Insolvency & Restructuring - Germany

Reform act on restructuring insolvent companies: upcoming changes

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Introduction

On October 27 2011 Parliament adopted various changes to the insolvency law which aim to facilitate the restructuring of operating companies. The revisions are expected to enter into force on March 1 2012.

The revisions aim to:

- improve the prospects of a successful restructuring;
- involve the debtor and creditors in the selection process of the preliminary insolvency administrator; and
- improve the reliability and predictability of insolvency proceedings.

The revisions also attempt to expand the opportunities for the reorganisation of an insolvent debtor through insolvency plan proceedings, and to limit the effects of potential appeals against the insolvency court's confirmation of such a plan, in order to reduce the number of appeals.

The existing insolvency law will remain valid until the revisions come into force and will continue to apply for insolvency proceedings which were filed before that date.

Preliminary creditors' committee

Under the existing regime, creditors have little influence over the preliminary proceedings in the period between filing of the insolvency petition and the opening of insolvency proceedings. It is left to the court's discretion to establish a preliminary creditors' committee at an early stage in the proceedings, when typically the critical and most decisive questions are resolved.

The reform act is breaking new ground by introducing an obligation to establish a preliminary creditors' committee at an early stage of the proceedings. This obligation is limited to debtors with ongoing business operations, but also applies to small and medium-sized enterprises. The insolvency court will be required to set up a committee if the debtor fulfilled at least two of the following requirements in the preceding business year:

- a balance-sheet total of at least €4.84 million (after the deduction of negative equity within the meaning of Section 268, Paragraph 3 of the Commercial Code);
- a revenue of at least €9.68 million within the 12 months preceding the date of the balance sheet; or
- an annual average of at least 50 employees.

Even if these requirements are not met, the court should set up a committee on the application of either the debtor, its preliminary insolvency administrator or a creditor, provided that eligible members are presented to the court together with consent forms from these entities.

The court may refuse to appoint a committee if this would adversely affect the debtor's financial situation or would be considered a disproportionate measure with regard to the value of the expected insolvency estate.

The provisions on the composition of the preliminary committee were the subject of intense debate during the legislation process, which resulted in last-minute changes. It is now provided that:

- the preliminary insolvency administrator may propose members for the preliminary committee at the request of the insolvency court; and
- new creditors which become creditors after the opening of insolvency proceedings are also eligible committee members.

These changes are crucial for the composition of the committee and may contribute to the success or failure of a unanimous proposal for a preliminary insolvency administrator.

Appointment of the insolvency administrator

Under the existing regime, the (preliminary) insolvency administrator is appointed by the insolvency court. Although the insolvency administrator decides important questions relating to the proceedings, and – unlike the insolvency court – has an influential position, the decision to appoint the administrator is at the court's discretion. Creditors have no influence over the process. At present, creditors have the opportunity to vote out the court-appointed administrator only at the first creditors' meeting and to elect a new administrator by majority vote. However, by this stage, the insolvency proceedings will be well advanced and many – if not all – important decisions will already have been made. Therefore, creditors generally avoid replacing the insolvency administrator at this stage, since it would be time consuming and costly to deal with a new administrator, who would need to familiarise himself or herself with the economic circumstances of the relevant business.

The revisions have introduced a generally binding right for the preliminary creditors' committee to propose unanimously an insolvency administrator. The court must appoint the proposed person as administrator as long as the candidate fulfils the legal requirements (eg, being independent of the creditors and the debtor, and having sufficient experience in business affairs). The committee is entitled to determine the requirements (other than independence and experience) to be fulfilled by the insolvency administrator. A candidate will not necessarily be precluded from acting as insolvency administrator if it advised the debtor on the course and the consequences of insolvency proceedings before the petition for the opening of insolvency proceedings. However, candidates which have assisted in preparing an insolvency plan are not eligible.

In insolvency proceedings without a preliminary creditors' committee, creditors have the option to propose a specific insolvency administrator on an informal basis; such a proposal is binding on the court.

Revitalisation of insolvency plan proceedings

Insolvency plan proceedings, as included in the Insolvency Code, are rarely used in practice. The main drawbacks of the current system are that:

- shareholder consent is required if shareholder rights are affected within the insolvency proceedings (eg, on a debt-to-equity swap or other corporate measures); and
- dissenting creditors can delay the implementation of insolvency plan proceedings.

