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Alert Memo

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Coordination but no Consolidation: Internal Draft Bill on Group Insolvencies in Germany

We have reviewed an internal draft of the German Federal Ministry of Justice (*Bundesjustizministerium*) of a Bill to Facilitate the Handling of Group Insolvencies (*Entwurf eines Gesetzes zur Erleichterung der Bewältigung von Konzerninsolvenzen*) (the "Draft Bill"). For the first time in Germany, the Draft Bill would, if enacted as drafted, introduce special rules relating to the insolvency of group companies. The Draft Bill continues a recent series of legislative initiatives to modernize German insolvency law. Most notably, this included the Act to Facilitate Further the Restructuring of Companies (*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*), which facilitates in-court restructurings of insolvent companies and became effective on March 1, 2012.[1]

The Draft Bill is not the only current legislative initiative dealing with group insolvencies. In December 2012, the European Commission published draft proposals (the "Proposals") to amend the European Insolvency Regulation (EC Regulation No. 1346/2000) which include, *inter alia*, special rules on group insolvencies.[2] While the Draft Bill preempts in part the changes contemplated by the Proposals, it remains to be seen how exactly the Proposals will affect the provisions set forth in Draft Bill.

Overview

Under current German law, there are no special provisions relating to group insolvencies. Under the German Insolvency Code (*Insolvenzordnung*), the competent insolvency courts open separate insolvency proceedings for each insolvent group company. In many cases, a different insolvency receiver is appointed for each insolvent group company. This applies particularly where different courts have jurisdiction to open insolvency proceedings over the respective group companies, which depends upon the location of the companies involved.

Where a multitude of separate insolvency proceedings with different insolvency receivers is opened, it is generally much more difficult or even impossible to realize the potential good will of a corporate group. This often results in lower realization proceeds for the creditors. For example, disadvantages for creditors may arise from essential group

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1 See our Alert Memorandum of December 14, 2011 -- http://www.cgsh.com/insolvency_reform_to_boost_restructurings_in_germany

2 http://ec.europa.eu/justice/newsroom/civil/news/121212_en.htm

services no longer being provided, in particular where certain support functions relating to a specific business are allocated to more than one group company. Further difficulties may arise due to a lack of coordination among the various insolvency receivers in respect of their liquidation or rehabilitation strategies. This problem is further emphasized by the statutory obligation of an insolvency receiver to maximize the proceeds for the creditors of the particular insolvent company for which he or she is appointed. For example, insolvency receivers may litigate over group transactions even where, from a group perspective, such litigation is costly and inefficient. In the worst case, conflicting interests of different insolvency receivers as well as a lack of coordination may prevent the restructuring of a corporate group, resulting in its unnecessary piecemeal liquidation, with lower recoveries for the creditors as a whole.

In the past, some German insolvency courts have, without an express legal basis, attempted to alleviate these issues by exercising jurisdiction over various group companies and appointing the same person as insolvency receiver for all such companies (*e.g.*, Arcandor/Quelle, Teldafax). However, this pragmatic approach of some courts has not changed the fact that current German law has been regarded unsatisfactory in this respect.

The Draft Bill addresses these issues in four ways: First, it establishes the possibility of a single venue for group insolvencies. Second, it facilitates the appointment of the same person as insolvency receiver for all group companies concerned. Third, it creates an obligation to cooperate for insolvency courts, insolvency receivers and creditors' committees. Fourth, it introduces so-called "coordination proceedings" (*Koordinations-verfahren*) among insolvency receivers of group companies and the possibility to adopt a "coordination plan" (*Koordinationsplan*). The Draft Bill does, however, not change the principle that separate insolvency proceedings are to be opened in respect of each group company. Accordingly, unlike bankruptcy laws in the U.S. and other jurisdictions, German law will continue not to permit the substantive consolidation of the assets and liabilities of various insolvent group companies.

Venue for group insolvencies

If enacted as drafted, the Draft Bill would introduce a right of a domestic insolvent company that forms part of a corporate group to apply, when filing for the opening of insolvency proceedings, for the respective insolvency court to take insolvency jurisdiction over all other group companies (such a court, a "Group Insolvency Court"). A "corporate group" within the meaning of the Draft Bill comprises all domestic companies that are directly or indirectly linked by an ability to control or by common management.

