NewsAlert

Financial Restructuring and Insolvency

June 2011

The new German laws governing the restructuring of companies – it's time for change!

On the bill of the Federal German Government for an Act Serving the Further Facilitation of the Reorganization of Enterprises (ESUG)

Now that the Federal Government's bill for the Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen (ESUG, Act Serving the Further Facilitation of the Reorganization of Enterprises) is available, the first of the three stages of reforming German insolvency laws has (nearly) been completed. At its core, the Reorganization Facilitation Act is intended to enable companies to be reorganized early, thus contributing to a new culture of reorganization in Germany. In Stages Two and Three, the Federal Government will then address consumer insolvency proceedings as well as the laws governing corporate insolvency and the professional standards of insolvency administrators. The Federal Minister of Justice, Sabine Leutheusser-Schnarrenberger, has stated that the reform of insolvency laws is among the major reform projects in German commercial law.

Enhancing the influence of creditors

The Reorganization Facilitation Act will enhance the influence in a variety of ways that creditors can take when their debtors become insolvent, extending it to cover the early phase of the insolvency filing procedure. Opportunities to so exercise an influence are to be seen in particular in the preliminary creditors' committee (Section 21 paragraph 2 first sentence no. 1a ESUG-InsO). Companies of a specific size in fact are under obligation to have this committee appointed by the court: this will be done wherever two of the following factors are given: a minimum balance sheet total of € 2 million; minimum sales revenue of € 2 million in the last twelve months prior to the balance sheet date; a minimum average of ten employees in the preceding year (Section 22a ESUG-InsO). Upon corresponding instructions being issued by the court, the debtor is to provide the names of persons who might be considered for appointment to the preliminary creditors' committee (Section 22a paragraph 3 ESUG-InsO). In this context, the various categories of creditors are to be balanced out (such as creditors with secured claims and unsecured claims, be they major or minor creditors, and employees). In particular, the preliminary creditors' committee will be able to influence the selection of the (temporary) insolvency administrator as well as the order issued by the court as to the debtor being allowed to itself manage and dispose of the assets involved in insolvency proceedings under the supervision of a custodian ("debtor in possession"), and, in this context, the selection of the (temporary) custodian.

Selection of the (temporary) insolvency administrator

The opportunity given to creditors to exercise their influence that is easily identifiable as the most significant is their involvement in selecting the (temporary) insolvency administrator; this process often is regarded as the crossroads at which the further

Dear reader,

The present NewsAlert on restructuring and insolvency is intended to provide you with an overview of current developments in German insolvency law.

We hope you will find it informative, and should you require any further information, please feel free to contact us at any time!

Yours truly,

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course of the entire proceedings is determined. The preliminary creditors' committee is entitled to formulate a general requirement profile based on which the administrator is to be selected, or may also specifically nominate an administrator (Section 56 paragraph 2 ESUG-InsO). The court may refuse to appoint the nominee the preliminary creditors' committee has unanimously suggested only if such nominee is unfit to take office (Section 56 paragraph 3 ESUG-InsO); in this context, the required independence of the nominee is not ruled out simply by such facts as his having been nominated by the debtor (along with others), or his having provided general consultancy services to the debtor, prior to the insolvency filing, on matters of reorganization and insolvency by advising the debtor on the course of insolvency proceedings and its consequences, or his having prepared an insolvency plan in collaboration with the debtor and the creditors (Section 56 paragraph 1 ESUG-InsO).

The involvement of the creditors in selecting the insolvency administrator is an option already under the laws currently in place, and the reorganization models that some courts have instituted for such proceedings have stood the test of time (such as the "Detmold model", in which the major creditors, the management and works council of the debtor and, where applicable, representatives of the unions are involved in the process of selecting the temporary and final insolvency administrator), in particular where production sites and jobs were jeopardized. By signing into law the Reorganization Facilitation Act, it is not intended to replace this "tried and tested" procedure by the institution of the preliminary creditors' committee, or to reduce the number of instances in which this procedure is applied; the objective is to open up new space for involving creditors.

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

The Reorganization Facilitation Act will abolish the strict separation of insolvency law and corporate law in the procedure serving to establish an insolvency plan: once it is enacted, it will be possible to take account of the rights of shareholders in the insolvency plan. This inclusion is a sensible alternative in particular in those cases in which the reorganization involving the sale of an insolvent company's assets to a legal entity, often a newly established one (übertragende Sanierung), is not a solution equivalent to the reorganization of the corporate subject of rights and duties (Unternehmensträger), as there is the risk that the legal entity might be deprived of rights specific to it (such as high tax losses carried forward, concessions, licenses).