Effectively, this means that both groups of stakeholders can block any in-court restructuring. At the same time, both issues provide non-consenting stakeholders with a considerable nuisance value, both before and during insolvency proceedings.

In tackling non-consenting shareholders, the revisions would introduce shareholders as a new class of constituent within insolvency plan proceedings (currently only creditors are included). If shareholders need to be treated differently due to the nature of their shareholding, the new legislation allows for several groups of shareholders to be established, as long as members in each group share similar commercial interests. The shareholders will have a voting right to support or reject the proposed insolvency plan; but even if a class of shareholders votes against implementation of the insolvency plan, this class can be 'crammed down' if, in particular, the dissenting shareholders would not be put in a worse position than that which they would find themselves in without the plan.

According to the revisions, an insolvency plan could:

- enable the debtor to continue as a going concern;

- facilitate the conversion of creditor claims (except for tax claims of public authorities) into equity (debt-to-equity swap);
- transfer shares to creditors; or
- permit the statutory capital to be reduced and subsequently increased by issuing new shares in order to absorb losses.

The corresponding corporate action (eg, capital decrease and increase) would be deemed effective when the insolvency plan became legally binding. The reform act clearly states that a debt-to-equity swap may not be conducted against the will of creditors whose claims are to be converted into equity. Moreover, it is contemplated that legal remedies against corporate actions, the valuation of claims contributed and the equity interest or impairments of creditors or shareholders should not delay the legal effect of the insolvency plan.

According to the revisions, such remedies will be allowed only if:

- the claimant can show that the plan would put it in a materially worse position than it would be in without the plan; and
- the claimant cannot be adequately compensated for this disadvantage by a payment from funds specifically reserved for this purpose in the insolvency plan.

Therefore, if funds have been reserved within the insolvency plan proceedings, the insolvency court will be obliged to approve the insolvency plan and any dispute will need to be settled outside insolvency proceedings.

The insolvency court will still be entitled to reject a remedy against the insolvency plan immediately if so requested by the insolvency administrator if the implementation of the insolvency plan is of immediate priority. The insolvency court might take this view if it believes that a delay in the insolvency plan caused by a legal remedy would outweigh the actual disadvantages for the claimant. If the legal remedy is rejected on this basis, the creditor may request to receive indemnification out of the insolvency estate.

Further, it is not necessary to provide for shareholder compensation in the insolvency plan in cases where the existing equity would be commercially worthless, which is normally the case in insolvency plan proceedings.

Another aspect of the reform act that should expedite insolvency plan proceedings is the inclusion of two provisions that oblige the insolvency court to schedule periods of no longer than two weeks for the court to review and reject the insolvency plan due to obvious flaws, and for various parties involved to review the plan.

Communication with creditors that are to participate in a debt-to-equity swap will be streamlined, insofar as such creditors must expressly object to such a swap if they wish to refuse the offer of a shareholding as laid out in the insolvency plan. In out-of-court restructurings, a common problem is that creditors risk equitable subordination if they swap debt for equity. Equitable subordination can be avoided if, for example, creditors take advantage of the restructuring privilege granted to them to take equity with the aim of restructuring the company. This is evidenced mostly by way of a workout opinion, which requires more time and money than an internal business review.

During the legislative process, it was also discussed whether creditors should be able to rely on the so-called 'restructuring privilege' in the context of a debt-to-equity swap. However, a clear statement to this effect was not inserted in the new act.

One further important relaxation of the current rules is the modification of the insolvency administrator's obligation to satisfy all undisputed preferential claims – due or not yet due – before the insolvency plan is implemented. This obligation ties up a lot of liquidity and, in practice, leads to the failure of many plans. In future, only preferential claims which are due and payable will have to be paid. For disputed claims, security will need to be granted. Claims that are not already due must be safeguarded only by a robust liquidity calculation.

The continuation of the operating business is ensured by the continuation of contracts entered into with the debtor. A debt-to-equity swap or other corporate measure which is the subject of an insolvency plan must not be used as a trigger for the termination of any contracts whatsoever, unless the debtor is in breach of such a contract. As a final point, the assertion of creditor claims at the 11th hour in insolvency proceedings can often threaten the implementation of insolvency plan proceedings. Therefore, the revisions provide the option to suspend, stay or discontinue execution by the insolvency court if the realisation of the insolvency plan is at risk as a result of threatened enforcement action based on creditor claims which have not been filed during the insolvency proceedings before voting on the insolvency plan. These claims become time-barred within one year of implementation of the plan at the latest.

