"Contractualised Distress Resolution in the Shadow of the Law"(*)

GERMAN NATIONAL FINDINGS (SUMMARY)

DRAFT OF 2 JULY 2018

INITIAL REMARKS

The German team faced a peculiar situation for research on Contractualised Distress Resolution – in particular through semi-formal proceedings outside and ahead of insolvency and with the aim to avoid it: German law, currently, does not provide for such semi-formal proceedings. Restructuring either takes place through informal (bilateral or collective but requiring unanimity) agreements between debtor and creditors [and potentially shareholders and investors], an informal going concern sale which is not facilitated by legal provisions, e.g. regarding the transfer of contracts or licenses, or in full-blown and formal insolvency proceedings. The latter may result in liquidation (standard scenario), either piece-meal or going concern, or in a restructuring according to an "*Insolvenzplan*" (insolvency plan) voted on and adopted by the stakeholders (creditors and shareholders) and confirmed by the court. This turns the German research into a "blind test", showing how a system works, and where are its shortcomings, without a preventive restructuring framework.

Another, connected issue regarding the German research is the relative lack of quantitative data: Restructurings by purely contractual agreements out-of-court usually take place in secrecy and their terms are confidential. Regarding insolvency proceedings, there are both official and inofficial statistics on their outcomes but these statistics are, for the most part, very limited, highly aggregated and do not allow for many conclusions at even remotely the level of granularity achieved in the other jurisdictions. The insolvency proceedings themselves and their files are also not publicly accessible. The (small) German team thus hugely relied on qualitative research in the form of extensive and structured interviews with pre-eminent restructuring experts, advising debtors, creditors, shareholders and investors, big or small, outside and during insolvency proceedings.

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The project addresses several key issues highlighted in the Recommendation of 12 March 2014 on a new approach to business failure and insolvency (2014/135/EU). It also considers the Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU (COM(2016) 723 final), published on November 22, 2016.

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The following findings, to a large degree, mirror the Italian National Findings in structure and, at times, even wording, showing many similarities but also some differences.

GENERAL FINDINGS

A) No clear trend regarding the contractual resolution of business distress.

While the Italian team reports a retreat of contractual resolutions of business distress, German qualitative research does not – or not clearly – echo such a trend. Only one expert, advising mostly smaller and regional banks as creditors, related that his clients have lately shown rather more reluctance to negotiate contractual out-of-court solutions than before 2013 and rather have debtors go through insolvency proceedings (with the restructuring option that has been strengthened by legislation in 2012). The other interviewees did not confirm such a trend but, when asked, saw out-of-court restructurings in a similar spot today than before 2013.

Regarding insolvency proceedings, the law reform of 2012 (*ESUG* – Act to further facilitate the restructuring of enterprises) introduced new tools – in particular the *Schutzschirmverfahren* (protective shield proceeding) – and strengthened others – in particular the *Eigenverwaltung* (*self or DIP administration*) –, and while these tools have seen several use cases (of varying success) during the past five years, there has not been a significant surge in successful insolvency restructurings – or so it has been perceived. A study / evaluation of the ESUG's success and possible shortcomings has been conducted by an expert group on behalf of the Federal Ministry of Justice, and the publication of the results will be forthcoming shortly, hopefully in time to be considered in the German National Report.

B) Additional rounds of restructuring are not uncommon.

Both contractual restructurings outside and inside of insolvency proceedings may require follow-ups. The assessment of the interviewees as to the frequency / ratio of sustainable restructurings and those requiring second or third rounds or ending up in liquidation varied hugely but it is undisputed that in a significant number of cases, a single restructuring agreement (be it a bilateral, multilateral or collective solution [including *Insolvenzplan*]) proves not to be sufficient in the longer run (or was never intended to be sufficient in the first place). A reason may be seen – on top of unpredicted changes in economic climate and markets or plain management mistakes – in too optimistic prognoses and plans/agreements not allowing for much latitude, thus offering stakeholders higher distributions and ensuring the necessary approval.

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1. TIMELY ACCESS TO RESTRUCTURING

1.1) In the vast majority of cases, debtors undertake serious restructuring efforts long after they should have to effectively tackle the distress.

An old (but still perceived to be indicative for the present) study[1] finds that the petition to commence insolvency proceedings has been filed, on average, 10.28 months, and in 70% of the cases more than six months too late (i.e. after the directors' duty to do so arose). The expert interviews suggest that the same is true for restructuring efforts ahead of an insolvency proceeding. Debtors usually start negotiations or seek expert advice too late – either unaware of the crisis or its extent, afraid of its consequences for their livelihood or reputation, or hoping for an (often no short of miraculous) solution without the other stakeholders' contribution. Quite frequently, experts have to advise clients to file for insolvency immediately upon being hired. In many other cases, restructuring options have been limited by time gone by before professional help is sought.

