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The New German Insolvency Code: Decoding Improvements and Remaining Risks

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With recent passage of a "Law to Facilitate Corporate Rehabilitation" (*Das Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*, hereinafter "ESUG" or "InsO-E"),[1] German parliament has enacted a groundbreaking reform of the German Insolvency Code (*Insolvenzordnung*, hereinafter the "German Code" or "InsO"). ESUG's primary changes to the German Code are (1) establishment of a three-month court-supervised process for a debtor and its key stakeholders to develop a restructuring plan subsequent to filing an insolvency petition (but prior to "commencement" (*Eröffnung*))[2] without interference from an insolvency administrator (*Insolvenzverwalter*),[3] (2) enactment of provisions allowing impairment of shareholder interests and "debt-equity swaps" and protecting creditors who exchange their old claims for equity,[4] and (3) increased creditor participation through establishment of a preliminary creditors' committee, which will counteract the potentially value-destructive influence exercised by insolvency administrators and make the in-court process more predictable.[5]

Drawbacks to the Current German Regime


Dr. Leo Plank

Need for reform assumes that something is wrong with the current system, and there is. Specifically, current weaknesses under the German Code include (1) limited use of "debtor in possession"(DIP) and near-universal appointment of an insolvency administrator (with attendant loss of control by management); (2) consequent liquidations or going-concern sales at fire sale value; (3) no input from key stakeholders on the choice of an administrator; and (4) "cram down" of shareholders not allowed.

ESUG addresses these critical weaknesses and, in doing so, transforms the German Code into a useful framework to effectuate a court-supervised restructuring. Where current practice relies heavily on tentative out-of-court solutions or attempts to shift a debtor's center of main interest to a friendlier Anglo-American jurisdiction,[6] future practitioners will have a more efficient domestic in-court solution at their disposal.

Precommencement Proceedings in Practice


Dr. Bernd Meyer-Löwy

ESUG alters the current German Code's discouragement of chapter 11-style DIP proceedings by establishing a three-month "pre-proceeding" subsequent to filing, but prior to "commencement," in which a debtor stays in possession and prepares and files a confirmable plan. Specifically, debtors that file an insolvency petition in instances of "impending illiquidity" or "overindebtedness"[7] will be able to petition the court to remain "in possession" (*eigenverwaltung*) for an initial three-month period prior to commencement to the extent the debtor can show that the proposed rehabilitation is not obviously unfeasible (*nicht offensichtlich aussichtslos*).[8]

1 Final Report and Recommendation of Parliamentary Legal Committee (*Rechtsauschuss*), BT-Drucks. 17/7511 from Oct. 26, 2011. ESUG went into effect on March 1, 2012.

2 In contrast to chapter 11 of the U.S. Bankruptcy Code, filing a petition under the German Code does not automatically commence (*eröffnen*) a bankruptcy case. Instead, a debtor or creditor petitions the bankruptcy court to commence the case, and the court makes a determination as to whether the requirements for case commencement have been fulfilled. *Compare* 11 U.S.C. §§ 301(a) and 303(a) *with* §§ 16 & 26-27 InsO.

3 *See* §§ 270a and 270b InsO-E.

4 *See* §§ 225a and 254, para. 4 InsO-E.

5 *See* § 22a InsO-E.

6 Plank/Lürken, in Theiselmann, *Praxishandbuch des Restrukturierungsrechts*, 2010, Kapitel 5, Rz. 184, *et seq.*

7 German insolvency proceedings can be commenced only in instances of (1) illiquidity (*Zahlungsunfähigkeit*), (2) overindebtedness (*Überschuldung*) or (3) impending illiquidity (*drohende Zahlungsunfähigkeit*). *See* §§ 16, *et seq.*, InsO. For comparison purposes, bankruptcy proceedings under chapter 11 of the U.S. Code may be commenced even where the debtor is not technically insolvent, as long as the filing is made with the "good-faith" intent to restructure debt and the debtor demonstrates some financial distress. *See INMSBPCSLDHB LP v. Integrated Telecom Express Inc. (In re Integrated Telecom Express Inc.)*, 384 F.3d 108, 121 (3d. Cir. 2004) ("[A] debtor need not be insolvent before filing for bankruptcy protection.").

8 *See* § 270b para. 1 sent. 1InsO-E.

