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ARTICLE

'Law for further Facilitation of the Restructuring of Companies': A Turning Point in the History of the German Insolvency Regime?

Part 3 – German Insolvency Law Reforms Still Going Strong: Sunset Provision on Balance Sheet Insolvency now Made Permanent; Further Changes in the Pipeline

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I. German insolvency law reforms accomplished in 2012

In two recent articles published in ICR,[2] we set out the significant changes brought about by the recent major German insolvency law reform, dubbed '*ESUG*', which came into force in March 2012. In part 2 of those articles we also described potential further law reforms that the German legislator then still had or might have in the pipeline, namely: the sunset provision on balance sheet insolvency, dealing with groups of companies, legal entities being permitted to be appointed as office-holders and out-of-court composition proceedings.[3] On 8 November 2012 the *Bundestag,* the German Parliament, passed a law dealing with the first and most pressing point on the above list, the sunset provision on balance sheet insolvency.[4] This is the main subject of this article, but we will also explore how the German legislature might be expected to deal with the other items on the list in the short, medium and long term.

II. The future of balance sheet insolvency in Germany

II.1. German insolvency tests and filing requirements

The first thing that usually comes to the minds of foreign stakeholders when asked about the German insolvency regime are the rigid filing requirements for the management of corporates. Once a company is unable to pay its debts as and when due, or is balance sheet insolvent,[5] management must file for formal insolvency proceedings to be opened, with a short grace-period of 3 weeks. This can be made use of only where there is a likely chance of the company recovering a solvent position. Non-compliance can have severe consequences, for example management can be held personally liable for payments made during a period after an insolvency filing should have been made and/or be subject to criminal charges. Before the changes brought about by *ESUG*, filings were often considered as embarking on the unknown and as being rescue-unfriendly, due to the choice of selection and appointment of an office-holder being at the full discretion of the court. The new law has changed this situation substantially.[6]

Notes

1 The views expressed by the authors are their own and do not represent the views of their firms.
2 Schlegel, 'Law for Further Facilitation of the Restructuring of Companies Part 1' 8:6 *International Corporate Rescue*, and Bewick and Schlegel, 'Law for Further Facilitation of the Restructuring of Companies Part 2' 9:1 *International Corporate Rescue*.
3 9:1 *International Corporate Rescue*.
4 See <dipbt.bundestag.de/dip21/brd/2012/0690-12.pdf> and for a substantiation of the law see corresponding resolution of the *Rechtsausschuss des Bundestages*, Parliamentary Legal Committee, of 7 November 2012 on page 27, <dipbt.bundestag.de/dip21/btd/17/113/1711385.pdf>.
5 Referred to as *überschuldet*, overindebted; the respective statute, s.19 *Insolvenzordnung* (*InsO*), of the German Insolvency Code, is therefore generically referred to as '*Überschuldungsbegriff*', definition of overindebtedness.
6 Schlegel, 'Law for further Facilitation of the Restructuring of Companies Part 1' 8:6 *International Corporate Rescue*.

II.2. The balance sheet insolvency test

II.2.1. Definition of balance sheet insolvency

Under the present German balance sheet insolvency test – and it is this test that, previously being a sunset provision, has now been made permanent – a company is *überschuldet*, overindebted, and therefore insolvent, if its assets no longer cover its liabilities, unless a continuation of the business is predominantly likely in the circumstances.[7] The likeliness of a continuation of the business is referred to as '*positive Fortbestehensprognose*',[8] positive continuation prognosis. The Insolvency Code does not provide any details of how such a continuation prognosis is to be assessed, nor over what time period: this is left to industry standards and case law. The minimum period which is consistently applied here is 12 months starting with the end of the company's reporting date.[9]

II.2.2. History and practical relevance of balance sheet insolvency

Over the past decades the German balance sheet test has undergone major reforms, and, interestingly, has also reverted to an earlier regime.

When the *Insolvenzordnung* (*InsO*), German Insolvency Code, came into force in 1999,[10] it introduced a balance sheet insolvency test which deviated from the former system:[11] under this new *InsO* regime a negative balance sheet inevitably resulted in a company having to file for insolvency. A company's viability was only taken into account when determining asset values for the balance sheet computations. To this extent, going-concern values (as opposed to break-up values) could only be applied if the continuation of a company's business was predominantly likely in the circumstances.

