CLIFFORD CHANCE

Client briefing
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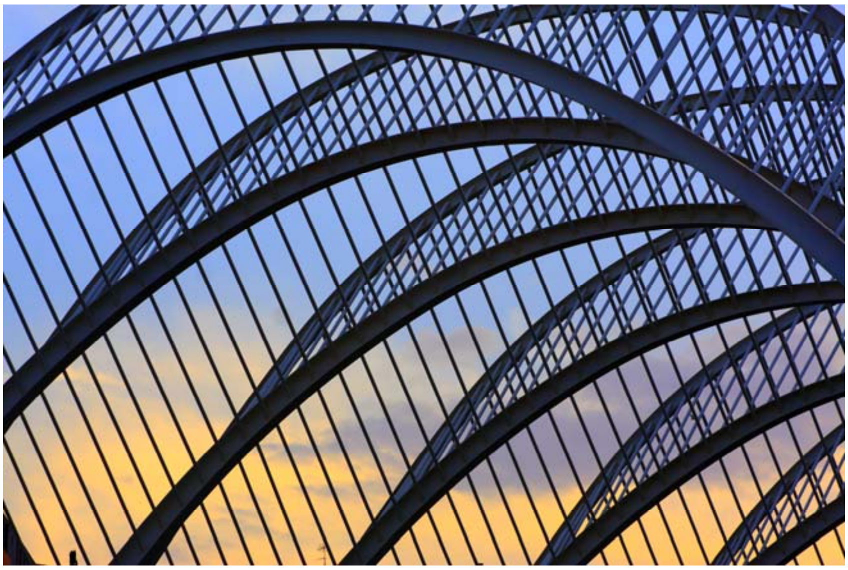
Draft Act for an Insolvency Law Reform



Key changes proposed

- Obligation to set up preliminary creditor committee in preliminary insolvency proceedings
- Binding proposal of the preliminary creditor committee for the appointment of the insolvency administrator
- Revitalising insolvency plan proceedings by allowing for debt-to-equity-swaps
- Debtor-in-possession and pre-insolvency restructurings encouraged

On 23 February 2011, the German Federal Government (*Bundesregierung*) published the first draft of a new act to facilitate the restructuring and the re-organisation of enterprises (*Gesetzesentwurf zur weiteren Erleichterung der Sanierung von Unternehmen*) ("**Draft Act**") which will be discussed in the German Parliament shortly.

According to the German Federal Government, the purpose of the Draft Act is to improve the prospects of a successful restructuring process, to involve the debtor and the creditors in the selection process of the (preliminary) insolvency administrator and to improve the reliability and predictability of insolvency proceedings. The Draft Act also attempts to expand the opportunities for the reorganisation of an insolvent debtor in so-called insolvency plan proceedings (*Insolvenzplanverfahren*) and to reduce the number of possible appeals in such proceedings.

These changes follow the suggestions made by a wide variety of restructuring professionals. Comparable to the consultation paper issued by the Ministry of Justice ("**Consultation Paper**") which we discussed in our previous client briefing (*"Consultation Paper on First Steps of Insolvency Law Reform")*, the Draft Act has been welcomed by insolvency administrators and insolvency judges, notwithstanding further corrections which might have to be made during the legislative process. It remains to be seen whether this draft will pass Parliament in the current form and within the timeline which is currently envisaged, *i.e.* before July 2011.

This client briefing sets out the main proposals which are comprised in the Draft Act, and the main improvements *vis-à-vis* the previous Consultation Paper.

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Preliminary Creditors' Committee in Preliminary Insolvency Proceedings

Under the current German insolvency regime, the creditors have little influence over the preliminary proceedings in the period between the petition for and the actual opening of insolvency proceedings. It is in the sole discretion of the court whether or not it establishes a preliminary creditors' committee (*vorläufiger Gläubigerausschuss)*. It is for the creditors' meeting (*Gläubigerversammlung*) to decide whether a permanent creditors' committee should be established. If the court has established a preliminary committee, the creditors' meeting will decide whether the existing committee would remain in place, be dismissed or replaced by another permanent creditors' committee.

The Draft Act is clearly breaking new ground in its proposals as it introduces an obligation to set up a preliminary creditors' committee at a very early stage of the proceedings. The obligation is limited to debtors with ongoing business operations (*laufender Geschäftsbetrieb*) and also applies to small and medium-sized enterprises. The insolvency court will be required to set up a preliminary creditors' committee if the debtor fulfilled at least two of the following requirements in the preceding business year:

- a balance sheet total of at least 2 million Euro (after deduction of the negative equity within the meaning of section 268 paragraph 3 of the German Commercial Code);
- a revenue of at least 2 million Euro within the 12 months preceding the date of the balance sheet;
- an annual average of at least 10 employees.

