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Reform Act on German Insolvency Law

On 1 March various changes to insolvency law which aim to facilitate the restructuring of operating companies will enter into force.

Stefan Sax, partner in the restructuring group in Frankfurt, comments "The purpose of the reform is to improve the prospects of a successful restructuring process, to involve creditors in the selection process of the (preliminary) insolvency administrator and to improve the reliability and predictability of insolvency proceedings. The reform also attempts to expand the opportunities for the reorganisation of insolvent debtors through insolvency plan proceedings and to limit the effects of potential appeals against such plans. The changes are an important development in promoting Germany as a place where complex restructurings can be achieved."

The German government also intends to implement further changes to consumer insolvency proceedings and group insolvencies. These are beyond the scope of this briefing.

Preliminary Creditors' Committee

Under the existing regime, creditors have little influence over the preliminary proceedings in the period between the filing of the insolvency petition and the opening of insolvency proceedings. It is left to the court's discretion to establish a preliminary creditors' committee (*vorläufiger Gläubigerausschuss)* at an early stage in the proceedings, when typically the critical and most decisive questions need to be resolved.

The reform act clearly breaks new ground in introducing an obligation to set up a preliminary creditors' committee at an early stage of the proceedings. The obligation is limited to debtors with ongoing business operations (*laufender*

Key issues

- Strengthening of creditors' rights in insolvency proceedings
- Binding proposal of the preliminary creditors' committee for the appointment of the insolvency administrator
- Revitalising insolvency plan proceedings by allowing for debt-to-equity swaps
- Facilitation of self-administration proceedings
- Introduction of pre-insolvency restructuring proceedings

Geschäftsbetrieb) but also applies to small and medium-sized enterprises. The insolvency court will be required to set up a committee if the debtor has satisfied at least two of the following requirements in the preceding business year:

- a balance sheet total of at least 4,840,000 Euro (after deduction of the negative equity);
- a revenue of at least 9,680,000 Euro;
- at least 50 employees.

If these requirements are not met, the court may still set up a preliminary creditors' committee upon application of either the debtor, its preliminary insolvency administrator or a creditor, provided that eligible members have consented.

The court may refuse to appoint a committee in case of a termination of the debtor's business operations or if such appointment would adversely affect the debtor's financial situation (*nachteilige Veränderung der Vermögenslage des Schuldners*) or would be considered a disproportionate (*unverhältnismäßig*) measure with regard to the value of the expected insolvency estate.

The provisions on the composition of the preliminary creditors' committee were the subject of intense debates in the legislative process, which resulted in last-minute-changes to the reform act. It is now provided that

- the preliminary insolvency administrator may propose members for the preliminary committee at the request of the insolvency court; and
- new creditors which become creditors after the opening of insolvency proceedings are also eligible committee members.

These changes are crucial for the composition of the committee and may contribute to the success or failure of the proposal for a preliminary insolvency administrator.

Appointment of the Insolvency Administrator

Under the existing regime, the (preliminary) insolvency administrator is appointed by the insolvency court. Although the insolvency administrator decides important questions relating to the proceedings and has an influential position, it is at the court's discretion whom to appoint as the insolvency administrator. Creditors have no influence over that process. At present, creditors only have the opportunity to vote out the court-appointed administrator at the first creditors' meeting (*Gläubigerversammlung*) and to elect a new administrator by majority vote. However, by this stage, the insolvency proceedings will be well advanced and many - if not all - important decisions will already have been taken. Therefore, creditors generally avoid replacing the insolvency administrator at this stage since it would be time-consuming and costly to deal with a new administrator who would need to familiarise himself with the economic circumstances of the relevant business.

The reform has introduced a generally binding right for the preliminary creditors’ committee to unanimously propose a specific individual to act as an insolvency administrator. The court must appoint the proposed person as insolvency administrator as long as the candidate fulfils the legal requirements (*e.g.* being independent of the creditors and the debtor, having sufficient experience in business). A candidate will not necessarily be precluded from acting as insolvency administrator if he or she had advised the debtor on the course and consequences of insolvency proceedings before the petition for the opening of insolvency proceedings.

In insolvency proceedings without a preliminary creditors’ committee, creditors will have the option to propose a specific insolvency administrator on an informal basis, but such proposal is not binding for the court.

Revitalisation of Insolvency Plan Proceedings

Insolvency plan proceedings (*Insolvenzplanverfahren*) as included in the German Insolvency Code are rarely used in practice. The main draw backs of the current system are that:

- shareholder consent is required if shareholder rights are affected within the insolvency proceedings (e.g. on a debt-to-equity swap or other corporate measures); and
- dissenting creditors are able to delay the implementation of insolvency plan proceedings.

Effectively, this means that both groups of stakeholders can block any court driven restructuring. At the same time, both issues provide non-consenting stakeholders with a considerable nuisance value, both before and during insolvency proceedings.

