

December 2011 / Restructuring

Paradigm Shift in Restructuring Law – Act to further Simplify the Restructuring of Companies (“*Das Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*”/ESUG)

This Client Information concerns the government draft of the Act to further Simplify the Restructuring of Companies, changed by the parliamentary legal committee (“ESUG”). The German Federal Parliament (“Bundestag”) passed the ESUG on October 27, 2011, the German Federal Council (“Bundesrat”) has approved the Act on November 25, 2011. Thus, the regulations are able to come into effect at the beginning of 2012.

A. Outline of the Problem and the Goals of the ESUG

German insolvency law admittedly does not provide any suitable regulations for the restructuring of companies threatened with insolvency. The course of German insolvency proceedings is therefore unpredictable for both the creditor and the debtor, particularly as they cannot influence the choice of the insolvency administrator. The period of an insolvency plan procedure with the aim of restructuring a company is also incalculable. This is mostly due to the fact that individual creditors can substantially delay the effective date of the insolvency plan through legal remedies. The right of self-administration, however, has acquired almost no practical significance, since insolvency courts are quite reluctant to make use of this option.

A further disadvantage for restructurings is presented by the fact that the German Insolvency Act (“*Insolvenzordnung*”/InsO) does not permit debt-equity-swaps. Insolvency law does not affect the

rights of the shareholder of the insolvent company. German insolvency law is therefore considered by both debtors and investors to be hostile towards restructurings. Companies normally only file for insolvency if the debtor’s assets are completely used up and a restructuring is no longer possible.

The goal of the ESUG is therefore to facilitate the restructuring of companies. This is to be achieved mostly through the possibility of factoring in the shareholders in the insolvency plan so that a debt-equity-swap would also be possible (further information under B.I.). In addition, ESUG serves to strengthen self-administration (further information under B.II.) and introduce a so-called “restructuring shield” (“*Sanierungsschutzschirm*”) for the preparation of self-administrated restructurings (further information under B.III.). These planned changes to the InsO mean a paradigm shift in German insolvency law and shall therefore be presented in the following.

B. Planned Alterations

- I. **Possibility of a Debt-Equity-Swap in Insolvency Plan Proceedings**
1. **Overview of the Involvement of the Shareholders in an Insolvency Plan**

According to applicable German insolvency law, the rights of the shareholders cannot be affected in insolvency plan proceedings without their participation.

If the restructuring of a company contains a reorganization of the shareholder structure, the previous shareholders must participate in the corresponding decisions. In the past, this was only rarely achieved, since the original shareholders blocked a reorganization of the shareholder structure despite the worthlessness of their shares. In this event, only restructuring by transfer of assets remained an option for the restructuring, which was often not implementable.

The ESUG serves to solve this problem by permitting the inclusion of individuals in debtor companies with shareholding and membership rights, hence the shareholders of the debtor, in the insolvency plan. In particular, the possibility of the insolvency plan containing a debt-equity-swap is explicitly provided, since “the claims of creditors can be converted into shareholding and membership rights” by the insolvency plan. In addition, “a capital reduction or increase, contributions in kind and the exclusion of subscription rights” can be regulated in the insolvency plan. The debt-equity-swap is the combination of these measures.

2. Implementation of a Debt-Equity-Swap in Insolvency Plan Proceedings

a) Arrangements in the Insolvency Plan

The insolvency plan must regulate the details regarding the implementation of the debt-equity-swap. It must especially arrange for the encroachment upon the rights of the shareholders. If the insolvency plan does not stipulate anything with regard thereto, the shareholdings shall remain unaffected. In return, the shareholders do not have the possibility of taking action against their inclusion in the insolvency plan.

The insolvency plan must regulate which capital measures are to be taken. Normally, a capital reduction is conducted and then followed by a capital increase. The capital increase takes place via a contribution in kind, whereby the claims are brought against the insolvent company. The plan must regulate the value with which the claims are to be set and which creditor shall acquire the newly created shareholdings. If the subscription right of the previous shareholders is excluded, this must also be included in the plan.

The arrangement of these measures in the insolvency plan modifies the implementation of the measures via the utilization of company law. Shareholder resolutions for the capital measures are not

required, since the resolutions of the shareholders for capital reductions or increases (which are to be notarized) as well as summons, notices and other measures taken for the preparation of these resolutions are effective along with the insolvency plan confirmed by a court. The declaration of the takeover of GmbH (limited liability company) shareholdings (which must at least be notarized) or the subscription form for the subscription to new shares is also covered.

b) Resolutions of Creditors and Shareholders

The creditors and shareholders must then approve the insolvency plan. Since the shareholders are involved in the debt-equity-swap in the plan, they also have voting rights. The approval of the measures takes place via the approval of the insolvency plan.

The approval of the shareholders takes place in accordance with the majorities which have already applied previously. However, the conversion of a creditor's claim without the approval of the affected creditor is impermissible, since creditors cannot be pushed into a shareholder position against their will. In addition, the approval of the creditors shall be considered to have taken place with the required majority if the requirements have been met thus far.

