

Comparative Guide to Restructuring Procedures

Weil



Introduction

We are delighted to introduce the Weil Comparative Guide to Restructuring Procedures. In this guide we focus on the restructuring procedures available in each of England, France and Germany and we compare key aspects of those procedures with US chapter 11. Chapter 11 US Bankruptcy Code continues to be the dominant formal restructuring tool and its key characteristic features have been and continue to be highly influential in the continuing development of restructuring laws world-wide.

This comparative guide is intended to serve as a summary reference point of practical value to stakeholders with interests in companies facing financial difficulty as the impact of financial distress nowadays is rarely limited by geographic boundaries. In the absence of a universal bankruptcy system, tailored strategic solutions need to be crafted and explored to achieve the best stakeholder outcome, whether within or outside the available formal procedures. The starting point of the strategic analysis in any given situation must be based on an appreciation of the key characteristics of the available procedures.

This guide also includes a short introduction to the EC Regulation on Insolvency Proceedings. This is a mandatory piece of legislation which, broadly, applies to companies headquartered within the European Union and which prescribes which of the (twenty-seven separate) Member States' courts have jurisdiction to open insolvency or restructuring proceedings and which Member State's insolvency law is to apply.

We hope you will find this guide informative and will be very happy to respond to any questions you have concerning the issues it covers. Queries can be addressed to your usual Weil contact, the main contact points for each of the jurisdictions featured in this guide or to the guide's contributing editors:

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About Weil's Business Finance and Restructuring Practice

Weil's business finance and restructuring practice is recognised as one of the leading practices in its field, referred to as the "gold standard" of bankruptcy practices by Chambers and as a "restructuring powerhouse" by The Deal. Weil has continued to reaffirm its pre-eminence in the restructuring sector during the current financial crisis by managing numerous large-scale and complex cases concurrently, including advising Lehman Brothers, AIG, Kaupthing, General Motors and MF Global.

Weil's European restructuring team has extensive experience in developing and implementing innovative restructuring solutions and strategies for a varied client base, accessed in part as a result of our market-leading private equity reputation. Our focus is squarely upon providing the most commercial, value-enhancing outcome in the most efficient way for our clients.

Our European team is part of a larger network of world class restructuring lawyers in the United States and Asia. Weil's lawyers collaborate with colleagues specialising in finance, corporate, litigation, derivatives, corporate governance, competition and tax law and, where appropriate, use a network of experienced local counsel where we have developed deep relationships over many years. Additionally, Weil has extensive experience in advising clients in offshore jurisdictions including the Cayman Islands, Bermuda, Jersey and the Isle of Man. We are therefore able to provide a fully integrated service within Europe and an unparalleled cross-border international service incorporating cutting edge advice on forum and strategic issues. Weil Business Finance and Restructuring contacts for the jurisdictions covered by this guide are set out at the back of this guide.