In tackling non-consenting shareholders, the reform introduces shareholders as a new class of constituents within insolvency plan proceedings (currently only creditors are included). If shareholders need to be treated differently due to the nature of their shareholding, the new legislation allows for several groups of shareholders to be established as long as members in each group share similar commercial interests. The shareholders will have a voting right to support or reject the proposed insolvency plan; but even if a class of shareholders votes against the implementation of the insolvency plan, this class can be 'crammed down' if, in particular, the dissenting shareholders would not be put in a worse position than without the plan.

According to the reform, an insolvency plan could:

- enable the debtor to continue as a going concern;
- facilitate the conversion of creditor claims (except for tax claims) into equity (debt-to-equity swap);
- transfer shares to creditors; or
- permit the statutory capital to be reduced and subsequently increased by issuing new shares in order to absorb losses.

The corresponding corporate action (*e.g.* capital decrease and increase) would be deemed effective when the insolvency plan became legally binding. The reform act clearly states that a debt-to-equity swap may not be conducted against the will of the creditors whose claims are to be converted into equity. Moreover, it is being considered that legal remedies against corporate actions, the valuation of claims contributed and the equity interest or impairments of creditors or shareholders should not delay the legal effect of the insolvency plan.

According to the reform act, such remedies would only be allowed if:

- the claimant could show that the plan would put it in a materially worse position than it would be in without the plan; and
- the claimant cannot be adequately compensated for this disadvantage by a payment from funds specifically reserved for this purpose in the insolvency plan.

Therefore, if funds have been reserved within the insolvency plan proceedings, the insolvency court will be obliged to approve the insolvency plan and any dispute will need to be settled outside insolvency proceedings.

The insolvency court will still be entitled to immediately reject a challenge against the insolvency plan if so requested by the insolvency administrator if the implementation of the insolvency plan is of immediate priority. The court might take this view if it believes that risks from a delay in the insolvency plan caused by a challenge would outweigh the actual disadvantages for the claimant. If the challenge is rejected on this basis, the creditor may request to receive indemnification out of the insolvency estate.

Furthermore, it is not necessary to provide for shareholder compensation in the insolvency plan in cases where the existing equity would be commercially worthless, which is normally the case in insolvency plan proceedings.

Another aspect of the reform which should expedite the process is the inclusion of two provisions that oblige the insolvency court to schedule periods of no longer than two weeks for the court to review and reject the insolvency plan for obvious flaws, and for the various parties involved to review the plan.

Communication with creditors that are to participate in the debt-to-equity swap will be streamlined insofar as such creditors must expressly object to such a swap if they wish to refuse the offer of a shareholding as laid out in the insolvency plan. In out-of-court restructurings, a common problem is that creditors risk equitable subordination if they swap debt for equity. Equitable subordination can be avoided if, *e.g.,* creditors accept equity with the aim of restructuring the company and make use of the 'restructuring privilege'. This is usually evidenced by way of a workout opinion (*Sanierungsgutachten*), which requires more detail and is more costly to prepare than an internal business review.

During the legislative process, it was also discussed whether creditors should be able to rely on the 'restructuring privilege' in the context of a debt-to-equity swap. However, a clear statement to this effect was not inserted into the new act.

One further important relaxation of the current rules is the modification of the insolvency administrator's obligation to satisfy all undisputed preferential claims (*Masseansprüche*) – due or not yet due – before the insolvency plan is implemented. This obligation ties up a lot of liquidity and, in practice, leads to the failure of many plans. In future, only preferential claims which are due and payable will have to be paid. For disputed claims, security will need to be granted. Claims that are not already due must be safeguarded only by a robust liquidity calculation.

The continuation of the operating business is ensured by a continuation of contracts entered into with the debtor. A debt-to-equity swap or other corporate measures which are the subject of an insolvency plan must not be used as a trigger for the termination of any contracts whatsoever, unless the debtor is in breach of such contract. As a final point, the assertion of creditor claims at the eleventh hour in insolvency proceedings can often put at risk the implementation of insolvency plan proceedings. Therefore, the reform provides the option to suspend, stay or discontinue execution by the insolvency court if the realisation of the insolvency plan is at risk as a result of threatened enforcement action based on creditor claims which have not been filed during the insolvency proceedings prior to the voting on the insolvency plan. These claims become time-barred within one year of the implementation of the plan at the latest.

Strengthening Self-Administration

In most cases where insolvency proceedings are initiated, the court appoints a preliminary insolvency administrator. Typically, the management remains in place but any important decision requires the administrator's consent. Upon the opening of insolvency proceedings, the then appointed administrator replaces the management and takes control of all affairs of the company.

An exception to these proceedings is the establishment of self-administration (*Eigenverwaltung*) which allows the management to remain in charge of managing its business under the supervision of a court-appointed trustee (*Sachwalter*). The objectives pursued by self-administration are mainly to keep the costs down and to ensure that the management's specific know-how is not lost during the insolvency proceedings.

