INSOLVENCY & RESTRUCTURING - GERMANY

Guidelines for creditors participating in financial restructurings

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Introduction

Case law has consistently set out the terms on which the refinancing or financial restructuring of a distressed company can take place in order to avoid lender liability and prevent the clawback of payments made under the finance agreements. The Federal Court of Justice has now provided more detail with respect to the requirements of a restructuring concept and has outlined certain guidelines and rules of conduct which creditors should observe in the context of financial restructurings.

According to German insolvency law, knowledge of a financial crisis or impending illiquidity is an indicator of a company's intention to prejudice its creditors. The same test applies to creditors having such knowledge. Settled Federal Court of Justice case law provides that the significance of such an indicator can be eliminated if the transaction forms part of a serious restructuring attempt, even if the restructuring attempt subsequently fails.

Federal Court of Justice decision

The Federal Court of Justice has now summarised what is meant by a serious restructuring attempt. This concept has been developed by the court over recent years and has determined the actions that financial creditors should take to avoid lender liability and clawback risks, as follows:

- Conclusiveness – the restructuring concept must be based on a fully developed restructuring plan, taking into account the factual circumstances of the relevant case (ie, the financial situation of the company, its liabilities, the different creditor groups, the restructuring measures and further circumstances which may be of particular relevance for the respective business).
- Likelihood of success – there must be a realistic prospect of the restructuring plan being successful. The mere hope of a successful restructuring provides no grounds for rebutting the presumption of intent to prejudice creditors. Creditors must pay careful attention if the company's efforts do not go beyond developing plans and discussing possibilities for economic support. The restructuring need not be absolutely certain, but the court requires a sound evidential basis that there is a good chance for its implementation.
- Judgement on sustainable restructuring – the restructuring plan must provide that the company will be restructured on a sustainable basis. A company incurring constant losses would, for example, not benefit from a restructuring agreement by merely reducing the current debt.
- Experienced judgement from an independent expert – an impartial expert (having knowledge of the relevant industry sector) and who has available all the necessary information must consider the factual circumstances and exercise his or her judgement on the feasibility and likelihood of success of the proposed restructuring. Such judgement requires the analysis of losses and the options available to avoid further losses in the future and an assessment of the company's future profitability and the measures required to avoid or remedy the (impending)

factual insolvency. However, the court has also held that the creditor is not obliged to:

- have the restructuring plan reviewed by its own professional experts;
- arrange for examinations and investigations on the restructuring plan's prospects of success; or
- have these done by other experts.

As long as there are no indications that the creditor's expert has been misled or that the restructuring plan simply has no prospect of success, creditors may rely on the statements made by the company or its restructuring consultants.

- IDWS6 is not absolutely mandatory – the German Institute of Auditors has set the minimum requirements for restructuring plans (IDWS6) in order to evidence a positive prognosis for a successful restructuring. IDWS6 may be helpful, but it is not strictly necessary from a legal perspective to adhere to the standard. A 'simple' restructuring plan that deals with the assets, profit and financial situation is sufficient.
- Implementation has started – the company has started to implement the restructuring concept.
- Definition of 'participating creditor groups' – a fully developed restructuring plan does not need to include all the creditors of the respective company. A restructuring plan may also succeed if the required support is granted by a certain group of creditors (eg, financial creditors providing fresh money or taking a 'haircut'). It is not a precondition for a successful restructuring to obtain support from each member of the creditors which are parties to the restructuring, the required quota depends on the circumstances of the individual case (eg, the required majority under a finance agreement).
- Burden of proof – a creditor which is aware of a financial crisis and any impending illiquidity has the burden of proof and must be able to demonstrate the above requirements if challenged. The prerequisites are not as high as those applying to the company and its managing directors, but creditors are obliged to describe and prove actual circumstances indicating that they were obviously unaware of the factors negating a successful restructuring.

Guidelines

Based on the above requirements, as outlined by the court, creditors participating in financial restructurings should consider the following approach:

- Creditors should, in their own interest, insist on being provided with the required information before entering into a restructuring agreement. This information allows them to form a qualified view of the feasibility of the restructuring. Creditors can generally rely on the information made available by the company, to the extent that such information is conclusive. A creditor may not have a contractual right to request such information and the company is from a legal point of view not obliged to provide such information to the creditor. However, the company will most likely be prepared to disclose such information as is required to get the necessary support to achieve a successful restructuring.
- The restructuring plan should provide sufficient information on the following items:
  - the types and volume of the existing liabilities;
  - the types and numbers of the existing creditors; and
  - the proportion of claims that must be discharged as part of a successful restructuring.

  If there is a risk that not all creditors will consent to the plan, it must be determined which creditors must give their consent in order to meet the required voting thresholds in the respective groups. The restructuring plan should further outline the treatment of non-consenting creditors. Further, the restructuring plan should provide details on the amount of fresh capital which will be provided as well as the security for the new money.

- Special attention must be paid in cases where a restructuring plan only reduces the present level of debt. A sustainable restructuring also requires the business to continue as a going concern and to generate future profits. If further financing will be required to compensate future losses, the courts may assume knowledge that creditors will not be satisfied in future. This translates into knowledge of the intention to prejudice creditors, which is the most important criteria for insolvency clawback and lender liability claims. This does not mean that

restructuring plans may not continue, but the creditors may be exposed to risks of such claims if there is no successful implementation. Creditors are required to assess the prospects of success: the restructuring plans must be comprehensible and realistic. The restructuring plan should finally give rise to the expectation that it is suitable to put the company on a robust financial basis.

- In cases where the financial crisis is based not only on payment defaults, but also on permanent inefficiencies of the business, the restructuring plan must also provide a description of at least the basics of a broader operational restructuring. This requires a detailed description of the financial or economic reasons which have caused the crisis.

In general. the guidelines are good news for creditors involved in restructurings. They set out clearly the basis on which creditors can participate in a restructuring without fear of their involvement being challenged at a later date.

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