The shareholders must also approve the insolvency plan. In this regard, they constitute their own group, whereby shareholders with insignificant shareholdings can also build their own group. This serves to take into account the various interests of the main shareholders with entrepreneurial influence and the shareholders without influence, especially in listed incorporated companies. The voting rights of the shareholders shall solely be determined in accordance with their shareholding in the capital of the debtor. Limitations to the voting rights, special voting rights and multiple voting rights are impermissible. Preferential shareholders or shareholders with shareholding without voting rights therefore have voting rights in this event. If the shareholders do not approve with the necessary majorities, this shall also be considered to be provided if no creditor receives economic values exceeding the full amount of its entitlement and no shareholder that would be equal to the shareholders of the same group without the plan would therefore be better positioned as the other shareholders of the group. Therefore, all shareholders must be treated equally in the insolvency plan. Restructuring contributions of individual shareholders, e.g. majority shareholders, may not be taken into consideration in this process. As a result, the

approval of the shareholders can be replaced and a debt-equity-swap can be implemented against their will, since it is hardly imaginable that shareholders could be positioned in a better manner under the assumption that the shareholdings in the company are economically worthless in insolvency. If the shareholders are not involved in the voting process, their approval shall also be considered to be granted.

c) Confirmation of the Insolvency Plan

After the approval of the insolvency plan by the creditors and shareholders, the plan is confirmed by the insolvency court.

At the request of a creditor or a shareholder, the confirmation is to be denied if the requestor objected to the plan and would likely be disadvantageously positioned by the plan in comparison to its position without the plan. This constitutes an expansion of the minority protection to the shareholders of the debtor included in the plan.

d) Legal Consequences

If the insolvency plan becomes legally binding, the effects determined for and against all involved parties take place. Therefore, the resolutions for capital reduction (if planned) and capital increase apply and declarations of the creditor for the takeover of new shareholdings are considered to be provided. The newly created shares in the debtor are provided and belong to the respective acquiring creditor. The adoption of a new shareholder list in the commercial register, for a limited liability company, or the registration of a new shareholder in the share register of an incorporated company with registered shares, is not a requirement for the acquisition of the newly created shares. Such action must be taken nevertheless. The contribution agreement regarding the transfer of the claims is also considered to be concluded. The claims are transferred to the company and expire, since debtor and creditor become one. Furthermore, the ESUG states that agreements with the participation of the debtor cannot be terminated due to the debt-equity-swap; the corresponding change-of-control clauses are not effective.

With regard to the submission of the claims, after the confirmation of the insolvency plan, the company cannot assert any claims due to an overvaluation of the claims in the plan against the previous creditors and new shareholders. The debtor is therefore not entitled to any differential liability outside of the in-

solveny plan proceedings vis-à-vis the new shareholders if the claim is submitted at a higher value. Although the ESUG does not mention the recoverability and evaluation of the claim to be submitted, the legislator assumes that the claim is to be set at its true value at the time of the submission. This value is to be included in the insolvency plan and, if necessary, documented in a report. It is simultaneously assumed that the true value shall be significantly lower than the nominal value due to the insolvency of the debtor. If the insolvency over-evaluates the claim, this is to be reprimanded by the shareholders within the framework of the insolvency plan proceedings. Following thereafter, it shall no longer be possible to assert the right of subsequent payment against the new shareholders.

This mechanism substantially limits the capital maintenance rules for the protection of the creditor, especially when considering the fact that the creditor is subject to a ten-year differential liability outside of the insolvency for contributions in kind.

II. Strengthening of Self-Administration

1. Simplification of the Requirements

A further goal of the insolvency law reform is the simplified choice of self-administration by the debtor, by which the management of the debtor maintains control of the company. The debtor can now also apply for self-administration when applying for the initiation of the insolvency proceedings. The application for self-administration may only be denied by the insolvency court if there are reasons to believe that the self-administration would result in disadvantages for the creditor. Uncertainties about possible disadvantages for the creditors are therefore no longer at the expense of the debtor.

The involvement of the creditors now only takes place in the hearing of the provisional committee of creditors. If a provisional committee of creditors is appointed, a hearing thereof is to take place unless this would obviously lead to a disadvantageous change of the debtor's financial situation. If the provisional committee of creditors has advocated the proposal in a unanimous decision, the arrangement shall not be considered disadvantageous for the creditor. In this event, the insolvency court is to allow the debtor's request for self-administration. If no unanimous decision is made, the court may only reject the request if actual concrete conditions are known that demonstrate that self-administration would result in disadvantages for the creditor. In the

event that a provisional committee of creditors is not appointed, however, the law does not provide for an involvement of the creditors.

