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Mapping Preventive Restructuring Frameworks and the EU Directive for the JCOERE Project

Country Report

Germany

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The German Perspective on Restructuring

In a comparative context the German approach to preventive restructuring seems to be conservative. Effectively there is no preventive restructuring framework available in Germany but the description of German insolvency procedures to this effect seems to rely on the dividing line of declared insolvency. In effect there is no rescue process available before a declared insolvency but post a declaration of insolvency the legislative framework does provide for a restructuring process. Once the debtor files for insolvency under the *Insolvenzverfahren* the restructuring or rescue process is available. The *Insolvenzverfahren* is included in the EIR Recast. German law allows for a restructuring plan to be approved despite the objections of an entire class, so this would indicate that cross-class cram-down is permitted weighed against criteria applied by the court.

PART 1: The General Context of Preventive Restructuring

Function and Aims of Insolvency and Rescue

German law does not currently provide for a preventive restructuring framework along the lines of the Preventive Restructuring Directive (PRD). Previously – between 1927 and 1999 – there was a preventive restructuring framework available (the "*Vergleichsordnung*") to debtors. This provided a collective procedure aimed at a debt restructuring agreement, which could be confirmed based on a majority vote of unsecured creditors and a statutory minimum payoff to creditors. Since 1999, however, the only preventive processes in existence in Germany are the restructuring of bonds (if provided for in the contractual terms of the bond) and in the restructuring of financial institutions.

The dominant aim in any business insolvency is the sale of assets comprising of the viable part of the business of an insolvent debtor, where possible. Insolvency law is geared towards the survival of businesses until their viability is tested by the administrator and creditors in the first general meeting of creditors. If an investor is identified and a purchase negotiated, the contract requires the confirmation

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of a creditor body, either the creditor committee or – in small cases – their general meeting. The assets are transferred under the contract while any liability stays with the debtor.[2]

Existing Legislative Frameworks

The German insolvency framework has a unitary procedure (the "*Insolvenzverfahren*") that includes a restructuring plan option inspired by Chapter 11 in the USA. Both insolvent debtors and debtors nearing insolvency are eligible to enter the framework. In 2012 the law was reformed to create the "*Schutzschirmverfahren*", a so-called umbrella (interim) proceeding option, which guarantees that the debtor will remain in possession while negotiating a plan. With both amendments, however, the legislator deliberately declined to provide any separate preventive framework.

There is an option to propose a restructuring plan that forms a part of German insolvency law. The *Insolvenzordnung* of 1999 (the "InsO") provides a unified insolvency procedure with three paths, one of which is an insolvency plan that can be agreed with creditors.[3] This can preserve the company as a legal entity by waiving certain residual claims owed to debtors of the company through the plan. The plan also aims for higher and quicker repayments to debtors than would otherwise be available in liquidation.[4] Filing for insolvency within a three week timeframe is mandatory for the managing directors of corporations under certain circumstances, including the inability of the debtor to meet most of its payment obligations as they become due.[5] This illiquidity is presumed if the firm has ceased making debt repayments entirely. As the procedure is also available if there is impending illiquidity, a debtor that has voluntarily filed for insolvency proceedings is eligible. This stems from an assumption that if the debtor has filed under the InsO, it is already in a position in which it will not be able to meet its repayment obligations.[6] The InsO is also accessible if the debtor's liabilities exceed its assets (the 'balance sheet test'). While the restructuring plan is only available if a firm meets the criteria for insolvency, German law also allows the parties to stipulate separate agreements in accordance with their respective needs, allowing for a private party to exercise contractual autonomy to create restructuring plan agreements. That said, there is no legal procedure or framework along the lines of the PRD yet available for restructuring prior to definitional insolvency in Germany.

The principal content of a plan is not restricted by law. It may contain a restructuring of the balance sheet, a transfer of assets, or simply propose a solution to some issues in dispute in a regular insolvency liquidation. The latter has become more frequent recently, leading to plans that do not prevent a liquidation but instead streamline the process. In practice, plan proceedings are rare; statistically, they were present in less than 2 per cent of all insolvency proceedings. They are a little more relevant, however, in cases where large companies are concerned. Overall, however, viable businesses are most commonly saved by a transfer of viable assets by the administrator in a sale rather the under a plan.