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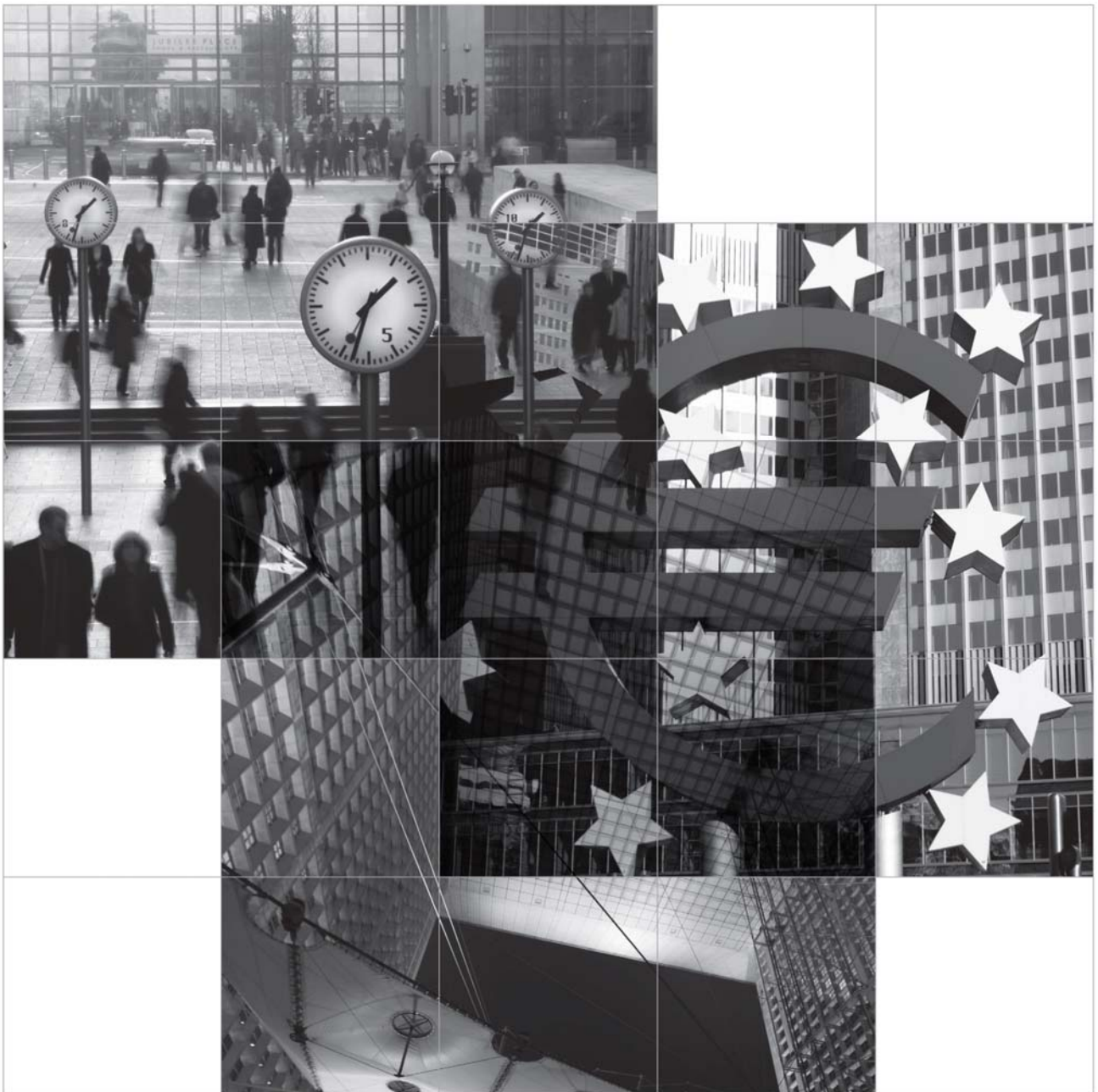
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Setting the Scene: The EC Regulation on Insolvency Proceedings



Setting the Scene: The EC Regulation on Insolvency Proceedings

Which Insolvency Law Applies in Europe and Which Court has Jurisdiction?

The European Union (EU) consists of twenty-seven Member States.¹ Each has their own legal system with different insolvency and restructuring laws, reflecting different underlying policies and traditions. Where a debtor is centred in Europe the provisions of the EC Regulation on Insolvency Proceedings (EIR) determine which Member State's insolvency laws applies and which Member State's courts has jurisdiction to decide on the issues arising in the insolvency proceedings. The EIR is mandatory and applies throughout the EU (except Denmark). Its aim is to ensure that insolvency proceedings, including cross-border aspects, operate efficiently and effectively within Europe, but it does not harmonise the substantive insolvency laws of the Member States. Insolvency judgments of the courts in Member States and the powers of the appointed office holders are, however, automatically recognised in other Member States. Further provisions are intended to promote cooperation between insolvency office holders where more than one set of insolvency proceedings have been opened for a particular debtor.

Scope of the EIR

The EIR applies to the specified types of collective insolvency proceedings which are listed separately for each Member State within its Annex A.² Insolvency proceedings concerning insurance undertakings and credit institutions are excluded from the scope of the EIR as different EU Directives apply to these regimes.

Establishing Jurisdiction

The key concept of the EIR is the location of the debtor's '*centre of main interests*' (COMI) as it is the courts of this Member State which have jurisdiction to open '*main proceedings*'. Main proceedings are deemed to be of universal scope (except where ancillary proceedings are started), and main proceedings extend to all of the debtor's assets and creditors, wherever they are located. If the debtor does not have a COMI within the EC, the EIR does not apply.

COMI is not a defined term, but recitals to the EIR require that it should correspond with the place where the debtor '*conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties*'. The EIR includes a presumption, in the absence of proof to the contrary, that the COMI will be the place of a corporate debtor's registered office. Unfortunately, the EIR does not include provisions for dealing with group companies on a consolidated basis, but rather the COMI of each separate entity has to be separately assessed. In the early days following the introduction of the EIR, particularly as insolvency professionals considered strategies for dealing with cross-border groups, there were uncertainties as to the correct approach in identifying COMI.

Following rulings of the European Court of Justice and further consideration of the case law by the English Court of Appeal (and its equivalents elsewhere in Europe) this issue has become broadly settled. Accordingly, whilst the fact that a parent company has control of its subsidiary will not itself be sufficient to rebut the registered office presumption as to COMI, the presumption can be rebutted

¹ Belgium, Denmark (which has exercised an opt out and is not a party to the EIR), Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden, United Kingdom, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, Romania and Bulgaria. The United Kingdom comprises England & Wales, Scotland and Northern Ireland. The Channel Islands and Isle of Man are not members of the EU and hence not subject to the EIR. However, Gibraltar is part of the United Kingdom for the purposes of the EIR by virtue of A299(e) of the Treaty of Rome.

