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Insolvency Reform to Boost Restructurings in Germany

On December 13, 2011, the so-called *Act to Facilitate Further the Restructuring of Companies* (*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*, the "Act") was promulgated.[1] The Act results in significant amendments to the German Insolvency Code (*Insolvenzordnung*) to facilitate in-court restructurings in Germany and will apply to any insolvency proceedings based on insolvency filings made on or after March 1, 2012.

Under existing law, there have been relatively few successful in-court restructurings of German companies. Parties often found it difficult to successfully restructure companies by using the means of German insolvency law, particularly by a so-called "insolvency plan". Any such restructuring within insolvency proceedings was fraught with significant uncertainties – in addition to the debtor being stigmatized as "insolvent". Creditors had little influence on the selection of the insolvency receiver by the court. Minority creditors and shareholders had various ways of blocking or delaying in-court restructurings. In many cases, the main practical alternative to an in-court restructuring by way of an insolvency plan, namely an asset sale (*übertragende Sanierung*), raises various legal and practical difficulties as well. German insolvency law was therefore generally perceived to be less restructuring-friendly than the laws of other jurisdictions, such as the United Kingdom.

As a consequence, in some restructuring transactions, the parties decided to have the debtor "migrate" to other jurisdictions in order to take advantage of the more flexible rules applicable there. In other cases, German companies sought to achieve a restructuring of certain indebtedness by using a Scheme of Arrangement under English law. Any such "COMI migration" or the use of a Scheme of Arrangement, however, raises complex legal issues as well.

The Act is intended to mitigate these risks and uncertainties by aligning the insolvency plan procedure more closely with Chapter 11 proceedings under U.S. bankruptcy law. In addition, changes include the formal involvement of the debtor's shareholders in the proceedings, the increase of the influence of creditors over the proceedings, and the streamlining of the procedure to adopt an insolvency plan.

[1] This memorandum is an update to our memorandum dated July 28, 2010, in which we discussed an early internal draft bill of the German Federal Ministry of Justice.

Involvement of Shareholders

The one change introduced by the Act which most fundamentally deviates from current German insolvency law relates to the formal involvement of the debtor's shareholders in the insolvency proceedings.

In German insolvency proceedings, the shares in the debtor do not form part of the debtor's estate and, under existing law, shareholders have not been formally involved in the proceedings. Unlike the bankruptcy laws in other jurisdictions, German law did not give the competent insolvency court the discretion to issue an order by which any shareholder resistance (*e.g.*, against a debt-equity swap) could be overcome. As a consequence, even a minority of shareholders could in practice block any restructuring involving a transfer of shares to creditors or any capital measures.

Under the Act, parties will be able to adopt an insolvency plan which, in addition to measures affecting creditors' rights, provides for measures affecting its shareholders. It will in particular be possible to provide that the debtor be continued as a going concern, that shares in the debtor be transferred to creditors, that the debtor's share capital be reduced to absorb existing losses and then increased by the issuance of new shares to an investor, any pre-emptive rights of existing shareholders being excluded, and other corporate measures. Thereby, it will be possible to force a debt-equity swap upon dissenting shareholders by majority vote of the creditors.

We note that, as under existing law, it will not be possible to force a creditor, by way of a majority vote, to participate in a debt-equity swap, except in special circumstances such as a restructuring of bonds in accordance with the German Bondholder Act (*Schuldverschreibungsgesetz*). This will have to be taken into account when structuring insolvency plans.

Creditors and shareholders, to the extent actually affected by the terms of the insolvency plan, vote on the plan in groups. If the majority of groups voting on the insolvency plan approve the plan, the vote of dissenting groups can be replaced by court order if certain conditions are met, and dissenting creditors or shareholders have only limited rights to prevent the plan from becoming effective (see "*Streamlining of Insolvency Plan Procedure*" below).

If the debtor is a listed company, a debt-equity swap will typically be structured as a capital reduction with a subsequent capital increase, in the course of which creditors contribute their claims against the issuance of new shares. Outside of insolvency proceedings, German corporate law requires that the contributed claims have a market value at least equivalent to the nominal value of the newly issued shares. If and to the extent the value of the contributed claims turns out to be lower, the relevant creditor will be liable to cover any such shortfall in cash. This liability constitutes a significant risk for investors participating in a debt-equity swap outside of insolvency proceedings. The Act addresses this concern by providing that this liability régime does not apply if a debt-equity swap is completed in insolvency pursuant to the provisions of the Act.

The Act also provides that a change of control with respect to the debtor occurring as a consequence of share transfers or capital measures based on an insolvency plan does not entitle the respective contractual counterparties of the debtor to terminate any agreements. Contractual change of control provisions are explicitly suspended by the Act.

Creditors who contemplate participating in any form of debt-equity swap with respect to a part (but not all) of their debt should seek legal advice on the German rules of equitable subordination of shareholder loans. These rules may lead to a subordination of the remaining debt claims in a subsequent insolvency of the debtor (second round restructuring) except if and to the extent legal exemptions apply.

