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CORPORATE RESTRUCTURING: THE BREAKING WAVE

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GERMANY: IN-COURT VERSUS OUT-OF-COURT RESTRUCTURINGS

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Arcandor, Qimonda and many more well-established German companies filed for insolvency within the past few months, as well as numerous global market leaders across a number of sectors. As with many, German companies are confronted with a fall in sales and revenues.

The reasons are manifold and not every distressed entity is a victim of the recent economic downturn. However, after the boom of leveraged buyouts and cheap money, many entities are carrying a significant debt burden that in the current economic situation is often no longer covered by the company's assets.

Companies have difficulties in honouring payment obligations or in complying with agreed financial covenants. As a consequence, management, lenders, noteholders, customers, suppliers, credit insurers, employees and shareholders of an increasing number of German companies are faced with the same set of questions:

Is management required to file for insolvency? Is it possible to avoid such filing, and how? Does a German insolvency ultimately lead to a liquidation of the company's business? Are there ways to reorganise the financial situation and operational business efficiently outside an insolvency? In general, what are the advantages and disadvantages for an in-court and out-of-court restructuring in Germany?

Reasons to file for insolvency in Germany

Under German insolvency law, a company with limited liability must file for insolvency if it is (i) illiquid (*zahlungsunfähig*) or (ii) over-indebted (*überschuldet*) and without a sufficient going concern perspective. The company may also file for insolvency if illiquidity is only imminent (*drohende Zahlungsunfähigkeit*).

These filing obligations, or in case of imminent illiquidity the filing right, apply to all legal entities with limited liability irrespective of their place and law of incorporation (e.g. a German limited liability company (GmbH), a German stock corporation (AG), a European company (SE) and a UK limited company (Ltd)), provided that such entities have their centre of main interest, i.e. their place of business and administration, in Germany.

Management has to file a petition for commencement of insolvency proceedings without undue delay after becoming aware of either an illiquidity or (in case of a lack of going concern perspective) over-indebtedness, but in any event not later than three weeks.

The statutory three-week period is a 'maximum period', which the managing directors may utilise only so long as efforts to achieve an out-of-court restructuring are made and have prospects of success. Any failure of management to adhere to the filing period constitutes a criminal offence and, in addition, exposes management to personal civil liability vis-à-vis creditors of the company.

Illiquidity arises if a company is no longer able to pay its matured debts. Generally, a company is deemed to be illiquid if it ceases to make payments. However, a mere unwillingness to make required payments does not suffice to constitute filing obligations if the company has enough cash available to pay the due debt.

Once occurred, illiquidity can be avoided, e.g. by execution of a standstill agreement prolonging the due date of the matured debts. If the necessary consent level (under many documents 100%) for a standstill of, say, interest payments cannot be achieved, lenders sometimes agree to a forbearance of their individual claims. While technically still due, this may enable management to no longer consider them for the purpose of determining illiquidity.

Because of the recent economic downturn, many companies are confronted with a situation where their balance sheet debts exceed the liquidation value of the company's assets and a specially drawn over-indebtedness balance sheet reveals that the company is over-indebted.

However, in order to prevent companies from filing for insolvency because of over-indebtedness, in October 2008 Germany enacted a new law permitting management not to file insolvency petitions if – in management's assessment based on the information and data available to it at that certain point in time – the company will more likely than not remain in business in the medium term (going-concern prognosis).[1]

As a result of this change of law, the over-indebtedness test has nowadays become a cashflow and liquidity analysis in order to conclude on a going-concern prognosis and thereby avoid insolvency filings.[2]

Common means to abolish a mere balance-sheet over-indebtedness are, among others, a contractual subordination of debt and issuance of comfort letters by parent companies (but with exclusion of non-recourse claims against the troubled company).

If no such instruments are available, the company has to seek for credible opportunities to re-establish a going-concern prognosis by finding new investors or the execution of documents guaranteeing the sustainable restructuring of the business until, at least, the end of the next business year.

This newly enacted German law preventing companies from insolvency filings because of over-indebtedness, provided that a going-concern prognosis exists, was originally only effective until the end of 2010. Unless the law was not changed to extend the applicability of this rule, from January 2011 onwards, companies would, notwithstanding a positive cashflow prognosis, have been obliged to file for insolvency if their balance sheet debts exceed the value of the company's assets.

The assets will be valued at their liquidation values unless there exists a going-concern prognosis – in which case the going-concern values will be relevant. In 2010, situations may occur in which management already foresees that the predicted debts for 2011 will exceed the companies' assets measured at, as applicable, liquidation or going-concern value and, as a consequence, would have created an obligation to file for insolvency in 2011.

It was an open question whether, in this situation, management in 2010 could nevertheless still conclude on a positive going-concern prognosis until the end of the next business year (e.g. if the business year is similar to the calendar year, December 2011) or whether management would already have to file for insolvency in 2010 if the debts exceed the company's assets and no measures to overcome the company's over-indebtedness would be available.