Under certain circumstances, the court may dispense with this requirement if appointing the committee would adversely affect the financial situation of the debtor (*nachteilige Veränderung der Vermögenslage des Schuldners*) or would be considered a disproportionate (*unverhältnismäßig*) measure with regard to the value of the expected insolvency estate. According to the Draft Act, the obligation to set up a preliminary committee is limited to proceedings initiated by the debtor. In insolvency proceedings initiated by a creditor, the creation of a preliminary creditors' committee is in the sole discretion of the court.

Binding Proposal for the Appointment of the Insolvency Administrator

Under the current German insolvency legislation, the (preliminary) insolvency administrator is appointed by the insolvency court. Notwithstanding the fact that the insolvency administrator decides important questions relating to the proceedings and has – as opposed to the insolvency court – an extremely influential position, the decision to appoint the insolvency administrator vests in the sole discretion of the insolvency court, and the creditors do not have any influence whatsoever over that process. At present, the creditors only have the opportunity to vote out the insolvency administrator appointed by the court at the first creditors` meeting (*Gläubigerversammlung*) and to vote for a new insolvency administrator with the approval of the requisite majority of creditors. However, by this stage the insolvency proceedings will be very well advanced and many important decisions will already have been taken. Therefore, creditors generally avoid the replacement of 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 with the economic circumstances of the relevant business.

In the Consultation Paper, the rights of the preliminary creditors' committee (*vorläufiger Gläubigerausschuss),* were limited to a non-binding right to be heard before the court that would appoint an insolvency administrator. The majority creditors would have had the same rights as the preliminary creditors' committee. The Draft Act extends the authority of the preliminary creditors' committee and introduces a binding right to propose an insolvency administrator in cases where the proposal has been adopted unanimously. The court must appoint the person proposed as the insolvency administrator as long as the proposed candidate fulfils the legal requirements such as being independent of the creditors and the debtor and having sufficient experience in business affairs. The preliminary creditors' committee is entitled to determine the requirements (other than independency and experience) to be fulfilled by the insolvency administrator. A candidate would not necessarily be precluded from acting as insolvency administrator if it had advised the debtor on the course and the consequences of insolvency proceedings prior to the petition for the opening of insolvency proceedings. The same applies if the relevant candidate assisted in preparing an insolvency plan and both the debtor and the creditors were involved. In insolvency proceedings without a preliminary creditors' committee, the creditors will have the option to propose a specific insolvency administrator, whereby such proposal would not be binding for the court.

Revitalisation of the Insolvency Plan Proceedings

Insolvency plan proceedings (*Insolvenzplanverfahren*) as included in the German Insolvency Code are rarely used in practice. The main draw backs of the current system are that (i) shareholder consent is required if shareholder rights are affected within the insolvency proceedings (*e.g.* on a debt-to-equity swap or other corporate measures); and (ii) dissenting creditors are able to 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 within, insolvency proceedings.

In tackling non-consenting shareholders, the Draft Act proposes to introduce shareholders as a new class of constituents within the insolvency plan proceedings (currently only creditors are included). If shareholders need to be treated differently due to the nature of their shareholding, the draft 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 voted against the implementation of the insolvency plan, this class could be crammed down if, in particular, the dissenting shareholders would not be put in a worse position than without the plan. According to the Draft Act, an insolvency plan could (i) allow for a debtor's business to be continued as a going concern, (ii) facilitate the conversion of creditor claims into equity (debt-to-equity swap), (iii) transfer shares to creditors, or (iv) permit the statutory capital to be reduced and subsequently increased by issuing new shares in order to absorb losses. The corresponding corporate action (capital decrease and increase etc.) would be deemed effective when the insolvency plan became legally binding. The Draft Act clearly states that a debt-to-equity swap may not be conducted against the will of the 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 Draft Act such remedies would only be allowed if (i) the claimant could show that the plan would put him in a materially worse position than he would be in without the plan and (ii) the claimant could not 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 would be obliged to approve the insolvency plan, and any dispute would need to be settled outside insolvency proceedings. Furthermore, 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 Draft Act that should expedite the insolvency plan proceedings is the inclusion of two provisions that oblige the insolvency court to schedule periods of no longer than two weeks for (i) the court to review and reject the insolvency plan for obvious flaws, and (ii) various parties involved to review the plan. Furthermore, communication with creditors that are to participate in the debt-to-equity swap will be streamlined insofar as such creditors must expressly object to such a swap if they want to refuse the offer of a shareholding as laid out in the insolvency plan.

