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Reform of In-Court Restructurings in Germany – New Options and Implications for Creditors, Debtors and Shareholders

With effect as of March 1, 2012, German insolvency law will be reformed by a bill (the "Bill") that will considerably facilitate in-court restructurings of distressed companies, provide new opportunities for creditors and debtors and will also affect the position of shareholders. The Bill applies to insolvency proceedings based on insolvency filings made on or after March 1, 2012. All other insolvency proceedings will continue to be governed by the existing legal regime. The following summary provides an overview of the background and the major amendments made by the Bill.

Background

The German insolvency law regime has been widely criticized by restructuring professionals and various other stakeholders for being rescue-unfriendly and, as regards the process, unpredictable. Amongst other issues, complaints have focused on the inadequate influence of creditors on important decisions such as the selection of the (preliminary) insolvency administrator, the obstacles faced when shareholders object to a restructuring and the fairly insignificant role self-administration has played in German restructurings to date. The perceived weaknesses of the current legal regime appear to be among the decisive reasons why many companies tend not to file for insolvency early when the prospects for a successful restructuring or a higher recovery value for creditors are generally more promising. In some instances, German companies have even migrated to a foreign jurisdiction in order to avail themselves of the benefits of a more flexible and more restructuring-friendly legal environment or have, to the extent possible, resorted to restructuring procedures offered under foreign law such as an English law scheme of arrangement.

Strengthening of Creditors' Influence

When the Bill becomes effective, creditors will be able to participate in core questions of the restructuring process and to exercise their influence earlier through a newly introduced so-called preliminary creditors' committee and the selection of the (preliminary) insolvency administrator:

- *Preliminary Creditors' Committee:* A preliminary creditors' committee will be established if the company meets at least two of the following three requirements: total assets of at least EUR 4.84 million (after deducting an equity shortfall if the company is over-indebted), revenues of at least EUR 9.68 million during the twelve months prior to the last balance sheet date, and an annual average of fifty employees. The court will refuse the appointment of a preliminary creditors' committee if it appears to be inappropriate with respect to the estimated value of the insolvency estate or if a delay caused by the establishment of the committee would lead to a further deterioration of the company's financial situation. As further described below, the preliminary creditors' committee is able to influence the selection of the (preliminary) insolvency administrator, the decision of the insolvency court to order self-administration and the appointment of a preliminary trustee (*Sachwalter*) supervising the debtor during self-administration. Since it will – even after the reform – still not be possible to conduct a single insolvency proceeding across a group of companies, it may become necessary to set up a committee for each individual insolvent company within the group.
- *Selection of Insolvency Administrator:* Under German law the insolvency administrator has broad power to set the direction for the restructuring process, for example by preparing a sale of the company and making business decisions. At present, however, creditors have no formal say in the selection process. This will be reversed by the Bill when a unanimous proposal for an administrator by the preliminary's creditor committee will be binding on the court unless the court considers the proposed candidate not to be qualified. Prior advice given to the company in connection with a potential restructuring does not disqualify the candidate, but he would become ineligible if it had previously prepared the insolvency plan. When arranging a pre-packaged deal it is therefore important to ensure that the person who has prepared the insolvency plan is not identical with the person proposed as insolvency administrator. Even if the court considers the proposed person not to be sufficiently qualified and ultimately appoints a different administrator, it has to take into account the criteria for the administrator as set forth by the preliminary creditors' committee. Given that the court does not need to solicit the committee's views if this would evidently cause a delay of the proceedings, it is advisable to reach an agreement on the criteria and the proposal for an individual as early as possible in the process.

Improved Restructuring Options for Distressed Companies and New Implications for Shareholders

There are further improvements by the Bill that will offer restructuring options for distressed companies. The Bill limits the discretion of the court to deny self-administration, provides the means to implement a debt-to-equity swap without consent of the shareholders and, finally, facilitates pre-packaged deals and insolvency plan proceeding.

