

# Germany's Insolvency Law Expected to Be Modernized in Reaction to the Financial Crisis

## Contributing Editor:

Adam Gallagher  
Freshfields Bruckhaus Deringer LLP  
London  
adam.gallagher@freshfields.com

**Editor's Note:** As with many other European countries, Germany has been reviewing both its restructuring and insolvency toolkit and its system of financial regulations. This has led to the presentation of two items of draft insolvency and restructuring legislation. One is by the German Ministry of Justice and the other by the German government. If implemented, the new legislation will considerably change the current restructuring regime in Germany and increase the existing restructuring instruments.

In this European Update, Wolf Harlfinger provides an overview of the legislative proposals. The German Ministry's draft proposals on corporate insolvencies and restructurings focus on (1) strengthening creditors' influence on insolvency practitioners' appointments, (2) expanding on the insolvency plan process, (3) simplifying access to the self-administration process and (4) strengthening the position of clearinghouses. By comparison, the German government's proposals are mainly responses to the recent financial crisis, with a view to providing tools for a restructuring of system-relevant financial institutions in a crisis to minimise negative impact on the stability of the financial system.

Despite Germany being one of the largest national economies, its insolvency law (and practice) is still very much focused on the best possible result for the creditors, thus lagging behind other jurisdictions in respect of state-of-the-art restructuring options. These deficiencies became particularly apparent in restructuring cases following the latest financial crisis.

Against this background, there are two separate legislative initiatives that may substantially expand available restructuring tools. In June 2010, the German Ministry of Justice presented the draft of a law for the further facilitation of the restructuring of companies (*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*) (hereinafter, "Law on Company Restructuring"). In August 2010, the German govern-

## About the Authors

Adam Gallagher is a partner at Freshfields Bruckhaus Deringer LLP in London, and Wolf Harlfinger is a senior associate in the firm's Cologne, Germany, office.



Adam Gallagher

ment presented the draft of a law on the restructuring and orderly wind-down of financial institutions, the establishment of a restructuring fund for financial institutions and the prolongation of the period of limitation regarding the liability of the organs of a stock corporation (*Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds*

## European Update

*für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung—Restrukturierungsgesetz*) (hereinafter, "Law on Bank Restructuring").

Both draft laws provide for significant changes to the existing German restructuring environment and a number of additional restructuring tools. If implemented, the German insolvency law will be brought more into line with internationally accepted restructuring principles, in particular the relevant provisions of chapter 11 of the U.S. Bankruptcy Code. This article provides an overview of and briefly comments on the relevant proposals.

### Law on Company Restructuring

The German Minister of Justice considers the reform of the German insolvency law as outlined in the Law on Company Restructuring as one of the most important projects of the current German government. The law aims to make Germany more attractive from an international restructuring perspec-

tive by facilitating the restructuring and continuation of viable companies. The draft law is based on the perception that the German insolvency law does not provide all of the necessary tools to implement a smooth and time-effective restructuring.

The official explanations to the Law on Company Restructuring expressly acknowledge that weaknesses of German insolvency law have prompted companies to (try to) move their center of main interest (COMI) to the U.K. for using the better-suited restructuring tools, such as schemes of arrangements. To the extent relevant in an international restructuring context, the main focus of the draft law is to (1) strengthen the creditors' influence on the choice of the person of the insolvency administrator, (2) expand and streamline the insolvency plan procedure, (3) simplify the access to the self-administration process and (4) strengthen the position of clearinghouses.

### Appointment of Insolvency Administrator

The paramount object of insolvency proceedings under the German Insolvency Code (*Insolvenzordnung*) is the satisfaction of the insolvent company's creditors. Against this background, the Law on Company Restructuring aims at further strengthening the creditors' positions in insolvency proceedings by considering their proposals when it comes to the choice of the insolvency administrator. Under the current version of the German Code, the choice of the insolvency administrator is at the sole discretion of a competent insolvency court. Subsequently, the creditors have the ability to vote on the replacement of the insolvency administrator in the first creditor assembly, but this possibility is used by the creditors, as such replacement would cause considerable frictions in the insolvency process and cost additional time and money.

