Focus on ESUG – Part 3: Debt-to-Equity Swap in German Insolvency Proceedings

In 2012, the so-called ESUG was introduced in Germany to legally ease financial restructurings and insolvencies. A working knowledge of the new restructuring arsenal is beneficial for international investors in order to achieve successful distressed transactions in Germany. With the third chapter of our new series "Focus on ESUG" we want to highlight new chances for debt-buy-ins under the new set of rules for debt-to-equity swaps and the preparation of insolvency plans.

Under the insolvency code before ESUG an insolvency plan could not provide for provisions infringing on the rights of shareholders. Considering the possibility to enforce a waiver of debt on creditors if a majority of creditor groups votes for this in an insolvency plan, that fact has always appeared as a striking contradiction against the backdrop that generally equity should rank behind debt in insolvency scenarios. The amendment of the sections in relation to insolvency plans (within the framework of ESUG) redresses such contradiction. That should pave the way for (international) investors to make significantly more use of the insolvency plan as a powerful restructuring tool in combination with debt-to-equity swaps as one of the world wide acknowledged tools for investments in distressed companies.

Debt-to-Equity Swap in Insolvency Proceedings: The New System

> Shareholder's rights taking part in insolvency plans: if the debtor is not an individual, the shares and/or membership rights of the debtor's (i.e. the distressed company's) shareholders can be included in the plan.

> Shareholders take part in the formation of groups to vote on insolvency plans: to determine the rights of the parties to an insolvency plan the German insolvency code provides for the formation of groups. In these, the parties are being grouped according to their differing legal positions. Shareholders shall form a group for their own, if their shares and/or membership rights are included in the plan.

> Debt-to-equity swaps as an explicit measure in insolvency plans: the insolvency plan may provide for any measure that is permissible under German corporate law. In particular, the plan may provide for the conversion of creditor claims into shares of the insolvent company (e.g. by way of capital reduction and/or capital increase; directly provided for in the insolvency plan).

> Voting rights of shareholders facing a debt-to-equity swap: the shareholder's voting rights are to be determined by the proportion of the respective participation in the nominal capital of the insolvent company. In the process of voting on the insolvency plan, the majority for the shareholder group is not to be defined by heads but by the sum of capital.

> Cram-Down: even if the required majorities for the shareholder group have not been achieved, it shall be deemed to have consented if

1. the parties to this group will presumably not be in a worse position under the insolvency plan than compared to their position in a normal insolvency proceeding,

2. the parties to this group participate adequately in the positive economic effects that shall be distributed to all participants of the insolvency plan, and

3. the majority of the voting groups have voted in favour of the insolvency plan with the respective majorities.

> *Limitation of legal remedies:* the appeal of a creditor against the confirmation of the insolvency plan shall be rejected by the court if the plan provides for funds to compensate appealing creditors. The dispute if such compensation is to be granted, shall be settled in a normal civil proceeding (i.e. meanwhile the plan can be confirmed and implemented).

The court shall reject an immediate appeal against the order confirming an insolvency plan if it finds – in its sole discretion – that the negative effects of a deferral in implementing the measures set out in the plan will outweigh the negative effects of the plan for the appealing creditor.

Advantages at a Glance

> *Easier:* the new insolvency plan regime adds all legally permissible (under corporate law) measures to the arsenal of distressed debt investors and their legal consultants; including – but not limited to – the debt-to-equity swap.

> *Faster:* the fact that all formal requirements for the legal process of the debt-to-equity swap (e.g. shareholder resolutions for the capital increase) are considered to be executed through the stipulation in the plan leads to a significant acceleration of the debt-to-equity swap process and its execution.

> *Safer:* the new set of rules providing for tools for the court to limit the ways in which creditors can obstruct the implementation of a plan improving the predictability of the whole insolvency plan proceeding.

> *Better:* one of the biggest threats to a debt-to-equity swap transaction before ESUG was a potential liability with respect to the difference between the real value of the claim to be transformed in equity and its face value. Such risks – this is one of the main achievements of the reform of the German insolvency regime – have been eliminated by ESUG. After the court has granted confirmation for the insolvency plan, the company (e.g. the insolvency administrator) cannot take legal actions against the former creditors anymore (claiming the overvaluation of the debt in the insolvency plan).

Conclusion

Investors seeking to invest in the debt of a distressed company have shunned the German market in the past.

The main reason for this have been the limitations on the ways to involve shareholder membership rights in insolvency plans. Especially the lack of predictability of the outcome of a debt-to-equity swap transaction – a well established restructuring tool in the US and Great Britain – has led to such restraints.

It is to be expected that the reform of insolvency plan proceedings in general and the loosening of the restrictions on involving shareholder membership rights in the plan through a debt-to-equity swap in particular, will lead to an increased use of insolvency plans and debt-to-equity swaps in restructurings and investments involving German companies.

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