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ARTICLE

On to Pastures New? Some Observations of Germany's Intended Insolvency Law Reforms

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It is well known that Germans love cars. German lawyers at least, love codified law. The pleasures of driving are sometimes constrained by speed limits and heavy traffic, not to mention the limitations of other drivers. But what the Germans really love about cars is the way in which they are made, repaired and even washed rather than the actual driving. Some of the same considerations apply to law reform.

In October 2009, there was a coalition agreement published by the then incoming German government. It contained a number of substantial declarations with regard to yet another attempt to reorganise insolvency law. In particular it addressed the need to promote the restructuring of businesses capable of being saved and with it, the much more important consideration of keeping people in employment. These aims were to be effected by improving the framework for out of court solutions in the case of companies and enterprises facing imminent insolvency and also by the related means of simplifying proceedings regarding what is called the insolvency plan procedure. Next, it was thought necessary to inhibit the assaults on insolvency legislation made by the finance ministries as well as the social security institutions insofar as such attacks impeded a proper and equal distribution among creditors. In addition there was felt a need to tighten up the regulations regarding the appointment and conduct of insolvency administrators as a whole. Finally, particular attention was concentrated upon the need to create some mechanism whereby there could be an effective restructuring of banks that might otherwise be facing financial difficulties at a relatively early stage. With regard to this last intention a new Restructuring Code came into force on 9 December 2010 dealing with the restructuring of financial institutions. This article, however, will not deal with that particular development but instead will attempt to provide an overview with regard to the contents of a draft bill which the German Government has recently put forward in an attempt to address the other matters which are listed above. These intended changes may well have a considerable impact upon German insolvency law and indeed European insolvency law as a whole.

Appointment of insolvency administrators

This topic will be taken first given its overall importance. Once upon a time and indeed as late as the second half of the 20th century, when insolvency cases were relatively few, lawyers would often work as administrators no doubt reflecting the fact that it was probably easier for them to take the job given their ability to access the courts more efficiently and more easily than their financial counterparts such as accountants. By the end of the 20th century, however, and certainly at the beginning of this century the number of insolvency cases and their size vastly increased. The insolvency market became more and more crowded. Quite apart from the need for administrators (whether they be lawyers or otherwise) to become more 'professional', the issue arose as to how to chose the right administrator and in particular how to regulate access to such appointments and the profession as a whole. Many insolvency courts developed their own and indeed sometimes quite diverse practices. For a long time the legislature did not step in to impose its own regulatory system. There remains even today no formal régime with regard to the licensing of practitioners. The only statutory requirements with regard to the appointment of an administrator in insolvency proceedings are that the administrator must be an individual who is experienced in business affairs, qualified for the case in question and who is independent of the creditors and of the debtor.

The general procedure can be shortly summarised. After a petition with regard to the opening of insolvency proceedings is filed, the judge will appoint an external expert to check whether the debtor is technically insolvent and whether there are sufficient assets to cover the costs of the proceedings as a whole. These are the basic pre-conditions for opening the proceedings. If necessary and invariably in the case of a going concern, the court will order certain security measures to be put in place in the sense that there will be the appointment of a provisional administrator to preserve the business. When the fully fledged insolvency proceeding is opened at a later stage, which could be as late as 3 months after the appointment of the provisional administrator, the latter will almost always

be appointed as the administrator. It is only at the first meeting of the creditors' assembly that the creditors themselves can appoint their own nominee. There is a need for there to be in effect a double majority both in terms of numbers of creditors in favour of the appointment and in terms of the total amounts of their claims. However in reality when this first formal meeting takes place (which might be at any time between 6 weeks and 3 months after the opening of proceedings), it will almost invariably be too late to influence the course of the proceedings by replacing the initial appointee who would have been the provisional administrator.

Each court will chose from its list of local or supra-regional administrators. There are of course informal approaches reflecting particular pressures present in any particular insolvency. The needs of the creditors or the debtor have no statutory reflection entitling them to make suggestions. Everything often turns upon the whims of the particular judge and whether any attempt to influence his choice stands any chance of success or indeed is likely to trigger the opposite effect. In any event, reflecting an overall need to avoid some form of basic conflict, any prior involvement in the insolvency would disqualify a practitioner from being appointed as an administrator.

The unpredictability referred to in the preceding paragraph can be viewed either as an advantage within the system or as a major drawback depending on which viewpoint is taken. The new draft bill now attempts to tackle this problem by taking a small step towards creditor involvement even though in terms of the German insolvency culture, as it might be called, this represents, some would say, a huge step into an abyss with an uncertain depth.

