The German economy has experienced minimal growth for a number of years. Insolvencies have reached record levels, and the number of businesses outside of formal insolvency proceedings, but in need of restructuring, is significant. Recently, however, a number of positive factors have fueled hopes for a revival of the German economy. There has been a strong increase in German industrial production activity and a substantial increase in the generation of new orders and capital expenditures by German businesses. Agreements with employees regarding wage and salary increases have been moderate on the whole, and financing conditions for businesses have been favorable. Although German companies have undergone significant operational restructuring in the past, many continue to exhibit weak balance sheets.

Not surprisingly, economic stagnation and record insolvency levels have left many German banks with large amounts of bad debt on their books. Estimates of aggregated bad debt range from €160 to €300 billion. German banks have historically held bad debt due to strong customer ties. However, beginning in 2003 and continuing in 2004 and 2005, German banks have sold non-performing loan portfolios as well as loans to single borrowers. Banks have become motivated to sell their non-performing loans for a number of reasons. Among them are the new risk-weighting criteria introduced by the Basel II banking accord, which will significantly increase the equity costs associated with banks holding non-performing assets and therefore create a strong incentive for them to sell.

The current market conditions provide excellent investment opportunities with respect to distressed companies and have attracted international investors, particularly U.S. investors who are familiar with distressed asset transactions. Investors typically acquire high-risk loans to companies with turnaround potential at a purchase price significantly below par. They attempt to generate high returns by performing an intensive workout of the acquired loans, usually in connection with a restructuring of the target company.
STRUCTURE OF THE INVESTMENT

The structure of the investment depends largely on the needs of the target company. While the specific restructuring measures are normally identified on a case-by-case basis by means of a restructuring plan drafted by turnaround advisors, target companies are invariably in need of new funds and a reduction of their debt burden.

The recapitalization of a distressed company typically involves a reduction of its statutory share capital to reflect the real amount of equity remaining after netting out historical losses. The registered share capital is then increased and new equity is contributed either in the form of cash or by releasing the company from a portion of its debt (debt-equity swap). Frequently, both types of capital increase are combined. The deal structures in this context are flexible and can be adapted to the requirements of different types of investors. Traditional private equity investors typically will seek to acquire 100 percent of the corporate debt in order to take control of the target company after the debt-equity swap and realize their return through an exit after three to five years. More passive investors, on the other hand, might only seek to provide financial resources for the restructuring without taking an active role in the process. These investors are more inclined to execute a modified debt-equity swap where instead of shares, they take convertible bonds or similar mezzanine instruments that are flexible and can be tailored to the specific needs of the investor. Over and above the actual capital measures, the investor may have to provide new lending facilities to the company and/or extend the maturity of any loans remaining after the debt-equity swap.

A successful implementation of a debt-equity swap transaction requires both (i) substantial restructuring expertise and an in-depth knowledge of the target's industry by the investor and (ii) the full support of at least a majority of the existing shareholders. If these conditions are fulfilled, the debt-equity swap can both save the target company from a possible winding-up and be a very interesting investment.

A number of issues under German law need to be addressed when implementing an investment that involves a debt-equity swap.

RESTRUCTURING PLAN

Before undertaking the investment, an investor will need to convince himself of the turnaround potential of the target company. Normally, a restructuring plan drawn up by turnaround advisors on the instructions of the target company will be available. Management of a German company in financial difficulty is required to explore restructuring opportunities. Management typically will involve external turnaround specialists when approaching banks for new loans. In order to avoid lender liability exposure, banks will extend loans to companies in financial difficulty only after a restructuring plan has been drawn up that demonstrates that the company is capable of being successfully restructured. The German Institute of Chartered Accountants (Institut der Wirtschaftsprüfer) requires a restructuring plan to set forth an analysis of the situation of the company together with the causes of the crisis and to specify the concrete measures that need to be implemented in order to return the company to profitability, including any necessary contributions by the various stakeholders (e.g., investors, existing shareholders, employees, creditors, etc.).

CONSENT OF EXISTING SHAREHOLDERS

To restructure a company successfully through a debt-equity swap transaction, it is important to obtain the consent of at least a majority of the existing shareholders, for both legal and practical reasons. The implementation of the capital measures, in particular the capital decrease and the ensuing capital increase, requires approval by the existing shareholders. Depending on the corporate form of the target and the provisions in the articles of association, the required shareholder approval percentage is usually at least 75 percent. In order to allow the investor to subscribe to the desired number of shares, the subscription rights of the existing shareholders must be waived. In order to convince shareholders whose shareholdings are being diluted that this waiver is necessary for the implementation of the restructuring, the support of a majority of the shareholders and the management of the company is vital. The same is also true for the discussions with the tax and securities authorities regarding necessary exemptions, which are described in more detail below.
Where the investor is unable or unwilling to obtain the consent of the existing management and shareholders to the investment and wants to pursue a more hostile approach, he can theoretically purchase the loans without the consent of the target company, provided that the bank — which typically has a long-standing business relationship with the target — is willing to sell. As the new owner of the non-performing loans, the investor then has significant leverage in the negotiations with management and shareholders. While an acquisition of shares may need to be disclosed, there are no disclosure obligations regarding the holding of certain portions of outstanding corporate debt. Needless to say, the risk that the investor will not achieve his aims with respect to equity in the target company is much higher with a hostile approach than with a consensual approach.