The draft Law on Company Restructuring provides that in the future, the insolvency court will be obliged to hear the views of main creditors of the

*continued on page 93*

# European Update: Germany's Insolvency Laws Expected to Be Modernized

from page 28

insolvent company before appointing an insolvency administrator. In order to facilitate such a hearing prior to the appointment, a debtor will be obliged to provide the court with a list of the company's main creditors. The court will then consider the proposals of the creditors having regard to certain factors, such as particular restructuring expertise in a certain business or experience with insolvency plans or even the proposal for a specifically named administrator unless there are doubts as to the suitability of the administrator. A proposed insolvency administrator will, in particular, be unsuited if it cannot be guaranteed that he or she will act independently and in the interest of all creditors. If the insolvency court decides not to consider a certain proposal made by the creditors, it will be obliged to put the reasons for such decision in writing.

## Expansion of Insolvency Plan Procedure

A further objective of the draft Law on Company Restructuring is an expansion of the options of the insolvency plan procedure. Experience has shown that the restructuring of companies regularly requires an impairment of shareholder rights. Currently, the insolvency plan procedure under the German Code does not allow for an amendment of existing shareholder rights. Such amendment of shareholder rights is only feasible in accordance with the relevant provisions of corporate law (*i.e.*, any amendment of shareholder rights necessarily requires the consent of the relevant shareholders).

Such strict segregation of corporate and insolvency law shall be abolished. In the interest of facilitating restructuring options, an insolvency plan will authorize necessary corporate actions, in particular a debt-to-equity swap, even without the shareholders' consent. For this purpose, the shareholders will form a separate group in the voting process on the insolvency plan. The creditor cramdown procedure will apply accordingly in respect of obstructing shareholder votes. The approved insolvency plan will replace all corporate decisions (*e.g.*, on a capital reduction, a capital increase or an exclusion of subscription rights) that would normally be required under the relevant provisions of corporate law.

A further proposed amendment to the insolvency plan procedure intends to reduce the blocking potential of individual creditors against the approved insolvency plan. In the future, only material impairments of a creditor will qualify as a justification to take action against the approved insolvency plan. In addition, the implementation of the insolvency plan shall not be suspended by such creditor action if the insolvency plan provides for a compensation of creditors successfully claiming that the insolvency plan disproportionately impaired their rights.

## Expansion of Self-Administration Process

The self-administration procedure was included in the German Insolvency Code in 1999. Similar to the insolvency plan procedure, the self-administration provisions were tailored along the relevant debtor in possession provisions of chapter 11 of the U.S. Bankruptcy Code. In practice, the self-administration has been of minor relevance in Germany. However, in the cases where self-administration was approved by the insolvency court in recent years, the relevant restructuring processes went rather quickly and smoothly.

Against this background, the hurdles for access to a self-administration process will be lowered and the self-administration will be made more attractive for debtors. For this purpose, creditors will be involved in the decision-making process regarding the court's approval of self-administration as early as possible (*i.e.*, even prior to the actual commencement of insolvency proceedings). Furthermore, if a debtor files for the commencement of insolvency proceedings due to a threatening illiquidity (*i.e.*, at a time when no filing obligation exists) and at the same time applies for self-administration, the insolvency court will inform the debtor and its management of any concerns regarding the approval of the self-administration, thus giving the debtor's management the opportunity to withdraw the application for commencement of insolvency proceedings prior to proceedings having been opened.

## Strengthening of the Position of Clearinghouses

Finally, the draft Law on Company Restructuring aims at clarifying and strengthening the position of clearinghouses in an insolvency of one of

the participants in the clearing system. Under the current version of the German Insolvency Code, multi-party transactions with a clearinghouse as a central counterparty are not specifically stipulated. As a consequence, general insolvency principles apply to such multi-party transactions (*i.e.*, all non-due obligations become due, setoff restrictions exist and the insolvency administrator may cherry-pick which open transactions to fulfil). These general principles are not suited to properly unwinding transactions with a clearinghouse as a central counterparty; it may have severe impacts on other participants to the clearing system and may even destabilize the financial markets. The aforementioned deficiencies are considered a disadvantage for Germany as a financial centre towards competing markets in the U.S. and U.K.

Against this background, the Law on Company Restructuring contains specific provisions dealing with such multiparty transactions, and its approach is twofold. On the one hand, in the case of an insolvency of one of the participants of the clearing system, the client business of such a participant, including collateral, can be transferred to another solvent participant of the clearing system (even without the consent of the insolvency administrator of the insolvent party). Alternatively, if a transfer of the relevant business of the insolvent participant to another participant cannot be realized, the client business of the insolvent participant will be liquidated by way of closing trades in a market-sensitive way (without involvement of the insolvency administrator of the insolvent party).

