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GERMAN BUSINESS RESTRUCTURING AND REORGANIZATION NEWS

CONTENTS

THE SELECTION OF GERMAN INSOLVENCY ADMINISTRATORS

Insolvency administrators are appointed in virtually all German insolvency proceedings. In practice, they are responsible for the continuation and management of the business as well as the review and (partial) satisfaction of creditors' claims. They have a key role in any restructuring of the insolvent entity, and they are the ones who will sell either the business as a whole or the individual assets in a liquidation. Given their central role in the proceedings, the success of any restructuring or divestment depends very much on the administrator. Consequently, the identity of the administrator and the selection process are of considerable importance to investors, creditors, and other stakeholders.

APPOINTMENT BY THE INSOLVENCY COURT

The insolvency administrator is appointed by the court if and when insolvency proceedings are formally commenced. The actual selection of the administrator usually occurs a couple of months earlier, since the court, at least in corporate insolvencies, normally appoints an interim administrator shortly after the actual insolvency application is filed. In the vast majority of cases, the interim administrator is later appointed insolvency administrator. Creditors or other stakeholders are not entitled to choose the administrator at this stage. Stakeholders may, of course, make a proposal to the insolvency court, but the court may use its discretion in deciding whether to follow the proposal. The practice of the courts varies. The law requires the insolvency administrator to be neutral, *i.e.*, independent from both the debtor and (individual) creditors. The insolvency court will usually examine carefully any proposals made by the major creditors. The fact that a candidate was proposed by a creditor will not rule out the appointment of that candidate if his impartiality is above question. However, such a proposal will not necessarily cause that candidate to be appointed.

The disadvantages of electing a new administrator are such that creditors rarely make use of this right. A new insolvency administrator would have to become acquainted with the insolvent company's business, which may require a substantial amount of time and delay the proceedings. . . . In practice, it is thus the insolvency courts that determine the administrators.

ELECTION BY CREDITORS' ASSEMBLY

While individual creditors have no right to a binding proposal, the creditors' assembly, at its first meeting, can elect a new insolvency administrator, who will then be appointed by the insolvency court unless he is not qualified for the position. In practice, the disadvantages of electing a new administrator are such that creditors rarely make use of this right. A new insolvency administrator would have to become acquainted with the insolvent company's business, which may require a substantial amount of time and delay the proceedings. The first creditors' assembly takes place a couple of months after the filing of the insolvency application and the appointment of the interim administrator, so the court-appointed administrator would have had enough time to familiarize himself with the business. Many important decisions are taken prior to the first creditors' assembly. Therefore, a new insolvency administrator is usually only chosen in exceptional circumstances.

LEGAL REQUIREMENTS

In practice, it is thus the insolvency courts that determine the administrators. The Insolvency Code has established a few criteria that the insolvency court needs to observe when appointing an insolvency administrator. The court may appoint only a natural person, not a corporation or a partnership. The candidate needs to be experienced in business and must be qualified for the individual case but need not belong to a certain profession. In most cases, lawyers, accountants, or tax advisors are appointed.

The complex legal and financial tasks that insolvency administrators often face in insolvency proceedings make it necessary for potential candidates (and their firms) to specialize. Over the last few decades, insolvency administration in Germany has become a profession and the core business of many firms. In recent years, the qualifications of the candidates and the selection process have been the subject of an intense discussion that has led to numerous precedents; various decisions by the German Federal Constitutional Court (*Bundesverfassungsgericht*); a change of the Insolvency Code; and the appointment of a commission to investigate the selection process, which recently published its report.

NO "CLOSED SHOP"

On the basis of various decisions of the German Federal Constitutional Court, a selection process has been established that comprises two stages. First, the court determines in a pre-selection process the candidates who are generally suitable for the position of administrator and then includes these persons (and their specific skills) in a list. Second, the court decides who is appointed in an individual case.

The Federal Constitutional Court ruled that the practice of some insolvency courts of providing a closed list, in which new candidates are not included until a person already on the list quits (and which leads to a "closed shop" at the respective insolvency court), is not permissible. Each person who applies for appointment as insolvency administrator, if appropriately qualified, needs to have a fair chance of being included on the list. The Law on the Simplification of Insolvency Proceedings, which became effective on July 1, 2007, introduced this rule into the Insolvency Code. Also, the court may not choose the insolvency administrator simply by appointing the next person on the list, as this will obviously not ensure that an administrator suitable for the specific proceedings is selected.