**ACQUISITION OF THE LOANS**

Once the investor has decided to invest, he must acquire the company’s debt from the banks. The level of complexity associated with the debt acquisition varies greatly, depending on the structure of the loans, the security (in particular if a security pool agreement is in place), and the selling bank(s) involved. Providing information regarding the loans and the debtor to the investor during a due diligence review can be an issue under German banking secrecy rules unless management has consented to the investment and agrees to the provision of due diligence information to the investor.

The acquisition of the loans can be structured as (i) a sub-participation in the loans and the underlying security, (ii) an assignment of the claims under the loans and the security, or (iii) a complete transfer of the loan agreements and the security agreements. A complete transfer of the loan agreements will usually be chosen where revolving or partially undrawn credit lines are acquired that need to remain available to the company. A transfer requires the consent of all the parties to the agreements that are being transferred and is more complicated as a result. If the loan is part of a syndicated loan or the underlying security is subject to a security pooling agreement, the bank must also transfer its contractual position under these agreements in order to allow the investor to assert his rights against the other members of the syndicate or the security pool. Under German law, the transfer of these contractual positions requires the consent of all other members of the syndicate or the security pool, which adds to the complexity and may delay the process.

Specific issues arise where the loans are secured by a government guaranty. The investor is well advised to approach the government at an early stage because its approval is generally required for a transfer of the guaranty to the investor. In any case, the investor and his advisors must ensure that the contractual positions assigned to the investor allow him to implement the workout strategy, in particular, contribution of the loans to the company in the debt-equity swap and the associated release of security.

**RESTRUCTURING IN FORMAL INSOLVENCY PROCEEDINGS**

In Germany, companies in financial difficulty are usually restructured outside of formal insolvency proceedings. The impact of a formal insolvency proceeding on business relations with suppliers and customers is usually severe, and there is a substantial risk that key employees will leave the company due to speculation that the company will be unable to continue with its business operations. However, the high volume of insolvencies in recent years has resulted in a number of successful restructurings in formal insolvency proceedings. Examples such as these are beginning to change the stakeholders’ perception that a formal insolvency process will most probably result in a winding-up of the business.

Formal insolvency proceedings offer a number of advantages for the restructuring of the company, in particular the ability to terminate (and possibly renegotiate the terms of) contracts and the easing of restrictions on the dismissal of employees. Restructuring in formal insolvency proceedings is achieved by means of an insolvency plan. It can be proposed by the insolvent company itself as a prepackaged plan in conjunction with the commencement of insolvency proceedings. The plan can be freely arranged and include all provisions that could be made in an ordinary restructuring agreement (e.g., waiver and deferral of claims, alteration of security, an undertaking of the investor to contribute the acquired loans and/or to provide new capital to the company, or an undertaking of a stakeholder to extend financing to the company to fund the reorganization).
Increasingly, an insolvency plan proposal is combined with a motion for “self-management” by the management of the insolvent company, which is similar to the concept of a chapter 11 “debtor in possession” under U.S. law. Under self-management, the management of the insolvent company remains in control of business operations but is placed under the supervision of a creditors’ trustee. To date, German insolvency courts have rarely left management in control, generally appointing an insolvency administrator who takes control of the company’s business operations. Self-management has the distinct advantage of retaining the experience and market know-how of existing management. An insolvency administrator who is unfamiliar with the company and its operations has very little time to acquaint himself with the business. The chances of prevailing on a motion for self-management can be improved if the insolvent company appoints proven restructuring experts to its board prior to filing an insolvency application. The main advantage of self-management is that the identity and expertise of the personnel who will be implementing the restructuring are known to the stakeholders at the outset of the proceedings. Investors are much more reluctant to invest if it is unclear who is managing the business, and whether such manager will implement the restructuring plan, as is frequently the case when an insolvency administrator is appointed.

