

# International Corporate Rescue



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## Germany's Special Resolution Regime for Failing Banks

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### I. Introduction

Banks, in their capacity as financial intermediaries, act at the very centre of modern economies. Their potential insolvency should therefore be considered unique. Indeed a bank's insolvency may affect the stability of the economy as a whole, thus creating vast externalities. The financial crisis of 2008-9 and the insolvency of Lehman Brothers are prime examples of this destabilising effect. Both events have demonstrated the shortcomings of corporate insolvency regimes in relation to the insolvency of banks. This results from the fact that corporate insolvency regimes are built upon principles that do not fully take into account the distinctive features behind a bank's insolvency.<sup>1</sup> *Firstly*, there is a difference in objectives. Corporate insolvency law seeks to achieve equal (*'pari passu'*) treatment of creditors and maximisation of the assets of the debtor in the interest of general creditors. By contrast, the main aim in bank insolvency proceedings is the protection of the underlying financial system. Other important considerations include prompt payment to depositors and minimising costs to deposit insurance funds. *Secondly*, creditors can be more active in general insolvency proceedings as compared to bank insolvency proceedings. While in the former, creditors can initiate the proceedings and act individually or collectively through creditor committees, in the latter, the power to commence and, to a certain extent, govern the proceedings typically lies with the regulator.<sup>2</sup> *Thirdly*, the general triggers usually associated with corporate insolvencies may be considered inappropriate for banks. In this regard, definitions of insolvency vacillate between cash-flow

(‘commercial’) and balance-sheet (‘absolute’) criteria. In relation to banks, however, the widely held view is that insolvency proceedings should commence at an earlier stage since, by the time a bank has already defaulted on any deposit liabilities, it will probably be too late for an orderly resolution. On the other hand, the balance sheet may not provide an accurate picture of the true depth of the accumulated losses since loan portfolios tend to deteriorate rapidly in bad times.<sup>3</sup>

German parliament has learned these lessons during the financial crisis. On 1 January 2011, after two years of drafting work, the Restructuring Act 2011<sup>4</sup> (the ‘Act’) came into force. Along with amendments to the German Banking Act,<sup>5</sup> the Act establishes a special resolution regime for banks in distress with a view not only to protecting the stability of the financial system,<sup>6</sup> but also enhancing public confidence in the stability of the financial system while protecting depositors.

### II. Germany's special resolution regime

#### 1. Overview

Both the Act and the German Banking Act provide specific provisions as to Germany's new special resolution regime for failing banks. While the Act establishes two stabilisation (or rescue) procedures, the German Banking Act provides for a supervisory procedure, in which Germany's regulator *BaFin*<sup>7</sup> may order a partial asset transfer onto a bridge bank. The new regime applies to banks within the meaning of § 1(1) of the German Banking Act.<sup>8</sup> More specifically, the Act applies to institutions that have permission to carry on

#### Notes

- 1 R.M. Lastra, ‘Northern Rock, UK bank insolvency and cross-border bank insolvency’ (2009) 9 *Journal of Banking Regulation* 165, 171 *et seq.*; M. Obermüller and K. Kuder, ‘Die Entwicklung der Gesetzgebung zu Bankinsolvenzen’ *ZInsO* 2010, p. 2016, 2017.
- 2 Lastra, *supra* note 1; Obermüller/Kuder, *supra* note 1, p. 2019.
- 3 C. Hadjiemannuil, ‘Bank Resolution Policy and the Organization of Bank Insolvency Proceedings: Critical Dilemmas’, in David G. Mayes and Liuksila, Aarno (eds.), *Who Pays for Bank Insolvency?* (London: Palgrave MacMillan, 2004).
- 4 *Restrukturierungsgesetz – KredReorgG*.
- 5 *Kreditwesengesetz – KWG*.
- 6 On the difficulty of defining the term financial stability, see H. Davies and D. Green, *Banking on the Future – The Fall and Rise of Central Banking* (Princeton University Press, Princeton and Oxford, 2010) pp. 54-59.
- 7 *Bundesanstalt für Finanzdienstleistungsaufsicht*. Further information is available at <[www.bafin.de](http://www.bafin.de)>.
- 8 A translation of the German Banking Act is available at <[www.iuscomp.org/gla/statutes/KWG.htm#1](http://www.iuscomp.org/gla/statutes/KWG.htm#1)>.

the regulated activities set forth in § 1(1) No 1-12 of the German Banking Act.<sup>9</sup> The Act does not apply to insurance companies. With regard to the baleful role played by some insurance companies during the financial crisis, the ambit of the regime is open to criticism for being too narrow. The Act applies to domestic banks only, *i.e.* banks with their statutory seat located in Germany.<sup>10</sup> It does not apply to branches of either EEA, or other foreign incorporated, banks. Lastly, none of the procedures require cash flow or balance sheet insolvency. Rather, their commencement standards are tied to the minimum capital and liquidity ratios derived from the Basel Accords as transformed into domestic law by the German Banking Act. Although Germany's new special resolution regime cannot therefore rightly be viewed as genuine insolvency law,<sup>11</sup> one should be aware that these commencement standards will in fact comprise cash flow and balance sheet insolvency as particularly intense forms of financial distress.