However, insolvency courts have shown a considerable reluctance to order self-administration. The reform aims to improve access to and promote the use of self-administration by limiting the court's ability to refuse to order self-administration. At present, a court will permit self-administration only if it is convinced that the procedure will not be deferred or will not otherwise adversely affect the creditors. In future, it will be sufficient for the court to order self-administration where there are no circumstances already known to the court that self-administration could negatively affect the creditors' position.

Furthermore, where a debtor files for insolvency on the basis of impending illiquidity (*drohende Zahlungsunfähigkeit*) and applies for self-administration, the insolvency court will be obliged to indicate to the debtor whether it intends to refuse its application. This will give a debtor which voluntarily files for insolvency (there is no such obligation in case of only impending illiquidity) the opportunity to withdraw its petition to open insolvency proceedings and to continue managing the business on its own.

Moreover, the preliminary creditors' committee will have a decisive influence on the court's decision as to whether to proceed with self-administration. Comparable to the new regulations on the choice of the insolvency administrator, the committee will also have the right to be heard by the insolvency court before the court decides on the petition for self-administration filed by the debtor. If the committee supports the petition, the court generally cannot refuse to order self-administration on the grounds that it would adversely affect the creditors. In addition, the preliminary creditors' committee will be entitled to demand the revocation of self-administration, whereas an individual creditor's right to appeal the decision taken by the court will be restricted.

Introduction of Pre-Insolvency Restructuring Proceedings

A further incentive to initiate restructuring proceedings at an early stage is the introduction of 'pre-insolvency restructuring proceedings' for the period between the petition for and the actual opening of the insolvency proceedings. If a debtor files a petition to initiate insolvency proceedings on the grounds of impending illiquidity (*drohende Zahlungsunfähigkeit*) or over-indebtedness (*Überschuldung*) and also applies for self-administration (*Eigenverwaltung*), the insolvency court can grant the debtor a period of time, not exceeding three months, in which the debtor must work out the details of an insolvency plan. Within that period, the court can order the prohibition or cessation of enforcement proceedings on the application of the debtor.

The advantages of these proceedings are obvious: Being protected from its creditors, the debtor will have enough capacity and time to develop the measures necessary to restructure the business and to implement an insolvency plan on an expedited basis. During the pre-insolvency proceedings, the insolvency court and a court-appointed trustee only supervise the debtor, which will provide a further incentive to debtors to file for insolvency proceedings at an early stage. According to the reform, the court will be able to revoke its decision to initiate restructuring proceedings before the expiration of the period initially set by the court only if:

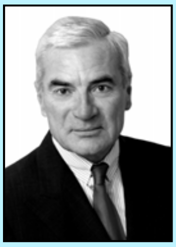
- the envisaged restructuring measures become unachievable; or
- the preliminary creditors' committee has demanded a revocation of the restructuring proceedings. In cases where a preliminary committee is not in place, each creditor will have a right to file a petition for revocation to the extent that it can substantiate a claim that it will be adversely affected in the restructuring proceedings. After the opening of insolvency proceedings, the draft insolvency plan can be implemented at short notice

No centralisation of Insolvency Courts

Under existing insolvency law, the jurisdiction of an insolvency court is generally determined by the corporate seat or the location where the debtor has its main business activity (if this place should deviate from the corporate seat). This results in a high number of insolvency courts with different compositions and varying experience. The existing regime does allow for the concentration of insolvency courts within a district court circuit (*Landgerichtsbezirk*), but this opportunity has not been extensively used in the past.

The reform misses the opportunity to rectify this issue. Insolvency professionals had initially proposed to concentrate the know-how in a single court and to ensure that the competent judges and judicial officers gather the necessary experience in order to supervise complex company insolvencies. The exclusive jurisdiction of insolvency courts remains a crucial issue which will hopefully be resolved by future changes to German insolvency law.

Authors



Heinz-Günter Gondert
Partner

T: +49 69 7199 1711
E: heinz-guenter.gondert
@cliffordchance.com

Dr. Arndt Stengel
Partner

T: +49 69 7199 1486
E: arndt.stengel
@cliffordchance.com

Adrian Leon Cohen
Partner

T: +44 20 7006 1627
E: adrian.cohen
@cliffordchance.com

Dr. Stefan Sax
Partner

T: +49 69 7199 1549
E: stefan.sax
@cliffordchance.com

Oda Lehmkuhl
Counsel

T: +49 69 7199 3261
E: oda.lehmkuhl
@cliffordchance.com

Dr. Cristina Weidner
Senior Associate

T: +49 69 7199 3145
E: cristina.weidner
@cliffordchance.com

Joachim Ponseck
Associate

T: +49 69 7199 1547
E: joachim.ponseck
@cliffordchance.com

Gabrielle Wood Ruiz
Senior PSL

T: +44 20 7006 1615
E: gabrielle.ruiz
@cliffordchance.com

Clifford Chance, Mainzer Landstraße 46, 60325 Frankfurt am Main, Germany

Clifford Chance Partnerschaftsgesellschaft von Rechtsanwälten, Wirtschaftsprüfern, Steuerberatern und Solicitors •

Sitz: Frankfurt am Main • AG Frankfurt am Main PR 1000

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