As Germany does not have a pre-insolvency procedure, the following sections will discuss its restructuring plan as it works within the InsO as any preventive procedure may follow some of its provisions where they are aligned to the PRD.

The Stay of Individual Enforcement Actions

The insolvency plan under the InsO does provide for a statutory moratorium upon the decision to commence proceedings, which cannot be lifted until the procedure is complete.[7] In interim proceedings, the court can decide whether to issue a stay up to the commencement of proceedings, but can later

[2] Some contracts such as lease and labour contracts are often transferred.
[3] InsO, s 217.
[4] Georg Streit & Fabian Burk, 'Restructuring and Insolvency in Germany: Overview' (2018) Practical Law Company available from <https://uk.practicallaw.thomsonreuters.com/2-501-6976?transitionType=Default&contextData=(sc.Default)&firstPage=true> accessed 16 September 2019.
[5] InsO, s 17 – defined as lacking more than 10% of the funding needed during the coming 21 days to meet its obligations, and it is not foreseeable that the financial gap will be less than 10% in the short term.
[6] InsO, s 18.
[7] Thomas Hoffman and Isabel Giancristofano, 'Germany: Corporate Recovery and Insolvency 2019' (ICLG.com 2019) available from <https://iclg.com/practice-areas/corporate-recovery-and-insolvency-laws-and-regulations/germany> first accessed 16/09/2019. The InsO provides for the possibility of agreeing an insolvency plan that can perform a similar function to a preventive restructuring plan, namely the preservation of the company as a legal entity by using similar mechanisms, such as the sale of the debtor's business, an operational restructuring based on an insolvency plan in which the debtor's business is continued, and financial restructurings. Georg Streit_and Fabian Burk, 'Restructuring and Insolvency in Germany: Overview' (Practical Law Company 2018) <https://uk.practicallaw.thomsonreuters.com/2-501-6976?transitionType=Default&contextData=(sc.Default)&firstPage=true> accessed 16 September 2019.

revoke this decision if necessary, though this rarely happens. Accordingly, the German legislature will need to introduce new provisions in order to implement stay as it is envisaged under the PRD.

The Adoption of Restructuring Plans

Under the InsO, impaired creditors and shareholders are entitled to vote on a restructuring plan, although admittedly the plan is conceived following functional insolvency as opposed to preventive restructuring. Within this framework, creditors are divided into classes on the basis of economic interests and their status under the law. These classes can include shareholders if they are impaired by the plan. As part of the process, there is a requirement that the courts verify the fairness of class formation and the voting process. A restructuring plan is adopted on the basis of a simple majority vote; in other words, if a simple majority within the individual classes by value and number votes in favour of the plan, then it is approved.

The Confirmation of Restructuring Plans

Under the InsO, the court is required to examine the restructuring plan to determine if any procedural mistakes were made. The court also assesses the viability of the plan; however, it is not empowered to reject a plan on the basis of its feasibility. Once the plan is confirmed, it will be forwarded to the individual responsible for its implementation.

The court can opt to reject the order for debtor in possession management aimed at agreeing a restructuring plan in three situations. First, the court can reject the order if the majority of the creditors' assembly requests it. Secondly, the court can reject the order if a secured creditor, also referred to as a creditor with a right to separate satisfaction, requests that the order is repealed. This can only be done in circumstances in which secured creditors could be placed at a disadvantage as a result of the debtor in possession management of the process.[8] The debtor can also request that the order is rejected; however, this can only be done on the basis that the "envisaged restructuring no longer has prospects of success."[9] In order to implement the PRD, the German legislature will likely need to extend the grounds for refusal currently contained in the InsO to include the conditions laid out in article 10, such as the likelihood of success of the restructuring plan.

Cross-Class Cram-Down

A cross-class cram-down exists within the German InsO restructuring process. If a class of creditors rejects a restructuring plan, the class may still be bound if a majority of classes accepted the plan and the requisite tests are met. Appeals against a court order confirming a plan stay its implementation unless the court of appeal orders the plan to become effective. When reforming its insolvency law in 1999, Germany adopted a strict adherence to absolute priority and the best-interests-of-creditors test to test the veto of a class against confirmation of a restructuring plan. As noted by the German contributor, it does, however, remain unclear which of the rules – absolute or relative priority – Germany will adopt for preventive restructuring.

