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Practice Group:  
Corporate

## New German Insolvency Law Rules to Facilitate Restructurings, Debt-Equity Swaps and Debtor in Possession

By Volker Gattringer

### *Introduction*

On 1 March 2012 new German insolvency law rules will come into effect which are intended to facilitate and promote debtor-in-possession proceedings and the use of restructuring plans and debt-equity swaps. In addition, the new insolvency law will introduce new rules to enhance creditor autonomy and control, in particular over the appointment of the insolvency administrator. When it comes into effect the new insolvency law is likely to drastically change the rule set for insolvency proceedings in Germany, increasing the number of plan proceedings versus liquidations and making distressed investment targets more attractive to financial investors. It will also further align German insolvency rules to international standards, in particular to US Chapter 11 proceedings.

With its new rules the German legislator has reacted to increasing criticism among German insolvency law experts about the unwieldy German legal environment for company restructurings. Over the past years there have been several cases of German distressed companies that have relocated their centre of main interest (COMI) to the United Kingdom to make use of a legal environment which was perceived to be more restructuring friendly to debtors and major creditors.

### *Strengthening of Creditor Influence on Insolvency Proceedings*

While German insolvency law is generally said to be friendly to creditors, in particular smaller creditors, it is in fact very restrictive when it comes to creditor autonomy and control in insolvency proceedings which mainly concern major creditors. For example the initial appointment of the preliminary or final insolvency administrator, who plays an instrumental role in any German insolvency proceeding, is up to the discretion of the insolvency court. In the past, insolvency courts have virtually disqualified any person for insolvency administration if such person was involved in any prior out-of-court restructuring or was proposed by a creditor. In theory, the creditors' meeting could elect another qualified person as insolvency administrator but in practice such option came too late and the election requires a combined majority of the amount of claims and of the number of creditors, which is difficult to achieve.

Under the new rules, the insolvency court would have to consult the preliminary creditors' committee when it makes a decision on the appointment of the (preliminary or final) insolvency administrator. Such preliminary creditors' committee is mandatory when in the past fiscal year the debtor has exceeded two out of the following three thresholds: revenues of EUR 9,680,000, total assets of EUR 4,840,000 and 50 employees. Further to that, the insolvency court shall follow a recommendation by a unanimous vote of the creditors' committee unless the proposed person is unqualified or biased. Pursuant to the new rules, a person shall not be deemed biased solely on grounds of having advised the debtor in insolvency matters or solely because he or she was proposed by a creditor or the debtor. Although it is still the insolvency court which makes the ultimate decision over the appointment of the (preliminary) insolvency administrator, the (preliminary) creditors' committee will now be able to exercise a certain control over the appointment by specifying the criteria for the appointment of the insolvency administrator.

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### *Debt-Equity Swaps and Other Changes to the Corporate Structure of the Debtor*

Currently, any change of the shareholder or corporate structure of the debtor requires the consent of the shareholders. For example the implementation of a debt-equity swap requires a 75% majority of the shareholders. In the past, insolvency administrators have tried to evade this by setting up a new legal entity, which is owned by some or all creditors and to which the assets of the debtor will be transferred. However, this concept did not always work in the past because not all valuable assets could be transferred to such new legal entity such as contracts, public permits, licenses or tax loss carry forwards. Thus, creditors had to choose between pursuing a suboptimal restructuring plan or paying a hold-out premium to the shareholders.

The new legislation will allow the insolvency plan to provide for an amendment of any kind of shareholder rights including capital decreases and capital increases, enabling a debt-equity swap or a compulsory transfer of shares to the creditors. In theory, an insolvency plan affecting the rights of the shareholders will still require the consent of both, the shareholders and the creditors. However, by means of a cram down the insolvency court can approve the plan even if shareholders have refused to give their consent, thus eliminating any hold out value. Another obstacle to debt-equity swaps which the new legislation will remove is the potential liability of the creditors for any value shortfall between the amount of the increased nominal share capital and the fair market value of the claims which are swapped. Under the new regulation, no such claims can be raised against the creditors anymore. The insolvency administrator can still be held liable for an incorrect valuation of the claims to be converted in connection with the debt-equity swap. However, the reasoning of the new legislation makes it clear that the insolvency administrator can eliminate such risk by obtaining a valuation opinion from a valuation expert.

