objected to the plan at the latest at the reconciliation meeting (Abstimmungstermin), and must have voted against it. Furthermore, the Reorganisation Law has introduced a critical threshold for a special appeal to become admissible. Claimants will have to demonstrate that the insolvency plan will place them at a significant disadvantage as compared to their position without the plan.

Easier access to "debtor in possession" status

One objective of the Reorganisation Law is to facilitate granting easier access to "debtor in possession" ("DIP") status, where the management continues to maintain control of the company; which is similar to the US Chapter 11 approach. The vast majority of German insolvency procedures have to date been ones where the insolvency administrator takes control. The intention is to put to the best possible use the knowledge and experience available within the company in the interests of its reorganization. In future, any petition that debtors may submit for DIP status may be refused only if specific circumstances are in fact known that give rise to the concern that their creditors might be placed at a disadvantage were this status to be accorded. The preliminary creditors' committee will be able to instruct that the court grants DIP status to debtors where the committee has unanimously passed the corresponding resolution. Finally, should a debtor be (merely) subject to the risk of being unable to pay its debts as they become due (Zahlungsunfähigkeit) (rather than currently being unable to pay its debts as it falls due) the debtor can retract the insolvency petition should it not, for some reason, be granted DIP status.

The Reorganisation Law obliges the court to support reorganizations in which the debtors themselves manage and dispose of the assets in the estate under the supervision of a custodian, provided such reorganizations hold out the prospect of success. This debtor will no longer be prohibited from disposing any assets in the insolvency filing proceedings, and a court can no longer order that all dispositions by the debtor shall be effective only with the approval of a preliminary insolvency administrator. To ensure protection of the estate however, a temporary custodian must be appointed in lieu of a preliminary insolvency administrator if sales are planned when a company has obtained debtor in possession status.

"Protected reorganization" pursuant to Section 270b ESUG-InsO

The opportunity given to debtors to place themselves under a "protective shield" is entirely new; this has been instituted in order to allow them to prepare for a reorganization early, namely when a creditor is facing the prospect of failing to pay its debts where it falls due or where it is over-indebted. Once the "shield" is in place, debtors are protected against certain enforcement measures for a period of up to three months; moreover, it is ensured that management retains control of the company. During this time, debtors then have the possibility of preparing a reorganization concept under the supervision of a temporary custodian that subsequently will be voted on as an insolvency plan. Accordingly this introduces an element which is new to German insolvency law as the plan can be "pre-packaged" in the "Protected Reorganisation" and implemented once insolvency proceedings have been initiated.

However, this "shield" does not mean that creditors will be prevented from calling their claims for immediate repayment, or from terminating agreements. But all creditors are excluded from compulsory administration and execution proceedings including security enforcement. Accordingly, since there is no moratorium, it is possible that the debtor will become unable to pay its debts as they become due. However, this will not unavoidably lead to the "protective shield" being cancelled. Once under the "shield", the only consequence of being unable to pay one's debts as they become due is that it triggers the obligation to notify the court. Reorganizing a company under a "protective shield" does not mean that coordinating all parties involved in the reorganization can be dispensed with in the run-up to the insolvency, however. Furthermore, the "protective shield" procedure requires the debtor to prove, at the time the petition is filed, that the company is able to be reorganized by submitting a corresponding certification from a person experienced in insolvency law matters approving that imminent illiquidity or overindebtedness but not illiquidity is present and that the intended reorganization is not obviously futile.

Conclusion

ESUG is not perfect and it remains to be seen whether a culture of reorganisation will result from the changes. The Parliamentary Committee on Legal Affairs (Rechtsausschuss) has asked the federal government to submit, in five years' time, its precise evaluation of the experience gained in applying the ESUG. The amendments are a brave effort by the German government to improve the current position where the onset of insolvency is currently a terminal procedure in most circumstances. It is to be hoped that the new procedures and changes such as improved access to debtor in possession status, the new "protective shield", the reduction of shareholder hold out rights where the economic position does not justify such rights, are effective in practice. Finally, it is hard not to welcome further creditor participation in the choice of the identity of the preliminary insolvency administrator.

In this publication, White & Case means the international legal practice comprising White & Case LLP, a New York State registered limited liability partnership, White & Case LLP, a limited liability partnership incorporated under English law and all other affiliated partnerships, companies and entities.
LON0312004_2