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Projected Reform of German Insolvency Law *Recapitalization Instead of Liquidation of Companies*

By Constantin Conrads

A large number of U.S. companies have investments in German entities, whether they be in the form of wholly owned subsidiaries, joint ventures etc. Should one of these German companies face a severe financial crisis, the U.S. shareholder must deal with German insolvency laws and procedures concerning its German subsidiary.

German insolvency law has met with criticism in the past, particularly during the economic crisis since 2008. The main criticisms include:

- The duration of insolvency proceedings.
- The lack of influence on the appointment of insolvency administrators, in particular with the consequence of losing control over the company with the commencement of insolvency proceedings.
- The impossibility of expedient debt-to-equity swaps without a cooperation of the existing shareholders.
- The impossibility of pre-packaged or pre-negotiated bankruptcy proceedings similar to those in the U.S., the latter of which seems to be a clear trend in the U.S. This procedure enables companies in a financial crisis to reorganize and recapitalize the company as quickly as possible and its implementation, in connection with German insolvency proceedings, would presumably be welcomed by U.S. shareholders.

Background

In February 2011, the German Federal Government issued a draft bill to facilitate the recapitalization of companies facing insolvency. The draft bill aims to focus on the recapitalization of insolvent but "survivable" companies instead of their liquidation, particularly in order to save jobs. In short, both the debtor and the creditors will be

involved in the selection of the insolvency administrator, to a greater extent, by extending the possibility to recapitalize the company through the setting-up of an insolvency plan and by reducing potential conflicts between the parties involved.

The draft bill, issued by the German Federal Government, proposes the following key changes.

Strengthening the Influence Of the Creditors

The influence of the creditors of a company facing insolvency on the selection of the insolvency administrator shall be strengthened. The court would then be obliged to implement a preliminary board of creditors ("*Gläubigerausschuss*") during the opening proceedings if certain preconditions are met. The insolvency court may only deviate from a person proposed unanimously by a preliminary board of creditors as a prospective insolvency administrator, if the suggested person is not qualified to assume the position as insolvency administrator.

If the board of creditors applies for debtor-in-possession in the course of insolvency proceedings, the court shall order such debtor-in-possession if the debtor agrees. The main reason for this proposal by the German Federal Government is that the insolvency Courts themselves only make use of this alternative on very rare occasions and it is seen as an efficient alternative to (regular) insolvency proceedings.

Debt-to-Equity Swap

Pursuant to the current provisions of the German Insolvency Act, the rights of the existing shareholders of a (insolvent) company remain unaffected by a recapitalization of the company, in connection with an insolvency plan in principle. Thus, for example, expedient debt-to-equity swaps in order to recapitalize a (insolvent) company are not possible without the cooperation of the existing shareholders.

This separation of insolvency law and corporate law shall be abandoned: According to the draft bill, an insolvency plan may provide for a debt-to-equity swap as a tool to recapitalize a company in jeopardy. Thus, an existing over-indebtedness could be abolished by the elimination of respective liabilities, in connection with the debt-to-equity swap, and the liquidity of the company could be restored as the obligation to make interest payments and amortization would cease.

Potential resistance of existing shareholders, against debt-to-equity swaps, shall be avoided by implementing this corporate law instrument into an insolvency plan; upon legal effect of the confirmation of the insolvency plan by the insolvency court, the corporate actions (*e.g.*, capital decrease, capital increase, exclusion of subscription rights etc.) are deemed to be resolved.

Plan Impediments

The obstruction of the implementation of an insolvency plan for the recapitalizations of companies by blockade tactics of individuals shall be minimized. Thus, the draft bill provides for several measures in order to avoid delays in the effectiveness of insolvency plans by obstructive appeals against such plan. In this respect, the draft bill stipulates *inter alia* that the appellant will have to have utilized all procedural facilities before filing such appeal and that she/he would be fundamentally worse off after the implementation of such plan than without the plan.

Administration

So far, cases of insolvency proceedings administered by the management of the (insolvent) company ("debtor-in-possession") are rather uncommon. The draft bill provides for certain facilitations with respect to the preconditions for the order of debtor-in-possession. Also, the creditors shall be involved in the decision process at a very early stage, *i.e.*, prior to the commencement of insolvency proceedings. For example, if a preliminary board of creditors unanimously votes for a respective application by the debtor, the insolvency court may not dismiss such application as being detrimental to the creditors.

Protective Shield

As a further incentive for an early recapitalization, by using the (modified) means of the German Insolvency Act, the draft bill provides for the implementation of a so-called "protective shield," which is similar to the pre-packaged or pre-negotiated bankruptcy proceedings in the U.S. In the event of an imminent illiquidity ("*drohende Zahlungsunfähigkeit*") or over-indebtedness of a company, such company shall have the opportunity to elaborate an own recapitalization plan for a period of three months under the supervision of a trustee ("*Sachwalter*"), but without the risk of any enforcement measures during that period. This recapitalization plan eventually may be transformed into a respective insolvency plan. The main purpose of

this new stipulation is the avoidance of abusive actions by individual creditors during the term of the "protective shield" and to shorten the duration of the insolvency proceedings.

Effective Date

The First Reading ("*Erste Lesung*") of the draft bill in the German Bundestag took place on Feb. 23, 2011. It has then been forwarded to the committee of the Bundestag on the same day. The commencement of the act is envisaged for Jan. 1, 2012.

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