ESUG: German for "Modernising Bankruptcy Law"

Gerret Höher reports on the most recent reforms to German insolvency law

For close on twenty years, Germany insolvency law has been one of the consistently and heavily criticised fields of German federal legislation. In the nineties it was deemed necessary to replace the Konkursordnung (*Bankruptcy Code*) enacted by Kaiser Wilhelm I by a modern Act, which would take into account the changes in the economic realities that had come about since the industrial revolution and would establish insolvency proceedings as a tool for properly organised corporate restructurings.

In those days the Ministry of Justice made no attempt to "market" its new Acts nor did it employ skilled wordsmiths capable of devising more readily comprehensible names for complex pieces of legislation. The new Act was simply called the "Insolvenzordnung" (*Insolvency Code*).

The fundamental objective of the new Act was creditor protection, which was primarily seen as the best possible way of achieving creditor satisfaction. This objective was to be attained using, among other things, overindebtedness as a reason for insolvency, so that companies were obliged to file for insolvency as early as possible when they entered a crisis situation. The democratic legislator promoted this objective by scrapping the priorities granted to the revenue and the social security bodies and ranking them equally with the other creditors.

We are now 13 years down the line. During this period we have experienced a few economic crises, globalisation and finally the financial crisis. In the last case, we don't yet know whether it is actually a national crisis. What is certain is that the Insolvenzordnung has failed to achieve important objectives that were set by the legislator at the time it was enacted.

For example, it has failed to establish insolvency proceedings as a broadly accepted restructuring instrument. In contrast, critics making international comparisons describe German insolvency proceedings as a German locational disadvantage. The insolvency plan procedure, designed for restructuring purposes, is only used in approx. 2% of cases. Debtor-in-possession rarely occurs, because the insolvency courts have almost unanimously adopted an extremely guarded position towards it (probably owing to the fact that it forces a conflict of interest as regards creditor protection), and they generally refuse to order it. Nor has it been possible to improve creditor's dividends. On the contrary, average dividend rates remain consistently below 5%. In many insolvency proceedings, no distributions at all are made to the creditors, because the insolvency estate does not even cover the costs of the proceedings. Finally, applications for insolvency are generally filed a year after the state of insolvency arises, i.e. far too late.

As a result, criticism of the existing rules very soon set in. Comparisons with England and the United States in particular

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THE SELECTION OF THE INSOLVENCY ADMINISTRATOR DETERMINES THE FATE OF THE INSOLVENCY ADMINISTRATION ITSELF

resulted in demands for greater influence by creditors on insolvency proceedings, for example on selection of the insolvency administrator, and for the opportunity to convert debt to equity. There were also some demands to introduce extrajudicial settlement proceedings in order to enable restructuring operations to be conducted outside insolvency proceedings.

In 2008, the German Federal Government sacrificed a heavy-handed overindebteness as a reason for insolvency on the altar of the financial crisis, by changing the general logic behind it and thus relieving an unknown but presumably large number of enterprises from their likely bankruptcy. An effective method of dealing with crises was rendering the Insolvenzordnung ineffective.

At the same time, the public purse was being depleted, and the revenue authority and the social security bodies had seen the costs of the loss of the privileges established by the Kaiser. They have since been determinedly attempting to reintroduce the old priorities through circuitous routes. The revenue authority is enjoying support from the Supreme Finance Court in particular and also from the legislator itself, driven by empty budgets. Despite resistance from insolvency professionals and the Federal Supreme Court, the virtually ineffective Insolvenzordnung was easy prey.

ESUG: Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen (*Act on Simplification of Corporate Restructuring*)

In 2009, Angela Merkel set her government the task of fundamentally reforming insolvency law. In 2010, the Ministry of Justice announced a three-stage reform, the first stage of which is the "ESUG", which has entered into force on 1 March 2012. A foretaste of this move was provided in autumn 2011 in the shape of the Gesetz zur Reorganisation von Kreditinstituten or KredReorgG for short (*Bank Restructuring Act*) which included provisions for encroaching upon the rights of shareholders outside of insolvency proceedings.

The declared objective of the Act is to facilitate company restructuring by increasing the influence of creditors on the selection of the insolvency administrator, optimising the insolvency plan procedure and debtor-in-possession, and also introducing a moratorium.

Creditor influence

Many people believe that the selection of the insolvency administrator determines the fate of the insolvency administration itself. Previously, creditors had to view the proceedings much like the weather: they had to take things as they come. No-one had a statutory right to submit a proposal. However, if an administrator was proposed, the customs of the insolvency court in question determined whether the proposed administrator was considered to be "biased" as a result of the proposal, in which case he was eliminated, or whether the insolvency court would at least give the proposal serious consideration. The ESUG establishes the legal basis for debtors and creditors to be permitted to propose an insolvency administrator. The person proposed may also have previously given general advice on the course of insolvency proceedings, without thereby having lost the independence required in order to assume the assignment.