² For the United Kingdom, the corporate proceedings falling within the framework of the EIR are compulsory winding up, creditors' voluntary liquidation, administration and voluntary arrangements. For France the applicable procedures are '*sauvegarde*' '*redressement judiciaire*' and '*liquidation judiciaire*'. The German proceedings which are covered are '*Das Konkursverfahren*' '*Das gerichtliche Vergleichsverfahren*', '*Das Gesamtvollstreckungsverfahren*' and '*Das Insolvenzverfahren*'.

if the head office functions of the subsidiary entity are located in a different Member State (for example, the state in which its parent is located), as long as the location of its head office is readily ascertainable by third parties. With the potential to encourage a race to the courts to open proceedings, the recitals require that Member States defer to the determination as to COMI made by the courts of the place where proceedings are first opened. Any appeal as to COMI must be made through the appeal courts of that jurisdiction, with a final appeal to the European Court of Justice.

Migrating COMI

The EIR requires that main proceedings are opened in the place where an entity has its COMI at the point in time that the relevant insolvency proceedings are initiated. There is, however, no requirement that an entity's COMI is fixed, indeed any such restriction has the potential to run counter to the basic freedom of movement principles upon which the European Union is based.³ In some cases there may be strategic advantages in migrating the COMI of an entity to another Member State prior to opening insolvency proceedings where, for example, the second Member State has more accessible, flexible or predictable restructuring procedures. An example of a strategic COMI migration, which was approved by the English courts, arose in the restructuring of the Wind Hellas Telecoms group. In that case a Luxembourg-based and registered group holding company migrated its COMI to England three months before English administration proceedings were opened.

Whilst identifying COMI requires a case by case analysis of the particular facts (on an entity by entity basis) it is instructive to note the factors which the English judge in Wind Hellas considered relevant when he evaluated and upheld the debtor's assertion that its COMI had been migrated to England.⁴ These comprised the following:

- a) the debtor's head office and principal address had been moved to London;
- b) the debtor's creditors had been notified of its change of head office;
- c) there was a press release announcing that the debtor's activities were shifting to England;
- d) the debtor had opened a bank account in London;
- e) the debtor had registered as an overseas company under the Companies Act in England; and
- f) all negotiations between the debtor and its creditors took place in London.

It should also be noted that a COMI-shift of an operational company, as opposed to a holding company, is much less likely to be feasible.

Opening Secondary and Territorial Proceedings

The EIR permits ancillary proceedings to be opened in a Member State other than that in which a debtor's COMI is located if the debtor has an '*establishment*' in another Member State. An establishment is defined as "*any place of operations where the debtor carries out a non-transitory economic activity with human means and goods.*" Effectively this is a branch concept. Where the ancillary proceedings are the first proceedings to be opened, they are known as territorial

³ The European Court of Justice has nevertheless upheld the right of Member States to legislate to the effect that a company cannot migrate its COMI to another Member State if it wishes to retain its registered office in the first Member State - *Cartesio Okato es Szolgaltato* [2009] Ch 354 so that the strategic migration of COMI may not be readily feasible in some jurisdictions.





⁴ Reported as: *In the Matter of: Hellas Telecommunications (Luxembourg) II SCA* [2009] EWHC 3199 (Ch).

proceedings. Where the proceedings are opened after the main proceedings, which is more usual, they are termed secondary proceedings. In either case, the scope of any ancillary proceedings is limited to the assets located in the relevant Member State territory. Unless the ancillary proceedings are territorial proceedings they cannot take the form of rescue proceedings, but must be one of the forms of winding up proceedings included within Annex B to the EIR. The opening of secondary proceedings will then, in practice, prevent or disrupt attempts to achieve a restructuring of an entity as a whole.

Applicable Law Under the EIR

Subject to a number of significant exceptions carved out from the EIR, including in particular, the law applying to secured assets located in another Member State, the law of the courts which open main proceedings is the applicable insolvency law for all matters, both procedural and substantive. Where secured assets are located outside the jurisdiction in which insolvency proceedings have been opened, the applicable law is the insolvency law of the jurisdiction in which those assets are sited.

Comparison of Chapter 11 of the US Bankruptcy Code with English Restructuring Procedures

				
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Comparison of Chapter 11 of the US Bankruptcy Code with English Restructuring Procedures

US Chapter 11

Overview of Chapter 11 of the US Bankruptcy Code

Chapter 11 of the US Bankruptcy Code provides a means for financially-distressed entities to restructure their finances so they can continue operating. It enables a debtor to remain in control of its business operations while it conducts restructuring negotiations. Chapter 11 provides for an orderly process for negotiating in a central forum governed by rules and procedures for administering the case.

