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# **German Insolvency Process - a Paradigm Shift towards a Rescue Culture ?**

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# Recent Changes in the German Insolvency Culture

## Recent Legislative Changes

- **German Financial Market Stabilization Act** (*Finanzmarkstabilisierungsgesetz, FMStG*):
  - the over-indebtedness rule (*Überschuldung*) of the German Insolvency Act (*Insolvenzordnung, InsO*) has been temporarily modified (until 31 December 2010);
  - as a result, managing directors no longer have to file for insolvency within three weeks when their company is balance-sheet insolvent (i.e. when the liabilities exceed the assets) if the continuation of the company as a going concern is more likely than not.
- **German Act on the Modernization of the German Limited Liability Company Act and the Prevention of Misuse** (*Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen, MoMiG*):
  - the court rules on equity-replacing loans (*Eigenkapitalersatz*) and other shareholder loans are no longer applicable;
  - as a result, shareholder financing structures are simplified:
    - shareholder loans are subordinated by law in an insolvency,
    - payments made to shareholders on such a loan within one year prior to filing for insolvency can be contested and reclaimed.

## Recent Substantive Changes

- **Increased use of the Insolvency Process**
- **Use of EC Council Regulation on Insolvency Proceedings** (amongst others, in the cases of PIN and Edscha);
- Insolvency used as an **accepted tool to affect a reorganization**, at least as a contingency;
- German administration for **group companies (EDSCHA)**;
- Internal **forum shopping** in Germany (Karstadt Quelle, PIN Group);
- Insolvency administrators as **CROs** (*Generalbevollmächtigte*).

## Recent Cases: Arcandor / Karstadt

- **Very positive statements of leading politicians:**
  - **Karl-Theodor zu Guttenberg:** "An insolvency [is] not the end, but can lay the **groundwork for a successful new beginning.**" (*"Eine Insolvenz [ist] jetzt nicht das Ende aller Dinge, sondern kann den Boden für einen erfolgreichen Neuanfang bereiten."*, bild.de, 10 June 2009).
  - **Angela Merkel:** Filing for insolvency protection can be the **opportunity** to put a company "on new feet" and "offer **new perspectives.**" (*Ein Insolvenzantrag kann die Möglichkeit sein, ein Unternehmen "auf neue Füße zu stellen" und ihm "neue Perspektiven zu eröffnen."*, sueddeutsche.de, 9 June 2009).
- **Joint insolvency proceedings for all group companies:** irrespective of the seat of business of the companies, all filings have been made with the Local Court of Essen (*Amtsgericht Essen*) which appointed the same insolvency administrator for the proceedings of all companies.
- **Self-administration supported by Chief Restructuring Officer:** Arcandor aims at a restructuring as debtor in possession (*Eigenverwaltung*) and has appointed a restructuring expert as CRO (*Generalbevollmächtigter*).
- Insolvency court held **pre-insolvency hearing** (*Vorkonferenz, "Detmolder Modell"*): involvement of main creditors already before formally instituting insolvency proceedings.

# Summary of the German Insolvency Process

# When can Insolvency Proceedings be initiated?

There are three situations in which Insolvency Proceedings against a debtor can be initiated:

- **Over-indebtedness** (*Überschuldung*, "balance sheet insolvency")
  - that is, "(...) if the assets do not longer cover the liabilities,
  - unless the continuation of business under the circumstances is sufficiently likely“
  - "Sufficiently likely" means more than 50%
- **Illiquidity** (*Zahlungsunfähigkeit*, "cash flow insolvency")
  - that is, the company is currently unable to pay its due debts.
- **Impending illiquidity** (*drohende Zahlungsunfähigkeit*)
  - that is, the company is in a position where it is unable (or it seems likely that it will not be able) to pay its debts when they fall due in the future.

# Who may initiate the Proceedings?

- **Creditors**

- Any creditor if it can demonstrate that it has a due and payable claim against the debtor.
- Filings by creditors may only be based on illiquidity or over-indebtedness.

- **Debtor**

- The debtor itself may initiate proceedings for all three reasons (impending illiquidity, illiquidity and over-indebtedness).
- Directors must file for proceedings without undue delay, but at the latest within three weeks (“21 day rule”) after the company has become (i) cash flow or (ii) balance sheet insolvent.
- Failure to file may result in civil as well as criminal liability of the directors.