The formal name for the draft bill can be roughly translated into the following, namely a Law for the Further Simplification of Restructuring of Businesses i.e. '*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*'. The underlying idea is to reflect an increased influence on the part of the parties involved with regard to the choice of an administrator. This underlying idea can be seen as blending in with the concept reflected in the formal title of the bill, namely the effecting of a reduction of any form of unpredictability and of any consequential risks which might arise to the prejudice of stakeholders by virtue of any uncertainty stemming from the choice of a suitable appointee. Any such risks are, at least from the draft bill's point of view, regarded as likely to impact upon a successful restructuring and the viability of the restructuring tools available to the business and the administrator.

At the moment, in Germany, there seems to be a fighting shy of any form of concurrent statutory out of court restructuring proceeding by adopting or even contemplating procedures which might omit or at least not allude to the actual notion of 'insolvency'. There seems to be some basic distaste for having, or even contemplating, the promotion of restructuring in formal insolvencies on the one hand, together with on the other, offering some form of extra judicial restructuring procedure which might adversely affect the chances of success for resurrecting a company or enterprise. In practical terms, this means that whenever an out of court restructuring or some form of informal basis does not work, then the stakeholders will have to revert to existing and prospective possibilities as adumbrated by the new bill.

The draft bill does however contain specific features with regard to the choice and selection of a potential administrator. First, the new provisions still adhere to the concept that the administrator must be independent of all stakeholders. However the draft does in some way water down the relevant requirements in the process. In future, specific suggestions by the parties or indeed the prior involvement of a practitioner will not automatically disqualify the latter from becoming an appointee. This does not necessarily mean that his independence is in some way threatened; the touchstone appears to be that as long as the appointee only provided general advice about the cause and the effect of an insolvency proceeding, then he can still remain a fit and proper appointee at the hands of the creditors or indeed by dint of the nomination of the debtor. The same applies, if the nominee drafted an insolvency plan with the involvement of the debtor and that of the creditors prior to the presentation of the petition which opens the insolvency proceeding.

Second, in high profile insolvency cases it has not been unusual for the management of the debtor and indeed for the main creditors, to seek to discuss the question of an appointment with the court prior to the petition opening the proceedings as a whole. As indicated above, some courts and certain judges are more open to suggestions of this sort than others. The draft bill therefore tries to codify what could be said to be a set of guidelines for judges with regard to their entering into discussions with the main creditors. According to the draft bill, the judge is now supposed to consult with the main creditors before deciding upon the appointee. If a provisional creditors' committee has already been installed (which represents another suggested change), then the court is supposed to consult the committee. It may only decline a unanimous proposal put forward by the committee on the basis of a written explanation, as to why the nominee (without mentioning his name) is not qualified to take the appointment. It could be said that this desirable aim is somewhat curious given its assumption that there is a provisional creditors' committee in place prior to the appointment of the provisional administrator himself.

The draft bill also increases the formal requirements for a debtor's petition to open insolvency proceedings. In future the petition will not only have to be in written form and comment on the grounds for the insolvency; the debtor will in addition among other things have to provide a list of the main claims against him in

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particular the main secured claims and the claims of tax and social security authorities in order for the court to identify key creditors or key nominees for the purposes of a provisional creditors' committee. It can only be assumed that some judges might consider it more urgent in any particular case first to appoint a provisional administrator and then a provisional creditors' committee, given the prospect that the latter's ideas regarding the provisional administrator might not correspond with the Judge's own and therefore cause the whole process to be slowed down.

Finally, the reforms expand the debtor's possibilities in what can be called a form of self administration. Should the debtor file his or its own petition to open insolvency proceedings at a stage when illiquidity is only imminent, and should he or it do so joined with an application for a self administration, coupled with formal confirmation on the part of an accountant or lawyer that illiquidity is imminent as contended for, and that restructuring will obviously not be futile, then the court has to grant a three-month period in which an insolvency plan must be drafted. In this constellation or pre- requisites the debtor has the possibility to put forward his or its own nominee as a (provisional) custodian – the (provisional) administrator's equivalent in self administration proceedings. The court can only decline to accept the debtor's nominee, if the latter is obviously unqualified.

A moment's thought in considering these changes should show that not all these features are going to be welcomed with open arms by all those involved in insolvency law in Germany. Germany's biggest association of insolvency practitioners, namely the VID (*Verband Insolvenzverwalter Deutschlands e.V.*) has already informally suggested, that big law firms specialising in advisory work are negotiating take-overs with practitioners specialising in administration in order to put themselves in what could be called a 'full service' position. This would enable them to cover not only out of court restructurings but the more formal insolvency administrations procedures for the same clients as well. At least one judge in the German Supreme Court has expressed the fear that should the draft bill become law, it might indeed sign the end of the era of independent insolvency administrators.