II.2.3. Impact of the 2008 credit crunch and introduction of sunset provision for balance sheet insolvency

As a very general rule, before the credit crunch in 2008, it could be said that the balance sheet insolvency test was more or less irrelevant in practice as, typically, a balance sheet insolvent company would at the same time be unable to pay its debts. This in itself triggered filing duties. This situation changed with the credit crunch, when the German Government realized that asset depreciations resulting from the crunch, in particular in the real estate sector, could render otherwise viable businesses balance sheet insolvent. In such circumstances, insolvency filings and formal insolvency processes would be nonsensical and potentially value-destructive. Therefore, as part of a law passed in autumn 2008 designed to counter the adverse effects of the credit crunch, the present balance sheet insolvency test was introduced, that is balance sheet insolvency could be ignored if a positive continuation prognosis could be made for a company,[12] thus reverting to the pre-1999 test.

The re-introduction of this rescue friendly balance sheet insolvency test had been a sunset provision, originally due to terminate on 31 December 2010 and then, after an extension in 2009, on 31 December 2013. The termination date, of course, very quickly presented a problem when looked at in conjunction with the industry standards requiring a minimum of twelve months, starting with the end of the company's reporting date[13] when determining the viability of businesses, potentially resulting in a risk of premature filings. As a result, the sunset provision spawned much debate and uncertainty. This provoked the use of 'safety nets' in restructurings, for example in the *Rodenstock* Scheme, which provided for conditional subordination provisions should the old balance sheet test come back into force on 1 January 2014.[14]

II.2.4. Government assessment of sunset provision for balance sheet insolvency

When, in 2009, the *Bundestag* extended the sunset provision until the end of 2013, it requested the Government to assess the effects of the sunset provision to enable the legislature to make an informed decision on whether the sunset provision should be extended (indefinitely) or reversed. To achieve this, the Ministry of

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7 S. 19 para 2 *InsO*, German Insolvency Code.
8 Also called '*Fortführungsprognose*'.
9 See for example the Auditors' Handbook published by the *IDW, Institut der Wirtschaftsprüfer in Deutschland e.V.,* Institute of Public Auditors in Germany: WP Handbuch 2012, *Band I*, volume 1, *14. Auflage,* 14th edition, on page 2414 para 53; or see para 13 of the recently updated *IDW Standard: Anforderungen an die Erstellung von Sanierungskonzepten (IDW S 6), standard set by IDW for the preparation of restructuring plans,* published in *IDW Fachnachrichten*, Nr. 12/2012.
10 As a result of reform discussions that had gone on for decades, inter alia consolidating a uniform insolvency law for the former East and West German Republics post reunification and introducing debtor-in-possession style proceedings.
11 This system was case-law based, see footnote 12.
12 On the history of balance sheet insolvency, case-law and the ratio behind the re-introduction of the 'old' balance sheet insolvency test see pages 12 and 13 of the *Begründung,* explanatory statements, of the 2008 *Finanzmarktstabilisierungsgesetz*, law for the stabilisation of the financial markets called <dip21.bundestag.de/dip21/btd/16/106/1610600.pdf>.
13 On these see footnote 9.
14 <www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWHC/Ch/2011/1104.html&query=rodenstock&method=boolean>, see para 13.

Justice instructed two academic institutions[15] which, during Spring 2012, undertook an empirical industry survey resulting in a 175 pages report and recommendation of further action for Parliament. This report was submitted to the Ministry of Justice on 15 May 2012. The recommendation for *Bundestag* was to not return to the regime between 1999 and 2008, but to maintain the status quo, either for a number of years or indefinitely; or even to abolish the balance sheet insolvency test altogether. Not surprisingly, this recommendation was more likely to be supported by those experts who were not taking appointments as office-holders.

The findings of the report and its empiric approach were summarised by its authors in an article for a German legal journal.[16] As explained there, the report was the result of a two-tier approach of (1) together with a select group of members from all areas of the profession (who dealt with companies of all sizes and from all regions of Germany) the authors of the report devised a questionnaire[17] on the effects and merits of the sunset provision; (2) this questionnaire was then sent to more than 2,700 industry experts (including lawyers, accountants, bankers, insolvency practitioners, and restructuring experts)[18] of whom 609 individuals returned the questionnaire. Of these individuals 45% were insolvency practitioners (lawyers) and the other 55% lawyers specialising in rescue, bankers, corporate advisers and accountants.[19] To ensure optimum interpretation of the questionnaires' results, these were also discussed with three groups of experts.