## Cash Flow Insolvency - Illiquidity

- The Company is **cash flow insolvent**, i.e. illiquid, **if unable to pay its debts due** (sec 17 German Insolvency Code, Insolvenzordnung, “**InsO**”).
- A minor liquidity gap ("*geringfügige Liquiditätslücke*") and a temporary illiquidity ("*Zahlungsstockung*") does not necessarily result in cash-flow insolvency.
- For practical purposes the German Federal Court has introduced a **10%-rule** establishing a presumption (BGHZ 163, 143):
  - Company is **not presumed illiquid**, if unable to pay less than 10% of his aggregate liabilities for a period of 3 weeks: unless shortfall will reach 10% or more at the end of the period or unless other facts contradict the presumption.
  - Company is **presumed illiquid**, if unable to pay 10% or more of its debts due for a period of 2-3 weeks: unless exceptional circumstances, e.g. with a probability reaching certainty the liquidity gap will be (at least almost) removed.
- **Daily cash flow forecast:** At any day at which the company will not be able to pay 10% or more (of its debts due at the end of a 2-3 weeks period) the company will be presumed illiquid although the assessment falls within the period of the initially positive forecast.

## Balance Sheet Insolvency - Over-Indebtedness

- **Balance sheet insolvency**, i.e. over-indebtedness (cp. sec.19 InsO), exists
    - once the liabilities exceed the assets,
    - unless there is a sufficient likelihood that the company can continue as a going concern,
  - **Going Concern Test:** Sufficient likelihood (more than 50%) that the financial means on a medium term basis are sufficient to continue with the business (i.e. to ensure cash flow solvency)
  - Directors should not be obliged to file where a turnaround is expected within the next few months.
  - Test has been introduced by a reform act (*Finanzmarktstabilisierungsgesetz*; "FMSTG") and will – so far – only be in force until 31 December 2010.
- => Company is balance sheet solvent if there is a positive going concern prognosis for the business even if the value of the assets (valued at going concern) is smaller than the face value of the liabilities.

# Course of Insolvency Proceedings in Germany

- **Preliminary Proceedings and Measures** (usually up to three months)
  - Appointment of preliminary administrator generally on the day of the petition.
  - Preliminary measures by the court to protect creditors' interests in the debtor's assets.
- **Main Insolvency Proceedings**
  - Formal opening of the main insolvency proceedings by the insolvency court.
  - Proceedings dominated by administrator.
  - Right to manage and dispose of assets passes automatically to the administrator.
  - Estate includes all assets of the debtor at the time of opening and all acquired during proceedings.
  - Power of administrator to claw back transactions undertaken up to three months prior to the petition, in particular cases even up to ten years depending on the available head of avoidance.

# Course of Insolvency Proceedings in Germany

- **Report Meeting** (*Berichtstermin*).
  - Usually around 6 weeks after the opening of the proceedings
  - Creditors' approval or refusal of court appointed administrator.
  - Presentation of statement of affairs, reason for failure and outcome of scenarios for reorganisation.
  - Creditors to decide whether to pursue liquidation or insolvency plan.
  
- **Verification Meeting** (*Prüfungstermin*): for proving claims.
  
- **Final Hearing** (*Schlussstermin*): for closing proceedings.

# Restructuring in Insolvency Proceedings

- **Debtor in Possession (*Eigenverwaltung*, self-administration)**
  - Court may leave the power of disposal with the debtor.
  - Management of assets and plan for reorganization under the supervision of a creditors' trustee.
  - Note: Courts reluctant to grant self-administration to companies that have filed for insolvency.
- **Insolvency Plan**
  - Insolvency Plan proceedings aim at a recovery plan along the lines of US Chapter 11 procedures.
  - To provide debtor and creditors with a solution to continue the business.
- **So-called "Transferred Restructuring" (*Übertragene Sanierung*)**
  - Assets of the insolvency estate to be transferred to a new corporate entity by way of an asset deal in order to ensure the continuation of the business.
  - e.g. if an insolvency plan can not be successfully implemented (due to time constraints or other reasons).

# Insolvency Plan

- Plan contains factual background and an explanation of how the legal position of the respective creditors is affected (even secured creditors).
- Acceptance by creditors requires:
  - majority of the creditors of each creditors' class and
  - aggregate of the claims of the consenting creditors which must exceed half the aggregate of the claims of the creditors voting in each class (see sec. 244 InsO).
- Non-consenting classes can be crammed down, see sec. 245 InsO.
- Plan needs to be approved by the Insolvency Court, see sec. 247.
- Note: Unfortunately, “old” equity has to approve any capital measures under corporate law which are often needed (e.g. debt equity swap).

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