Given the criminal and civil law consequences for management personally, this uncertainty in application of German law could have led to an increase of insolvency filings already in 2010. Hence, in order to clarify the legal situation and avoid any uncertainty, Germany only very recently passed new legislation to the effect that this outlined law will be extended for a further three years, i.e. until the end of 2013.

Because of the extension of the existing German law, the currently existing facilitation of out-of-court restructurings and pre-packed insolvency plans in Germany will continue to apply.

In future, it should be considered whether or not over-indebtedness should be abolished entirely as a reason to file for insolvency, but at least the current (going-concern based) regime should be extended.

Restructuring of business in German insolvency

One primary goal of the German insolvency regime that has been in effect since 1999 has been to facilitate the restructuring of troubled businesses in the course of insolvency proceedings. Although the previous laws did not preclude reorganisations through insolvency, this rarely happened and in the vast majority of cases businesses were liquidated. In order to achieve more sustainable insolvency restructurings, the German legislator introduced new or improved existing legal instruments.

Following a filing for the opening of insolvency proceedings over the company's assets, the insolvency court orders the commencement of preliminary insolvency proceedings and, inter alia, appoints an interim insolvency administrator. For a period of up to three months, the federal employment agency advances salaries for the employees of the insolvent company (*Insolvenzausfallgeld*).

In the insolvency proceedings, the federal employment agency's recourse claim against the insolvency estate is neither secured nor preferred vis-à-vis other creditors. This enables the preliminary administrator to continue business operations without having to fund salaries.

In addition, German insolvency courts are ordering a comprehensive automatic stay for the period of the preliminary proceedings, to avoid that secured creditors enforce the security and thereby take away assets that are necessary for continuance of business operations. As a result, the opportunities to explore and find solutions for a restructuring of an ongoing business already in course of the preliminary proceedings have improved significantly.

Preliminary administrators, after having determined that the business could generally be restructured, very early, together with financial advisers, talk to all stakeholders and set up an M&A process to sell the business in whole or part to potential investors by way of both an asset deal, i.e. through the individual transfer of any item of property belonging to the company's business, and a share deal.

The sale of the company's business will be subject to creditors' approval, which usually does not raise problems if the insolvency administrator can prove that, for example, in cases where bidders were competing in an M&A process, the realised purchase price and terms and conditions of the sale constitute the best achievable offer.

After a so-called transferring reorganisation (*übertragende Sanierung*), the insolvent company remains in insolvency and will be liquidated with the proceeds from the sale of the business being distributed in course of the insolvency proceedings.

By the time of the opening of formal insolvency proceedings, the negotiations for a sale of the business are usually very advanced and, in most cases, the troubled business (but not the insolvent company) can exit the insolvency within a relatively short timeframe after the opening of insolvency proceedings.

Recent German examples for sales of businesses out of insolvency include TMD Friction Group, a worldwide operating automotive supplier with headquarters in Germany, which was sold to Pamplona Capital Management less than four months after filing for opening of insolvency proceedings; and Stankiewicz, another Germany-based internationally producing automotive supplier, which was sold to IAC Group after six months following the insolvency filings.

Although not yet being sold to a new investor, since the end of March 2009 Märklin, a renowned German manufacturer of model railways, has been continuing its business even in course of the insolvency proceedings and, after having stabilised the operational business, the insolvency administrator is now talking to various potential investors.

Contrary to the described transferring reorganisation, an insolvency plan provides an opportunity to restructure the insolvent company together with its business. Prominent examples of a successful reorganisation through an insolvency plan are Ihr Platz, Babcock Borsig and, most recently, SinnLeffers.

An insolvency plan may be submitted to the insolvency court by either the insolvency administrator or the company itself. The plan, among others, specifies all measures that have been or will be taken to create the basis required for reorganising the company's business and whether it is capable of such restructuring.

The plan also has to contain all information about its basis and impacts and the plan concept needs to be compared with a liquidation scenario (including, if possible, by way of a transferring reorganisation).

After review of the insolvency plan by creditors and formal sign-off by the court, creditors will vote on the proposed plan on a group-by-group basis, with each group comprising creditors of the same legal position and similar economic interests.

Approval of an insolvency plan in each group requires the consent of the majority in terms of number and value of the voting creditors. As group classification will have a substantial impact on the voting results, composition of creditor groups in drafting the insolvency plan is crucial.

If the insolvency plan is accepted by the majority but not all groups, then the insolvency court may nonetheless approve such plan and substitute any missing consent, if the position of the dissenting creditors group is not worse than without such plan (i.e. than in case of a liquidation) and further provided that such creditors are given a reasonable share of the economic value payable under that plan to the parties involved (which does not require each creditor being treated equally).

The effects contemplated in the insolvency plan will arise upon its confirmation by the insolvency court and, once this confirmation becomes final and binding, the court will resolve that the insolvency proceedings are terminated.

Furthermore, German insolvency law enables company's management, subject to the supervision of an administrator, to autonomously reorganise and administer the company's business if the insolvency court orders self-administration (*Eigenverwaltung*), a concept closely related to the US concept of 'debtor in possession'.