Broadly speaking, insolvency practitioners tended rather to oppose the sunset provision, whilst the vast majority of the other industry members credited it with benefitting the economy and encouraging rescue, especially of larger companies.[20] 40% of insolvency practitioners thought that the sunset provision resulted in early rescue measures being neglected or not implemented, an opinion shared by only 15% of bankers interviewed.[21] A key finding, where there was more or less unanimous opinion, was that a risk of 'zombie companies' existed predominantly in the small companies sector, where management were not generally advised and were therefore largely ignorant of the insolvency tests and filing requirements. In this situation, whether or not to return to the old regime was considered irrelevant.[22]

II.3. Legislative action

The Bundestag's decision to pass a law making the current sunset provision permanent a year before the 'sun set' was also based on the recommendations in the report described under II.2.4. and on the fact that the sunset nature of the balance sheet insolvency test had created great uncertainty that needed to be put to an end very swiftly. Due to the urgency, the sunset provision came into force with permanent effect immediately upon ratification of the respective law, which happened on 12 December 2012. It will have to be seen whether, as a result of on-going reform discussions (see III. below) the situation will change once more and whether, perhaps, the balance sheet insolvency test will be abolished altogether, a recommendation also given in the report, although based on the opinion of a minority of experts interviewed.

III. Further reforms in the pipeline

As mentioned in I. above, other corporate insolvency topics on the German legislature's agenda (potentially) are: dealing with groups of companies, legal entities being permitted to be appointed as office-holders and out-of-court composition proceedings with cram-down options.

III.1. Dealing with groups of companies

Legislative action can be expected imminently on the issue of dealing with groups of companies. On 3 January 2013 the *Bundesministerium der Justiz*, Ministry of Justice, circulated a *Diskussionsentwurf*, draft for

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15 Namely: *Zentrum für Insolvenz und Sanierung an der Universität Mannheim* (*ZIS*) headed by Prof. Dr. Georg Bitter and *Institut Hommerich Forschung* (*IHF*) headed by Prof. Dr. Christoph Hommerich.

16 Prof. Bitter, Prof. Hommerich and Nicole Reiß in *Zeitschrift für Wirtschaftsrecht (ZIP), Die Zukunft des Überschuldungsbegriffs*, 2012, p.1201 ff. When this ICR article discusses the report and its findings, the authors draw their information from the article published in *ZIP*, not from the actual report.

17 <www.zis.uni-mannheim.de/studien/dokumente/fragebogen_insolvenz/fragebogen_insolvenz.pdf>.

18 For a detailed list of industry bodies and associations to whose members the questionnaires were sent see article *Die Zukunft des Überschuldungsbegriffs, Zeitschrift für Wirtschaftsrecht (ZIP),* 2012, p. 1202 under II.

19 For a detailed split, including industry expertise and specialisation in restructuring / insolvency of the experts interviewed see *Die Zukunft des Überschuldungsbegriffs, Zeitschrift für Wirtschaftsrecht (ZIP),* 2012, p.1202 under III. 1.

20 For a detailed analysis see *Die Zukunft des Überschuldungsbegriffs, Zeitschrift für Wirtschaftsrecht (ZIP*), 2012, p. 1203 under III. 2.1. and 2.3.

21 See *Die Zukunft des Überschuldungsbegriffs, Zeitschrift für Wirtschaftsrecht (ZIP),* 2012, p. 1203 under III. 2.2.

22 See *Die Zukunft des Überschuldungsbegriffs*, Zeitschrift für Wirtschaftsrecht (ZIP), 2012, p. 1203 under III. 2.2.

23 <www.bgbl.de/Xaver/text.xav?bk=Bundesanzeiger_BGBl&start=%2F%2F*%5b%40attr_id%3D%27bgbl112s2418.pdf%27%5d&wc=1&skin=WC>.

discussion purposes, to *Verbände/interessierte Kreise*, interested parties (such as e.g. the voluntary bodies for German insolvency practitioners), and asked them to come forward with any comments they may have until 15 February 2013.[24] At some point after that date (and having undergone consultations amongst various other Ministries concerned) the draft law can be expected to be published (in amended form) as a *Regierungsentwurf*, Government draft, and be presented to *Bundestag* for enactment. Some key features of the *Diskussionsentwurf* are the encouragement of co-operation and co-ordination amongst individual office-holders of group companies, creditors and also courts and, quite innovatively, the introduction of a voluntary overall co-ordination process and of an overall co-ordinating office-holder. This should be considered in the light of the recent proposed changes to the EU Insolvency Regulation, which set out this suggestion or an alternative proposal of a 'lead' liquidator.[25] The Ministry of Justice is not considering introducing substantive consolidation.