The ESUG also introduces a provisional creditors' committee, which is mandatory in large-scale proceedings[1] and which can be used in smaller proceedings in response to an application by the debtor, the provisional insolvency administrator or a creditor. The provisional creditors' committee may set criteria for the subsequent insolvency administrator and may unanimously propose an insolvency administrator. The insolvency court must accept the proposal, if unanimous, and may only disagree in well-founded exceptional circumstances. If the creditor's committee is not heard, and notwithstanding the insolvency court appointing an administrator, the creditors' committee may still elect a different administrator by a unanimous resolution during its first meeting. The ESUG enables creditors to influence the appointment of insolvency administrators. However, its successful use demands careful preparation. The insolvency courts are accepting this part of the law with considerable reservations, because they believe it unconstitutionally restricts the independence of the judiciary. If proposals are made that do not appeal to the insolvency courts, they are therefore likely to use every opportunity not to apply the new rules. Poorly prepared insolvency applications can open doors for such opportunities.

Debt for equity swap

There has long been criticism of the fact that German insolvency law does not grant access to this restructuring instrument. The ESUG has changed the situation. With effect from 1 March 2012, an insolvency plan may contain any proposal that is admissible under company law. The Act refers explicitly to the conversion of debts into share or membership rights in the debtor company. Using this restructuring instrument, the creditor contributes its debt against the debtor by way of a contribution in kind, e.g. by means of a capital reduction followed by a capital increase. The debtor (or a future administrator) may not raise claims against the creditor for any overvaluation of the debts contributed. The ESUG requires the debt-for-equity swap to be approved by all the debtors whose debts are to be converted. No-one may acquire a holding in a company against his will, whereas the debtor's shareholders may be outvoted.

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This new rule has been widely welcomed. However, German notaries have expressed serious reservations regarding its implementation in practice, because in an insolvency plan contracts requiring notarisation may be concluded without the involvement of a notary and will become effective when the insolvency plan is confirmed by the insolvency court. Finally, there are concerns that ESUG may be in breach of the EU Capital Requirements Directive. The Federal Government shares these reservations, as may be seen from the preamble to the KredReorgG. However, the Federal Government is relying here on "signals" from the Commission that the Capital Requirements Directive is soon to be amended, at least for banks. It remains to be seen whether these changes will cover other sectors beyond banking. It must be noted that despite its broad approval, this new rule under the ESUG is currently subject to serious reservations under European law, so that it is questionable whether it will be possible to use this instrument with legal certainty after 1 March 2012.

Debtor-in-possession

The ESUG improves the opportunities for debtor-in-possession by laying down some important new rules. First of all, the insolvency court should generally refrain from ordering provisional precautionary measures when an application for debtor-in-possession is made, and should instead simply appoint a provisional trustee. This allows the debtor, for the time being, to retain control over his company during the opening proceedings. The access requirements for debtor-in-possession are low. According to the Act, a debtor-in-possession order may only be refused if it is likely to cause disadvantage to the creditors. The insolvency court does not have to answer this question alone, but must hear the views of the creditors' committee, if one has been appointed.

Protective shield procedure

The ESUG establishes a protective shield procedure as a further restructuring instrument. In response to an application by the debtor, the court sets a maximum time limit of three months to submit an insolvency plan, if the debtor makes the opening application at the time of impending illiquidity or overindebtedness. The debtor must submit a substantiated opinion in this respect, issued by a tax advisor, chartered accountant or lawyer, or a person holding a comparable qualification, who is experienced in insolvency cases. The certificate must confirm that there is impending illiquidity or overindebtedness, but not actual illiquidity, and that the sought-after restructuring is not obviously futile. If the criteria are met, the court appoints a provisional trustee, whose identity can not be the same as that of the person who rendered the opinion. The insolvency court may only vary from a proposal by the debtor if the person proposed is clearly not suitable to take the appointment. The court may also order precautionary measures in response to an application by the debtor. This enables the debtor to prepare an insolvency plan within the prescribed period with as little disturbance as possible.

Epilogue

The entire ESUG is likely to bring about a significant change in the German insolvency field. In addition to the new restructuring instruments, whose practical use remains to be seen, the administrator arena is likely to change over the coming years, if creditors use the rights granted to them in a coherent manner.

The reform of insolvency law is continuing what the KredReorgG began. The German legislator's fundamental understanding of creditor protection is changing. The concept of securing assets with a view to optimum creditor satisfaction appears to be giving ground to the finding that restructuring and speedier reintroduction of a debtor to the market represents better creditor protection, and that an internationally comparable, or better, framework must be provided in order to achieve this. This constitutes the new backbone of German insolvency law. Although it may be doubted from its content, the aim of the law is to achieve extensive stability in economic policy, and not least to seek to preserve jobs and thus to relieve the public purse. Overall, therefore, the ESUG means making Germany a far stronger place, in the international arena, for dealing with insolvency.

However, the reforms are not yet complete. The ESUG has just come into force, since although the draft bill for the second stage of the reform is already available, it only covers consumer insolvencies (in this case too, German consumers were drawn abroad to achieve speedier discharge). The third stage has been announced and its content will primarily deal with optimising group insolvencies.

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FOOTNOTES

1. Two of the three criteria, 1) total assets of at least EUR 4.84 million 2) sales revenue of at least EUR 9.68 million and 3) at least 50 employees on average during the course of the year, must be met during the year before the application.