In addition, even the end of the self-administration should be hampered for the operation of individual creditors. The arrangement of self-administration can therefore only be abolished based on the request of the creditors' meeting if it approves with the majority of the claim amounts and the creditors. Individual creditors only have individual rights to make proposals if the respective creditor asserts that it is threatened by a severe detriment if the self-administration is continued.

As a result, the influence of the creditors on the arrangement of self-administration is reduced, since the rejections by individual creditors can no longer directly influence the arrangement or end of self-administration. However, it remains to be seen whether these legal interventions promote restructurings through self-administration. The courts will surely only fulfill requests for self-administration if the responsibilities are also shared with the creditors.

2. Appointment of a Provisional Trustee

In order to secure the advantages of self-administration, the court should avoid appointing a strong insolvency administrator in the opening procedure if the debtor's request for self-administration is not obviously hopeless. Instead, a provisional trustee should be appointed. The debtor should not lose the control of its company in the opening procedure due to prohibitions of transfers or corresponding limitations, since this could in turn threaten the trust of the business associates in the company management and as well as its restructuring concept.

3. Self-Administration in the Event of Impending Insolvency

If the debtor proposes self-administration in the event of impending insolvency, it can withdraw this proposal if the court does not consider the requirements for the arrangement of self-administration to have been met. The court must indicate this to the debtor so that it can avoid the danger of the opening of an ordinary insolvency procedure. This shall not apply, however, if, at the time of the court's decision, the elements of over-indebtedness or insolvency already exist. In this event, the court is required to initiate the proceedings.

III. Introduction of a Restructuring Shield

A further important development of the ESUG is the introduction of a so-called "restructuring shield" ("*Sanierungsschutzschirm*"). In accordance therewith, the debtor, the insolvency or over-indebtedness of which is impending, can request that the court provide it a period of a maximum of three months for the presentation of an insolvency plan. This serves to provide the debtor with the opportunity to restructure itself or at least to prepare its own restructuring concept by presenting an insolvency plan.

The requirement for such a proposal is that the debtor has applied for the initiation of an insolvency procedure as well as self-administration. Furthermore, it is required that the targeted restructuring is not obviously hopeless. The debtor must present a founded statement from an individual experienced in insolvency matters stating that the debtor truly is threatened with insolvency or over-indebtedness, but insolvency has not yet taken place and restructuring does not seem to be obviously hopeless. This does not create any insurmountable hurdles for the debtor in practice, especially considering that no comprehensive restructuring reports must be turned in. However, the debtor must keep in mind that obtaining such a qualified statement will cost time.

If the requirements have been met, the court shall order self-administration and demand that the debtor present an insolvency plan within the set period. During this period, the debtor is subject to the supervision of a provisional trustee, but can incur debts of the insolvency assets if the court grants the corresponding permit upon the request of the debtor. Additionally, the court can make further arrangements for the protection of the debtor, in particular by preliminarily prohibiting enforcement measures concerning its assets. If the debtor makes a corresponding proposal, the court is even obligated to make such arrangements. The court can also arrange for items that could actually be sorted out or exploited in the insolvency proceedings to be removed from the access of the creditor and partially be used for the continuation of the company.

The self-administration is to be cancelled prior to the end of the period if the targeted restructuring has become hopeless, or the provisional committee of creditors or – if this does not exist – a creditor with the right to separate satisfaction or creditor of the insolvency proceedings applies for this. However, the latter must credibly demonstrate that the self-

administration has led to disadvantages of the creditors.

If the debtor becomes insolvent prior to the end of the period, this does not necessarily result in the cancellation of self-administration. Lenders and important suppliers therefore may not terminate the shield proceedings by rescinding credit lines or terminating loans or insisting prepayment or shortened payment periods. The event of insolvency is to be presented to the court, however, in order to ensure the necessary supervision of the debtor. After the end of the period, the court must decide on the initiation of the insolvency proceedings. The debtor is thereby able to prepare a restructuring through its own insolvency plan by way of shield proceedings ("pre-packaged plan"). This provides the debtor with the possibility of restructuring its commitments – similar to the English "Scheme of Arrangement" – via the shield proceedings and a subsequent insolvency plan procedure.

C. Conclusion and Outlook

With the coming into effect of the ESUG's regulations, companies and their creditors are provided more leeway for approaching and implementing restructurings with legal certainty. It remains to be seen whether this actually takes place, especially considering the fact that the fiscal regulations generally considered to be hostile towards restructuring, such as the principle taxation of yields due to termination of commitments of the company or the (proportionate) abolishment of losses carried forward with the acquisition of at least 25% of the shares, shall remain in effect for the time being.

Therefore, one must wait and see whether the ESUG actually does simplify company restructurings or if the legal regulations influence out-of-court restructurings. When considering a debt-equity-swap in insolvency proceedings against their will, the shareholders of a company will most likely be more willing to cooperate in restructurings in the future in the event of a company crisis.

This publication merely serves as a basis for discussion and is no substitute for legal advice. We would be pleased to provide you with additional information or to render advice with regard to a specific situation.

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