Alongside all the above there remains an ongoing discussion about whether and how to regulate access to the profession. One aspect of that discussion is the Ministry of Justice's view that according to the EU Services Directive, Germany will have to allow for the fact that, apart from individuals who can take appointments, corporate bodies can also become administrators. Furthermore, there are efforts especially by the VID in effect to seal off the market. VID members who are already part of that organisation have just gone through a quality management certification procedure voluntarily. There is in addition an aim to institute a binding professional code of conduct. These discussions have also led to the formal suggestion that there be access tests or formal examinations with regard to the qualification of insolvency practitioners as a whole.

Amendments to Insolvency Plan Proceedings

When the present German Insolvency Code came into force on 1 January 1999, it did so as a result of reform efforts that were started more than 20 years beforehand. After intensive discussions and two reports on the part of a specifically established commission of scholars and practitioners, the end result could be seen to be deeply influenced by the ideas of Thomas Jackson who had authored a work published in 1986 by the Harvard University Press entitled *The Logic and Limits of Bankruptcy Law* as well as by US Chapter 11 proceedings as a whole. However, the reforms in Germany went well beyond the US-American model. In the wake of Jackson's ideas, one of the main characteristics of German insolvency law is that there is only one kind of proceeding that is solely aimed towards satisfying the creditors of an insolvent debtor on an equal and rateable basis either by means of a liquidation and/or sale and/or restructuring of the underlying business depending on the best outcome thought to be achievable for the creditors as a whole. The German insolvency code includes the possibility of a plan proceeding known as the insolvency plan procedure ('*Insolvenzplanverfahren*') which can be started at any time within an insolvency proceeding. The right to present a plan lies with the debtor or with the administrator. The creditors' assembly can take the initiative by commissioning the administrator to draw up a plan as to which the assembly can determine the objectives. The difference between the German model and its equivalent in other jurisdictions is that an insolvency plan is supposed to remain a very flexible tool, not simply geared towards the restructuring of a business. In this respect the plan proceeding is broadly similar to that envisaged and set up under the US Bankruptcy Code Chapter 11, including the formation of and voting in and by groups of creditors together with a cram-down rule for dissenting minorities should the latter not suffer a loss by comparison with the situation that might arise without a plan.

Initially at least, and for a while after its implementation, the plan proceeding concept aroused high expectations. Those expectations might have been relatively unsophisticated, perhaps inevitably so, and for a while remained so, given the fact that the plan proceeding formula was only sparsely used in practice for quite a long time. This could be said to reflect a typical form of German reserve towards things which are otherwise strange and unfamiliar. One other explanation is that the new instrument just did not fit with regard to most of the cases that came up in the sense that the latter simply did not qualify for any formal plan solution. Where a business was already moribund at the time

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the petition for an insolvency proceeding was filed or was in its death throes, it was arguable that even the most creative insolvency plan could offer little, if any alternative treatment for the patient. However, in time it came to be seen that the real drawback of the present plan proceeding is the inherent danger that it takes too long and is prone to excessive risks of appeal and other legal uncertainties. Moreover, critics of the current position increasingly came to demand a workable option whereby debt could be exchanged for equity by means of the plan itself.

The draft bill now seeks to solve at least the last mentioned issue. Among other things, it is now possible for the first time under German law to involve shareholders of the debtor in an insolvency proceeding by virtue of reconstituting the debtor as a 'group' with its own identity within the insolvency plan and then effecting or allowing the effecting of a change in the shareholders' ownership rights by means of a debt to equity swap. The draft provisions therefore grant shareholders the right to vote on the plan should their ownership rights be affected. There is therefore a new-found ability on the part of shareholders to form groups within the overall categories of creditors and shareholders as a whole, and, in particular, groups representing small claim creditors and shareholders who might hold less than 1% or EUR 1,000 worth of the available equity. If no member of a shareholder group participates in the voting on the plan, that fact shall be counted as denoting agreement by that group. The draft provisions also contemplate the shortening of deadlines with regard to court activities and with regard to hearings generally with a view to speeding up the process. In addition, the requirements for admissible appeals are being increased. Furthermore, single creditors are no longer able to block the plan coming into force by means of an appeal on their own score, should the plan otherwise provide for a proper reserve for such creditors.