## 2. Stabilisation procedures

### a) *Sanierungsverfahren*

As soon as a bank is no longer compliant with the minimum capital or liquidity requirements of the German Banking Act, it is eligible for what has been named *Sanierungsverfahren*. The *Sanierungsverfahren* is set forth in §§ 2-6 of the Act and it is a voluntary non-public procedure available to any bank irrespective of its systemic relevance.<sup>12</sup> This procedure is similar to a CVA or a Scheme of Arrangement under ss. 895-901 of the Companies Act 2006 in that it is a multilateral agreement between the creditors, the distressed bank and its

shareholders with the aim of preserving the bank as a going concern. The *Sanierungsverfahren* is conducted under the supervision of the Court<sup>13</sup> and it shall not interfere with third parties' rights and interests.<sup>14</sup>

The *Sanierungsverfahren* is triggered by a notice from the bank to *BaFin* where the bank notifies that it is no longer compliant with the minimum capital or liquidity requirements under § 10 and § 11 of the German Banking Act.<sup>15</sup> Along with the notice, the bank shall submit a draft reorganisation arrangement and propose a reorganisation advisor.<sup>16</sup> If *BaFin* determines that the bank is no longer compliant with the minimum capital or liquidity requirements and that such distress may successfully be remedied by way of the proposed arrangement, it shall immediately apply to the Higher Regional Court (*Oberlandesgericht*) of Frankfurt/M.<sup>17</sup> for commencement of a *Sanierungsverfahren*. If the court is satisfied that the proposed arrangement is not 'evidently unsuitable' (a test comparable to the feasibility test in a chapter 11 proceeding), it will grant an order allowing the *Sanierungsverfahren* to proceed and appoint a reorganisation advisor to that effect. This rather complicated procedure – notice, application, court order – is the result of the legislator's desire to combine private initiative with both early regulatory participation and court supervision.

The reorganisation advisor has the most important role in the *Sanierungsverfahren*. The reorganisation advisor implements the reorganisation arrangement and may, *inter alia*, investigate the bank's business conduct, inspect the bank's records, take part in board meetings, and give instructions to the bank's management.<sup>18</sup> The reorganisation advisor is entitled to remuneration<sup>19</sup> and shall be liable for acts and omissions negligently committed in exercise of their office.<sup>20</sup> Lastly, they are

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- 9 Namely the acceptance of funds from others as deposits or of other repayable funds from the public unless the claim to repayment is securitised in the form of bearer or order debt certificates, the granting of loans, the purchase of bills of exchange and cheques, the purchase and sale of financial instruments in the credit institution's own name for the account of others, the safe custody and administration of securities for the account of others, the business specified in section 1 of the Act on Investment Companies (*Gesetz über Kapitalanlagegesellschaften*), the incurrance of the obligation to acquire claims in respect of loans prior to their maturity, the assumption of guarantees and other warranties on behalf of others, the execution of cashless payment and clearing operations, the purchase of financial instruments at the credit institution's own risk for placing in the market or the assumption of equivalent guarantees, the issuance of prepaid cards for payment purposes, unless the card issuer is also the service provider and hence the recipient of the payment made using the card, and the creation and administration of units of payment in computer networks.
- 10 § 1(1) of the Act. On the international application of the Act, *see* below III.
- 11 S. Schelo, 'Neue Restrukturierungsregeln für Banken' NJW 2011, p. 186, 188. This may be regarded as a notable difference from the U.K. Banking Act 2009, which does in fact establish both a new genuine bank insolvency procedure and a new bank administration procedure.
- 12 Schelo, *supra* note 11, p. 186 *et seq.*
- 13 § 3(1), § 4(2), § 5 and § 6(2) of the Act.
- 14 § 2(2) of the Act.
- 15 § 2(1) of the Act.
- 16 § 2(2) of the Act. The reorganisation advisor may be an employee of the bank or a member of the bank's management board, § 3(3) of the Act. Both *BaFin* and the Court may deviate from the bank's proposal if they think the proposed advisor may not to be the right person (§ 2(3) and § 3(1), respectively).
- 17 § 2(3) of the Act and Schelo, *supra* note 11, p. 186 *et seq.*
- 18 § 4(1) of the Act.
- 19 § 4(4) of the Act.
- 20 § 4(3) of the Act.