DISCRETION OF THE INSOLVENCY COURT

Despite these rules, the insolvency courts still have a great deal of discretion regarding candidates' inclusion in the list and appointment in the individual case. As a consequence, while a candidate who believes that he was unjustifiably passed over may take legal action against the court's decision, he will be successful only in exceptional cases. In addition, such legal action can aim only at damages against the state, not at appointment as administrator in place of the person selected by the court. This would delay insolvency proceedings and obviously be to the detriment of the creditors.

CRITERIA FOR SELECTION

According to the Federal Constitutional Court, it is up to the insolvency courts to determine the criteria for including candidates in the list and for appointment in the individual case. To standardize these criteria, the Uhlenbruck Commission, named after its chairman, Professor Uhlenbruck, was appointed, which recently published its report. Among the criteria developed by the commission are a set of skills (including qualifications in business economics and law as well as management skills) and a demonstrated level of experience. The report also recommends that the criteria applied by the respective insolvency court for inclusion in the list, as well as the list itself, be made accessible by the court and posted on its web site. It remains to be seen whether the recommendations made by the commission will be accepted by the insolvency courts. If so, it will lead to greater transparency in the selection of insolvency administrators.

NEW LEGISLATION

A number of new laws have been passed or proposed in 2007 that provide for significant changes to the German Insolvency Code and other laws applicable to businesses in financial difficulties:

- The **Law on the Simplification of Insolvency Proceedings** (*Gesetz zur Vereinfachung des Insolvenzverfahrens*) became effective on July 1, 2007, and provides for the following changes (amongst others):
  - The insolvency courts are authorized during opening proceedings to prevent secured creditors from (i) taking possession of and selling movables such as inventory, machinery, or equipment, and (ii) collecting trade receivables, even if the assets were assigned to the creditors as security. Similarly, lessors can be prevented from regaining possession of movables, even if they have effectively terminated the lease agreement with the debtor. "Opening proceedings" describes the stage of insolvency proceedings that starts with the insolvency application and ends with the court decision on the formal commencement of proceedings. The court may pass such orders only with respect to assets that the debtor requires to continue its business operations. The court can also authorize the interim insolvency administrator to collect the trade receivables. The administrator needs to turn over the proceeds of the collection to the secured creditor but is entitled to retain a contribution for the estate (generally 9 percent). To the extent that the continued use of machinery or equipment impairs its value and the security interest, the creditor can require compensation from the estate. In addition, a creditor that is prevented from enforcing its security interest is entitled to interest payment after a period of three months following the court order. In practice, secured creditors frequently enter into realization agreements with the insolvency administrator.

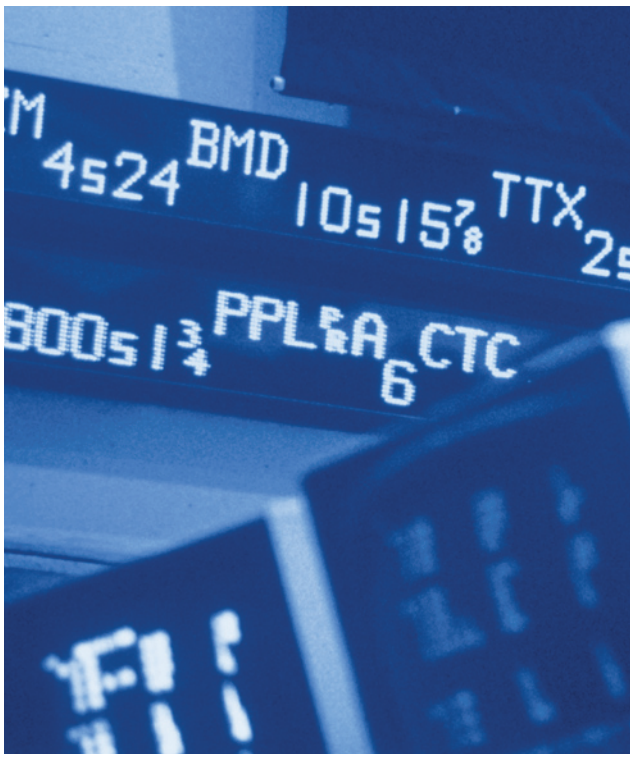
  - The notice period for lease agreements over real estate rented by the debtor (including business premises) is now three months at the most, regardless of whether the agreement provides for longer notice periods or a fixed term. This amendment allows an early termination by the insolvency administrator of lease agreements with respect to real estate that the business no longer needs, in order to reduce estate costs and to facilitate restructuring. Prior to the reform, the administrator had to observe much longer notice periods, depending on the type of lease agreement.