Enhanced Prospects for Self-Administration and Pre-Packaged Deals

The procedure of self-administration available under German law is inspired by the US debtor-in-possession regime. In the past German companies had little incentive to make an early insolvency petition and apply for self-administration. Even if the court had ultimately permitted self-administration after the opening of main insolvency proceedings, it nevertheless appointed a preliminary insolvency administrator who assumed a great deal of (if not entire) control over the company during initial insolvency proceedings until self-administration could ultimately take effect. In practice this did cut across the purpose of self-administration. Shareholders and management further faced the risk that they would lose control over the company because it was not certain that a court would actually permit self-administration at all.

The Bill will facilitate the institution of self-administration and will make this instrument more attractive for distressed companies:

- First of all, pursuant to the Bill a court must permit self-administration unless there are specific circumstances justifying the expectation that self-administration would adversely affect the position of creditors. It may not deny the motion on grounds that self-administration would adversely affect the position of creditors if the preliminary creditors' committee unanimously supports the motion.

- Secondly, if the company files an insolvency petition on grounds of imminent illiquidity and applies for self-administration, the court has to inform the company of its intention to refuse issuing a corresponding order permitting self-administration. The company has then the opportunity to withdraw a voluntary filing and to avoid the appointment of a preliminary insolvency administrator. The expectation is that more companies will make use of the option to voluntarily initiate insolvency proceedings at an earlier stage if they do not face the risk that the court may ultimately deny the motion and order the opening of main insolvency proceedings under the control of an insolvency administrator.

- Thirdly, a company running its business in self-administration (and not only the insolvency administrator as under the current legal regime) will, upon a corresponding motion to the insolvency court, be able to incur new obligations that will rank ahead of existing unsecured creditors (*Masseverbindlichkeiten*). This will be crucial for a company running the business which has additional financing needs during the restructuring period.

- Finally, with a view to enabling an early restructuring of companies the legislator has introduced a new so-called rescue umbrella. The insolvency court may determine a protection period not exceeding three months during which the company can work out an insolvency plan provided that a company files for insolvency on grounds of imminent illiquidity (*drohende Zahlungsunfähigkeit*) or over-indebtedness (*Überschuldung*) and applies for self-administration. Further, the court is, *inter alia*, entitled to issue protection orders preventing creditors from taking individual enforcement action against the company. The protection period is only available if a third party insolvency expert has certified that, at the time of the application, the company is still able to pay its debts as and when they fall due (*zahlungsfähig*) and that its reorganization is not obviously without any prospect of success.

  The protection period will be suspended by court order in particular if the preliminary creditors' committee applies for a suspension or if the reorganization becomes futile. Upon the expiry or suspension of the protection period regular insolvency proceedings will be instituted, which includes the appointment of a (preliminary) insolvency administrator. A suspension may, however, not be based on the fact alone that the company has later become unable to pay its debts as and when they fall due (*zahlungsunfähig*), unless at the same time a successful restructuring has become futile. Individual creditors will therefore not be able to interfere with a pre-insolvency restructuring initiated by the company simply by accelerating their claims.

Facilitating Debt-to-Equity Swaps and other Reorganization Measures

The Bill will facilitate debt-to-equity swaps and other reorganization measures if they will be completed in the course of insolvency plan proceedings. The new regime will offer new opportunities for distressed debt investors to whom it might be appealing that it will henceforth become much easier to convert debt into equity.

In the past, it has been virtually impossible to implement a debt-to-equity swap or to transfer shares in the debtor to third parties without the consent of the shareholders. Under the previous regime shareholders had effectively the power to block the restructuring process even though the value of their equity interest in a distressed company was (close to) zero. Further, a creditor participating in a debt-to-equity swap was at risk to become liable under German capital maintenance rules vis-à-vis the company and, in case the debt was only partially swapped into equity, that its remaining claim would be equitably subordinated like an ordinary shareholder loan.

