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HEADNOTE: LENDERS' EXERCISE OF "SOLE DISCRETION"
Steven A. Meyerowitz 481

GOOD FAITH AND LENDERS' EXERCISE OF CONTRACTUAL "SOLE DISCRETION"
Thomas J. Hall and Stacey Trimmer 483

BANK REGULATORS TACKLE LEVERAGED LENDING
Derrick D. Cephas, Heath P. Tarbert, and Dimia E. Fogam 495

FSA: BANKS HAVE "MORE WORK TO DO" ON ANTI-BRIBERY COMPLIANCE
Robert Plotkin, Vivian Robinson, Adam Greaves and Kurt E. Wolfe 504

FINANCIAL AND TRADE SANCTIONS: WHAT BANKS NEED TO KNOW
Peter Burrell, Rita Mitchell, and David Savell 510

DELAWARE COURT BLOCKS SALE OF BANK STRIPPED OF ITS "CRITICIZED ASSETS"
Robert S. Reder, David Schwartz, and Julie Constantinides 522

IMPLICATIONS OF THE CFPB'S FIRST ANNUAL REPORT REGARDING THE FAIR DEBT COLLECTION PRACTICES ACT
Robert E. Bostrom, Gary L. Goldberg, Stephen F.J. Ornstein, Scott D. Samlin, and Jennifer Maree 529

REVISITING THE LENDER'S RECOVERY TOOLBOX: REMEDIES OF SETOFF AND RECOUPMENT
Kelly E. Waits 536

A TROUBLING BANK BALANCE — COMPETING DUTIES FOR BANKS WHEN MAKING SUSPICIOUS ACTIVITY REPORTS
Peter Burrell, Rita Mitchell, and David Savell 542

LANDMARK GERMAN BANKRUPTCY REFORM LAW CREATES OPPORTUNITIES FOR STAKEHOLDERS
Bernd Meyer-Löwy, Leo Plank, Carl Pickerill, and Florian Bruder **548**

COMMUNITY BANKS: 12 STRATEGIES FOR RAISING CAPITAL IN A CAPITAL POOR ENVIRONMENT
Victoria Pool 555

BANKING BRIEFS
Terence G. Banich 565

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LANDMARK GERMAN BANKRUPTCY REFORM LAW CREATES OPPORTUNITIES FOR STAKEHOLDERS

BERND MEYER-LÖWY, LEO PLANK, CARL PICKERILL, AND FLORIAN BRUDER

Changes to German restructuring law represent an enormous step toward full implementation of a "Chapter 11" model in Germany.

The German parliament recently enacted a broad package of corporate bankruptcy reforms that will align Germany's restructuring laws with Anglo-American practice and eliminate certain challenges currently faced by stakeholders seeking to protect their interests.[1] The reforms fundamentally improve the German bankruptcy code (the "Insolvenzordnung" or "InsO") by creating new opportunities to preserve enterprise value and transfer equity to creditors in a court-supervised process, which has proven nearly impossible under the current legal regime.

The key changes to the German bankruptcy code which apply to all bankruptcy cases filed after March 1, 2012, include:

- facilitating debt-to-equity swaps by enabling cancellation of shareholder equity (which was prohibited under the prior version of the code);
- promoting a U.S.-style "debtor in possession" model;
- permitting early involvement of a creditors' committee; and
- permitting the creditors' committee to choose the trustee in cases where the debtor does not remain in possession of its assets.

The authors, attorneys based in the Munich office of Kirkland & Ellis, LLP, can be reached at bernd.meyer-loewy@kirkland.com, leo.plank@kirkland.com, and florian.bruder@kirkland.com, respectively.

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DEBT-FOR-EQUITY SWAPS

Unlike U.S. bankruptcy law, the prior version of Germany's bankruptcy law did not allow for the non-consensual impairment of equity interests under a court-sanctioned restructuring plan. Thus, a trustee or debtor in possession often was unable to do anything to re-allocate equity interests to debt security holders, even when equityholders were "out of the money." As a result, equityholders in a distressed company often were able to hold up a restructuring to obtain consideration for their otherwise worthless interests.

The new law specifically provides for issuance of new equity to creditors and the cancellation of old equity without the old equityholders' consent. As a result, "out of the money" equityholders will no longer be able to hold up a restructuring.[2] In addition, to the extent pre-petition out-of-the-money equityholders wish to preserve their place in the capital structure, the revised German bankruptcy law, similar to American bankruptcy law, will enable them to obtain new equity in the reorganized debtor to the extent they provide "new value." The ability to obtain new equity in a debtor will benefit both debtors in need of additional capital and investors seeking to profit on the long-term potential of a reorganized company.