Strengthening self-administration

In most cases in which insolvency proceedings are initiated, the court appoints a preliminary insolvency administrator. Typically, the management remains in place, but any important decisions require the administrator's consent. On the opening of insolvency proceedings, the then-appointed administrator replaces the management and takes control of all company affairs.

An exception to these proceedings is the establishment of self-administration, which allows management to remain in charge of managing its business under the supervision of a court-appointed trustee. The objectives pursued by self-administration are mainly to keep costs down and ensure that the management's specific know-how is not lost during the insolvency proceedings.

However, the insolvency courts have shown considerable reluctance to order self-administration in insolvency proceedings. The reform act aims to strengthen self-administration by limiting the insolvency court's ability to refuse to order self-administration. At present, a court will permit self-administration only if it is convinced that the procedure will not be deferred or will not otherwise adversely affect creditors. In future, it will be sufficient for the court to order self-administration where there are no circumstances already known to the court that self-administration could negatively affect the creditors' position.

Further, where a debtor files for insolvency on the basis of impending illiquidity and applies for self-administration, the insolvency court will be obliged to indicate to the debtor whether it intends to refuse this application. This will give a debtor which voluntarily files for insolvency (there is no obligation to file for insolvency in cases of impending illiquidity only) the opportunity to withdraw its petition to open insolvency proceedings and to continue managing the business on its own.

Moreover, the preliminary creditors' committee will have a decisive influence on the court's decision as to whether to proceed with self-administration. As with the proposed new regulations on the choice of insolvency administrator, the committee will also have the right to be heard by the insolvency court before the court decides on the petition for self-administration filed by the debtor. If the committee supports the petition, the court generally cannot refuse to order self-administration on the grounds that it would adversely affect the creditors. In addition, the committee will be entitled to demand the revocation of self-administration, whereas an individual creditor's right to appeal the decision taken by the court will be restricted.

Pre-insolvency restructuring proceedings

A further incentive to initiate restructuring at an early stage provided for in the revisions is the introduction of pre-insolvency restructuring proceedings for the period between filing of the insolvency petition and the actual opening of insolvency proceedings. If a debtor files a petition to initiate insolvency proceedings on the grounds of impending illiquidity or over-indebtedness, and also applies for self-administration, the insolvency court can grant the debtor a period of time - not exceeding three months - in which it must work out the details of an insolvency plan. Within that period, the court can order the interdiction or cessation of enforcement proceedings on the application of the debtor.

The advantages of these proceedings are clear. This protection from its creditors should afford the debtor enough breathing space to develop the measures necessary to restructure the business and to implement an insolvency plan on an expedited basis. During the pre-insolvency proceedings, the insolvency court and a court-appointed trustee supervise the debtor, which provides a further incentive for debtors to file for insolvency proceedings at an early stage. According to the revisions, the court will be able to revoke its decision to initiate restructuring proceedings before the expiration of the period initially set by the court only if:

- the envisaged restructuring measures become unachievable; or
- the preliminary creditors' committee demands the revocation of the restructuring proceedings. In cases where a preliminary creditors' committee is not in place, each creditor will have a right to file a petition for revocation, to the extent that it can substantiate a claim that it will be adversely affected in the restructuring proceedings. After the opening of insolvency proceedings, the draft insolvency plan can be implemented at short notice.

No centralisation of insolvency courts

Under existing insolvency law, the jurisdiction of an insolvency court is generally determined by the corporate seat or the location where the debtor has its main business activity (if this place deviates from the corporate seat). This results in a high number of insolvency courts, with different compositions and varying experience. The existing regime does allow for the concentration of insolvency courts within a district court circuit, but this opportunity has not been extensively used in the past.

The revisions miss the opportunity to rectify this issue. Insolvency professionals had initially proposed to concentrate the know-how in a single court and to ensure that the competent judges and judicial officers gather the necessary experience in order to supervise complex company insolvencies. This proposal was dropped during the legislative process. The exclusive jurisdiction of the insolvency courts remains a crucial issue which will hopefully be resolved by future changes to insolvency law.

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