The draft bill also includes what can be viewed as a solution statement in an attempt to resolve the often intractable problem of how to deal with potentially unknown creditors who have not lodged their claims in the proceedings. The provisions relating to and the limitations of the plan are now made to apply with regard to such creditors. Their claims are to be time barred after one year following the date on which the plan comes into force.

Most of the provisions described above are largely to be welcomed and indeed are not regarded as controversial by scholars and practitioners alike. Nonetheless, some critics still point out that the provisions regarding the inclusion of shareholders might unnecessarily be said to complicate matters. It is claimed there is simply no justification to grant shareholders who have worthless ownership rights the same participation possibilities as other creditors.

The intended changes to the plan proceedings are accompanied by an organisational change with regard to the internal jurisdiction of the insolvency court. According to the draft bill, jurisdiction with regard to the governance of insolvency plan proceedings is to be with the judge and is to remain so. This issue requires some explanation. In Germany, what can be regarded as a question of jurisdiction or competence with regard to insolvency proceedings is split as between the judge and the registrar. Each has a temporary role in that the judge as distinct from a registrar makes a decision as to the petition to open an insolvency proceeding and with regard to the governance of the proceedings up to the point. As soon as the proceeding is opened, the relevant jurisdiction or competence switches to the registrar for the rest of the proceeding unless the judge decides to retain jurisdiction, which hardly ever happens. The suggested changes which are designed to give the judge rather more responsibility reflect the fact that the work of insolvency judges is largely administrative and of limited interest, and many judges do not work full time in the insolvency department. Shifting the jurisdiction with regard to running of an insolvency plan to the judge can be seen as an attempt to make his or her job more interesting and more particularly to motivate suitable candidates to specialise and thereafter stay within that area. Needless to say, the official rationale is that a judge is likely to be more capable than a registrar in handling the economic implications of plan proceedings as a whole. Remarkably the draft bill explicitly seeks to codify the fact that judges as well as registrars working in the insolvency department are supposed to have or shortly will have to acquire specialised knowledge in the fields of insolvency law, commercial and corporate law as well as basic knowledge of insolvency related aspects with regard to labour, social, tax law and accountancy issues. Additionally, there are plans to reduce the number of insolvency courts in Germany presently standing at 187. This, too, was designed to improve expertise amongst core personnel and also to create more full time jobs with a correspondingly higher degree of confidence.

Paradigm changes in respect of debtor in possession proceedings

Debtor in possession proceedings can also be described as a form of self administration. This possibility within an insolvency proceeding was invented in 1999 but has hardly ever been used in practice. One of the main reasons centres on the fact that a debtor without any specific knowledge of insolvency law and practice will usually not be able to administer his or its own insolvency proceeding in any adequate manner. The other attendant reason was one of psychology and indeed of culture. For centuries, bankruptcy has been considered as a social stigma in Germany rather than as a chance for a new start. This is why German insolvency law has always favoured creditors' interests, rather than those

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of the debtor. This is also why German legal and commercial culture has always been extremely hesitant in allowing (to revert to the analogy set out at the beginning of this article) the driver to remain in the driver's seat given that he was considered responsible for crashing the car.

The notions set out in the preceding paragraph can be inferred from the current provisions of the insolvency code. A pre-condition for self administration is, apart from the debtor making the application itself or himself, that, dependant on the circumstances, the proceedings and the creditors will not suffer any disadvantage should the debtor stay in possession. The court has an obligation to end self administration on the application of a creditor who demonstrates in a credible fashion that the said pre-condition has ceased to apply and indeed it must end self administration on an application made by the creditors' assembly without any pre-conditions.

The above means that self administration in effect represents the exception rather than the rule. The draft bill now seeks to reverse that state of affairs. A court is now supposed to allow a debtor's request for self administration if it knows of no circumstances that lead to the expectation of any disadvantage for the creditors. In the case of there being a provisional creditors' committee backing the debtor's application or in the event of there not being such a committee, should the main creditors do so, and if there is no indication that there exists any disadvantage with regard to the joint interests of all creditors, then the court must assume that self administration is not detrimental to the creditors as a whole. Furthermore, the court has to justify any decision to the contrary in a written judgment.

The draft bill also seeks to remove an existing inconsistency in the current provisions. If there is a debtor's application for self administration which is not obviously futile, the court must now consider installing a provisional custodian instead of a provisional insolvency administrator. Furthermore, the court is supposed not to deprive the debtor fully or his or its power to dispose of his or its assets.