- The German government resolved on a draft **Law on the Relief of Fundless Persons, the Improvement of Creditors' Rights, and the Regulation of Licenses** (*Entwurf eines Gesetzes zur Entschuldung mittelloser Personen, zur Stärkung der Gläubigerrechte sowie zur Regelung der Insolvenzfestigkeit von Lizenzen*)

on August 22, 2007. The government expects to complete the parliamentary process in the spring of 2008 so that the law may become effective later in that year. It will provide for the following major amendments, with changes possible in the further legislative process:

- The draft proposes to facilitate the process of relieving the debts of (natural) persons who are entirely without funds. This issue has been a major topic in Germany at least since 2001. The current process is deemed to be far too cumbersome. The existing law requires the debtor to go through insolvency proceedings (a simplified version applies in the event that the debtor is a consumer), even though there are not sufficient funds in the estate to cover the costs of proceedings. Relief proceedings follow and require the debtor to assign the major portion of his income to a creditors' trustee for a period of six years following the formal commencement of insolvency proceedings. The draft proposes to do away with the necessity of going through insolvency proceedings if it is clear that the debtor does not have sufficient funds to cover even the costs of proceedings. If this is determined by the court, then relief proceedings immediately follow opening proceedings. The debtor is required to submit lists of his property and confirm their accuracy by means of an affidavit. He is supervised by a court-appointed preliminary trustee. If the insufficiency of funds is established during the insolvency proceedings, this proceeding is terminated and relief proceedings can follow.

- Additional new rules intend to ensure that managing directors of German corporations file for insolvency within the statutory three-week period following the corporation's becoming unable to pay its liabilities or overindebted. The interim insolvency administrator or any ordinary creditor can require directors who failed to file in time, to advance funds covering the costs of the insolvency proceedings. Insolvency proceedings are opened by the court only if there are sufficient funds in the estate to cover the costs of such proceedings. Frequently it is only in the stage of proceedings following the opening decision that the administrator discovers and collects assets belonging to the estate. Furthermore, if insolvency proceedings are opened with respect to the managing director himself, he will not be entitled to be relieved of his debt if it turned out that he had culpably failed to file for insolvency in time.



- The draft will introduce a provision into the Insolvency Code that will allow licenses enabling the licensee to use intellectual property rights of the licensor to survive the latter's insolvency. Under existing law, upon the opening of insolvency proceedings, the insolvency administrator is entitled to decide, on behalf of the licensor, whether to fulfill the license agreement or to terminate it. In the latter case, the licensee merely has a claim for damages as an ordinary creditor. Since the solvency of licensees frequently depends on the continued use of the intellectual property rights, it was deemed appropriate to ensure that the license would survive in the insolvency of a licensor.

- The draft of the Federal Council (*Bundesrat*) of a **Law on the Improvement and Simplification of the Supervision in Insolvency Proceedings** (*Gesetz zur Verbesserung und Vereinfachung der Aufsicht in Insolvenzverfahren*) of October 12, 2007, is still in the early stages of the legislative process. It aims to extend the scope of the insolvency court's supervision of the administrator and to improve the transparency of the insolvency process for the benefit of creditors.

COURTS HELP GERMAN LISTED COMPANIES DEAL WITH PREDATORY SHAREHOLDERS

Opposing shareholders regularly challenge fundamental corporate transactions of publicly listed companies in Germany in an attempt to obtain unjustified personal benefits. Frequently targeted transactions include capital increases and decreases, squeeze-outs, enterprise agreements, and mergers. The (potential) delay in implementing such measures is usually very damaging for the company and can cause the transaction as such to fail. This is particularly obvious in cases where the company is in need of new equity due to financial difficulties but investors are unable or unwilling to wait an undetermined period before the company can issue new shares. However, in two recent decisions, German courts have taken away incentives for abusive shareholder action and significantly increased the risks to such shareholders.

DELAYING CORPORATE TRANSACTIONS

Such shareholders of German stock corporations regularly seek to take advantage of the fact that certain corporate transactions, like the ones mentioned above, are subject to shareholder approval and become effective only upon registration of the shareholder resolution in the commercial register. The resolution is usually not registered until any challenges by shareholders have been ultimately dismissed by the courts. Therefore, shareholders, even those holding only a single share in the company, are in the position to delay the implementation of any of the aforementioned transactions for several months or even years by challenging the underlying shareholder resolution.

