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Game Change for German Restructurings

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On March 1, 2012, the "Act Concerning the Improvement of Restructurings under German Insolvency Law" (ESUG) will come into force and effect. The new act will substantially change the landscape for restructurings in Germany: (i) it will materially increase the creditors' influence, (ii) insolvency plan proceedings will be strengthened and shortened, (iii) the frequency of debtor-in-possession proceedings will dramatically rise, and (iv) debtors may want to use the new protective shield mechanism to prepare an insolvency plan. The new rules provided for and will result in new opportunities and risks for market participants. As a result, shareholders, managing directors, senior and junior lenders, agents, as well as servicers, should be well aware of the impact of the changes in order to be well positioned.

Executive Summary:

(i) *Substantial Increase of Creditors' Influence During Insolvency Proceedings*

The ESUG generally introduces the necessity of a preliminary creditors' committee provided that at least two of the following three criteria are met: (i) at least € 9,680,000 net revenues during the last 12 months prior to the opening of insolvency proceedings, (ii) at least € 4,840,000 total assets on the balance sheet, and (iii) at least 50 employees. One of the most important competencies of the preliminary creditors' committee is the right to recommend a preliminary insolvency administrator by way of unanimous decision, which is then binding for the insolvency court.

The new rights will change the behavior of insolvency administrators vis-à-vis the creditors in general since insolvency administrators will risk losing market share and "clients" unless they cooperate more closely with the creditors. It is very likely that creditors will team up in the future to exert their influence in the preliminary creditors' committee, and creditors may also want to take preparatory actions in order to be duly represented in such committees on a general basis.

(ii) *Strengthening of Insolvency Plan Proceedings*

Insolvency plan proceedings, by way of which participants of insolvency proceedings among other things, can agree upon restructurings of an insolvent company and will be strengthened (w) by including shareholders in the proceedings (as creditors) so that future plans can now affect their rights (up to losing this equity position), (x) by introducing debt-to-equity swaps in the Act according to which the debt side of an insolvent company can be restructured, (y) by introducing mechanisms which simplify corporate restructurings (e.g. the transfer of shares to creditors), and (z) by speeding up the process of insolvency plan proceedings in general.

Shareholders and junior creditors may want to pay special attention to the cram-down mechanism of German insolvency law. According to such mechanism, a voting group shall be deemed to have consented if the respective group shall be presumed to suffer no loss by the insolvency plan compared to a liquidation scenario of the insolvent entity (so out of money creditors are not assessed on a going-concern basis).

(iii) *Increase of Debtor-in-Possession Proceedings*

Debtor-in-possession proceedings shall principally permit the existing management of the company to remain in charge under the supervision of a (preliminary) trustee. The insolvency court shall approve applications for debtor-in-possession proceedings unless the court is aware of concrete circumstances according to which such proceedings would have a negative impact on the creditors. If the preliminary creditors' committee consents to such application, it is assumed by law that the debtor-in-possession proceedings do not adversely affect the creditors. Moreover, insolvency courts are not permitted to appoint a strong preliminary insolvency administrator (who could then make all important business decisions of an insolvent company) unless the debtor-in-possession proceedings are not obviously unsuccessful. Finally, the management has the right to withdraw a petition to open insolvency proceedings in case of over-indebtedness and imminent illiquidity if the insolvency court is not willing to grant debtor-in-possession proceedings. According to the Act, shareholders (as well as supervisory boards) shall not have any influence on the management during debtor-in-possession proceedings.

The new legislation will result in increased debtor-in-possession proceedings since the insolvency courts have much less discretion in rejecting respective applications. Debtor-in-possession proceedings in combination with insolvency plan proceedings should also rise in number (also against the background of (iv) below).

(iv) *Introduction of Protective Shield Mechanism*

The new protective shield mechanism allows the management of the company to prepare a (pre-packaged) insolvency plan during a period of up to three months if it applies to an insolvency plan (based on over-indebtedness or imminent illiquidity/not illiquidity) in combination with debtor-in-possession proceedings, provided that the success of the restructuring is not highly unlikely. The court is principally bound to the recommendation of the debtor regarding the person of the trustee. The protective shield will be lifted before the expiry of the deadline by the insolvency court if (i) it becomes evident that the restructuring will not be successful, and (ii) the preliminary creditors' committee applies for a respective repeal but not in cases of the company’s illiquidity.

During the duration of the protective shield, the insolvency court can furthermore prohibit compulsory enforcement measures as well as the enforcement of collateral regarding moveable assets.

(v) *Conclusion*

The new influence of creditors will change the process of insolvency proceedings in general. It can be estimated that the current and virtually absolute powers of the insolvency administrators will be cut back and that major creditors will have a more important role in the future. Such influence will also increase the transparency and the predictability of proceedings, since it is likely that insolvency administrators will, in the future, cooperate more closely with creditors and creditors' representatives. Major creditors, agents and servicers will seek to be represented in the preliminary creditors' committee and it is likely that certain creditor groups will team up to be in a position to appoint a favored insolvency administrator.

The quantum of insolvency plan proceedings should increase in order to restructure the debt side of companies struggling to find refinancing in the current market environment. Shareholders (and junior creditors) should be well aware about the cram-down mechanism and its potential implications, while senior lenders should benefit from the changes. All in all, insolvency plan proceedings may become a serious alternative to restructurings by way of an asset deal in debt-side restructurings.

Further to the implementation of this new Act, the number of debtor-in-possession proceedings (also in combination with the protective shield mechanism) will increase substantially and these proceedings will give the management of companies in trouble the possibility of restructuring without losing control, while their personal liability risk is mitigated. The new rules also increase the possibility of early restructurings.

As a final conclusion, each market participant should take the aforementioned changes into close consideration since the changes will inevitably imply risks and opportunities for each of them.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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