Overall, the possibility of the debtor nominating his own, albeit provisional, custodian and receiving a grace period for the drafting of an insolvency plan, is supposed to make self administration and restructuring on the basis of an insolvency plan more attractive. It is also designed to motivate debtors to file a petition for insolvency proceedings at an early stage even though a pre-packaged plan may not have been drafted. This motivation is backed up by yet another provision: If, in the case of an illiquidity being only imminent, the court intends to reject a debtor's application for self administration, it has to notify the debtor and offer the possibility to withdraw the petition to open insolvency proceedings prior to the court's decision.

Co-operation of courts in cross-border cases

Everybody knows that in cross-border cases where there is more than one insolvency proceeding in one jurisdiction, it can be extremely helpful as well as time saving simply to pick up the phone and discuss problems and share information with colleagues or counterparts abroad. In a number of cases that was exactly what some German judges did, even though their influence in the actual course of the proceedings, apart from the appointment of the administrator, is and remains small. Nevertheless, and this may be considered typically German in a way, the problem was spotted that there was no legal basis for international phone calls by an insolvency Judge and therefore there may now be a reluctance to take such measures.

The draft bill takes up that problem and includes the Regulation that if according to German law an insolvency proceeding in another jurisdiction has to be acknowledge, the German insolvency court may co-operate with the foreign insolvency court and in particular may pass on information that may be of relevance for the purposes of the foreign proceeding.

An old saw: money against principle

Neither German jurisprudence nor its terminology includes the expression or concept 'priority claims' let alone 'preferential claims'. However, some types of claim have to be paid out prior to others, e.g. the costs of the proceedings prior to other debts created by activities of the insolvency administrator and the latter prior to claims that arose prior to the opening of insolvency proceedings. Overall, German thinking and terminology do not focus upon the order in which claims get paid: rather upon their legal status, mindful of the time at which such claims arise.

German insolvency law before 1999 knew of the concept of ranking amongst unsecured creditors whose claims arose prior to the opening of insolvency proceedings. In particular, tax claims and social security claims enjoyed a form of priority status. In 1999, the insolvency code abolished such a ranking and there was uniform praise for the new concept of equal treatment for all except of course on the part of certain disappointed beneficiaries. Since that time, nobody has seriously questioned the overall concept. On the contrary, many commentators consider this as one of the prime equitable achievements of the reforms in 1999. Years later, however, the insolvency battlefield now begins to reveal deep cuts suffered by the Government finance departments and by social security institutions. Those organs are normally the first to try and cut away body parts during the final writhings of the debtor whilst the debtor is in economic difficulties. Their advantage in comparison to other creditors is in particular that they can create their own executory

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titles and have their own enforcement staff. They are also however the preferred victims of the extensive claw back provisions under German insolvency law. That dangerous cocktail resulted in the finance ministries and the related departments together with the social security institutions imposing an increasing amount of pressure on the legislators to curtail the activities of administrators and of the courts. It all culminated in a series of events which perhaps should be kept secret from and remain unknown to all those who still seek to preserve some form of idealistic faith in the democratic systems of Western governments and the rule of law.

The coalition agreement created by the current German government in 2009 has already been mentioned. It agreed on the otherwise noble purpose of preserving the jewel of equal treatment of creditors on the one hand and on the other, defending it against any allegedly immoral attacks. Nobody really catered for, let alone foresaw, the fiscal implications of the recent and ongoing global crisis. The draft bill therefore contained provisions that would have resulted in the finance ministries becoming more or less the only beneficiaries of insolvency proceedings. Massive opposition from all sides was able to avoid the worst. There has been in this respect one particular new piece of legislation though coming into force on 1 January 2011 arising out of all the matters which have been described.

Prior to that date and during a preliminary insolvency proceeding, in which the full power of disposal of the debtor's assets is not transferred to the provisional administrator, German law allowed the debtor only to pay current liabilities where necessary to continue the business. This meant in practical terms that apart from other cash claims that the debtor had to defray, VAT for taxable turnover during that period could be ignored and the tax authorities had to lodge their claim after the opening of the insolvency proceedings as a normal unsecured creditor. According to the new regulations which have been passed at the beginning of 2011, this will no longer be possible and VAT has to be paid in full for the period of the preliminary proceeding.

There is no question but that this change will affect the liquidity of a debtor's business and thus make its continued existence more difficult. Furthermore, it seems openly to contradict the main principle of equal treatment of creditors as articulated and reflected in the Government's own promises in the coalition agreement, coupled with the explicit aim of the draft bill, promoting as it seeks to do , insolvency proceedings as a restructuring tool. However, it could have been worse. It may be said to represent an object lesson in how legislation really works. Reverting for the last time to the initial analogy at the beginning of this article, it may be better not to develop the perfect car. That would simply deprive us of the fun of constructing other ones.

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