Accordingly, shareholders are to be taken into account when creditor voting groups are formed (Section 222 paragraph 1 second sentence no. 4 ESUG-InsO). Their consent may be construed wherever such groups violate the prohibition of obstruction (Section 245 InsO). Accordingly, the reorganization of the corporate subject of rights and duties (Unternehmensträger) based on an insolvency plan in future will no longer absolutely depend on the constructive involvement and assistance of the shareholders. Instead, the measures under corporate law provided for by the insolvency plan will enter into force upon the court having confirmed the plan and this confirmation having attained legal force. This means, to cite but one example, that in procedures serving to establish an insolvency plan, reductions or increases of capital will not require a resolution to be passed by the annual general meeting. Pursuant to Section 254a paragraph 2 ESUG-InsO, all of the requirements as to form governing the measures under corporate law provided for in the insolvency plan will be deemed to have been complied with (such as the required notarization where a share in a GmbH (limited liability company) is taken over pursuant to Section 55 paragraph 1 of the Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG, Limited Liability Company Act), or the corresponding declaration of subscription made in a written subscription form pursuant to Section 185 paragraph 1 of the Aktiengesetz (AktG, German Stock Corporation Act)). This provision significantly reduces the means thus far available to a company's representatives having supervisory responsibilities, and in particular to individual shareholders, to obstruct the proceedings. On the other hand, the general protection accorded to minorities (Section 251 InsO) is also granted to shareholders.

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

By including the participation interests in the process, it will now be possible to provide for debt-equity swaps in the procedure serving to establish an insolvency plan, in other words to convert outside capital into equity (Section 225a paragraph 2 ESUG-InsO). In fact, wherever the participation interests have no economic value, which is the norm, such debt-equity swap can even be performed independently of the intentions that the individual shareholder may pursue because the participation interests are taken into account in the procedure serving to establish an insolvency plan. By contrast, no creditors may be pressured, against their will, to take on a shareholder position (Section 225a paragraph 2 second sentence ESUG-InsO). As a general rule, debt-equity swaps are performed by reducing the capital and subsequently increasing it, ruling out the subscription right of the shareholders thus far, in which context the creditors contribute their claims against the company as a contribution in kind.

This type of capital measure was impeded in the past not only because the shareholder(s) may have pursued other intentions, it was also subject to significant liability risks due to the strict requirements that any contribution of capital had to meet. Where claims were over-valued at the time of their being contributed, the creditors ran the risk of being held liable for the difference between the value of the contribution in kind and the initial contribution (Differenzhaftung) pursuant to Section 56 paragraph 2 in conjunction with Section 9 of the Limited Liability Company Act (GmbHG), or they faced the drastic legal consequences entailed by an assessment that the transaction was in fact a

hidden contribution in kind. However, the Reorganization Facilitation Act has, for the most part, mitigated this liability risk: performing a debt-equity swap is privileged in the procedure serving to establish an insolvency plan insofar as the evaluations of the claims as a contribution in kind may be challenged only in the context of that procedure, in other words, 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 (Section 254 paragraph 4 second sentence ESUG-InsO).

Reorganization plan cannot be obstructed by legal remedies

The Reorganization Facilitation Act has made it a priority to prevent delays where the effects of the insolvency plan are concerned, which often entailed many months. 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 impacts, had the ability to enormously disrupt reorganization processes; it did so in many cases, and even served as a means of extortion in some. It was not an infrequent occurrence to see the entire reorganization called into question. That is why the Reorganization Facilitation Act has limited the means of obtaining legal protection against a confirmed insolvency plan, in the interest of reducing the means available to individual parties involved in the plan to obstruct the proceedings. In future, any special appeal subject to a time limit 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) (Section 253 paragraph 2 no. 1 ESUG-InsO), and must have voted against it (Section 253 paragraph 2 no. 2 ESUG-InsO). Furthermore, the Reorganization Facilitation Act has introduced a critical threshold for a special appeal to become admissible. Claimants accordingly will have to demonstrate, in a satisfactory way, that the insolvency plan will place them at a significant disadvantage as compared to their position without the plan (Section 253 paragraph 2 no. 3 ESUG-InsO). It should be noted that as a consequence, the presence of the parties involved in the procedure serving to establish an insolvency plan is vital in order to preserve the means of obtaining legal protection available to them under law.