Selection of Insolvency Receiver

In the past, creditors have had little influence on the identity of the insolvency receiver to be appointed by the insolvency court. German courts frequently refused to appoint a candidate who had been proposed by creditors or who had provided pre-filing advice to creditors, arguing that such person was compromised thereby. The uncertainty as to the identity, experience and willingness to cooperate of a future insolvency receiver has been a significant risk for in-court restructurings in Germany.

The Act now mitigates this risk by strengthening the position of the so-called preliminary creditors' committee (*vorläufiger Gläubigerausschuss*), which consists of representatives of the creditors generally and which can take influence on the process during the so-called "preliminary insolvency proceedings" (which generally take place between the date of insolvency filing and the date on which actual proceedings are opened by the court).

The Act provides that the insolvency court must appoint a preliminary creditors' committee if the debtor's business exceeds certain thresholds.

The insolvency court shall generally give the preliminary creditors' committee the opportunity to express its views on the selection of the insolvency receiver. The court can reject any corresponding proposal only if the proposed person is not suited as insolvency receiver, and prior general advice given by the proposed person to creditors would not *per se* lead to the ineligibility of such person. If, however, the person has, together with creditors and the debtor, prepared a draft insolvency plan, such person would be ineligible.

In light of the increased importance of preliminary creditors' committees (see "*Strengthening of Self-Administration*" below) creditors should, in restructuring transactions where an insolvency filing is imminent, make preparations to be able to exercise their related rights on short notice. Necessary actions will include discussing (*e.g.,* among lenders) who could act as representative in a preliminary creditors' committee, and establishing contacts with other creditor groups.

Strengthening of Self-Administration

Under German insolvency law, debtors may apply for so-called self-administration (*Eigenverwaltung*). If so ordered by the court, the debtor's management remains in office, albeit supervised by a trustee. Self-administration has been successfully utilized in some restructuring cases but has remained a rare exception. In addition, it has been relatively easy for creditors to have a court order for self-administration lifted.

The Act addresses the main current obstacles to self-administration: If the debtor applies for self-administration, the court generally first has to solicit the views of the preliminary creditors' committee. The court can deny the application only if there would be evidence to the effect that self-administration would likely prejudice the creditors as a whole, unless the members of the preliminary creditors' committee unanimously vote in favor of self-administration.

If the debtor applies for self-administration, the court will not be able to prohibit the debtor from disposing of its assets or to make such disposals subject to the consent of a "preliminary insolvency receiver", unless the debtor's application for self-administration is manifestly futile.

Where a debtor files for insolvency on the basis of imminent illiquidity (as opposed to actual insolvency, *i.e.*, illiquidity or over-indebtedness) and applies for self-administration, the court will have to inform the debtor in advance if it intends to deny such application. This will enable the debtor to withdraw the insolvency filing and undertake or continue restructuring efforts out of court.

Furthermore, where an insolvency filing has been made for purposes of an in-court restructuring and where the debtor is not illiquid, the court will have to order a grace period of up to three months during which the debtor may prepare a pre-packaged insolvency plan, unless the restructuring appears manifestly futile. In addition, upon application by the debtor, the court will have to order that (i) enforcement measures by single creditors be suspended during the grace period and (ii) obligations incurred after the filing constitute preferential debt (*Masseverbindlichkeiten*) in the subsequent insolvency proceedings.

Streamlining of Insolvency Plan Procedure

Under existing law, individual creditors are effectively able to block or delay the adoption of insolvency plans by using appeal rights, and to thereby put restructurings at risk. The Act now makes it more difficult for individual creditors to obstruct promising restructurings by imposing further procedurals requirements and requiring that the insolvency plan be materially prejudicial to an objecting creditor.

Furthermore, it will be possible to have an insolvency plan provide for the financial compensation of objecting creditors for losses incurred, in which case the insolvency court must not deny the approval of the plan on the basis of a creditor's claim that it would be put at a material disadvantage if the plan was adopted. In any such case, the suit for compensation would be conducted outside of the insolvency proceedings and not prevent the restructuring.

Rights of Central Counterparties not addressed by the Act

While earlier drafts of the Act contained provisions strengthening the rights of central counterparties in the insolvency of a participant, the legislature decided to further consider and eventually adopt such changes separately at a later point in time.

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If you have any questions in regard to the issues addressed herein, please feel free to contact Dr. Werner Meier (wmeier@cgsh.com), Michael Kern (mkern@cgsh.com) or Christoph Schauenburg (cschauenburg@cgsh.com) at the Frankfurt office of Cleary Gottlieb or any of our partners and counsel listed under "Germany", "Lawyers in this Practice", under the "Practices" section, "Regions", of our website at http://www.clearygottlieb.com.

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