GERMANY AMENDS INSOLVENCY REGIME

March 9, 2012

To Our Clients and Friends:

On March 1, 2012 a number of important changes to the insolvency regime in Germany came into force.[1] The main objective of the reforms is to facilitate the restructuring of companies and to enhance creditor's involvement. The German government believes – in light of the recent financial crisis – that these reforms are necessary to facilitate complex restructurings.

NEW PRELIMINARY CREDITORS' COMMITTEE

A new form of statutory creditor participation has been introduced to overcome the perceived inability of creditors to influence preliminary matters in the period between the filing and the opening of the proceedings. The reform act imposes an obligation to establish a "Preliminary Creditors' Committee" (*vorläufiger Gläubigerausschuss*) at an early stage of the proceedings. The obligation, however, only applies to proceedings in respect of debtors with ongoing business operations and where the debtor has satisfied at least two of the following requirements in the preceding business year:

- a balance sheet total of at least 4,840,000 Euro (after deduction of negative equity, if any);
- revenues of at least 9,680,000 Euro; and
- an annual average of at least 50 employees.

Where these requirements are not met it is still open to the court to establish a Preliminary Creditors' Committee when the debtor, its preliminary administrator or a creditor request that such a committee be established and provided that eligible members have consented. On the other hand, the court may refuse to appoint a committee if the debtor's business operations are terminated or where the court is of the view that the appointment would negatively affect the debtor's financial situation.

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[1] *Act for the Further Facilitation of the Restructuring of Companies (Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen, ESUG), passed by the German parliament (Bundestag) on October 27, 2011.*

Assuming the tests discussed above are satisfied, a Preliminary Creditors' Committee will be established after the application for the commencement of insolvency proceedings. As such, the Preliminary Creditors' Committee is able to influence certain important decisions of the insolvency court, in particular the selection of the (preliminary) insolvency administrators ((*vorläufiger) Insolvenzverwalter*) and orders for self-administration (*Anordnung der Eigenverwaltung*), each of which is discussed further below.

CREDITORS MAY INFLUENCE APPOINTMENT OF INSOLVENCY ADMINISTRATORS

Prior to the appointment of the insolvency administrator, the insolvency court has to give the Preliminary Creditors' Committee the opportunity to comment with respect to the appointment of the insolvency administrator. The Preliminary Creditors' Committee may set out requirements or qualifications the insolvency administrator has to meet or can propose certain individuals to act as the insolvency administrator (prior to the recent reforms the election of the insolvency administrator was in the sole discretion of the court).

The court is required to appoint any individual unanimously proposed as the insolvency administrator unless the candidate is not eligible (*e.g.*, for conflict reasons or insufficient experience). Where no Preliminary Creditors' Committee has been established creditors will still have the opportunity to propose insolvency administrators on an informal basis which does not bind the court in any way.

Consequently, the Preliminary Creditors' Committee now has the ability to prescribe either a person of its choosing or to set qualification standards that will prevent the appointment of insolvency administrators with no or limited experience in the debtor's business.

FACILITATION OF DEBT-EQUITY-SWAPS

The mechanics by which creditors are able to convert their debt claims into equity have been significantly improved by the recent reforms, increasing the flexibility for insolvency restructurings and giving investors more incentive to invest in the debt of stressed or distressed companies.

While in the past it was necessary for shareholders to approve a debt to equity swap, by utilizing an insolvency plan it is now possible to achieve a debt to equity swap without shareholder consent. The same is true for other corporate restructurings of a debtor such as an increase to its capital or the introduction of a new shareholder.

As a result of these changes, restructuring is expected to become much easier with increased opportunity and flexibility for the introduction of new financing sources into the distressed vehicle.

STRENGTHENING OF SELF-ADMINISTRATION (EIGENVERWALTUNG)

When an insolvency proceeding has been initiated, the court appoints a preliminary insolvency administrator taking control of all the company's business.

In contrast, where a company is in self-administration (*Eigenverwaltung*) the management remains in charge of the business (under the supervision of a court-appointed trustee). Instances of self-administration are relatively rare, although it has been successfully utilized in some restructuring cases. In the past, a court would permit self-administration only where it was of the opinion that it would not delay the insolvency procedures and would not otherwise adversely affect creditors: Under the new law a debtor can apply for self-administration and the court can only reject the application if it is of the view that one could expect that creditors would be negatively affected by the self-administration. In coming to its conclusion the court must hear submissions from the Preliminary Creditors' Committee.

Finally, as a result of the recent changes a debtor may now file for a grace period of up to three months in order to enable the debtor to prepare a pre-packaged insolvency plan. Such a procedure is only permitted where the debtor is not illiquid and where the intended restructuring does not appear to be evidently futile. Where a grace period is granted the court must ensure that (i) enforcement measures (*Zwangsvollstreckungen*) of creditors are suspended during that time and (ii) obligations incurred after the filing constitute preferential debt in any subsequent insolvency proceedings. These new rules can be seen as the German equivalent of the Chapter 11 (US bankruptcy code) regime applied in the United States.

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