This reorganisation instrument generally allows companies to submit, along with an application for institution of insolvency proceedings subject to self-administration, an insolvency plan prepared in consultation with the company's main creditors.

This will help to reduce considerably the length of the insolvency plan procedure and thus expedite reorganisation of the company's business. However, experience shows that insolvency courts only rarely make use of this reorganisation instrument and the company does need sufficient funds, provided, for example, by way of new borrowings, to continue the financing of the business. Again, Babcock Borsig and SinnLeffers are, together with only a few other companies, successful examples of self-administration in Germany.

Only recently, management of Arcandor, a German publicly listed stock corporation engaging globally in different businesses (e.g. retail and internet shopping, tourism services) with more than 70,000 employees and revenues of almost €20bn, filed for insolvency and expressed the intention to continue the restructuring of the company and its subsidiaries with an insolvency plan and under its own management.

As has become standard practice, a well-known insolvency practitioner has been hired as a sort of CRO to demonstrate to the court that there is sufficient knowledge of the particularities of German insolvency proceedings within management. However, this practitioner has recently resigned, and it remains to be seen how this impacts on the petition for self-administration.

Reasons for out-of-court restructurings in Germany

Although German law provides for, and practice makes use of, different instruments to restructure troubled businesses in the course of German insolvency proceedings, there exists a variety of reasons why out-of-court restructurings are nevertheless favoured in many cases and the involved parties attempt to achieve reorganisations outside an insolvency.

One key factor for a successful restructuring in the course of insolvency proceedings is the insolvency administrator himself. His legal and industry-specific expertise, his reputation and network and, most important, commercial understanding are decisive in setting rapidly the right directions of the insolvency proceedings and, consequently, the fate of the company's business, its creditors, employees and shareholders.

Notwithstanding this, German law does not entitle company, creditors or others to bindingly choose one specific administrator or even provide a list of candidates, but the insolvency judge, in its own discretion, has the sole power to determine an administrator.

Nevertheless, it has become increasingly accepted by courts to have an informal exchange of views with key stakeholders on general criteria and requirements that should be met by an insolvency administrator in a given case. However, in order to avoid being accused of prejudice, German insolvency judges are very cautious in following certain proposals for the appointment of insolvency administrators, and some courts even (still) refuse any discussion on this (most crucial) topic.

Other considerations against the opening of insolvency proceedings are their negative standing in Germany. Unlike in the US, insolvencies in Germany are still widely recognised as being the first steps to liquidation of a business and therefore any such news is generally ill received. This, ultimately, makes it difficult to keep all major customers and suppliers on board and, accordingly, decreases the likelihood to continue the company's business.

Insolvency administrators are more and more proactively issuing press releases on the prospects of a restructuring in the course of insolvency proceedings. Such campaigns, however, often prove to be successful only if the company itself is a key player in its market and therefore potential investors are at hand and will be able to raise the required bridge financing.

In addition, an insolvency filing without appropriate preparations as to how a credible business restructuring could look like based on up-to-date financial and operational data and projections often unnecessarily destroys values and hinders a reorganisation. If no such assessments have been made in advance or are not sufficiently progressed, it is unlikely that detailed considerations as to the best solution will be made in course the insolvency proceedings. Insolvencies do call for fast (often irrevocable) decisions in order to keep the business going and, as a matter of fact, are not the right forum to consider in depth the advantages and disadvantages of alternative restructuring scenarios.

The toolbox for out-of-court turnarounds contains many different instruments for each step required at the relevant point in time of a reorganisation: standstill or forbearance agreements to buy the necessary time for a restructuring; lock-up agreements to keep the involved parties on the table; and the execution of term sheets and documents implementing the generally agreed principles (e.g. partial waiver of claims, debt-for-equity swap, prolongation of maturity, change of terms and conditions of existing loans, lending new funds, presentation of restructuring reports, etc).

What and to what extent is needed is determined by the specifics of each individual case. However, parties to an out-of-court restructuring should at each stage be prepared that, for whatever reason, an insolvency filing may become inevitable. Therefore, although management, creditors and shareholders are focusing on preventing an insolvency, sufficient time and efforts should also be reserved for contingency planning, i.e. a prepared insolvency and, in particular, the appropriate measures to be taken to achieve an efficient restructuring in the course of insolvency proceedings.

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1. To determine whether there are sufficient grounds for a going-concern prognosis, managing directors have to analyse whether the company's liquidity is not only sufficient at that respective point in time (as they have to do when determining illiquidity), but also whether it will be sufficient to continue the business for a reasonable period of time into the future, i.e. until at least the end of the next business year.
2.This German legislation facilitates the implementation of out-of-court restructurings and pre-packed insolvency plans in Germany as it relieves managing directors from the obligation of filing for insolvency because of over-indebtedness if a valid going-concern prognosis exists. If constructive restructuring discussions are ongoing between the company and the creditors, it will become easier for German directors to be able to conclude that it is more likely than not that the business will continue as a going-concern, and thereby allow for such discussions to be conducted without having to file for insolvency prematurely.