Easier access to "debtor in possession" status

The Reorganization Facilitation Act also pursues the objective of granting easier access to "debtor in possession" status, in which the management continues to have control of the company. The intention is to put to the best possible use the knowledge and experience available within the company in the interests of its reorganization. For this purpose, the Reorganization Facilitation Act has turned around the relationship given between rules and exceptions thus far wherever courts instructed that the debtors themselves manage and dispose of the assets involved in insolvency proceedings under the supervision of a custodian (debtor in possession). In future, any petition that debtors may submit for "debtor in possession" 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 (Section 270 paragraph 2 no. 2 ESUG-InsO). This means, as set out in the reasoning provided for the law, that any instances in which it is not clear what the potential disadvantages for creditors might be will now no longer work to the detriment of the debtors. In fact, the preliminary creditors' committee in future will have the possibility to force the court to give "debtor in possession" status to debtors where the committee has unanimously passed the corresponding resolution, because under these circumstances, the order will not be deemed to place the creditors at a disadvantage (Section 270 paragraph 3 second sentence ESUG-InsO). Finally, should a debtor be (merely) subject to the risk of being unable to pay its debts as they become due (Zahlungsunfähigkeit), the option will always remain open to it to retract the insolvency petition should the pre-requisites applicable to granting "debtor in possession" status be deemed to not have been met; should the court have concerns in this regard, it is to communicate them to the debtor in due time (Section 270a paragraph 2 ESUG-InsO).

It bears noting that the Reorganization Facilitation Act obligates the court to support reorganizations in which the debtors themselves manage and dispose of the assets involved in insolvency proceedings under the supervision of a custodian, provided such reorganizations hold out the prospect of success, by not prohibiting the debtor generally from disposing over any assets in the insolvency filing proceedings, and by not ordering that all dispositions by the debtor shall be effective only with the approval of a temporary insolvency administrator. In these cases, a temporary custodian is to be appointed in lieu of a temporary insolvency administrator (Section 270a paragraph 1 ESUG-InsO).

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

The opportunity given to debtors to place themselves under a "protective shield" (Section 270b ESUG-InsO) is entirely new; this has been instituted in order to allow them to prepare for a reorganization already in the phase of an impending inability to pay debts as they become due, or where they are over-indebted. In this way, debtors are protected against enforcement measures for a period of up to three months, moreover, it is ensured that they retain 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 in the sense of a "pre-packaged plan", 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. Accordingly, since the "protective shield" may be cancelled by the court wherever the debtors do become unable to pay debts as they become due (Section 270b paragraph 3 first sentence no. 1 ESUG-InsO), 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. Moreover, the court order will be issued subject to the pre-requisite of the debtors proving that the company is able to be reorganized by submitting a corresponding certification from a person experienced in insolvency matters (Section 270b paragraph 1 second sentence ESUG-InsO). Accordingly, preparing for reorganization will not begin only once the petition is filed to initiate the procedure for creating the "protective shield" – this work will begin much earlier.

The Achilles' heel: financing serving to maintain the company as a going concern

The obvious question asked wherever companies are reorganized by way of an insolvency plan, or by having them manage and dispose of the assets involved in insolvency proceedings under the supervision of a custodian, is how this continuation of the debtor companies will be funded. For the most part, the Reorganization Facilitation Act provides no answer to this question. This means that the availability of the required funding must be recognized as the Achilles' heel of many reorganization concepts. There are significant risks for all parties involved in financing the company as a going concern: the debtor, the banks or other third parties providing funding (such as suppliers), as well as the insolvency administrator. The background for this is to be seen in the strictures of insolvency law and corporate law as given in Germany, which palpably limit the flexibility available to any financing serving to maintain a company as a going concern. The subordination under insolvency law of shareholder loans is one aspect, as is the risk that the provision of additional collateral may be contested in insolvency proceedings, and the liability for delaying the initiation of insolvency proceedings. In a regulatory environment this difficult, the stakeholders must be able to create structures that are conducive to the reorganization and that will outlast the insolvency in order to obtain financing serving to maintain the company as a going concern. This means that reorganization concepts must be tied to innovative financing solutions that are in line with the individual needs of the company. Should this not be possible, the Reorganization Facilitation Act risks failing to achieve its objective: to improve the chances of survival of reorganized companies.

"Special laws" for clearing systems

Finally, by introducing the new Section 104a ESUG-InsO, the Reorganization Facilitation Act has created a "special law" for clearing systems, which will stabilize the financial market and is intended to promote Germany as a financial center. The objective is to continue implementing the transactions within a clearing system despite the fact that one of its participants has become insolvent. To this end, two paths may be gone down: on the one hand, the rights and obligations of an insolvent participant of a clearing system may be transferred in their entirety, or in part, to one or several solvent participants in the clearing system (Section 104a paragraph 1 ESUG-InsO). On the other hand, the central counterparty may balance out individual items, or even an entire portfolio, using offsetting transactions, while any securitizations becoming available are to be returned (Section 104a paragraph 2 ESUG-InsO). However, it should be ensured in either case that this procedure does not have any detrimental impacts on creditors. Otherwise, the insolvency administrator may demand that the funds so gained be transferred to the insolvency estate (Section 104a paragraph 3 ESUG-InsO).

Financial restructuring of German companies using the British "Scheme of Arrangement" – new and "boundless" opportunities?