In the light of the United States' credit-oriented society, the US Bankruptcy Code was enacted to create a mechanism to enable distressed entities to have a fresh start and reorganise their business. Chapter 11 is based on the fundamental principle that reorganisation is preferable to liquidation because a reorganisation preserves going concern value, protects jobs, and generally provides greater recoveries to creditors.

The major benefits the US Bankruptcy Code provides to debtors, many of which are discussed more fully below, include:

- The "*automatic stay*," imposed by the US Bankruptcy Code as soon as a bankruptcy case is commenced (the "commencement date"). The automatic stay provides a breathing space in which a debtor can try to reorganise by restructuring its business or selling its assets without being pressured by the commencement of lawsuits or the seizure of assets.
- The presumption that the debtor's management will remain in place, rather than be replaced by a trustee.
- The ability to obtain post-petition financing.
- The ability to obtain access to trade credit by paying post-petition creditors in full as an administrative expense.

English Restructuring Procedures

Overview of English Restructuring Procedures

When administration was first introduced through the Insolvency Act 1986 it was envisaged that it would be the main form of formal rescue procedure available and deployed in England⁵; prior to 1986 no formal collective rescue procedure was available aimed at insolvent or near insolvent companies. Administration is a very flexible procedure and operates as a gateway procedure; it may be followed, for example, by the company entering into a company voluntary arrangement (CVA) or a scheme of arrangement. Its primary aim is to facilitate company rescue, its secondary objective, the survival of the business.

Because of certain shortcomings in the administration procedure, increasingly the CVA and the scheme of arrangement procedures are now implemented instead as "stand-alone" rescue procedures, rather than as an exit strategy from administration.

The CVA procedure was also first introduced via the Insolvency Act 1986. The scheme of arrangement, however, is a long-established company law procedure available to solvent as well as insolvent companies.

Since the start of the global credit crisis, however, and because of perceived limitations with the available formal procedures, out of court, informal restructurings are now much more commonplace, particularly at the top end of the market.

Another marked trend has been the increase in the use of pre-packaged administrations in which the business (or part of it) is sold immediately following the appointment of the administrator, but on terms negotiated prior to their appointment.

In this section we set out an overview of the three available formal rescue procedures in England. In later sections we will focus on certain specific characteristics of each of the procedures and compare their operation with chapter 11 of the US Bankruptcy Code.

⁵ England & Wales is one of the component jurisdictions of the United Kingdom. Its other component jurisdictions are Scotland and Northern Ireland. Although broadly analogous, and in some areas identical, there are some differences in the detail of the statutory frameworks and each component jurisdiction has its own courts. This section of the guide refers to the law as it applies in England & Wales.

US Chapter 11

- The ability to sell property of the debtor's estate free and clear of liens, claims and encumbrances.
- The ability to reject burdensome executory contracts and unexpired leases and assume and assign executory contracts and unexpired leases to third parties notwithstanding contractual assignment prohibitions.
- The exclusive right to propose a *chapter 11* plan during the initial 120 days of a chapter 11 case and solicit and obtain acceptances of the plan during the initial 180 days.
- The ability to restructure financial obligations on a non-consensual basis pursuant to the "*cramdown*" provisions of the US Bankruptcy Code.
- The discharge of a debtor from any debt that arose before the date of confirmation of a plan of reorganisation, regardless of whether a proof of claim was filed or the creditor accepted the plan.

In addition to protecting the interests of a debtor, the US Bankruptcy Code concurrently includes provisions aimed at protecting the interests of other stakeholders, including creditors. Over the years the US Bankruptcy Code has been amended to expand creditor protections in certain special interest areas, for example derivatives.

Chapter 11 cases fall into two general categories: (i) "free fall" cases or (ii) pre-packaged or pre-arranged/pre-negotiated cases. In a traditional "free fall" case, the chapter 11 filing is made without an exit strategy having been agreed between the debtor and at least a critical mass of its creditors. In a pre-packaged case, the debtor negotiates and solicits votes on a plan of reorganisation before commencing its chapter 11 case, while in a pre-negotiated case, the debtor files a plan of reorganisation on the commencement date, but does not solicit votes on the plan until afterwards.

In either scenario, chapter 11 enables a wide range of proposals to be implemented in a plan. While one scenario has the debtor and its management survive the process, a chapter 11 plan could, however, encompass any of the following:

English Restructuring Procedures

Background to Administration and the Limited Residual Ability to Appoint an Administrative Receiver

Administration was introduced through the Insolvency Act 1986 as the UK's first collective rescue procedure. Central to the dynamics of the administration procedure is an automatic stay, termed a "*moratorium*", which comes into effect as soon as the administration process is initiated. This gives the debtor a breathing space from creditor enforcement action, allowing time for the administrator to assess the debtor's future and to formulate a rescue plan.