Carl Pickerill

During the three-month precommencement proceeding (*Vorbereitung einer Sanierung or Schutzschirmverfahren*), the debtor will have the exclusive ability to formulate and file with the court a restructuring plan without interference from an insolvency administrator.[9] Even if, during the precommencement proceeding, "actual illiquidity" as opposed to "impending illiquidity" sets in, the debtor can remain "in possession."[10]

Once the plan is on file, an actual insolvency proceeding can be commenced, creditors can vote on the plan and the court confirms it. Shortly after confirmation, the plan goes effective. The timeline below depicts the material elements of the precommencement proceeding, including illustration of pre-petition efforts to negotiate an out-of-court solution, similar to current U.S. bankruptcy practice (*see* Diagram 1):

> As set forth above, a formal insolvency proceeding is commenced upon termination of the three-month process and, with preliminary creditors' committee approval, the debtor would remain "in possession."[11]

With the debtor remaining in possession and a proceeding commenced, the debtor would then solicit creditor votes and seek the court's confirmation. As under U.S. bankruptcy law, the German Code provides a "cram down mechanism" (*obstruktionsverbot*) in the event one or more creditor classes vote to reject the plan.[12] The German "cram down" standards are met[13] as long as (1) the creditors in the rejecting class are no worse off with the plan than without it (*i.e.*, a version of the U.S. "best-interests test"),[14] (2) the "absolute-priority rule" is complied with as to the rejecting class[15] and (3) more than 50 percent of all voting classes vote to accept the plan.[16] Once the plan has been accepted by the creditors with the required statutory majorities and assuming that the standards for cramdown have been met, the court may confirm the plan (*Bestätigung*).[17]

Debt-Equity Swaps under Revised Code

The current German Code sets forth a limited enumeration of measures that can be undertaken pursuant to a plan. This list does not currently include impairment of shareholder interests. The ESUG modifications, however, make explicit that shareholder interests can be impaired and that new interests can be exchanged for pre-petition claims.[18] Combined with the three-month precommencement proceeding, this should lead to broader implementation of debt-equity swaps, in which fulcrum creditors whose claims are "in the money" exchange their claims for shares in the reorganized debtor.

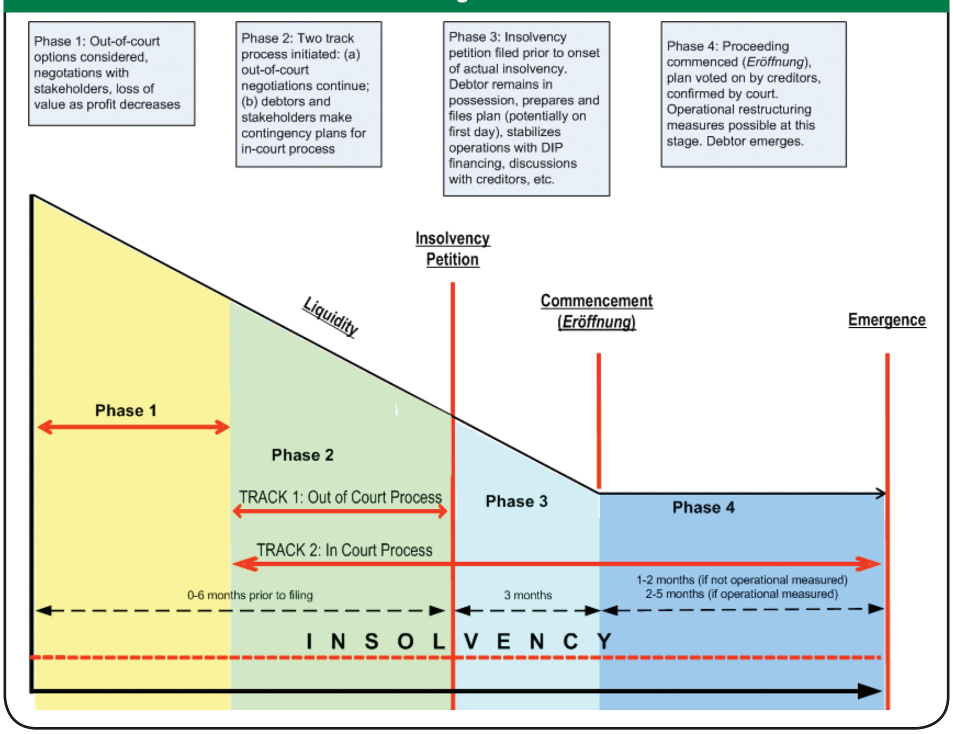
Critically, it is not merely the inability to impair shareholder interests under the current German Code that hinders debt-equity swaps. In addition, German corporate law generally allows corporations to assert claims against creditors making "contributions in kind" (*Sacheinlage*), including contributions in the form of claims (*Forderungen*), to the extent the creditor received value (*i.e.*, in a debt-equity swap, the equity interests) greater than the value of its claims.[19] ESUG bars such claims to the extent the debt-equity swap took place pursuant to a confirmed plan (*nach gerichtlicher Bestätigung*).[20] Each of these changes will lead both to greater process certainty and more effective means of restructuring a company over the dissent of hold-out stakeholders.