While most of the listed companies in Germany have been confronted with such shareholder action at some point, it is a small group of about 40 individuals (and their corporate vehicles) who most frequently engage in the “business” of obtaining benefits from the company or its other shareholders as consideration for discontinuing their challenge of corporate transactions.

The company can apply to the court for an order allowing capital measures or enterprise agreements to be registered even though the specific transaction was challenged by shareholders and this challenge has not yet been resolved (*Freigabeverfahren*). The scope of this remedy was significantly broadened in 2005 in an attempt to curb abusive shareholder actions, but it has not had the desired effect, since the remedy procedure as such can last several months.

INCENTIVES

While most of the listed companies in Germany have been confronted with such shareholder action at some point, it is a small group of about 40 individuals (and their corporate vehicles) who most frequently engage in the “business” of obtaining benefits from the company or its other

shareholders as consideration for discontinuing their challenge of corporate transactions.

Until a few years ago, settlements included direct payments of significant amounts by the companies to the opposing shareholders. Today, as the companies now have to disclose such settlements, it has become almost standard practice for the opposing shareholders to request instead: (i) payment from a third party (*e.g.*, a controlling shareholder); (ii) an allocation of more subscription rights than they are entitled to, in order to purchase newly issued shares at a rate below market value; or (iii) reimbursement of their expenses, including legal fees, from the company. Opposing shareholders are believed to benefit from the reimbursements of legal fees in the form of kickbacks. To make a settlement more attractive to the opposing shareholders, the legal fees are calculated not on the basis of the value of the opposing shareholder's stake in the company, but on the basis of a discretionary higher amount, or even on the basis of the overall transaction value. It is not surprising that the terms "professional claimants" and "predatory shareholders" are often used for this group.

"FRUITLESS" INTERVENTION

In a number of cases, when one or several shareholders filed an action in court to set aside a shareholder resolution, other opposing shareholders joined the proceedings not as plaintiffs but only as interveners by means of an intervention in support of the plaintiffs. This allowed the interveners to limit their efforts in court to a mere assent to the plaintiff's actions. Their intention was to request reimbursement of legal fees for virtually no effort once the plaintiff settled the case. In July 2007, the Federal Supreme Court had to decide on a case where the plaintiff and the company reached a settlement that did not provide for any financial benefits to the intervener. The intervener claimed before the court reimbursement of legal fees. The court took the position that the intervener was not entitled to any reimbursement from the company and further stated in its press release with regard to the case that "the interveners to so-called 'professional shareholders' should not expect to receive any significant payments for attorneys' fees in future proceedings, if the plaintiff and the company have reached a settlement."

ABUSIVE SHAREHOLDER ACTION

In October 2007, the Regional Court of Frankfurt am Main awarded damages to a company sued by one of its shareholders. The shareholder had challenged on formal grounds a shareholder resolution providing for a capital increase. The plaintiff offered to withdraw his action if the company ensured that he and five fellow shareholders whom he represented were each granted subscription rights for 3,500 new shares. All six shareholders together were entitled to subscription rights for 38 new shares, since they held only 53 existing shares in the company. The subscription rights that the plaintiff requested would have allowed him and his fellow shareholders to obtain 21,000 new shares for €1 each. The market value of these shares amounted to about €265,000.

Both court decisions are bound to curb abusive shareholder actions but are unlikely to cure the phenomenon as such. Further amendments to the Stock Corporation Act may be necessary to limit the ability of opposing shareholders to take personal advantage of fundamental transactions by the companies.

The court found the plaintiff's action to be immoral, dismissed the action, and upheld the company's counterclaim to damages. It ruled that the company was entitled to be indemnified of all damages it had incurred because the capital increase had been delayed by the shareholder's action.

FURTHER IMPROVEMENTS OF THE STATUTORY REGIME

Both court decisions are bound to curb abusive shareholder actions but are unlikely to cure the phenomenon as such. Further amendments to the Stock Corporation Act may be necessary to limit the ability of opposing shareholders to take personal advantage of fundamental transactions by the companies.

The current discussion focuses on whether a quorum (of 1 percent, 2 percent, or more of a company's share capital) should be required for a shareholder to be able to challenge a shareholder resolution or whether the rules of the remedy procedure to accomplish early registration of a resolution (*Freigabeverfahren*) can be improved. The latter appears to be a more viable instrument for a balanced solution to the conflict between shareholder protection on the one hand and deal protection on the other.

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