"DEBTOR IN POSSESSION" PROCEEDINGS

Under the former German system, a trustee typically would take over a bankrupt enterprise to either wind it down or sell it to a strategic buyer, with management removed from the process. Debtor in possession proceedings without a trustee were theoretically possible under the former law, but the standards to remove the debtor from possession were fairly low — a creditor needed only demonstrate that further debtor in possession proceedings would harm creditors or lead to delay.[3]

Moreover, the decision as to whether the debtor was entitled to remain in possession was not made on the petition date, but up to three months thereafter, leaving the debtor and its stakeholders in a state of uncertainty until the debtor was officially afforded debtor in possession status.[4] Further, the insolvency court was able to exercise its authority during this interim period to appoint a "preliminary" administrator, who generally lacked authority to

dispose of estate assets, but was likely to have consent rights with respect to postpetition transactions.[5]

To address this uncertainty, the new law implemented two key changes. First, new § 270b InsO provides for a three-month "pre-commencement" proceeding to encourage corporate debtors in financial distress to attend to their liquidity needs in an in-court forum prior to the onset of actual insolvency. The new § 270b proceeding raises the standards for removal of the debtor from possession of the estate and gives the debtor three months to formulate and file a plan of reorganization with the court (although it is possible, as under the U.S. model, that a debtor will coordinate with its constituents prior to and after the petition date to ensure support for a "pre-arranged" plan). Once a plan has been filed, the § 270b proceeding is terminated and a formal proceeding under § 270 InsO is commenced.

The standards for removal of a debtor from possession in § 270 also have been amended in a debtor-friendly way, by requiring a creditor seeking removal to demonstrate specific harm caused by leaving the debtor in possession (rather than merely alleging harm to the estate generally).[6] Moreover, the revised statute requires a majority of creditors by claim amount to petition the court to remove a debtor from possession.[7] To the extent the debtor has a plan on file, particularly if the plan is confirmable and supported by key constituents, creditors likely will be hard pressed to obtain the majority necessary to remove the debtor from possession.

Second, upon the filing of the petition, as long as the debtor's request to remain in possession is not overwhelmingly likely to fail, the court must now refrain from imposing more drastic protective measures to curtail the debtor's activities (e.g., appointment of a preliminary insolvency trustee or prohibiting the debtor from administering its assets).[8] This will provide the debtor and its constituents additional assurances that they will have the opportunity to reach some kind of restructuring arrangement even in those instances where, notwithstanding a promising chance of a successful turnaround, the debtor does not have a pre-arranged plan on file and has not chosen to make use of a § 270b proceeding.

Once the debtor files the plan, creditors vote in classes (with a class having accepted a plan when a majority of creditors in the class, both in number and amount, vote in favor of the plan) and the plan is presented to the court

for confirmation.[9] A debtor can "cram down" dissenting classes as long as (a) the "best interests test" is met (i.e., no creditor is worse off under the plan than in a liquidation), (b) the "absolute priority test" is met (i.e., no creditor receives more than its claim amount and no classes junior to a dissenting class receive anything under the plan), and (c) a majority of all classes entitled to vote on the plan, vote to accept it.[10] Here, too, German lawmakers limited the circumstances under which a disgruntled party can stay confirmation.[11]

MORE CREDITOR INVOLVEMENT, LESS TRUSTEE INTERFERENCE

The prior German bankruptcy law contemplated appointment of a creditors' committee on or soon after the commencement date. In a typical case, a trustee would administer an estate without meaningful creditor participation for three months. This, coupled with high potential personal liability for trustee malfeasance, which motivated trustees to act quickly to prevent deterioration of asset value, created a situation where creditors have little say as plans are made by a trustee to market and sell the debtor's assets quickly.

To remedy this, the new law requires appointment of a creditors' committee from the outset of large and mid-sized debtor cases. The presence of a committee will result in an immediate check on the debtor or trustee, providing creditors with greater influence.

Another key change involves selection of other court officers. First, in the debtor in possession setting, the German bankruptcy code mandates appointment of an examiner. However, the debtor has the right to elect the examiner under the new law, and the court can reject the debtor's choice only if it is shown that the person chosen is "obviously unqualified." Second, in a traditional administration (i.e., where the debtor does not remain in possession and is replaced by a trustee), a unanimous creditors' committee will have the right to elect the trustee.

These changes provide the debtor and creditors with a stronger voice, earlier in the case. Earlier, more meaningful participation will facilitate greater coordination among stakeholders, enabling deviation from the "fire sale" approach that was prevalent under the old law.

The ultimate purpose and hoped-for result of these changes is to preserve

going concern value[12] — even where the debtor does not remain "in possession" — and to reduce the unpredictability that has plagued the German bankruptcy code.

LIMITATIONS OF THE NEW LAW

Important distinctions between the U.S. and German bankruptcy systems remain. For example, while creditors can be "crammed down" under German bankruptcy law, they cannot be forced to accept shares in the reorganized entity in consideration for their claims. Debtors and constituents will therefore need to carefully navigate complicated plan classification, cram down, and other legal requirements to ensure compliance.