Streamlining reforms were introduced in 2003 which were intended to make administration better able to deliver a company rescue. The reforms require administrators in all cases to consider whether the company's survival can be achieved. If that is not feasible, the administrator must put together a plan which will result in a better financial outcome for creditors than would be the case in a liquidation. Often this might involve the administrator negotiating a sale of whole or part of the business as a going concern. Where the administrator is unable to formulate a plan which will result in unsecured creditors receiving a dividend distribution, his duty is to realise property in order to make a distribution to secured or preferential creditors and the debtor is likely then to be dissolved.

Historically, a creditor with security (to include a floating charge) over all or substantially all of a debtor's assets could, on the debtor's default, deploy their own individual enforcement action by appointing an administrative receiver. An administrative receiver's role was to act on the appointing chargeholder's instructions and to make maximum realisations for its appointor. However, since September 2003 (but only covering new security created from that point) secured creditors have in most circumstances been prohibited from appointing administrative receivers. A number of exceptions have been carved out from this prohibition, most significantly to cover certain capital market and project finance transactions involving borrowings exceeding £50M where the appointment rights remain.

Instead, a simple out of court administration appointment procedure was introduced for qualifying floating charge holders (QFC) (broadly those with fixed and floating charge security over all or substantially all of a debtor's assets who had previously been able to appoint administrative

US Chapter 11

- a consensual "stand-alone" plan, in which the creditors (secured and unsecured) and, if applicable, the company and its equity security holders, agree on a means of reorganising the debtor's business without the need to sell the business. A stand-alone plan could take the form of certain creditors agreeing to accept less than 100% payment or to take a combination of debt and equity issued by the reorganised company in satisfaction of their claims;
- a plan which effects a sale of all or substantially all of the debtor's assets as a going concern and distributes the consideration to creditors in accordance with the US Bankruptcy Code's priority scheme;
- a plan which relies on a capital infusion from an investor;
- a liquidating plan which sells all of the debtor's assets and provides for a distribution of the sale proceeds to creditors in accordance with the US Bankruptcy Code's priority scheme;
- a plan which includes a litigation trust to pursue and prosecute causes of action belonging to the debtor; or
- a combination of the above.

In recent years, debtors have increasingly used chapter 11 to sell substantially all of their assets shortly after the commencement date outside of a chapter 11 plan pursuant to section 363(b) of the US Bankruptcy Code. The predominance of section 363 sales has raised the question whether the objective of chapter 11 has morphed from its original purpose of rehabilitating a debtor to promptly disposing of viable or "good" assets and business operations to be continued by the purchaser, while leaving the less desirable or "bad" assets with the debtor to be liquidated in chapter 11.

English Restructuring Procedures

receivers) when a debtor defaulted under the terms of their banking facilities. Before these changes, all administration appointments had to be made by court and were subject to the court's discretion.

Although there have not been substantial substantive changes to the statutory procedure of administration since 2003, there have been significant changes as to how administration operates in practice. In particular, there has been a growing trend in the use of pre-packaged administrations across all sectors of the market, with around 30% of all administrations thought to take the form of pre-packs by 2011.

CVAs

CVAs were also introduced as a new procedure in 1986. CVAs are a form of statute-governed contractual compromise between a corporate debtor and its unsecured creditors (or some of them). Provided that prescribed statutory formalities are complied with CVAs can be very flexibly worked as mechanisms through which unsecured creditors' rights can be adjusted leading either, in appropriate cases, to company rescue or alternatively providing a better platform for realising and distributing assets than would be achieved through liquidation. Although CVAs can be implemented on a "stand-alone" basis, they are sometimes implemented through administration. This provides the debtor with the protection of the administration moratorium whilst the CVA terms are being drafted and negotiated and before they are presented to creditors for voting approval.

In a CVA, unsecured creditors vote as a single class and the court has no involvement in the approval process unless a creditor subsequently mounts a challenge to the validity of the CVA. A CVA cannot be used to compromise the rights of secured or preferential creditors in the absence of unanimous agreement.