In spite of the fact that the Reorganization Facilitation Act is set to be signed into law in the near future, this still does not mean a solution is available under German law ensuring the "free" reorganization of companies ahead of insolvency proceedings. Accordingly, it will be possible to obtain this, outside of insolvency proceedings, solely within the bounds of private autonomy. The consequence is that, leaving aside the cases provided for by Section 5 of the Gesetz über Schuldverschreibungen aus Gesamtemissionen (SchVG, Act on Debt Securities from Total Issues), no decisions taken by a majority vote of those affected will take hold; they are ruled out. As a result, any financial restructuring done "quietly" in Germany will be faced with insurmountable obstacles. The unanimity requirement not only encumbers the flexibility of any reorganization performed prior to insolvency proceedings, it can even cast into doubt the fairness of the distribution where so-called "non-stop disrupters" take action and, as creditors, exploit their veto rights as a means of extortion in order to obtain benefits for themselves.

Tele Columbus, Rodenstock and others

This is why we have been seeing a development most recently in which companies having their registered seat in Germany (among others) are seeking to move to England, already in the pre-insolvency stage, in order to restructure their finances pursuant to British law using a Scheme of Arrangement (ss. 895 et seq. Companies Act 2006). Under this scheme, the simple majority in number of creditors, nominally representing at least 75% of the claims, will determine the reorganization. In the cases of the cable network operator Tele Columbus and the optical product manufacturer Rodenstock, it was possible to achieve a comprehensive restructuring of the companies' liabilities. The London High Court of Justice issued the required court confirmation of the Scheme of Arrangement to both of these companies.

Financially restructuring a company under British law, by way of a Scheme of Arrangement, is an option only for those companies

that have a sufficient connection to England. This, however, is easy to obtain: wherever the financing is subject to British law, as is the general rule for larger companies and for leveraged buy-outs (and as was the case for Tele Columbus and Rodenstock), this sufficient connection exists. The company concerned need not have a branch office in England, nor does it need to have the "center of its main interests" in England, as stipulated by Article 3 paragraph 1 of Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings. Strategically relocating the center of main interests, as the automotive supplier Schefenacker did, is not a necessity under English law.

The question of recognition: Does the British Scheme of Arrangement have limits after all?

The question is whether the Scheme of Arrangement under British law might be accorded a legal impact in Germany as well, or even must be accorded such an impact. It is not certain that British law will be recognized and applied in Germany as taking precedence over German law. Should German courts refuse to recognize the Scheme of Arrangement, any interference with the status of creditors, such as by a forcible waiver, deferral or subordination under a Scheme of Arrangement, would have no effects in Germany. The consequence: German creditors would assert their claims, notwithstanding any provisions made in the Scheme of Arrangement, and would be able to enforce them. It should not be overlooked in this context that German courts must in all cases take account of the mandatory stipulations of economic or social policy (so-called "norms of intervention") applicable at the debtor's residence. From a German perspective, this concerns no less than an intrusion into the principle of private autonomy, as the boundary at which a company may be reorganized prior to initiating insolvency proceedings, which is admissible even in insolvency proceedings only within the narrow confines imposed by Sections 217 et seq. InsO. Finally, the application of a provision may be refused if this obviously cannot be brought in line with the ordre public of the state in which the court dealing with the insolvency is situate.

On this matter, German courts are in disagreement. In the case of a British life insurance company, the Scheme of Arrangement interfered with the rights of German insured parties (among others) as creditors. The Oberlandesgericht (OLG, Higher Regional Court) of Celle refused to recognize the effects (ruling of September 8th, 2009 – reference no.: 8 U 46/09), whereas the Landgericht (Regional Court) of Rottweil held, in different proceedings, that the German insured parties were likewise bound by the Scheme of Arrangement (ruling of May 17th, 2010 – reference no.: 3 O 2/08). The appeal on points of law against the ruling handed down by the Higher Regional Court of Celle is pending with the Federal Court of Justice (reference no.: IV ZR 194/09) and is set to be decided in this year still.

Review and design of syndicated financing

The above cases clearly show that there is a demand for "quietly" restructuring debtor companies outside of insolvency proceedings, which continues to be unsatisfied in spite of the Reorganization Facilitation Act. Under German law, the pre-requisite continues to be that a consensus must prevail among creditors regarding the steps to reorganize the company as intended, also where the "protective shield" pursuant to Section 270b ESUG-InsO is concerned. However, even where a company is financed under German law, such a "quiet" restructuring process is possible, provided that the corresponding terms were included in the financing contracts. Where companies have their registered seat in Germany, it is not assured that the restructuring of their financing under British law using a Scheme of Arrangement will be recognized, and accordingly will require detailed review, in particular where the standards imposed by German insolvency law are concerned.

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