What Influence Do Creditors Have?

ESUG alters the German Code to require appointment of a "preliminary creditors' committee" (*vorläufiger Gläubigerausschuss*) for mid- and large-size corporate debtors in both the three-month precommencement proceeding as well as a traditional "free-fall" bankruptcy.[21] The debtor (or insolvency administrator in a traditional administrator-led proceeding) can, upon request by the court, propose members of the preliminary creditors' committee.[22]

ESUG's requirement that a preliminary creditors' committee be appointed

Diagram 1



9 Instead of appointment of an insolvency administrator, the court will appoint an examiner or supervisor (*sachverwalter*), with comparatively limited authorities and functions. *See* § 270c InsO-E. The DIP will be able to exercise nearly complete influence over who the court appoints as examiner. *See* § 270b, para. 2 InsO-E.

10 The bankruptcy court, however, must be notified of the debtor's actual illiquidity to the extent it occurs. *See* § 270b para. 3 sent. 2 InsO-E.

11 *See* § 270 para. 2 and 3 InsO-E. Unanimous support by the preliminary creditors' committee of a DIP petition suffices to meet the requirements for entry of an order approving it.

12 *See* § 245 InsO.

13 *See* § 245-E InsO.

14 *See* § 245 para. 1 Nr. 1 InsO. *Compare* 11 U.S.C. § 1129(a)(7).

15 *See* §§ 245 para. 1 Nr. 2; 245 para. 2 InsO-E. *Compare* 11 U.S.C. § 1129(b)(2)(B)(ii). As under U.S. law, the "absolute-priority rule" likely would not prohibit shareholders from receiving value (*e.g.*, shares in the reorganized entity) on account of "new value" contributed to the reorganizing debtor. *Compare Bank of Am. Nat'l Tr. & Savings Assoc. v. 203 N. LaSalle Street P'ship*, 526 U.S. 434, 444-45 (1999) (recognizing "new value" exception to "absolute-priority" rule in chapter 11 as long as new money contribution is subject to market test); *compare Uhlenbruck/Uhlenbruck*, InsO § 245, 2010, Rz. 26-27.

16 *See* § 245 para. 1 Nr. 3 InsO.

17 *See* § 248 InsO.

18 *See* §§ 217 para. 2 and 225a InsO-E.

19 *See* §§ 9 para. 1; 19 para. 4 GmbHG.

20 *See* § 254 para. 4 InsO-E.

21 *See* § 22a InsO-E (requiring appointment of preliminary creditors' committee if two of following three facts are true: (1) debtor has at least EUR 4.8 million balance sheet, (2) debtor has at least EUR 9.8 million in sales in last 12 months and (3) debtor has, on yearly running average, at least 50 employees). The preliminary creditors' committee consists of representatives of the secured creditors, unsecured creditors holding the largest claims, small creditors and employees. *See* § 21 para. 2 sent. 1 Nr. 1a InsO-E; § 67 para. 2 InsO.

22 *See* § 22a para. 3 InsO-E.

upon an insolvency filing is a critical change intended to counterbalance the power currently exercised by the preliminary insolvency administrator (*vorläufiger Insolvenzverwalter*). Under current law, the preliminary insolvency administrator generally seeks to set in motion a rapid liquidation of a debtor's assets, optimally within the first three months of a case, partially to limit his or her own liability (due to deterioration in value of the debtor's assets post-filing)[23] and obtain the full benefit of assumption of salary payments by the German Federal Employment Service (*Bundesanstalt für Arbeit*).[24] As a counterbalance to the administrator, subsequent to ESUG, the preliminary committee will have input rights on, among other things (1) appointment of an insolvency administrator (to the extent one is appointed);[25] (2) debtor's application for a DIP order both outside[26] and within[27] the precommencement proceeding; and (3) potential approval of major asset sales and post-petition financing.

Thus, to the extent the debtor does "lose possession" over the in-court restructuring, ESUG provides creditors a new source of influence over the process. Further, even if a debtor commences a free-fall proceeding and does not seek to remain in possession, the shift in authority over administrator appointment away from the courts to the debtor's key stakeholders is a key change, as it will introduce greater predictability to the process.