Schemes of Arrangement

Schemes of arrangement are increasingly being used to implement restructurings of large, complex and often cross-border businesses with substantial, highly-leveraged secured debt. Schemes of arrangements are not strictly insolvency procedures as they derive from company law and can be used to reorganise solvent companies as well as those in financial crisis. Schemes of arrangement are very flexible

US Chapter 11

English Restructuring Procedures

procedures, however, which offer some significant advantages over administrations. In particular:

- Schemes can be accessed by a debtor without the need to satisfy any financial distress threshold (whereas administration is generally only available at the point that the debtor is or is likely to be insolvent);
- Existing management remains in place;
- No change is made to the tax treatment of a group when a scheme is put in place (although the terms of the scheme itself may have taxation impact);
- The English court has jurisdiction to sanction a scheme of arrangement on a fairly wide jurisdictional basis, namely wherever it is satisfied that there is a close connection with the UK and where it considers it appropriate in the circumstances to sanction the scheme. The close connection requirement can be satisfied where the debtor's finance documents are governed by English law. Schemes may more readily be capable of providing a group-wide solution where the debtor is part of a cross-border group, as stand-alone schemes are not procedures covered by the EIR and so do not operate within its jurisdictional constraints. (See comment below)

Schemes of arrangement are sometimes combined with administrations so as to benefit from the automatic recognition within the EU which then applies by virtue of the application of the EIR.

Schemes have on many occasions been recognised as main or non-main proceedings under chapter 15 of the US Bankruptcy Code.

Whether stand-alone schemes are recognised in other jurisdictions (including in the EU Member States) is a matter for the private international law of the Member State seeking recognition. This is a developing area of the law upon which specific advice should be sought.

Comparative Comment

The UK administration procedure has generally been considered the procedure most analogous to US chapter 11, with both procedures featuring an automatic stay on creditor enforcement action giving a breathing space which provides time for the debtor to formulate plans for a reorganisation. However, there are some fundamental differences between the procedures, including issues relating to the control of the running of the business, the accessibility of the procedure in terms of qualifying criteria, the availability of rescue finance and the priority of its terms, the ability of the debtor to elect which contracts to continue and the general disability of counterparties to exercise ipso facto termination clauses.

In recent months there has been an increase in use in the UK of both schemes of arrangement and CVAs as preferred vehicles through which to implement a restructuring. It is notable that both of these procedures are "debtor in possession" style procedures allowing existing management to remain in place, and further are procedures which can be implemented before a debtor has reached an extreme point of financial crisis. They are also procedures which may more readily lend themselves to rescue finance. In these ways, schemes and CVAs share some significant similarities with chapter 11. On the other hand, in most cases neither schemes of arrangement nor CVAs benefit from a statutory form of stay compelling creditors to desist from taking enforcement action.

US Chapter 11

Qualifying Criteria and Jurisdiction

An individual, partnership or corporation may be a chapter 11 debtor so long as it resides or has a domicile, a place of business, or property in the United States at the time proceedings are opened. Corporations are domiciled in the state of their incorporation.

Insolvency is not a requirement for commencing a voluntary chapter 11 case because the open access policy of the US Bankruptcy Code encourages debtors to commence a case before their condition deteriorates to the point that it is too late to reorganise. However, lack of good faith in filing a chapter 11 petition is cause for dismissal of the case. A chapter 11 filing generally would not be in good faith absent some present or anticipated financial distress.

Although a chapter 11 petition must be filed in the bankruptcy court, the federal district courts have original and exclusive jurisdiction of all cases under the US Bankruptcy Code. The district court has exclusive jurisdiction of all of the property of the debtor (wherever located) and over the property of the estate as of the commencement date.

A chapter 11 case may be commenced in the district court for the district in which (i) the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the debtor have been located for the 180 days immediately prior to the commencement date or for a longer portion of such 180 day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of the debtor were located in any other district; or (ii) there is a case pending under the US Bankruptcy Code concerning the debtor's affiliate, general partner, or partnership.

English Restructuring Procedures

Qualifying Criteria and Jurisdiction

Administration - Overarching Jurisdictional Requirements

Where administration is intended to be pursued to achieve a rescue, and the debtor has its COMI within the EU, administration can only be initiated where the debtor's COMI is in England. Broadly, a debtor's COMI will correspond with the place where it has its registered office, unless the registered office is not also evidently the location of its head office functions. Where administration is being pursued as an alternative distribution mechanism to liquidation, administration proceedings can also be opened in England if the debtor has an establishment in England. Broadly, an establishment corresponds with a place where the debtor has a branch.

Outside of the mandatory application of the EIR, the English court also has a discretionary power to permit the opening of administration proceedings at the request of a foreign court in one of several jurisdictions which have been designated as applicable territories for the purposes of section 426 Insolvency Act 1986. These are largely former Commonwealth countries with a common law tradition.⁶ Administration proceedings can also be opened in respect of a company incorporated in a state within the European Economic Area (consisting of the 27 EC Member States and Iceland, Norway and Liechtenstein).

Statutory provisions otherwise expressly limit the scope of administration so that, for example, unless an US registered company had its COMI in England, it would not be possible for administration proceedings to be initiated.