1.2) The governance structure of the firm is relevant in determining timeliness in addressing distress.

Experts unanimously agree that directors (usually co-owners) of (in particular: smaller) family businesses often close their eyes to a crisis and the need for restructuring but rather rely on objectively unlikely events to improve the situation. Even if the directors are aware of the crisis, they will sometimes be directed by the owners to not consider insolvency or measures that may lead to insolvency. Experts relay that they have been let go or threatened to be fired if they even present insolvency as an option or consideration.

1.3) Smaller businesses often have an inadequate accounting and reporting system, which does not allow early detection of distress and/or makes assessing and addressing it more cumbersome.

Experts agree that smaller businesses are – often – facing a number of different challenges where detecting a crisis and effecting a timely restructuring are concerned. Directors and key employees often lack professionality and training; accounting, reporting and compliance systems and mechanisms are lacking and by far less sophisticated than in bigger enterprises; costs for seeking professional advice are proportionally higher (as compared to the available funds); owners / shareholders tend to interfere more with the management's decision-making process.

1.4) The key trigger for restructuring are liquidity constraints.

Experts confirm that many debtors seeking their advice (in particular smaller businesses, see *supra*, 1.3) are already insolvent or face severe liquidity issues. Due also to the directors' duty to file for insolvency proceedings in (in particular) limited liability corporations in case of

[1] *Kirstein*, ZInsO 2006, 966.

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illiquidity/insolvency (or over-indebtedness), out-of-court solutions cannot be successfully pursued in many cases.

1.5) Financial covenants can play an important role as an early-warning mechanism.

Experts pointed out that, in particular with small and medium sized businesses, the initial impulse to seek advice, to assess the business's situation further, and to enter into negotiations with creditors, often comes from one of two external players: tax advisors hired by the company or banks. Regarding banks, the various reporting obligations under financial covenants appear to be of particular importance because these reports (or in case of regular reporting duties also their absence) may alert the bank to the fact that their client/debtor may face a crisis which, in turn, may lead to the bank approaching the debtor. Just like for Italy, it is true for Germany as well, however, that banks do not tend to enforce the covenants by accelerating loans but usually waive them or just renegotiate; covenants are not perceived to be used opportunistically.

1.6) The stigma of insolvency is still regarded as very high and is – to only a marginally lesser extent – also attached to *Schutzschirmverfahren* and subsequent insolvency proceedings in *Eigenverwaltung*.

Thus, for many directors / owners, "insolvency" is not an option to be considered unless (more than) unavoidable. This is also one reason, among others, why experts tend to hugely favour – where viable – out-of-court solutions over insolvency proceedings even though some restructuring tools are only or more easily accessible during insolvency proceedings.

1.7) The earlier the restructuring, the better the outcome.

While lacking quantitative evidence for this, German qualitative research suggests – hardly surprising – that any kind of restructuring (out-of-court or in insolvency) benefits hugely from an early start. Two main reasons: (a) there tend to be more assets available to use for restructuring measures and/or distributions, (b) it is usually easier to gain creditors' trust when approaching restructurings soon and proactively.

2. TYPE OF PROCEDURE

2.1) When an out-of-court restructuring seems possible, advisors usually advise against formal insolvency proceedings.

See already *supra*, 1.6. Advisors in the huge majority of cases advise against formal insolvency proceedings where a (purely contractual) out-of-court solution is a viable option – while insolvency law offers some restructuring tools unavailable outside insolvency, the downsides (both legal and economical) are usually perceived as outweighing them by far.

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2.2) Businesses involved in a restructuring are usually larger (when size is measured by total assets) than those liquidated during insolvency proceedings.

Bigger companies are more likely to pull off both complicated out-of-court restructurings and restructurings in insolvency plan proceedings. Three main reasons: (a) timelier start, (b) bigger concern to creditors increases their willingness to cooperate and put in the effort, (c) more assets to hire advisors and finance the restructuring.

2.3) Especially in the biggest cases, advisors may consider forum shopping / COMI- or choice of law-shifts to access foreign restructuring proceedings (in particular the English Scheme of Arrangement, but also the French *procedure de sauvegarde* or the US-American chapter-11-proceeding). Actual use cases are rare, however.