III.2. Legal entities as office-holders

As regards permitting legal entities to be appointed as office-holders – an issue that, against the background of the European Services Directive, should currently be under debate in all EU Member States – other than foreign office-holders being given access to the 'lists' kept by German insolvency courts and from which office-holders are chosen[26] there has been no official movement on the implementation of the European Services Directive as yet. We will have to see whether it will, perhaps, be dealt with at the European Court of Justice level at some point before the legislature has dealt with the issue.[27]

III.3. Out-of-court composition proceedings with cram-down options

Out-of-court composition proceedings with cram-down options are not currently on the agenda of the German legislature, as, when *ESUG* was passed in Autumn 2011, *Bundestag* requested Government to assess in 2017 whether the 'rescue umbrella proceedings',[28] newly introduced to the re-vamped debtor-in-possession regime, met industry expectations, encouraged timely filings and promoted the use of debtor-in-possession processes, or whether there was still a need for an introduction of out-of-court composition proceedings to the German market.[29] It will be interesting to see whether the Government will use the same type of formal and thorough consultation process it just employed with regard to the sunset provision on balance sheet insolvency for such assessment (see II.2.4 above). Against this background, members of the industry interested in the (non-) introduction of out-of-court composition proceedings should bear in mind that over the coming years both their approval or criticism of the new regime and in particular the 'rescue umbrella proceedings'[30] might be taken into account when it comes to any assessment in 2017.

III.4. Adjustments to ESUG

Even though still a young reform – *ESUG* only came into force in March 2012 – it has received both approval and harsh criticism, to such an extent that it would be a difficult task to try to summarise all the views. It has already become quite clear that, for *ESUG* to achieve its main objectives, such as when it comes to selecting the office-holder, the shift of power towards creditors and away from the courts, the law requires fine-tuning as currently it contains far too many loopholes. However, *ESUG* will be monitored for some time, so changes should not be expected in the near future: certainly not before the next elections in Autumn 2013.

IV. Conclusion

Making the current sunset provision on balance sheet insolvency permanent is just one more step which the German legislature has taken recently to align the German insolvency regime with other rescue friendly regimes. It will be interesting to see whether and how this trend continues, with the ultimate test seeming to be the assessment of the need for out-of-court composition proceedings with cram down options by 2017.

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24 <zip-online.de/pdf/zip/Diskussionsentwurf-des-BMJ-zu-Konzerninsolvenzen.pdf>.

25 For a discussion of the proposed changes see S. Bewick 'First Do No Harm – changes to the EU Insolvency Regulation' (2012) 5:6 *Corporate Rescue and Insolvency.*

26 S. 102 a *EGInsO, Einführungsgesetz,* introductory law, to I*nsO. ESUG* however has rendered this provision practically obsolete as creditors can now select and put forward office-holders with courts where those office-holders are not listed.

27 Bewick and Schlegel, 'Law for further Facilitation of the Restructuring of Companies Part 2' 9:1 *International Corporate Rescue.*

28 Schlegel, 'Law for further Facilitation of the Restructuring of Companies Part 1' 8:6 *International Corporate Rescue.*

29 See <dipbt.bundestag.de/dip21/btd/17/075/1707511.pdf> on page 5, quote: 'Wird das neu geschaffene "Schutzschirmverfahren" des § 270b InsO den Erwartungen gerecht und hat es insbesondere zu einer frühzeitigen Antragstel lung und zu einer Stärkung der Eigenverwaltung geführt? Wird trotz § 270b InsO noch ein Bedürfnis für ein vorinsolvenzliches Sanierungsverfahren gesehen?'.

30 Schlegel, 'Law for further Facilitation of the Restructuring of Companies Part 1' 8:6 *International Corporate Rescue.*

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