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GERMANY'S REVISED BANKRUPTCY CODE

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Global distressed hedge funds accustomed to the predictability of the U.S. restructuring and bankruptcy regime generally try to avoid continental Europe's uncertain patchwork collection of insolvency laws. There is good reason for this: Continental Europe's insolvency laws generally are not friendly to participants once a company in distress is forced to file for bankruptcy. This reality is changing, however, with the Bundestag's passage of a law that, upon its anticipated April 1 effective date, will bring Germany's corporate insolvency laws into the 21st century, introduce predictability to Germany's archaic in-court process and provide fresh impulse for cross-border distressed opportunities.

Similar to Chapter 11 of the U.S. Bankruptcy Code, Germany's new bankruptcy law will enable corporate debtors and their creditors to structure prenegotiated, court-approved balance sheet restructurings with the consensus of some, but not necessarily all, stakeholders. In particular, the new law, among other things, rids the German bankruptcy code of its current prohibition on nonconsensual impairment of equity.

Under the current code, while equity goes away empty-handed if insufficient funds remain in the estate, a corporate debtor cannot issue new equity and cancel old as typically occurs under a Chapter 11 plan. This gives equity holders in a German insolvency proceeding a blocking position in any proposed debt-for-equity swap, resulting in diversion of value even if equity is clearly out of the money. The new German code does away with its historical protection of out-of-the-money stakeholders, a key impediment to serious consideration of its use as a restructuring tool.

Inability to flush equity is not the only complaint practitioners have against the current German code. Germany, like most Continental systems, exhibits a particularly "management-unfriendly" insolvency regime. Accordingly, in addition to promoting debt-for-equity swaps, the new law aims to encourage corporate debtors to remain "in possession."

Whereas, today, an order allowing a debtor to remain in possession is granted in only the most rare of circumstances (currently 1% of all business bankruptcies), the new German law aims to keep the debtor in possession without interference from a trustee/administrator as long as a path to exit exists (for example, in the form of a prenegotiated insolvency plan) and the debtor's constituents generally approve. Since insolvency administrators can be expensive (racking up fees of 5% to 9% of a going-concern sale, for instance, which fees come out of the sale proceeds) and may have interests inconsistent with, in particular, creditors with strategic interests, stakeholders generally should be supportive.

Further key revisions pertain to creditors' committees. The current code provides for appointment of a committee only after, generally, a case is three to four months old. In certain instances, so-called preliminary creditors' committees may, in practice, be appointed earlier than that, but they have little decision-making or approval power. In the absence of a creditor-controlled counterweight, an insolvency administrator (or a debtor in possession, for that matter), will accomplish a lot in three to four months, including preparations for asset sales, financing and other matters.

To counteract this, the new German law mandates appointment of a creditors' committee at the outset -- in all but the smallest -- of corporate debtor cases. This is important, as, similar to England, clearly not all corporate debtors will remain in possession during a case and creditors will need a source of leverage to check the administrator. Immediate committee appointment coupled with committee approval of non-ordinary course transactions does just that.

The changes are historic by German legal standards, but what do they mean for the rest of us? First and foremost, U.S. companies now have an avenue for extending a proposed restructuring beyond the U.S./U.K. in the not uncommon situation where they have German operations. Lehman Brothers Bankhaus AG, Lear Corp., Visteon Corp. and Reader's Digest Association Inc. immediately come to mind. For hedge funds, the new law provides an incentive to expand loan-to-own and other distressed-investment objectives to the Continent. Enhanced creditor protection and opportunities for increased involvement in an in-court scenario provide greater means of maximizing investment value and exercising leverage over the process. This is key, as the current code grants substantial discretion to an administrator to manage the process at the administrator's whim.

The new law, however, is not perfect. The most glaring imperfections include: (a) an inability to force creditors to take new equity issued under a plan; (b) only moderate improvements to the German code's DIP financing options; and (c) retention of a mandatory "examiner" (Sachwalter) in "debtor-in-possession" cases. That said, even these shortfalls have their remedies.

First, the most obvious shortfall -- and the one that most distinguishes German and U.S. plan confirmation processes -- is that a confirmed plan in Germany cannot force unsecured creditors to receive equity over their objection. Creditors (and shareholders) can be "crammed down," as in a U.S. Chapter 11 case, but not with an equity recovery. Solution to the dilemma can be found in the German code's imitation of U.S. rules regarding creditor classification. In the U.S., creditors are grouped for voting and distribution purposes on the basis that their claims are "substantially similar." It's no different in Germany, except that, arguably, plan proponents have even more flexibility than in the U.S. in classifying creditors. A plan could theoretically separately classify creditors that do not consent to an equity contribution on the basis that their contribution to the debtor's rehabilitation efforts differs from that of those creditors that consent to an equity payout. Another alternative is to obtain consents from the creditors in a class that certain creditors will receive equity and other cash or warrants.

Second, the new law does little to encourage DIP financing. In the U.S., DIP lenders may receive priming liens on a debtor's existing assets. This is not the case in Germany. However, the absence of priming liens is not as worrisome as it might seem. As in the U.S., German DIP lenders will be entitled to administrative-expense priority status on account of the financing. Further, new assets generated postpetition do not constitute prepetition lenders' collateral, meaning they are available to serve as DIP collateral. Finally, in Germany, all salary obligations of a corporate debtor are assumed by the German Federal Employment Service during the first three months of a case, alleviating liquidity concerns and reducing the need for immediate financing.

Third, while no administrator is appointed in a "debtor-in-possession" case, the court is obligated to appoint an "examiner," who will have authority to approve non-ordinary course transactions and pursue avoidance actions. This could be problematic to the extent an examiner were to go after a debtor's suppliers, customers or other key constituents. However, the debtor has wide latitude to select its own examiner. The court can reject the debtor's choice only if it finds that the debtor's chosen examiner is clearly inappropriate for the role. By contrast, in a U.S. Chapter 11 case, an examiner (who may be appointed merely "on request" of any party in interests as long as the debtor's liabilities exceed $5 million) is specifically called upon to investigate fraud, incompetence and mismanagement on the part of the debtor's officers and directors.

The new law alters an unpredictable and at times value-destructive process and turns it into one with significant opportunities for stakeholders. The bill passed by the German Bundestag takes substantial steps toward the further "Anglo-Americanization" of the German restructuring practice that began with establishment of the current German code in 1999. As a result, the restructuring process has become more accessible to outsiders, whether on the debtor side or the creditor/investor side. Corporate debtors, distressed funds and professional advisers should therefore take note that Germany, like England and the U.S. before it, will become a very attractive restructuring venue.

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