Protection of New and Interim Financing

Interim finance is commonly repaid before the insolvency proceedings are terminated. If new financing under a plan is "good faith provided" it will be safe from claw-back mechanisms and may enjoy a privilege in later insolvency proceedings, if provided for in the plan.[10]

PART III: Specific Procedural Aspects of Preventive Restructuring in Domestic Processes and in the Directive

The Threshold of Insolvency

Insolvency is defined as the inability to pay debts as they fall due.[11] Case law has explained that this inability to pay is present for the applicability of the InsO if it extends to more than 10 per cent of debt

[8] InsO, s 270(2)(2).
[9] InsO, s 270b(4).
[10] InsO, s 264-265.
[11] InsO, s 17.

owing over a period of more than 3 weeks. Any cessation of payment unequivocally indicates the inability to pay. In addition, German law offers two further insolvency tests for specific debtors. First, the debtor can initiate insolvency proceedings early in order to use it for a restructuring.[12] In order to enter these proceedings, it is sufficient that inability to repay debts is at least foreseeable. Case law provides that the forecast may include a timeframe of up to two years in the future, for example, at the time a bond is to fall due.

Second, any limited liability company (corporation) is insolvent under a balance sheet test once it has no prospect of continuation, in other words, a viability test.[13] Since 2008, balance sheet insolvency alone has been insufficient to negate a duty to file under the InsO. This was due to the crash in market value of relevant assets experienced at that time. Only a balance sheet insolvent corporation that is also unable to continue trading would be insolvent under InsO s 19 and thereby be required to file.[14] There is concern that a future preventive restructuring framework could interfere with the purpose of s 18 of the InsO, which pertains to a voluntary petition under the InsO. It is unlikely that the voluntary petition under the InsO would be available for debtors that are already unable to pay their debts. Corporations in the process of promising restructuring negotiations protected by the new framework would probably be unlikely to be seen as able to continue trading, so no conflict should arise there.

Debtor in Possession

Insolvency practitioners are appointed to all insolvency proceedings, even where the debtor remains in possession. It is likely that the German legislature will apply this existing insolvency rule to any newly introduced preventive restructuring procedure.

Such practitioners act as a supervisor and may be authorised to co-sign or approve acts of the debtor, which conflicts with the debtor-in-possession concept to some extent. The provisions of 5(2) allow for an appointment *when necessary,* therefore while the blanket requirement for the appointment of an insolvency practitioner may not be in conflict with the PRD, it is contrary to the spirit of the compromise that led to the drafting of article 5(2), which aimed at preventing an insolvency practitioner being involved in all cases by default.

Rights *in Rem* under the EIR Recast and the PRD

Security rights are defined by private law, rather than insolvency law, which has its own special rights. German insolvency law continues to respect security rights in terms of a priority in access to the value of secured or encumbered assets. In insolvency, retention of title clauses allow for the segregation of the assets to which the title applies. If the debtor is in possession of a moveable asset, the right to enforce is assigned to the insolvency practitioner who may sell the asset with proceeds going to the secured creditor, less a deduction of legal costs (min. 9%). The process of liquidating the asset outside of insolvency proceedings and thus controlling its timing is only granted to the secured creditor where the asset is immovable, or the creditor is currently in possession of a moveable asset. The enforcement of security rights outside of insolvency proceedings can be stayed in favour of securing a going concern of the debtor's business in Germany. Furthermore, an insolvency plan may even permanently modify security rights provided that the secured creditor agrees or receives the value achievable in a liquidation. Whether or not art. 8 of the EIR Recast will protect creditors with rights *in rem* in relation to assets situated abroad will depend on the applicability of the EIR to preventive restructuring plans. Article 1 (1) appears to leave this decision to Member States. If the new preventive process is scheme-like and situated within company rather than insolvency law, art. 8 will be unable to provide protection.

[12] InsO, s 18.
[13] InsO, s 19.
[14] InsO, s 15(a).