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Changes to the German Insolvency Code: Angles for Opportunistic Investors

About the Author

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The German parliament has completed the first or three phases of implementing sweeping changes for the German Insolvency Code. This first phase addresses certain long-standing inefficiencies of German insolvency law and brings it closer to the flexibility of the UK or US insolvency regimes. The amendments create new options for both creditors and management and have already introduced an element of competition between insolvency practitioners for future market share from creditors. The briefing highlights those changes that are most relevant for creditors and special situation investors in Germany.

Introduction

The bill introducing the new law to facilitate corporate restructurings was approved by the German Parliament (the *Bundestag*) and the German Federal Assembly (the *Bundesrat*) in the form proposed by the parliament's justice committee on October 26, 2011.[1] The bill will radically change German insolvency law from its effective date on March 1, 2012 — incentivising management to make use of insolvent corporate restructurings in Germany more easily and giving both the debtor's management and the creditors more options.

The changes focus on three main areas:

- an enhancement of influence for creditors, especially in the process of choosing a German insolvency practitioner to take the lead role;
- a much greater emphasis on the insolvency plan procedure, which was introduced as part of the German insolvency reform in 1999, but which has not lived up to its potential, particularly by

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1 The „Law for a further facilitation of corporate restructuring of December 7, 2011 (*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen vom 7. Dezember 2011*)" was published in the German Federal Gazette (*Bundesgesetzblatt*) on December 13, 2011 (BGBl. I S. 2582).

introducing a possible cram down of the equity and debt-to-equity-swaps that can be forced on the shareholders; and

- a strengthening of the debtor-in-possession procedure.

The combination of these newly introduced tools offers distressed investors and other creditors the opportunity to implement a controlled and more efficient in-court restructuring.

Status Quo

Germany's insolvency procedures have long been seen as too risky to be effective tools for successful corporate restructurings, especially compared to insolvency regimes in the United Kingdom or the United States where the restructuring community can easier predict the outcome. Some of this perception was caused by a lack of familiarity with the law as it has existed; some, however, was rooted in a system that has limited incentives for insolvency administrators to have the creditors lead the process. The German government has identified the following reasons why German restructurings are often pushed into England (as it was the case for *Deutsche Nickel AG, Schefenacker, Tele Columbus* and *Rodenstock)*:

- limited ability of creditors or the company to chose the identity of the office-holder;
- debtor-in-possession proceedings exist in Germany — but are rare;
- shareholders could not be forced into a debt-for-equity swap; and
- hold out creditors have a plethora of tools available to obstruct the insolvency plan process.

The Introduction of the New Law

The German Federal Government announced that it would address these issues in a three-phased reform of the insolvency law. The first phase is to improve the legal requirements for corporate restructurings. A second phase will simplify insolvency procedures applicable to private individuals. The third phase, which will be more interesting in a transactional context, will focus on insolvency reform regarding corporate groups.

What are the Key Changes Proposed in Phase 1?

In a number of quite radical changes, Phase 1 addresses the issues identified as obstacles to restructuring in Germany. The new law:

- strengthens the influence of creditors at an early stage by formally establishing a preliminary committee of creditors before an appointment is made — thus, creditors' influence will also extend to the selection of the office-holder;
- increases the scope for debtor-in-possession proceedings;
- gives real teeth to the insolvency plan as a viable restructuring tool (including introducing a "protective shield" period of up to three months as well as enabling creditors to cram down shareholders and/or implement a forced debt-for-equity swap);
- reduces the opportunity for creditors and shareholders to lodge an immediate appeal against insolvency plan proceedings.

The Preliminary Creditors' Committee

Under current law, there is no legal requirement for the courts to appoint a preliminary creditors' committee (*vorläufiger Gläubigerausschuss*). In practice, the insolvency administrators often do – but these preliminary creditors' committees do not have a formal say. Under the new law, courts must appoint a preliminary creditors' committee if at least two of the following conditions are met by the debtor:

- a minimum balance sheet total of € 4,840,000;
- a minimum turnover of € 9,680,000 within the last 12 months; or
- a minimum annual average of 50 employees.

The court will, however, still have discretion to appoint a preliminary committee for companies not meeting these criteria. The court will not need to appoint a preliminary committee of creditors (even for large companies) if the debtor has discontinued its business activities, if the court considers that the appointment is disproportionate with respect to the expected insolvent estate, or if the court considers that the delay caused by the appointment is likely to be detrimental to the debtor's asset position.

The selection of members for the preliminary creditors' committee will be in the discretion of the court — but effectively be based on the contact information and the claim amounts provided in the filing to the court. Correspondingly, while under the current law a one-page application is sufficient to file for insolvency leaving the court to figure out the factual situation with the help of an expert or preliminary insolvency administrator. Under the new law, a company filing for insolvency will need to provide more comprehensive information, including a list of creditors, if the thresholds are met, debtor-in-possession administration is applied for, or the debtor has applied to appoint a preliminary creditors' committee.

Choice of Office-Holder

Under current law, the court appoints a preliminary insolvency office-holder. The office-holder is normally appointed from an unofficial and local court list without the necessity to consult the creditors. The preliminary office-holder is normally confirmed as the final office-holder when the court makes the final insolvency order.

Creditors have only one opportunity to change the office-holder. They could do so, in theory, at the initial creditors' meeting; however, this meeting takes place a few months into the process when it is practically too late to change the team and key decisions have already been made by the preliminary office-holder.

