CLEARY GOTTLIEB Alert Memo

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Proposed Insolvency Reform to Boost Restructurings in Germany

In July 2010, the German Federal Ministry of Justice issued an internal draft bill of the *Act to Facilitate Further the Restructuring of Companies*. (A separate internal draft bill, issued during the same month, addresses the restructuring of banks.) As yet, the draft bill has met broad political support and highly positive feedback in the market, so that it may well become law within the next few months. If enacted as proposed, the draft bill would result in significant amendments to the German Insolvency Code and thereby facilitate the in-court restructuring of German companies.

Under current law, parties often find it difficult to successfully restructure companies by using the means of German insolvency law, particularly by a so-called "insolvency plan". Any such restructuring within insolvency proceedings (as opposed to an out-of-court restructuring, typically by way of a debt-equity swap) is fraught with significant uncertainties – in addition to the debtor being stigmatized as "insolvent". Creditors have little influence on the selection of the insolvency receiver by the court or on the ability of the debtor's management to remain in office (so-called "self-administration"). Minority creditors and shareholders have various ways of blocking or delaying in-court restructurings. The main practical alternative to an in-court restructuring by way of an insolvency plan, namely an asset sale, raises various legal and practical difficulties as well. German insolvency law is therefore generally perceived to be less restructuring-friendly than the laws of other jurisdictions, such as the United Kingdom. As a consequence, the parties in some restructuring cases have decided to have the debtor "migrate" to other jurisdictions in order to take advantage of the more flexible rules applicable there. Any such "migration", however, can raise complex legal issues as well.

The Federal Government's draft bill is intended to mitigate these risks and uncertainties, by aligning the insolvency plan procedure closer to Chapter 11 proceedings under U.S. bankruptcy law. Changes include the formal involvement of an insolvent debtor's shareholders in the proceedings, the increase of the influence of creditors over the proceedings, and the streamlining of the procedure to adopt an insolvency plan.

Involvement of Shareholders

The one change reflected in the draft bill which most fundamentally deviates from current German insolvency law relates to the formal involvement of the debtor's shareholders in the insolvency proceedings. Under current law the shares in an insolvent debtor do not belong to the debtor's estate, so that shareholders are not formally involved in the proceedings. As a consequence, shareholders are able to block any in-court restructuring by means of an insolvency plan, by refusing to give their consent to the continuation of the debtor as a going concern or to capital measures such as a debt-equity swap. Unlike the bankruptcy laws in other jurisdictions, current German law does not give an insolvency court the discretion to issue an order by which any such shareholder resistance can be overcome.

Under the draft bill, an insolvency plan could no longer just provide for measures affecting the debtor's creditors, but also for measures affecting its shareholders. An insolvency plan could provide that the debtor shall be continued as a going concern, that shares in the debtor shall be transferred to creditors, that the debtor's share capital is reduced to absorb existing losses and then increased by the issuance of new shares to an investor, any pre-emptive rights of existing shareholders being excluded, and other corporate measures. Thereby, a debt-equity swap could be forced by majority votes upon dissenting shareholders.

Creditors and shareholders would, to the extent actually affected by the terms of the insolvency plan, vote on the plan in groups. If the majority of groups voting on the insolvency plan approved the plan, the vote of dissenting groups could be replaced by court order if certain conditions would be met, and dissenting creditors or shareholders would have only limited rights to prevent the plan from becoming effective (see "*Streamlining of Insolvency Plan Procedure*" below).

If enacted as proposed, this would result in a fundamental change to current German law. It remains to be seen whether there will be demands for a modification of this proposal on the basis of, *e.g.*, EU law and German constitutional law considerations.

Selection of Insolvency Receiver

Under current law, creditors of an insolvent debtor have little influence on the identity of the insolvency receiver to be appointed by the court. In the past, German insolvency courts have frequently refused to appoint a candidate who had been proposed by creditors or who had provided pre-filing advice to creditors, arguing that such person was compromised thereby.

