



REPRINTED FROM EXCLUSIVE ONLINE CONTENT PUBLISHED IN:
MARCH 2012

© 2012 Financier Worldwide Limited.
Permission to use this reprint has been granted by the publisher.

Impact Of German ESUG On Distressed M&A Transactions

BY DR MARTIN STRÖHMANN

The German distressed M&A market has long been plagued by a restructuring regime that was perceived by the distressed M&A market as cumbersome and unpredictable. Hopefully this perception will start to change, due to the December 2011 passage of a comprehensive reform bill to modernise the German Insolvency Code (Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen ('ESUG') – Reform Bill to Further Facilitate Corporate Restructurings), which is set to become effective on 1 March 2012.

The reform bill's name already implies its main goal, i.e., to further facilitate corporate restructurings. This goal is not new to German restructuring law, as the current German Insolvency Code ('InsO'), effective as of 1 January 1999, was passed with the same purpose. Despite being modelled largely after the US Chapter 11 regime, the InsO never fully satisfied the market's desires for overall predictability, easy access to debtor-in-possession restructurings, and clear rules for debt-for-equity swaps, among other things. As a result, liquidations, not restructurings, remain the norm for troubled companies in Germany.

In-court asset deals currently provide the best alternative for M&A investors

Distressed M&A investors typically have certain key considerations in mind when analysing distressed M&A transactions: (i) access to reliable due diligence; (ii) the ability to limit historical liabilities; (iii) the ability to deleverage the target company; and (iv) transaction certainty. Unfortunately, the current German insolvency regime does not sufficiently address these considerations. Under the InsO, in a typical restructuring case, the court-appointed insolvency administrator lacks detailed and company-specific insights about the business. Existing management has little incentive to cooperate and cash flow limitations do not allow for the lengthy and detailed due diligence process common in non-distressed M&A transactions. In addition, although the InsO does not provide for specific procedures, a debtor's historical liabilities can effectively only be discharged in an asset sale, not through a share deal. Moreover, the deleveraging of a distressed target usually requires fully consensual agreements between all affected parties with limited options to cram-down rejecting creditors and no ability to 'squeeze-out' existing equity holders. Because equity holders have disproportionate leverage, it is typical for investors to give them a nuisance settlement.

A desire to avoid nuisance settlements has influenced the growing trend of German companies to shift their centre of main interests or 'COMI' to England and utilise UK schemes of arrangement. Further, the appetite of distressed M&A investors for out-of-court transactions is severely hampered by the uncertainty created by the court's ability to appoint an insolvency administrator at free will once an insolvency filing has been made. And court-appointed insolvency administrators typically follow a different agenda than the debtor's management, which renders out-of-court negotiations with the company largely futile (as no transaction continuity is given).

Due to these and other shortcomings, a typical M&A investor in Germany prefers in-court asset deals to out-of-court transactions or share deals. Given the replacement of management with an insolvency administrator once a company files, it is not uncommon for investors to largely avoid out-of-court distressed transactions and start meaningful negotiations only after the court has appointed an insolvency administrator. Consequently, an in-court asset deal (Übertragende Sanierung) is the usual course of action for distressed M&A investors, unless a target has assets that are non-transferable or difficult to transfer.

Fundamental changes imposed by the ESUG

The ESUG introduces several important changes to the existing InsO: (i) reinforcement of creditor rights; (ii) simplification of the existing 'debtor-in-possession' scheme (Eigenverwaltung) and implementation of a pre-commencement rehabilitation procedure; and (iii) reform of the insolvency plan procedure (Insolvenzplanverfahren).

First, creditors' rights will be reinforced by the court's ability to form a preliminary creditors' committee (vorläufiger Gläubigerausschuss) in certain cases. The ESUG contains debt amount and numerosity requirements for constituting a creditors' committee. Under the ESUG, the creditors' committee will also possess the right to propose an insolvency administrator.

Second, debtor-in-possession procedure will be permitted, even in instances of over indebtedness (i.e., not merely impending inability to pay debts when due). In addition, the creditors' committee will have the right to terminate this procedure.

Finally, the most dramatic changes affect the insolvency plan ►►



REPRINTED FROM EXCLUSIVE ONLINE CONTENT PUBLISHED IN:
MARCH 2012

© 2012 Financier Worldwide Limited.
Permission to use this reprint has been granted by the publisher.

procedure. The ESUG contains specific provisions relating to the impairment of shareholders in an insolvency plan and loan-to-own transactions. The debtor also has the ability to stay enforcement actions to aid the consummation of the insolvency plan.

These changes aim to make corporate restructurings easier and more effective, moving the pendulum from liquidation towards restructuring.

Effect on distressed M&A transactions

The effect of the ESUG on the distressed M&A market remains to be seen. Nevertheless, some initial observations can be drawn at this early stage, as follows.

It is definitely a step in the right direction to increase the predictability of the appointment process for insolvency administrators. From an international viewpoint, the unpredictability of the appointment process has been a significant disadvantage of the German insolvency system. Given the typical creditor structure and the amount and numerosity requirements for constituting a preliminary creditors' committee, such a committee may be more useful for mid- to large-cap debtors who have well-known major creditors.

But, smaller debtors might also benefit from this change. Moreover, greater predictability around the appointment of insolvency administrators will allow distressed M&A investors to better assess the risks and advantages of an investment.

Additionally, the ESUG's more defined option for debtors to cram-down existing equity holders could boost loan-to-own transactions, although again this is likely more attractive for mid- to large-cap debtors. As in any share deal, a transaction by which the existing corporate entity changes ownership necessarily results in the assumption of existing

liabilities, a major drawback for any distressed investor because limiting liabilities is a key goal in a distressed M&A transaction. But, by providing another distressed transaction option, the loan-to-own option should be considered by investors, at least conceptually, in a greater variety of deals.

Finally, the new debtor-in-possession procedure should lead to more debtor-in-possession proceedings, which could offer some advantages to distressed investors. A debtor whose management stays in possession or 'in control' of operations is better equipped in due diligence and negotiation scenarios than a newly-appointed insolvency administrator. In addition to reducing information barriers, a debtor-in-possession provides for greater continuity, potentially lower transaction costs, and ultimately a higher likelihood of completing a transaction. This change could benefit both share and asset deals.

Summary

Despite providing distressed M&A market participants with new structuring options like loan-to-own deals, the most likely effect of the ESUG will be reducing certain transaction barriers, such as the discontinuity of decision makers and information deficiencies. Will the ESUG change the attractiveness of asset deals for distressed M&A investors? Probably not. Because the ESUG does not substantively address the existing leverage ratio and historical liabilities issues (even taking into account the new option to squeeze out equity), asset deals appear to remain the best choice for distressed M&A investors in Germany after the effectiveness of the ESUG. ■

Dr Martin Ströhmann is a partner at Kirkland & Ellis International LLP.
He can be contacted on +49 89 2030 6000 or by email: martin.stroehmann@kirkland.com

KIRKLAND & ELLIS LLP