Threshold Financial Test to Access Administration

Unless initiated by a QFC, administration is only available if the debtor meets a threshold test, namely that it *'is or is likely to become unable to pay its debts'* (on a cash-flow or balance sheet basis). This threshold test applies whether administration is being accessed through court or by the out of court procedure. The effect of this requirement is that administration is only available

⁶ The countries designated for the purposes of section 426 Insolvency Act 1986 are Anguilla, Australia, the Bahamas, Bermuda, Botswana, Brunei, Canada, Cayman Islands, Falkland Islands, Gibraltar, Hong Kong, the Republic of Ireland, Montserrat, New Zealand, St Helena, Turks and Caicos Islands, Tuvalu, the Virgin Islands, Malaysia, South Africa.

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at a late stage of a debtor's financial difficulties and potentially too late in the day to facilitate a rescue. A QFC, however, can initiate administration if the underlying debt is enforceable (albeit that, in practice, once the debt is enforceable the company will usually be cash-flow insolvent in any event.)

Migration of COMI to Access English Insolvency Procedures

In recent years, particularly in the case of large cross-border groups, there has been a growing trend in implementing strategies in appropriate cases to migrate the COMI of a debtor group, typically at holding company level, to another jurisdiction. This is in order to access a preferred restructuring regime, for example the administration regime in England, and in particular, pre-pack administration.

CVAs

CVAs are insolvency rescue procedures covered by the EIR so that they can be put in place for debtors with their COMI in England. Jurisdiction to implement a CVA otherwise mirrors the provisions applicable in the case of administration (see above.)

There have been cases in which the COMI of a holding company has been strategically shifted from another jurisdiction to England to enable creditors to access the English CVA procedure. The most well known example is the restructuring of the German auto-parts group, Schefenacker.

Schemes of Arrangement

No financial qualifying threshold applies to access the scheme of arrangement process. Schemes are often used outside the restructuring context for solvent companies.

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Where schemes of arrangement are "stand-alone" procedures, i.e. where they are not initiated or implemented by an administrator, they are not proceedings covered by the EIR so jurisdiction is not determined in accordance with the EIR's provisions.⁷ Rather, the English courts have jurisdiction to sanction a scheme where satisfied that there is a "close connection" with England. The case-law is continuing to develop, but the test can be satisfied where the debtor has entered into financing facilities governed by English law and it proposes to agree a compromise or arrangement with its financial creditors.

Comparative Comment

There are very limited threshold requirements applicable for the filing of a voluntary chapter 11 case making the procedure readily available and accessible to management before the finances of a company have entered into a state of terminal decline. In contrast, administration can effectively only be accessed at a later stage and at a point when rescue may not be viable. The lack of a financial threshold qualifying criteria is one factor accounting for the current increase in the use in the UK of schemes of arrangement.

The qualifying criteria for chapter 11 cases are also very wide in scope, and whilst a filing not made in good faith can be the subject of a later challenge, there is no requirement as such for a connection to the jurisdiction.

Where the EIR applies, as is the case with chapter 15, the jurisdictional threshold test for opening proceedings is tested at the time that proceedings are opened. This therefore opens up the possibility in appropriate cases of migrating COMI to England (or to another European jurisdiction) in order to access the procedures governed by the EIR. Such a strategy is likely to be expensive and its success would be dependent to a large extent on creditor support, whether the entity in question was a holding company or an operational company (a COMI shift of the latter being much less likely to be feasible) and any court considering the issue would want to be satisfied amongst other things that the COMI shift involved an appropriate element of permanence ascertainable by the debtor's creditors.

⁷ Insolvency proceedings falling within the EIR are those collective insolvency proceedings which involve existing management relinquishing control of the running of the business and which are listed at Annex A to the EIR.

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Directors' Duties and Mandatory Filing Requirements

The US Bankruptcy Code does not require an entity or its directors at any point to initiate a Chapter 11 filing.

However, corporate directors and officers owe fiduciary duties to the corporation. State statutes and the common law of the state of incorporation govern these duties. As the vast majority of businesses have selected Delaware as their state of incorporation, the Delaware statutes and decisions interpreting such statutes establish the general governing principles.

With respect to solvent corporations, the duties of loyalty and care run to the shareholders. The duty of loyalty requires the abstention from actions that could be detrimental to the corporation and its shareholders or which are intended to benefit the interests of the directors, officers, or a third party. The duty of care requires the exercise of the degree of care that a person of ordinary prudence would exercise under the same or similar circumstances. It incorporates an obligation to be informed about all material information reasonably available, including the responsibility to consider alternatives and get professional advice where necessary. In discharging these duties, directors and officers are protected by the business judgment rule. The business judgment rule is a presumption that, in making a business decision, the directors and officers acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation. The effect is that unless there are clear grounds for rebutting this presumption, courts will typically not question the business decisions of the corporation's directors and officers.

Once a company enters the "zone of insolvency", however, the fiduciary duties are to the company rather than any particular constituency. Actions taken in the best interests of the company will benefit its residual stakeholders. When a corporation is insolvent, directors and officers must take into account all the interests of the corporation's economic stakeholders.

