Proposed reform of the Insolvency Code creates a favourable environment for turnaround investments in Germany

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Author page »

Recently the German Federal Government introduced a reform of the German Insolvency Code by adopting a draft bill of an Act to Further Facilitate the Restructuring of Businesses (the "Bill"). The Bill primarily focuses on the facilitation of insolvency plans as a tool for restructurings and to eliminate certain obstacles of the German insolvency law. If enacted as proposed, the Bill would simplify the purchase of shares of an insolvent company and would give investors more influence and flexibility in in-solvency plan proceedings.

INSOLVENCY PLANS

So called insolvency plans are a tool for restructurings of insolvent companies. Such plans are comparable to the Chapter 11 proceedings under U.S. bankruptcy law. An insolvency plan proceeding is initiated by the insolvency administrator upon the credi-tors' request or by the debtor and requires the confirmation by the insolvency court. At present such insolvency plans have only very limited practical importance. One shortcoming is that insolvency plan proceedings under the current law do not provide for the substitution of shareholders' rights.

Moreover, the existing shareholders of an insolvent company cannot be forced to transfer their shares or to consent to restructuring measures. Therefore, sharehold-ers have various ways of obstructing or delaying restructurings. Under the current law the main alternative to an insolvency plan proceeding is to transfer the entire or part of the insolvent business by way of an asset deal to a new legal entity, a trustee, or directly to an investor. However, an asset deal may have certain disadvantages, if substantial corporate assets cannot be transferred, such as telecommunications licenses or certain public permits. Also contracts with third parties need the consent of the respective third party to be transferred. Moreover, the transfer of patents is generally expensive and time consuming.

The Bill stipulates that shareholders' rights can be included in the insolvency plan, which fundamentally deviates from current law. Under the Bill any regulation permissi-ble under German corporate law can be stipulated as part of the insolvency plan, such as the consent to the continuation of the company as a going concern, any capital measure (e.g. capital increase for cash or contributions in-kind, debt-to-equity swap) including the exclusion of pre-emptive rights, or the transfer of the insolvent companies shares to a third party.

If shareholder rights are included in the insolvency plan, the shareholders are involved in the insolvency proceedings as a group. The shareholders then exercise their rights as a group by voting on the approval of the insolvency plan. Such approval requires a simple majority of the represented share capital. If such approval is denied, the so called prohibition-of-obstruction principle applies for the group of shareholders – just as for the groups of creditors under current law. Accordingly, the approval of a group is deemed to be given if (i) the members of the group will likely not be treated less favourably by the insolvency plan than they would without the insolvency plan (ii) the members of the group will have sufficient participation in the economic value, which should be assigned to the participants on the basis of the plan and (iii) the majority of the groups of creditors and shareholders voting on the plan approved the plan.

The Bill also increases the transaction security for the implementation of a debt-to equity swap by excluding the risk of a differential liability as it currently exists under German law, if creditors contribute their claims against the company by way of a capital increase through contribution in-kind for newly issued shares.

SELF-ADMINISTRATION

Until now, self-administration – comparable to the debtor-in-possession under Chap-ter 11 U.S. bankruptcy law – has remained the exception rather than the rule under German insolvency law. The Bill eases the access to self-administration insolvency significantly. The debtors' application for self-administration can only be rejected by the insolvency court, if there are grounds to believe that the self-administration may lead to disadvantages for the creditors. Further, the insolvency court would have to state the reasons for a rejection in writing.

SELECTION OF THE INSOLVENCY ADMINISTRATOR

If the debtor does not apply for self-administration, the appointment of the insolvency administrator is one of the most important decisions for the insolvency proceedings. At present, creditors have almost no influence on the appointment of the insolvency administrator by the court. Many insolvency courts would reject a proposal made by the creditors or the company. The Bill provides that a proposal unanimously agreed on by the preliminary-creditors-committee will be binding for the court. The insolvency court can reject such proposal, only if the proposed person is not suitable to hold office as insolvency administrator.

PERSPECTIVE

The Bill still must pass the German Parliament and may be subject to changes. However, as yet the Bill has received broad political support, so that it may become law within the next months. If enacted as proposed, the Bill would create a favourable envi-ronment for turnaround investments in Germany.

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