An additional point of contrast concerns avoidance actions. German law, like U.S. law, features complicated statutory provisions supplemented by voluminous case law with respect to pre-petition preferences and fraudulent transfers. But in contrast to U.S. law, look back periods for avoidance actions can be longer (10 years in some instances)[13] and German trustees are more willing to pursue them, even against a debtor's critical contract counterparties. While the new law's openness toward allowing corporate debtors to remain "in possession" will alleviate some of the avoidance risks, vendors, lenders, and other transacting parties will need to be cautious with respect to pre-petition transfers.

Finally, U.S. bankruptcy courts consider the nature of a loan as one of many factors when considering whether to recharacterize the loan as equity.[14] German bankruptcy courts, on the other hand, are required to recharacterize loans from shareholders as equity interests.[15] This provision may prevent shareholders from infusing much needed capital to a troubled company, even on favorable credit terms, and even in circumstances where doing so could prevent the need for an in-court process.

THE NEW LAW IS A STEP IN THE RIGHT DIRECTION

On balance, the changes to German restructuring law represent an enormous step toward full implementation of a "Chapter 11" model in Germany and promise to make German restructuring laws accessible to outsiders, in-

cluding creditors, investors, and other participants.

At the very least, the German code will now provide a critical value-maximizing alternative for debtors and their constituents in what was once an uncertain and unpredictable area of the law.

NOTES

[1] *See* Law to Further Facilitate the Rehabilitation of Companies, Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen, Bundesgesetzblatt, Pt. I, Nr. 64 (7 Dec. 2011). The new law went into effect March 1, 2012.

[2] In contrast, in out-of-court bond restructurings, the new German Bond Act, which came into effect in 2010, provides a mechanism for holders of bonds to carry out a debt-for-equity-swap with 75 percent bondholder approval. *See* § 5, para. 3 Nr. 5, Bond Act, Schuldverschreibungsgesetz.

[3] *See* § 272 InsO.

[4] In contrast to U.S. bankruptcy law, where a filed petition "commences" a case under Chapter 11, German bankruptcy law requires the bankruptcy court to determine first whether the requirements for a proper bankruptcy filing are met. *See* § 16 InsO. Thus, a German bankruptcy case is typically "commenced" three months after the filing of a bankruptcy petition. The order granting "debtor in possession" status is issued, at the earliest, upon actual "commencement" of the case. § 270 InsO. Similarly, a committee is not appointed until a case actually "commences."

The three-month delay between petition and commencement dates is explained by the fact that the German Federal Employment Service (Bundesanstalt für Arbeit) pays all employee salaries of a bankrupt company during the three months prior to formal "commencement" of a case. § 183 *et seq*. Third Social Security Statute, Sozialgesetzbuch, SGB III. Thus, the debtor or trustee typically does not ask for a hearing on "commencement" until three months after the petition date. A debtor with few or no employees may seek a commencement date less than three months after the filing, but this is unlikely for debtors with significant wage obligations.

[5] § 21 InsO.

[6] Under the revised statutes, mere delay in the case caused by permitting "debtor in possession" status to continue will not justify removal of the debtor from possession. *See* §§ 270 & 272 InsO (revised version). In addition to showing that "debtor in possession" status will harm creditors generally, the creditor must convincingly show how allowing the debtor to remain in possession will harm that creditor in particular. *See* § 272 InsO (revised version).

[7] § 272, para. 1, Nr. 1 InsO.

[8] § 270a InsO.
[9] In comparison, the U.S. Bankruptcy Code sets a higher mark for the percentage of voting creditors required to constitute an accepting class — at least two thirds in amount and more than one-half in number. 11 U.S.C. § 1126(c).
[10] *See* § 245 InsO. In comparison, the U.S. Bankruptcy Code requires acceptance by only one impaired consenting class, provided that other impaired classes can be crammed down pursuant to Section 1129(b). 11 U.S.C. § 1129(a)(10).
[11] In particular, the creditor must show that the debtor did not meet the "best interests" test as to it. *See* § 253 InsO (revised version).
[12] *See* Report Accompanying Government's Draft Law, Begründung zum Regierungsentwurf, at 25.
[13] *See* §§ 133, para. 1 & 135 InsO. In contrast, the look-back periods in the U.S. are 90 days to one year for preferences and between two and six years for federal and state law fraudulent transfers depending on applicable state law. 11 U.S.C. §§ 547, 548.
[14] Matter of Fabricators, Inc., 926 F.2d 1458, 1469 (5th Cir. 1991) ("When an insider makes a loan to an undercapitalized corporation, a court may recast the loans as contributions to capital.")
[15] *See* § 39 para. 1 Nr. 5.