If the insolvency court determines that (i) the company's insolvency filing is admissible, (ii) the interests of the group's creditors justify a concentration of the various insolvency proceedings at the same court, and (iii) the company concerned is not evidently of minor importance for the group as a whole, it must assume insolvency jurisdiction over

all group companies. Upon the opening of insolvency proceedings in respect of a particular group company, such an application may also be filed by such company's insolvency receiver. Creditors would not be able to file such an application. If there is more than one such filing, the earlier filing prevails, and in the case of concurrent filings the filing of the company with the highest balance sheet total prevails. Once a Group Insolvency Court has been established, any other insolvency courts where insolvency proceedings in respect of group companies are pending may (and, upon the application of the relevant group company or insolvency receiver, must) refer such proceedings to such court.

Joint insolvency receiver

The Draft Bill also provides that, where insolvency proceedings in respect of various group companies are pending at different courts, such courts must coordinate their determination as to whether it is in the respective creditors' interests to appoint the same person as insolvency receiver for the whole group. In this respect, where a preliminary creditors' committee has been established, the relevant insolvency court must hear such committee, and it may deviate from the proposal by the creditors' committee for a joint insolvency receiver only if the creditors' committee of another group company unanimously proposes a suitable alternative receiver.

Cooperation obligations

The Draft Bill sets forth information and cooperation obligations for the parties involved. In particular, the insolvency receivers of different group companies now have the express obligation to cooperate and provide to each other any information that might be of relevance for the respective other proceedings. However, such obligations would not apply where the interests of the creditors of the respective group company would otherwise be prejudiced. For example, an insolvency receiver need not furnish information to another receiver where such information would enable the second receiver to challenge an intragroup transaction. The Draft Bill also stipulates cooperation obligations among different insolvency courts and creditors' committees. Finally, upon the application of the creditors' committee of a group company, a Group Insolvency Court must appoint a group creditors' committee.

Coordination proceedings

According to the Draft Bill, each group company in respect of which insolvency proceedings have not yet been opened, and each insolvency receiver or creditors' committee of an insolvent group company, may apply to the Group Insolvency Court for the opening of "coordination proceedings" and the appointment of a "coordination receiver". The "coordination receiver" would be one of the insolvency receivers of the insolvent group companies. Such receiver is obligated to coordinate the various insolvency proceedings and, in particular, to ensure a coordinated liquidation or restructuring of the insolvent group companies. For this purpose, the coordination receiver may draw up a "coordination plan"

describing all measures necessary for a coordinated liquidation or restructuring of the insolvent group companies, including (i) any measures necessary to restore the group's economic viability, (ii) any steps to resolve pending or threatened intragroup litigation, and (iii) proposals for contractual arrangements among the various insolvency receivers. Any coordination plan is subject to approval by the Group Insolvency Court. If the respective creditors' meetings so decide, the "coordination plan" can be used as a basis for the individual insolvency plans for the respective group companies. The "coordination plan" itself, however, cannot be used to affect the rights of the creditors of group companies. The respective assets and liabilities will continue to be unconsolidated.

Outlook

The Draft Bill is a step forward towards an improved coordination of the various insolvency proceedings of group companies. Coordination would particularly be enhanced by the possibility to have a single venue and, ideally, a single insolvency receiver for all relevant proceedings. Where this proves impossible, coordination would still be facilitated by the express obligation of the parties involved to cooperate with the goal of preserving any good will of the group and realizing higher recovery proceeds for the creditors.

At the same time, the Draft Bill would not introduce a substantive consolidation of assets and liabilities of various insolvent group companies, because such a consolidation would be incompatible with fundamental principles of German corporate law. In fact, in some respects the Draft Bill would merely codify existing practice of many German insolvency courts and receivers. As compared with other jurisdictions where a substantive consolidation is possible, the restructuring of an insolvent corporate group would continue to be more difficult. Nevertheless, within the boundaries of mandatory law, the Draft Bill would enhance legal certainty and facilitate group restructurings in Germany.

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