## Law on Bank Restructuring

Even more than the draft Law on Company Restructuring, the draft Law on Bank Restructuring is an immediate response to the financial crisis and to the lessons learned during the financial crisis in bank restructuring cases. In particular, the case of *Hypo Real Estate*—in which former shareholders were threatened to be disappropriated based on a newly shaped law—showed that the German Insolvency Code, as well as the German Banking Act (*Kreditwesengesetz*), were not suited to deal with a severe crisis of a system-relevant financial institution.

*continued on page 94*

The draft Law on Bank Restructuring is providing tools for a restructuring of system-relevant financial institutions in a crisis, thus aiming at avoiding negative impacts on the stability of the financial system due to such crises. The ratio of the draft law is that the financial distress of a bank will primarily be rectified by its stakeholders (*i.e.*, in particular its shareholders and its creditors). An intervention by the German Federal Financial Supervisory Agency (*Bundesanstalt für Finanzdienstleistungsaufsicht*) will only be considered if the stakeholders failed to implement adequate restructuring measures and if the stability of the financial system would otherwise be put at risk. In the light of this approach, the Law on Bank Restructuring provides for two restructuring procedures, both of which can only be initiated by the financial institution itself with the purpose of self-dependent crisis management. Both procedures will provide a framework for a collective negotiated settlement.

## Recovery Procedure

On a first level, the draft law features a recovery procedure (*sanierungsverfahren*), which can be initiated by the management of a distressed bank far in advance of a potential insolvency. The recovery procedure shall be commenced by the management of the bank giving notice of its need for recovery *vis-à-vis* the German Federal Financial Supervisory Agency and by presenting a recovery plan, which will outline the measures proposed to recover the bank but may not contain any impairment of third-party rights. The recovery plan may, in particular, provide for new debt incurred by the bank under the plan to have priority over existing

debt. If the German Federal Financial Supervisory Agency considers such a plan to be suitable to recover the bank, it will present the plan to the competent higher regional court (*oberlandesgericht*) for approval.

## Restructuring Procedure

On a second level, the Law on Bank Restructuring provides for a restructuring procedure (*reorganisationsverfahren*) that would be initiated if the existence of the bank is endangered and if the collapse of the bank would severely impact the stability of the financial system. The restructuring procedure is shaped along the lines of the insolvency plan procedure under the German Insolvency Code (*i.e.*, creditors of the financial institution form different creditor groups that vote on the restructuring plan, including the possibility of a cramdown).

The restructuring plan may impair shareholder rights and may also provide for a debt-to-equity swap. Beyond this, the restructuring plan may also stipulate the spin-off of certain parts of the financial institution into an existing or a newly established affiliate. Both the process under the recovery procedure, as well as under the restructuring procedure will be supervised by an appointed recovery/restructuring officer, who would be responsible for the implementation of the recovery/restructuring plan.

## Intervention Rights of the German Federal Financial Supervisory Agency

If the stakeholders are not willing to stabilize the distressed financial institution or if the taken measures do not sufficiently allow for a recovery so that the stability of the financial system is (still) in danger,

the German Federal Financial Supervisory Agency has certain intervention rights under the German Banking Act, which will be widened under the Law on Bank Restructuring. Under the Law on Bank Restructuring, the German Federal Financial Supervisory Agency will be empowered to nominate a special representative who is assigned certain tasks, responsibilities and rights that the German Federal Financial Supervisory Agency considers to be necessary to recover the financial institution. In addition, the German Federal Financial Supervisory Agency will be endowed with the right to force a financial institution to transfer its business in whole or in part to another (public or private) bank.

## Establishment of a Restructuring Fund

The Law on Bank Restructuring further provides for the establishment of a restructuring fund for financial institutions that will be used to finance future restructurings or orderly wind-downs of system-relevant financial institutions. Contributions to the fund will be made by all financial institutions in Germany, whereas the scope of the contribution will depend on the individual systemic risk of the relevant bank.

## Prolongation of Limitation Periods

Ultimately, the Law on Bank Restructuring envisages a prolongation of the period of limitation regarding the liability of the organs of a stock corporation. Currently, the relevant period of limitation is five years, but can this be extended to 10 years to facilitate the assertion of liability claims if the existence of such claims only becomes known at a later stage or if such claims can, from a factual perspective, only be asserted once the relevant member of the organ has been replaced. ■