Most advisors to large-sized debtors or else closely involved in large restructurings confirm that they consider whether a foreign legal system would be more suited for a successful restructuring and, if so, whether and how to move the forum abroad. This becomes particularly relevant when faced with a (potential) strong hold-out position since German law does not normally offer any cram-down / majority rule mechanisms outside of formal insolvency proceedings. In most cases, costs, difficulties and uncertainties outweigh the potential benefits, though, so that cases in which German enterprises avail themselves of foreign proceedings (do exist but) remain rare.

However, interviewed advisors universally advocated (more or less strongly) the introduction of a pre-insolvency restructuring proceedings in Germany. It would be a valuable addition to the tool box – regardless of how often it would actually (have to) be used. The threat alone would keep hold-out stakeholders in line and willing to compromise.

2.4) Do professionals not exert sufficient pressure to filter out bad cases from viable restructuring candidates?

Interviews with German experts have not positively confirmed this Italian finding. However, it is likely – to some extent – true in Germany as well: Advisors will usually take the money available to them in fees. They will advise (or try to advise) the debtor on the available avenues and suggest liquidation (inside or outside of insolvency procedures) if the company does not appear to be viable – but upon being directed to still pursue restructuring negotiations, they will not likely refuse – and are under no obligation to do so.

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3. RESTRUCTURING COSTS FOR PROFESSIONALS AND ADVISORS

3) Restructuring costs for professionals and advisors are regarded as high and may be particularly burdensome for MSMEs.

Costs for professionals and advisors in Germany are regarded as high and a significant obstacle, especially for MSMEs. In addition to the complexities of the subject matter and the highly specialised, yet at the same time broad expertise required, a main concern is the number of experts working on a "case" – sequentially, for different stakeholders (esp. banks hiring experts at debtor's expense), and for different tasks (taxes, workforce, creditors, etc., possibly in different jurisdictions). Also, not only the law is complex but also the cases, requiring a considerable amount of time (usually the basis of fee calculation outside of insolvency where IP fees are based on the estate size).

4. NEGOTIATING THE PLAN

4.1) Core actors in restructurings of companies reflect the ownership structure.

The central role in negotiating restructurings is played by the debtor. This is due to the (commonly) superior knowledge regarding the financial and economic details and to legal and factual obstacles other stakeholders face. Key creditors can, however, take on important parts.

Within the debtor organisation, the directors are the pre-eminent actors, with legal, accounting, compliance and similar departments usually acting in the background (if at all). The involvement of owners/shareholders varies hugely depending on the ownership structure – in family businesses, in particular, the directors are usually co-owners / shareholders themselves and/or the owners are heavily and closely involved in the decision-making and negotiations.

4.2) Banks' internal decisional processes have an impact on negotiations.

Banks are sometimes perceived to drag their feet due to internal procedures. Even in case of bank pools with a pool leader and where steering committees exist (which is rather uncommon), individual banks often seem to reserve the final say on restructuring plans or other key decisions.

4.3) Tax regulations and issues can pose significant obstacles to restructurings.

Almost universally, tax regulations (in particular regarding taxation of gains in restructuring) and their reach, vagueness and uncertainty are perceived an obstacle. The laws regarding taxation of restructurings and insolvency are notoriously unclear and in (almost universally acknowledged) desperate need of reform.

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Evidence regarding the role of the tax authorities – in particular in their role of institutional creditors – is more ambiguous, though. Some experts relate that they are cooperative enough, in particular concerning standstills and extensions and in particular in bigger cases, whereas the majority of experts state that it is very difficult to negotiate with tax authorities due to their general reluctance to discount, reschedule or forgive claims. One reason for this can be seen in the role of public auditing / accounting bodies such as the *Bundesrechnungshof* and the *Landesrechnungshöfe*. The federal system with taxes being administered on federal, state and municipal levels adds a layer of complexity.

4.4) The involvement of mediators is exceedingly rare, if not unheard of.

None of the interviewed experts has ever seen a mediator involved as such to facilitate negotiations on a restructuring plan.

5. CONTENT OF THE RESTRUCTURING PLAN

5.1) Restructuring attempts usually aim at a turn-around of the business and often also at maintaining the debtor entity; going-concern sales are a common alternative mostly in insolvency proceedings. Restructuring with the aim of orderly business liquidation is rare.