to notify the Court on the successful completion of the *Sanierungsverfahren*.<sup>21</sup>

The reorganisation arrangement may allow for any appropriate or adequate measure that remedies a bank's distress. Some notable examples include discharge or deferment of the bank's debts, new loans, capital increases and/or reductions and debt equity swaps. As mentioned above, the reorganisation arrangement shall not interfere with third parties' rights and interests. There is, however, one important exception to that rule. The reorganisation arrangement may stipulate that newly granted loans shall enjoy priority in subsequent insolvency proceedings, if such proceedings are commenced within three years after the court has ordered the *Sanierungsverfahren* to commence.<sup>22</sup> The rationale of this rule is that, in its absence, the bank would have difficulty obtaining new financing if potential lenders carried the risk of ranking *pari passu* with unsecured creditors in subsequent insolvency proceedings. This exception is truly remarkable, given that the German corporate insolvency law is, in general, not cognisant of priority rules. The percentage of such priority funding shall, however, not exceed ten percent of the banks own funds. Unsecured creditors may appeal against the priority status on the grounds that the commencement standards for a *Sanierungsverfahren* were not met or that the 10% threshold was exceeded.<sup>23</sup>

#### b) Reorganisationsverfahren

If the bank considers a *Sanierungsverfahren* futile, or if it fails, a *Reorganisationsverfahren*, under §§ 7-23<sup>24</sup> of the Act, may be commenced. The *Reorganisationsverfahren* is modelled after the German *Insolvenzplanverfahren*: Germany's closest equivalent to Chapter 11 of the U.S. Bankruptcy Code. It is a voluntary public procedure conducted by a court-appointed practitioner (not necessarily an IP) under the supervision of the Court.

According to § 7(1) and (2) of the Act, the *Reorganisationsverfahren* is triggered by a notice to *BaFin* that indicates that the existence of the bank is endangered and that this, in turn, endangers the stability of the financial system. A bank's existence shall be deemed

endangered if its capital or liquidity has fallen below or is likely to fall below the minimum capital and liquidity requirements as set forth in § 10 and § 11 of the German Banking Act by 90% or more.<sup>25</sup> The stability of the financial system is deemed endangered if the bank's distress is likely to detrimentally affect other market participants in the financial sector, the financial markets or public confidence in the proper functioning of the financial markets.<sup>26</sup> Hence, § 7 of the Act does not only provide for the commencement standards of the *Reorganisationsverfahren*, but it also confines its scope to banks of systemic relevance. Along with the notice under § 7 of the Act, the bank shall submit a draft reorganisation plan and propose a reorganisation advisor.

If *BaFin* is satisfied that the requirements set forth in § 7 of the Act are met, it may apply to the Higher Regional Court (*Oberlandesgericht*) of Frankfurt/M. for a *Reorganisationsverfahren* to be commenced. The court shall hear *Deutsche Bundesbank* before making a determination.<sup>27</sup> While there is no moratorium in the strict sense of the word, once the bank has notified *BaFin* any prior agreement with the bank may not be terminated until the end of the following day.<sup>28</sup> This provision, which shall apply, *inter alia*, to close-out netting,<sup>29</sup> is thought to facilitate reorganisation since it prevents creditors from withdrawing assets in the form of contractual claims. However, the established period of time is clearly too short to achieve this goal: a bank cannot possibly be restructured in one day.<sup>30</sup>

At the heart of the *Reorganisationsverfahren* lies the reorganisation plan submitted by the bank. Unlike the reorganisation arrangement under § 2 of the Act, the reorganisation plan is not a multilateral agreement. Rather, it is a bundle of reorganisation measures voted on by the creditors and the shareholders of the distressed bank. It does not require unanimous consent but, broadly speaking, a majority vote; thereby allowing for the interference with the rights and interests of dissenting creditors' and shareholders.<sup>31</sup> Class formation is mandatory.<sup>32</sup> Court approval is required. The *Reorganisationsverfahren* is distinct from a traditional *Insolvenzplanverfahren* in two respects: (i) creditor's appeals will be limited to a minimum so as to render

#### Notes

21 § 6(3) of the Act.

22 § 2(2) of the Act.

23 § 3(2) of the Act.

24 In addition, the provisions on the *Sanierungsverfahren* shall apply according to § 7(5) of the Act.

25 § 48b(1) of the German Banking Act.

26 § 48b(2) of the German Banking Act.

27 § 7(4) of the Act.

28 § 13 of the Act.

29 Schelo, *supra* note 11, p. 189; Lorenz, 'Der Regierungsentwurf eines Gesetzes zur Restrukturierung und geordneten Abwicklung von Kreditinstituten – Überblick und erste Einordnung' NZG 2010, p. 1046, 1050.

30 Schelo, *supra* note 11, p. 189.

31 § 8(3), 9-12 of the Act.