To avoid a violation of constitutional rights the new regulation had to introduce two provisions which on the surface may impede a restructuring of the debtor but which after closer scrutiny should not pose a problem:

- The shareholders are entitled to an adequate compensation by the insolvency estate in case they lose any of their shareholder rights. The reasoning of the legislation makes clear, however, that there is typically no compensation amount to be paid and only in the rare case when the shares still have a residual value.
- Even if a debt-equity swap or a compulsory transfer of shares to the creditors has been approved by the required majority of the creditors, each individual creditor still has the right to explicitly opt out of any such debt-equity swap or transfer. The opt-out declaration has to be made, however, within 2 weeks after having been properly informed about the plan and prior to the voting of the creditors on the plan. Hence, the plan can still be adjusted when a creditor opts out of the debt-equity swap.

### *Debtor in Possession*

While German insolvency law already provides for debtor-in-possession proceedings there are only very few cases in which insolvency courts have approved such option. This is due to a number of reasons, namely a combination of very restrictive requirements for such debtor in possession and a deeply rooted distrust of the management of insolvent companies by German insolvency courts.

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The new regulation will substantially reduce any legal hurdles for such debtor-in-possession proceedings:

- Currently, the burden of proof is on the insolvent company to demonstrate that a debtor in possession would not cause any adverse effects to the creditors, making it easy for the insolvency courts to turn down any such application by just saying "no." The new regulation will shift the burden of proof from the debtor to the insolvency court. In addition, the insolvency court will need to produce a detailed written court ruling when denying a debtor-in-possession proceeding, whereas it can avoid such paperwork by granting the application.
- A debtor-in-possession application cannot be turned down on grounds of adversely affecting creditor rights when the preliminary creditors' committee has passed a unanimous resolution. Similar to the appointment of the (preliminary) insolvency administrator, the insolvency court shall consult the preliminary creditors' committee before ruling on a debtor-in-possession application.
- To avoid any negative prejudice against debtor-in-possession proceedings the new regulation provides that the insolvency court shall not appoint a preliminary insolvency administrator for the insolvency opening proceedings unless it is obvious that the application of the debtor will not be granted. Instead, it shall appoint a trustee who mainly has a monitoring role.
- To give the management of a corporation time to present a pre-packaged plan to the insolvency court, the new rules allow the insolvency court to issue an up to 3 month moratorium during which the debtor is protected against any enforcement actions by its creditors. When applying for such moratorium the management of the debtor needs to submit an opinion by an accounting firm, tax advisor or law firm which certifies that the debtor is imminently but not actually illiquid yet and that a restructuring is not obviously hopeless. A debtor-in-possession proceeding is still possible if the debtor actually becomes illiquid during the three month moratorium.
- Upon the debtor's application, the insolvency court has to grant priority to all who become a creditor during the up to three months moratorium. This will substantially improve debtor's chances to obtain DIP financing necessary to continue its business.
- By passing a resolution to that effect the creditors' meeting can even enforce a debtor-in-possession proceeding and thus overrule a prior contrary court ruling. However, this will only be a theoretical option given that any voting of the creditors' meeting will come too late to determine the course of events when it comes to allowing debtor-in-possession proceedings.

### *Other Important Changes to Facilitate Restructuring Plans*

The legislator has identified and addressed further aspects which are said to impede a restructuring plan of the debtor:

- The new regulation raises the legal hurdles for dissenting minority creditors or shareholders who intend to thwart the plan by initiating litigation against it. Among other things, the dissenting party must have already submitted written protest against the plan at the creditors' meeting voting on the plan, and it must demonstrate that the plan adversely affects its position to a material extent, without being properly secured by funds provided by the plan to compensate the dissenting party. Finally, the district court can upon application by the insolvency administrator approve the immediate execution of the plan if the benefits of the plan appear to outweigh any adverse effects on the dissenting creditor. These changes will materially reduce any litigation risk in connection with the plan.

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- The prior fulfilment of undue or disputed preferential claims against the insolvency estate is no longer a requirement for the termination of the insolvency proceedings after court approval of the plan. Instead, the plan can provide that the insolvency administrator grants security for such claims or, in the case of undue claims, that the debtor will be able to fulfil any preferential claims pursuant to its liquidity plan.
- In order to protect the debtor against unknown unregistered claims after termination of the insolvency proceedings and thus after termination of the automatic stay, the insolvency court can, at the request of the debtor, suspend or stop the enforcement of such unregistered claims.

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