Remaining Risks Post-ESUG

The ESUG legislation will leave the German Code with certain remaining risks. However, these risks can be addressed by stakeholders in advance and do not render an in-court restructuring under the revised German Code value-destructive. Debtors and their stakeholders negotiating the parameters of a court-supervised process should consider and develop strategies for addressing the following aspects:

- Creditors cannot be forced to accept equity under a German Code plan: [28]

  Strategy: The plan can separately classify dissenting creditors based on their differing "economic interests" (*wirtschaftliches Interesse*), which German courts typically have interpreted flexibly.[29] Alternatively, the debtor can seek consent from creditors within a class that certain creditors will receive an alternative "nonequity" treatment.[30]

- In contrast to U.S. bankruptcy law, the revised German Code does not contemplate hard and fast claims bar dates:[31]

  Strategy: ESUG introduces a real bar date one year after a claim becomes due and occurrence of the plan effective date.[32] Moreover, most debtor claims and claimants will be known at petition date through the debtors' schedules, similar to the process in U.S. bankruptcies.[33] The potential danger from the more open-ended German claims process arising from so-called "unknown" claims (especially by tort or other litigants) remains.[34]

- The German Code, even after ESUG, is unclear on the status of post-petition financing:

  Strategy: While priming is not allowed, post-petition financing may receive administrative claim status, as in a U.S. chapter 11 proceeding.[35] In addition, pre-petition financiers do not have liens on the debtor's post-petition acquired assets (*e.g.*, receivables and proceeds obtained post-petition), which frees up post-petition assets.[36] Finally, the state covers employee salaries prior to official commencement, lessening the debtor's liquidity crunch.[37]

Conclusion

ESUG promises to provide an additional tool in the debtor "toolbox" for the purposes of undertaking efficient and value-maximizing restructuring efforts to the benefit of debtors and their stakeholders. Strengthening of the DIP model, ensuring greater creditor participation and modification of the German Code to allow "debt-equity swaps" fundamentally alters the way participants in a rehabilitation process will consider their options and makes the in-court option a feasible one. Ultimately, ESUG ensures that the range of negotiation options will be increased and that debtors and creditors will become more involved in the direction a bankrupt company takes, even when the company seeks insolvency protection. ■

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23 *See* § 60 InsO (setting forth insolvency administrator duty of care and providing for liability for breach); § 21 para. 2 Nr. 1 InsO (applying § 60 InsO standards to preliminary insolvency administrator).
24 *See* § 183, *et seq.*, SGB III.
25 *See* § 56a para. 1 InsO-E. To the extent that the insolvency administrator is supported unanimously by the preliminary committee, the court may reject the proposal only if the person is not competent (*nicht geeignet*) for the position. *See* § 56a para. 2 InsO-E.
26 *See* § 270 para. 3 InsO-E.
27 *See* § 270b para. 3 Nr. 3 InsO-E.
28 *See* § 225a para. 2 sent. 2 InsO-E.
29 *See* § 222 para. 2 InsO; § 222 para. 2 InsO; *Uhlenbruck/Uhlenbruck*, InsO § 222, 2010 Rz. 32.
30 *See* § 226 para. 2 InsO.
31 *See* § 177 para. 1 InsO (providing that proofs of claim filed after claim-filing deadline must also be considered); § 201 InsO (providing that pre-petition creditors can assert their claims against debtor even after termination of insolvency proceedings).
32 *See* § 259b para. 1 and 2 InsO-E.
33 *See* § 229 InsO-E. *Compare* 11 U.S.C. § 521; Fed. R. Bankr. P. 1007(c).
34 *Compare In re Texaco Inc.*, 182 B.R. 937, 955 (Bankr. S.D.N.Y. 1995) (discharging pre-petition unknown environmental claims); *Mullane v. Cent. Hannover Bank & Trust Co.*, 339 U.S. 306, 314 (1950) (holding that publication notice to unknown claimants in trust provided sufficient due-process to such claimants). By contrast, German jurisprudence has not yet developed similar strategies to deal with unknown claims.
35 *See* §§ 55; 53 InsO. In addition, ESUG adds a provision providing that a DIP can seek court approval to incur administrative claims during the precommencement proceeding. *See* § 270 para. 3 InsO-E.
36 *See* § 91 InsO (prohibiting rights on estate assets from arising subsequent to commencement); *Uhlenbruck/Uhlenbruck*, InsO, 2010, § 91, Rz. 21 (discussing fact that assignment of receivables executed pre-commencement will not extend to postcommencement receivables).
37 *See* § 183, *et seq.*, SGB III.