In German 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, the creditors take advantage of the restructuring privilege granted to creditors that take equity with the aim of restructuring the company. This is evidenced mostly by way of a workout opinion (*Sanierungsgutachten*), which takes more time and money than an internal business review. According to the reasoning of the Draft Act, creditors should be able to rely on the so-called "restructuring privilege" in the context of a debt-to-equity swap. However, it would be advisable to insert a clear statement to this effect in the Draft Act in order to avoid any legal uncertainty on this point.

One further important relaxation of the current rules is the proposal to modify the obligation that the insolvency administrator (*Insolvenzverwalter*) has to satisfy all undisputed preferential claims (*Masseansprüche*) – due or not yet due – before the insolvency plan is implemented. This current obligation ties up a lot of liquidity and, in practice, leads to many plans not succeeding. In the 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 only have to be safeguarded by a robust liquidity calculation.

As a final point, the assertion of creditor claims at the eleventh hour in insolvency proceedings can often threaten the implementation of insolvency plan proceedings. Therefore, the Draft Act provides the option to suspend or to 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 within the insolvency proceedings prior to the voting on the insolvency plan. These claims become time-barred within one year of the implementation of the plan at the latest.

Strengthening Self-Administration

In most of the cases where insolvency proceedings are initiated, the court appoints a (preliminary) insolvency administrator. Typically, the management remains in place but any important decisions require the consent of the preliminary insolvency administrator. Upon the opening of insolvency proceedings, the – then appointed – administrator replaces the management and takes control of all affairs of the company.

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

However, insolvency courts have shown a considerable reluctance to order self-administration in German insolvency proceedings. The Draft Act aims to strengthen self-administration by limiting the ability of the insolvency court to refuse to order self-administration. At present, a court will only permit self-administration if it is convinced that the procedure will not be deferred or will not otherwise adversely affect the 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 will possibly negatively affect the creditors' position.

Furthermore, where a debtor files for insolvency on the basis of impending illiquidity (*drohende Zahlungsunfähigkeit*) and applies for self-administration, the insolvency court will be obliged to indicate to the debtor whether it intends to refuse its application for self-administration. This will give the debtor who voluntarily filed for insolvency (there is no obligation to file for insolvency in case of only impending illiquidity) 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 gain decisive influence on the court's decision as to whether to proceed with self-administration. Comparable to the proposed new regulations concerning the choice of the insolvency administrator, the preliminary creditors' 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 preliminary creditors' committee supports the petition, generally the court cannot refuse to order self-administration on the grounds that it would adversely affect the creditors. In addition, the preliminary creditors' 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.

Introduction of a Pre-insolvency Restructuring Proceedings

A further incentive to initiate restructuring proceedings at an early stage provided for in the Draft Act is the introduction of so-called pre-insolvency restructuring proceedings for the period between the petition for and the actual opening of the insolvency proceedings. If a debtor files a petition to initiate insolvency proceedings on the grounds of imminent illiquidity (*drohende Zahlungsunfähigkeit*) or over-indebtedness (*Überschuldung*) and also applies for self-administration (*Eigenverwaltung*), the insolvency court can grant the debtor a period of time, not exceeding three months, in which the debtor has to work out the details of an insolvency plan. The envisaged advantages of these proceedings are obvious: Being protected from its creditors, the debtor will have enough capacity and time to develop and lay out 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 only supervise the debtor, which will provide a further incentive to debtors to file for insolvency proceedings at an early stage. According to the Draft Act, the court will only be able to revoke its decision to initiate restructuring proceedings before the expiration of the period initially set by the court if the debtor becomes illiquid (z*ahlungsunfähig*), the envisaged restructuring measures become unachievable or if the preliminary creditors' committee has demanded a 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 such 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.

Centralisation of the Competent Insolvency Courts

The Draft Act has maintained the provisions centralising the jurisdiction of the competent insolvency courts. Only one insolvency court per district court circuit (*Landgerichtsbezirk*) will be competent for all company insolvencies within this circuit. The intention behind the proposal is to concentrate the know-how at a single court and to ensure that the competent judges and judicial officers gather the experience they need to supervise complex company insolvencies. This idea has been very well received by insolvency professionals.