The draft bill provides that the insolvency court shall generally give the insolvent debtor's main creditors the opportunity to express their views on the selection of the receiver. The court could reject any corresponding proposal only if the proposed person is not suited as insolvency receiver, and the prior involvement of such person would not lead to a disqualification of such person *per se*. The court would have to state the reasons for its decision in writing.

Strengthening of Self-Administration

Under current German insolvency law, the debtor may apply for self-administration (*Eigenverwaltung*). If so ordered by the court, the debtor's management remains in office, albeit supervised by a trustee. Self-administration has been successfully utilized in some restructuring cases but has remained a rare exception. In addition, it has been relatively easy for creditors to have a court order for self-administration lifted.

The draft bill addresses the main current obstacles to self-administration: If the insolvent debtor applied for self-administration, the court would generally first have to solicit the views of the main creditors, and could deny the application only if there would be evidence to the effect that self-administration would likely prejudice the creditors as a whole. If a debtor's application for self-administration would not be manifestly futile, the court would generally not be able to prohibit management from disposing of assets of the debtor during the so-called "preliminary insolvency proceedings" (which generally take place between the date of insolvency filing and the date on which actual proceedings are opened by the court), or to make such disposals subject to the consent of the "preliminary insolvency receiver" who would have been appointed for such proceedings.

Where a debtor filed for insolvency on the basis of imminent illiquidity (as opposed to actual insolvency, *i.e.*, illiquidity or over-indebtedness) and applied for self-administration, the court would have to inform the debtor in advance if it intends to deny such application, to enable the debtor to withdraw the insolvency filing and undertake or continue restructuring efforts out of court. Furthermore, where any such insolvency filing has been made for purposes of an in-court restructuring, the court would have to order a grace period of up to three months during which the debtor may prepare a (pre-packaged) insolvency plan under enforcement protection, unless a restructuring would not appear promising.

Streamlining of Insolvency Plan Procedure

Under current law, individual creditors are often able to block or delay the adoption of insolvency plans by using appeal rights and thereby put restructurings at risk. The draft bill would make it more difficult for individual creditors to obstruct promising restructurings by imposing further procedurals requirements and requiring that the insolvency plan be materially prejudicial to an objecting creditor. Furthermore, an insolvency plan could provide for the financial compensation of objecting creditors for losses incurred, in which case the insolvency court could not deny its approval of the plan on the basis of a creditor's claim that it would be put at a material disadvantage if the plan was adopted. In any such case, the suit for compensation would be conducted outside of the insolvency proceedings and not prevent the restructuring.

Central Counterparties

The draft bill contemplates central counterparties to be vested with the right to transfer, within one day of the opening of insolvency proceedings, the debtor's rights and obligations (including collateral) relating to transactions cleared by the central counterparty, provided that (i) the central counterparty and the debtor have agreed on the possibility of such transfers in advance, and (ii) the rights and obligations to be transferred relate to transactions for which there are offsetting transactions with customers. Alternatively, the central counterparty would be able to enter into close-out transactions based upon market rates. The central counterparty would be required to compensate the insolvency estate for any losses resulting from such transfers or close-out transactions. These changes would provide market participants with more flexibility, in line with similar procedures available in other jurisdictions.

Privileges

The draft bill proposes to abolish the protection from claw-back rights of an insolvency receiver which currently applies to payments made by the debtor to social security insurance carriers during the last three months prior to the insolvency filing. The draft bill does not, however, contain any provisions that would re-introduce preferential rights of the tax authorities, as was contemplated in the German Federal Government's cost savings plans of June 2010.

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If you have any questions in regard to the issues addressed herein, please feel free to contact Dr. Werner Meier (wmeier@cgsh.com), Michael Kern (mkern@cgsh.com) or Christoph Schauenburg (cschauenburg@cgsh.com) at the Frankfurt office of Cleary Gottlieb or any of our partners and counsel listed under "Germany", "Lawyers in this Practice", under the "Practices" section, "Regions", of our website at http://www.clearygottlieb.com.

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