**VALUATION OF THE DEBT**

During the course of a debt-equity swap, the non-performing loans will be contributed to the target company as a contribution in kind in exchange for the issuance of new shares that are issued in connection with the increase in the target’s capital. If the loans are contributed to a corporation (either a stock corporation (“AG”) or a limited liability company (“GmbH”)) or by a limited partner of a limited partnership (“KG”), the fair market value of the contribution (i.e., the claims against the target company based upon the loans) must be at least equal to the nominal value of the shares or partnership interest issued for it. Should the fair market value of the contribution in kind be below the nominal value of the shares, the investor runs the risk that (i) the commercial register will refuse to register and thus prevent the capital increase, or (ii) if the deficiency in the value is discovered after the registration, the investor will be personally liable to pay the shortfall. Because in turnaround situations the fair market value of the loan will be substantially below its nominal value, the exact value has to be determined by means of an expert opinion of an auditor. In the case of a capital increase in a stock corporation, such opinion has to be provided by a court-appointed neutral auditor. In the case of a limited liability company, an expert opinion will typically be requested by the commercial register before the capital increase is registered.

**EQUITABLE SUBORDINATION OF LOANS**

Typically, an investor will convert only a portion of the purchased loans into equity and will retain the remainder in the form of shareholder loans. Shareholder loans to a company in financial difficulty may be subject to the rules of equitable subordination and may be treated as if they were equity. During an insolvency, equitably subordinated loans rank behind the claims of normal creditors. Outside of formal insolvency, the company may be entitled to refrain from repaying such loans until its financial difficulties have been resolved.

In order to provide an incentive for investors to provide new funds to distressed companies, the rules of equitable subordination were modified by the introduction of the so-called restructuring privilege. Under these rules, existing and new loans by an investor will not be subject to the rules of equitable subordination, provided that the investor becomes a shareholder of the company in a crisis situation with the aim of restructuring the company. Nevertheless, an investor should carefully review whether the requirements of the restructuring privilege have been met.

**TAX EXEMPTION FOR “RESTRUCTURING PROFITS”**

Because the nominal amount of the shares issued as consideration for the contribution of the non-performing loans in a debt-equity swap will be significantly lower than the nominal amount of such debt on the books of the company, the target company will show a restructuring profit in the amount of the difference. If this restructuring profit were subject to regular taxation (i.e., income and trade tax), the benefits of the restructuring to the company would be largely eliminated.
In order to address this conflict between the taxation of restructuring profits and the aim of the German Insolvency Code to facilitate the restructuring of a distressed company, the German Federal Finance Ministry on March 27, 2003, issued a letter to the state tax authorities providing that income tax on restructuring profits shall be deferred and subsequently waived under the principles of equity (sachliche Billigkeitsgründe) if the following conditions are met: the company is (i) in a crisis but (ii) capable of being restructured and (iii) the tax waiver is a suitable and sufficient restructuring measure and (iv) the investor intends to restructure the company. The tax authorities will normally require the company to provide them with its restructuring plan to determine whether these conditions have been fulfilled.

Once the tax authority has qualified the profits as privileged restructuring profits and agreed to defer and waive the respective income tax, the company can apply to the municipality where the company's operations are located for a similar decision with respect to the trade tax. Although these are two separate proceedings and the municipality is not bound by the decision of the tax authority, the municipality generally follows the lead of the tax authority, particularly if the waiver of the trade tax is necessary for a successful restructuring of the company and the decision will keep jobs and a (potential) taxpayer in the city.

EXEMPTION FROM MANDATORY TENDER OFFER

If the target company is listed on a stock exchange, the rules of the German Takeover Code (Wertpapiererwerbs- und Übernahmegesetz) apply. Pursuant to the German Takeover Code, an investor who acquires shares in a listed company as a result of a debt-equity swap or otherwise and subsequently directly or indirectly holds at least 30 percent of the voting rights in the company must make a mandatory tender offer for all of the remaining shares of the company. This obligation generally makes any debt-equity swap transaction regarding a public company unattractive for an investor who, alone or jointly with other investors, intends to take a controlling interest in the company in order to implement the restructuring plan. In order to address this concern, the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, or “BaFin”) may exempt an investor from the obligation to make a tender offer if the investor gains control of the target company in connection with the restructuring of the company.

The decision to grant an exemption is in the discretion of BaFin. However, the exemption will generally be granted if the interests of the other shareholders are not negatively affected and the investor can demonstrate to BaFin that the target company is in a serious crisis and that the planned restructuring measures are suitable to restructure the company. In addition, the investor seeking the exemption must make a substantial restructuring contribution to the company, which in the case of a debt-equity swap will be the waiver of the claims under the acquired loans plus, in most cases, the provision of new money. The investor can apply for the exemption either before he assumes a controlling interest in the company or within seven days thereafter.

CONCLUSION

German companies in financial difficulty continue to provide interesting investment opportunities for international investors. The acquisition of controlling stakes by means of debt-equity swaps is no longer a novelty in the German market. Although it is potentially more complicated than a straightforward M&A transaction, a debt-equity swap can still offer extremely attractive returns.

LAWYER CONTACTS

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