If a crisis is severe enough or a business model of a distressed debtor is not viable, liquidation usually will take place as a result of "normal" formal insolvency proceedings. While it is possible to draft a liquidation plan as *Insolvenzplan*, this option is rarely – if ever – used. Out-of-court restructurings usually aim at a turn-around of the business and the debtor entity, going-concern sales at this stage of a distressed business are – according to most interviewees – not too common because of potential avoidance and liability risks. During insolvency proceedings, however, a going-concern sale with or without an *Insolvenzplan* is a valid and common measure.

5.2) Operative measures are frequently an integral part of restructuring efforts.

According to the interviewed experts, purely financial restructurings happen – in particular as a consequence of exogenous shocks, e. g. to the financial markets – but the majority of business restructurings require operative measures to be effective and sustainable because the crises usually have their roots in operational, strategical or leadership issues. Changes to the management, introducing restructuring experts as CROs or general representatives, are common especially in larger cases, as are changes to production, workforce, strategies, etc.

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These operative measures, however, are not necessarily reflected in the actual restructuring plan / *Insolvenzplan* approved by the creditors or only as part of the descriptive / declaratory section or as milestones.

5.3) The most common financial restructuring tools are standstills, reschedulings and prolongations. Ambiguous evidence regarding subordination, hair-cuts, compensation from future profits, and fresh money/new financing.

Experts agree that the most common financial measures agreed upon by far are such delaying payments but not outright reducing the debt. The delays accepted vary hugely but will often reach time spans of 1-2 years, allowing operative measures to take effect.

While standstill, rescheduling etc. can address some liquidity issues, they will not improve the debtor's balance sheet and might not provide enough free liquidity to finance the restructuring efforts. Measures to relieve the balance sheet (e.g. subordination, hair-cuts, debt-equity-swap [see *ultra* 5.4]) and to provide additional liquidity (e.g. fresh money) are not quite as common. However, experts' statements as to the prevalence and volume of these financial restructuring tolls varied significantly; they seem to be very case-dependent. The same applies to the question whether the debtor will be asked to agree to a compensation from future profits (*Besserungsabrede*) in case of hair-cuts.

Regarding hair-cuts, while some experts said that creditors tend to not accept hair-cuts in out-of-court restructurings, or if they did only to a rather nominal degree (up to 10-20%), other experts related that significant hair-cuts (up to 80% and more) do happen. Compensation agreements appear to be rather common but not universally requested.

Concerning fresh money, several experts pointed out that creditors (in particular banks) usually expect shareholders and/or external investors to provide fresh money needed or good securities even though the shareholders' claims would regularly be subordinated by law. Uncertainties regarding the avoidance of bridge loan and restructuring loan repayments in subsequent insolvency proceedings as well as the (often rather theoretical) risk of lenders' liability act as a further deterrent to lenders of fresh money outside of formal insolvency proceedings. All this makes distressed equity investors an altogether interesting and important source of fresh money but often difficult to find.

5.4) Debt-for-equity swaps and conversion of debt into "hybrid" financial instruments are rare and virtually absent for small businesses.

The high costs and small market are rather prohibitive for small businesses. Debt-for-equity swaps or the swap into new hybrid instruments are more common for large businesses, but still mostly avoided by bank creditors due to their prudential and capital requirements.

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6. CIRCUMSTANCES AFFECTING THE OUTCOME OF THE RESTRUCTURING ATTEMPT

6.1) Family-owned businesses are more difficult to restructure than other businesses.

Experts universally confirmed that dealing with family businesses poses specific (additional) challenges. Not only are the owners' reputations and fortunes dependent on the business, and do they require counsel and shielding against liability of their own which creates conflicts of interests, the owners often are not as amenable to changes of strategy or – even worse – leadership. The upside, however, is that it appears easier to solicit fresh money from owners/shareholders where needed than with non-family owned businesses – unless, which is common, all personal reserves have already been invested into the business or used as a security for business debt before seeking professional restructuring advice – far too late.

6.2) The probability of achieving a restructuring is likely increased by a high degree of debt concentration.

Hardly surprising, anecdotal evidence suggests that negotiations are easier with fewer but highly engaged, interested and committed creditors.

6.3) The lack of adequate specialisation and/or competence by judges likely undermines the efficiency of insolvency restructurings.

Echoing a frequent criticism, several experts suggested that insolvency judges and judicial officers (*Rechtspfleger*) – with few notable exceptions – are not competent, experienced and equipped enough to conduct or facilitate insolvency restructurings. The provisions introduced by ESUG that judges and judicial officers in insolvency matters are required to show sufficient knowledge of certain subject matters (including accounting) have not yet shown significant results (and are unlikely to do so).

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