Under the new law, the court is required to consult the preliminary committee of creditors before appointing an office-holder. If the preliminary committee of creditors unanimously proposes an office-holder, the court <u>must</u> follow this proposal, unless the proposed office-holder is clearly unsuitable. The new provisions also provide clear guidance to the courts that a recommendation by the creditors or the debtor should not be seen as impeding the impartiality of the office-holder. The new provisions set out that office-holders will not be considered to be partial, just because:

- they are proposed by the debtor or the creditors; or
- they have advised the debtor before filing for insolvency on the general aspects of an insolvency procedure.

Increased Scope for Debtor-in-Possession Proceedings

At the moment, motions for debtor-in-possession ("**DIP**") proceedings are rare. Notable exceptions are building company *Philipp Holzmann*, media company *Leo Kirch* and retail company *Sinn-Leffers.*

The new law will lower the legal requirements for DIP proceedings. The procedure will be open at the debtor's request unless there are specific and actual facts known to the court that the court considers will lead to a disadvantage for creditors. The court will have to consult the preliminary creditors' committee before ordering the DIP proceedings (unless hearing the committee would be detrimental to the debtor's financial status). If the committee supports the DIP proceedings unanimously, it will be assumed that creditors' rights will not be adversely affected. The DIP proceedings are available if creditors vote in favour (and the debtor consents) after formal insolvency proceedings have been opened.

The new provisions also make it clear that DIP proceedings should not be the exception (unless the debtor's request is obviously without a chance of success). The court is asked not to appoint a preliminary office-holder or impose trading restrictions so that the debtor can continue to carry out its business. The court may, however, appoint a custodian (with a somewhat weaker role than a preliminary office-holder) to monitor the management of the business.

The new law seeks to encourage early DIP filings. Under current law, a major obstacle to DIP proceedings is that the courts only allow a DIP proceeding in very few cases, while ordering regular insolvency proceedings in most cases. Under the new law, a debtor seeking insolvency protection but is still liquid, will be notified if the court intends to reject the DIP filing and open a regular insolvency procedure. A debtor will then be able to decide whether it wants to withdraw its motion and continue its restructuring out of court or whether it submits to the regular procedure.

Protective Shield Period

Under the new law, a debtor can enjoy a "protective shield" (*Schutzschirm*) for a maximum of three months if:

- the debtor files for insolvency proceedings due to imminent illiquidity or over-indebtedness; or
- the debtor files for DIP proceedings; and
- the envisaged restructuring is not obviously without chances of success.

The debtor has to submit a certificate by an insolvency-experienced tax consultant, auditor or a lawyer confirming that over-indebtedness has occurred or illiquidity is imminent but that the company is not yet illiquid and the restructuring is not obviously without success. The protection period then provides the debtor with some time in which to prepare an insolvency plan. Upon application of the creditor, the court has to order that the debtor is creating preferential liabilities (*Masseverbindlichkeiten*).

Note that the protective shield does not provide an automatic moratorium, but the court has the power to grant a stay on enforcement, if the debtor so requests. The court has no power to prevent acceleration of a debt during this time. The court may appoint a preliminary custodian who will monitor the management of the business. In selecting the custodian, the court must follow the debtor's recommendation unless the person recommended is clearly unsuitable. The preliminary custodian must not be the person who issued the declaration confirming imminent liquidity or over-indebtedness.

The court will repeal its order for the protective shield before the end of the three-month period, if:

- the envisaged restructuring looks likely to fail;
- the preliminary creditors' committee applies for the repeal; or
- a secured or unsecured creditor (but not a subordinated creditor) applies for the repeal in circumstances where: (i) there is no preliminary creditors' committee; and (ii) the court is made aware of circumstances that lead the court to believe that to continue the protection period would be detrimental to creditors.

Debt-for-Equity Swap

The new law introduces a debt-for-equity swap as a formal restructuring tool as part of an insolvency plan — introducing the concept of cram down on shareholders. Creditors whose rights are affected will still need to consent to the plan — they cannot be crammed down.

Under current law, shareholder rights cannot be affected by a debt-for-equity swap. The new law reverses this and allows shareholder rights to be altered under an insolvency plan. The formal involvement of the shareholders whose rights are affected will be required and they will form a class that votes on the approval of the insolvency plan. Small shareholders who possess less than 1 percent of the shares can be placed into a separate class.

Restricted Rights to Immediate Appeal

Under current law, individual creditors can delay the implementation of an insolvency plan by way of appealing after the court has approved an insolvency plan — even if the appealing creditors did not get involved at an earlier stage of the plan.

Under the new German insolvency law, this will change. An appeal will only be possible where the creditor has:

- opposed the plan in writing or opposition is recorded in the minutes of the meeting where the plan was voted upon;
- voted against the insolvency plan; and
- credibly demonstrated that it is placed at a disadvantage by the plan compared with his situation without a plan and that the disadvantage cannot be compensated by financial means already provided for in the insolvency plan.

Conclusion and Angles for Potential Investors

Starting from March 1, 2012, the new German insolvency law provides opportunities for investors to:

- extinguish unsecured or subordinated debt and/or equity;
- line up an office-holder prior to the insolvency (although it is unclear if the office holder can be involved in the preparation of the insolvency plan from the start, since the express reference to such early involvement was deleted from the previous draft of the reform bill);
- obtain new money for the debtor through a post insolvency or DIP loan. The equity can participate in such super-senior financing; and
- engage in a coordinated approach between creditors and management to make the success of a pre-pack style insolvency plan much more likely.

Therefore, there should be less of a reason to take financial creditors to German companies through costly English law schemes of arrangements that leave large parts of the unsecured debt unimpaired, and also less of a reason to permit the equity holders to draw out negotiations through a series of waivers for fear that in an insolvent German restructuring creditors would lose control in such a manner that anything is better than insolvency.