32 § 8(2) of the Act.



obstructive behaviour less likely, and (ii) shareholders will be allowed to participate in the procedure, thereby ensuring their consent when the reorganisation is later voted upon in the shareholder's general meeting.

If the creditors so vote, the reorganisation plan may discharge or defer the bank's debts, may provide for new loans, capital increases and/or reductions, or debt equity swaps.<sup>33</sup> Since debt equity swaps dilute the holdings of the bank's existing shareholders, the bank shall grant appropriate financial compensation. According to parliament, the value of the compensation shall be determined on the basis of a going concern valuation of the bank.<sup>34</sup> Finally, the plan may also stipulate that part or all of the bank's assets shall be transferred to a suitable third party purchaser with sufficient market confidence.<sup>35</sup>

### 3. Asset transfer order

If rescue proves untenable, a supervisory procedure modeled after U.S. conservatorship will take place. Under § 48a-§ 48s of the German Banking Act, *BaFin* has the power to transfer the systemically relevant parts of the distressed bank to a transitional bridge bank.<sup>36</sup> As with the *Reorganisationsverfahren*, the supervisory procedure requires that the bank's existence and financial stability be endangered. In addition, the asset transfer is only permissible if there are no other equally effective but less severe means to remedy the distress. In these circumstances, *BaFin* shall take into account factors such as the bank's existing funding profile, the sources of additional capital or liquidity open to it (such as from other group companies and the market) and the markets in which it is seeking to access those funds (taking into account factors such as its credit rating and past attempts to raise capital). *BaFin* may also afford the bank the opportunity to submit its own recovery plan.

If a partial asset transfer is ordered, the bridge bank will assume some of the bank's failed deposits and other liabilities as well as acquiring some of its assets. It will only exist for a limited time and it will be used by the regulator as a transition bank until it can transfer the assets and liabilities of the failed bank to a healthy institution. In order to facilitate the transfer, contractual

termination rights are suspended.<sup>37</sup> Through the mechanism of a partial asset transfer, *BaFin* has the ability to 'split' a failing bank; that is, to transfer only part of the bank's business (such as its deposit book) to a purchaser or bridge bank at a suitable price, while leaving more troublesome assets (such as collateralised debt obligations or similar securities) with the 'rump' bank, to be sold or run off by means of an usual corporate insolvency proceeding.

### 4. Reorganisation fund

A separate act<sup>38</sup> introduces a restructuring fund administered by the German Federal Authority for Financial Market Stabilisation.<sup>39</sup> The EUR 70 billion fund will be financed by way of a bank levy and shall serve to support failing banks. The fund has been criticised for being too small and becoming available too late, as it will take a couple of years before it will reach its intended size.<sup>40</sup>

## III. EC cross-border insolvency

Both of the aforementioned stabilisation procedures as well as the asset transfer order under § 48a of the German Banking Act should fall within the purview of Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the Reorganisation and Winding-up of Credit Institutions (the 'Directive'). Art. 2, seventh indent, of the Directive will cover these procedures since 'reorganisation measures' include measures which are intended to preserve or restore the financial situation of a credit institution and which could affect third parties' pre-existing rights, including measures that involve possible suspension of payments, suspension of enforcement measures or reduction of claims. Where foreign law does not permit the asset transfer order to become effective, the bank shall be obliged to take any action necessary to give effect to the asset transfer order.<sup>41</sup> The liquidation of the 'rump' bank's estate, if this is governed by German corporate insolvency law, will be covered by Art. 2, ninth indent, of the Directive whereby 'winding-up proceedings'

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33 § 9 of the Act and Schelo, *supra* note 11, p. 188.

34 BT-Dr 17/3024, p. 51.

35 § 11 of the Act.

36 The bridge bank may be incorporated by the restructuring fund administered by the *FMSA* (see below 4.), see T. Höche, 'Das Restrukturierungsgesetz – Neue Wege in der Bankenaufsicht' WM 2011, p. 46, 57.

37 § 48g(7) of the German Banking Act. The U.K. Banking Act 2009 contains a similar provision, see B. Hearnden and J. Whitfield, 'The Banking Act 2009' Corporate Rescue and Insolvency (2009) 3 CRI 94, p. 99.

38 *Restrukturierungsfondsgesetz – RStruktFG*.

39 *Bundesanstalt für Finanzmarktstabilisierung*.

40 Schelo, *supra* note 11, p. 189.

41 § 48i(2) of the German Banking Act.

includes collective proceedings opened and monitored by the administrative or judicial authorities of a Member State (as defined in the Directive) with the aim of realising assets under the supervision of those authorities, including where the proceedings are terminated by a composition or other, similar measure.

## **International Corporate Rescue**

*International Corporate Rescue* addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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