The Bill addresses most, but not all of these issues:

- In insolvency proceedings it will now be possible to cram-down dissenting shareholders under certain circumstances, in particular if the plan will not place them in a worse position than without the plan (taking into account any compensation awarded to them in the plan). This will most likely not be an obstacle as the equity interest in a distressed company will generally be commercially worthless in most restructuring situations. Under the Bill, however, it will not be possible to force a creditor into a debt-to-equity conversion.
- Further, once the insolvency plan has been approved by the court, the Bill expressly excludes liability claims against the creditors arising under German capital maintenance rules.
- A debt-to-equity swap might trigger a change of control provision in one or more of the company's material agreements. The Bill, however, provides that any termination or withdrawal rights resulting from a change of control shall be suspended.
- Unfortunately, the Bill has not provided for a safe harbor for the portion of debt not swapped into equity. Creditors may thus only rely on the general restructuring privilege already contained in the German Insolvency Code. It remains unclear when exactly the restructuring exemption will be triggered and how long a creditor may benefit from it. Only creditors acquiring an equity participation of less than 10% are sufficiently protected. Other creditors will therefore still face the risk that any remaining loans will be regarded as shareholder loans in a subsequent insolvency of the company.
- And, most importantly, the Bill does not eliminate the risk either that a debt-to-equity swap might lead to a taxable restructuring profit and/or a loss of loss carry forwards on the part of the debtor. This may, however, be avoided or mitigated by creative custom-tailored structures.

In addition, the Bill permits all other restructuring measures permitted under corporate law to be implemented by way of an insolvency plan. This includes a transfer of shares in the company to third parties, a spin-off or a change of the corporate form. The insolvency plan may also substitute the shareholder resolution required for a continuation of the business, which will further reduce the obstruction power of incumbent shareholders.

Enhanced Prospects for Execution of Insolvency Plans

Finally, the Bill also addresses a few problems that prevented a successful execution of an insolvency plan in practice:

- It will now be more difficult for a dissenting creditor to challenge the adoption of an insolvency plan. This is because it will need to prove that it would be in a significantly worse position if the plan were to be executed than it would be in without the plan and that such shortcoming could not be compensated for by funds reserved for that purpose in the insolvency plan. The challenge may be rejected if the advantages of implementing the plan without delay outweigh the potential disadvantages to the challenging creditor. The creditor may, however, be entitled to indemnification to be paid out of the insolvency estate.

- There are examples where an adopted insolvency plan has failed in the end because it had not accounted for claims of creditors who have not registered their claims until the final plan had been put to vote. Such creditors are nevertheless entitled to demand payment (albeit in a reduced amount if the plan provides for a haircut). Under the new regime such claims need to be reflected in the financial model underlying the plan if they are known to the company even though the respective creditors have not registered their claims. After the implementation of an insolvency plan the court will be entitled to lift or stay enforcement actions by such creditors against the company for a period of up to three years. The Bill also cuts the limitation period for such claims to one year.

- Under the previous legal regime, the insolvency administrator was obliged to satisfy all undisputed claims, and to provide collateral for disputed claims, of preferred creditors (*Massegläubiger*) before the insolvency plan could be executed, even if such claims were not yet due. In the future it will suffice if the administrator does so with respect to claims which are due and payable and submits a robust liquidity forecast showing that claims which are not yet due can be satisfied at their due date. This will free up much needed liquidity in particular during the initial phase of an implemented plan.

Summary and Outlook

The reform is an important step towards increasing Germany's attractiveness as business location also with respect to a potential restructuring of companies. It will contribute to enhancing the prospects for a successful restructuring through an early and active participation of all stakeholders.

However, there remain unsolved issues as regards cross-border insolvencies, the insolvency of a group of companies and the treatment of licenses in insolvency. The next step has already been initiated by the first draft of a further reform bill published by the Federal Ministry of Justice on 18 January 2012. According to the proposal, it is, *inter alia*, intended to introduce a new provision in the German Insolvency Code which will strengthen the position of a licensee or sub-licensee in the insolvency of the licensor.

This publication is intended only as general information on these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact any of the following:

Winfried M. Carli	Dr. Esther Jansen	Rainer Wilke
Munich	Frankfurt	Düsseldorf
+49.89.23888.2607	+49.69.9711.1621	+49.211.17888.717
winfried.carli.@shearman.com	esther.jansen@shearman.com	rainer.wilke@shearman.com