Directors and officers of distressed corporations may need to choose from different restructuring options that could limit creditor recoveries or dilute, if not eliminate, equity interests. As a result, out-of-the-money creditors and/or equity security holders may carefully scrutinise which options

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Directors' Duties and Mandatory Filing Requirements

There are no requirements under English corporate or insolvency law specifically requiring the directors of a debtor company to open insolvency proceedings at any stage.

However, section 214 of the Insolvency Act 1986, entitled wrongful trading, permits a subsequently-appointed liquidator to start court proceedings against the debtor's directors and shadow directors for an order requiring them to personally compensate the debtor for its losses. Directors and shadow directors will be liable to make such a payment if the court is satisfied that:

- (1) the directors knew or ought to have known that there was no reasonable prospect of the debtor avoiding insolvent liquidation; and
- (2) the directors then failed to take every step to minimise losses to creditors.

Directors found to have wrongfully traded can also be disqualified from acting as a director for a period of up to 15 years.

Apart from this potential statutory liability, directors and shadow directors can also face civil proceedings for breach of their common law duties to the company. Directors' common law duties have recently been codified to provide that when a company is solvent their predominant duty is to act in good faith and in a manner likely to promote the success of the company for the benefit of its members as a whole (section 172 Companies Act 2006). However, when a company enters into the 'zone of insolvency', the application of this duty shifts and the interests of the company changes to reflect the interests of its creditors. The point at which the focus of the duty changes has not been identified with any precision through the case-law.

Summary proceedings for misfeasance can also be brought under section 212 Insolvency Act 1986 if, in the course of a winding up, those involved in a company's management have been guilty of misfeasance or breach of fiduciary duty. Additional claims can also be brought in cases of fraud in which it is usual for both criminal and civil proceedings to be pursued).

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were or were not chosen by the company's directors and officers, with directors and officers potentially subject to claims for breach of their fiduciary obligations.

In the past decade, a new concept of liability, called "*deepening insolvency*," developed. This concept is premised on the fiduciary duty concept and the notion that the corporation itself may be harmed when directors and officers cause the corporation to deplete its assets and accrue excessive debt. The theory is that directors and officers have a duty to protect the corporation from further unnecessary losses. Whether deepening insolvency constitutes a valid theory of damages is a matter that is uniquely subject to state law principles. While some courts have recognised a cause of action for deepening insolvency, this theory of liability as a separate cause of action has been rejected in Delaware. Nevertheless, some courts may permit deepening insolvency to be considered as a measure of damages.

Comparative Comment

Neither the US nor the English insolvency regimes contains prescriptive provisions requiring insolvency proceedings to be opened at a specified point and within a specified time limit (unlike the position in both France and Germany). The greater degree of flexibility afforded in these jurisdictions may permit, particularly in the context of substantial group companies, including those with cross-border businesses, group restructurings to be formulated without the risk of a formal filing of a single subsidiary jeopardising the plan. English directors will wish to ensure however, that when a company is in the zone of insolvency, they are not at risk to statutory claims for wrongful trading or other misfeasance claims. Directors in the US are generally at less risk to claims for breach of duty, although there is a potential risk at least in some court districts of claims for breach of duty arising in the context of the company's "deepening insolvency."

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Procedure

A voluntary or involuntary chapter 11 case is started by filing a chapter 11 petition with the bankruptcy court.

A chapter 11 corporate debtor must file: (i) a list of creditors; (ii) unless the bankruptcy court orders otherwise, a schedule of assets and liabilities, a schedule of executory contracts and unexpired leases, a statement of financial affairs and a list of equity security holders; (iii) a corporate ownership statement; and (iv) a list of creditors holding the twenty largest unsecured claims, excluding insiders.

Generally, a debtor is permitted to continue to operate its business as a debtor in possession (DIP) after a chapter 11 case has commenced, and to remain in control of its assets. However, a trustee may be appointed to operate a debtor's business if grounds for making such an appointment are established.

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Procedure

An administrator can be appointed either following a court application, or alternatively, in certain cases, via an out of court process involving filing certain notices and documentation. It is usual for two administrators to be appointed with powers to act jointly and severally.

Administration – Out of Court Appointment

A QFC may appoint an administrator out of court by filing a notice of appointment in court which is a form of statutory declaration confirming that the QFC holds an enforceable qualifying floating charge. This form is also signed by the administrators, who must state their opinion that the purpose of the administration is reasonably likely to be achieved. The appointment takes effect once the papers are filed in court. Other creditors cannot make an out of court appointment and court applications by creditors to appoint administrators are rare.

The company or its directors can, however, alternatively initiate an out of court administration appointment as long as the company has not been in some form of insolvency proceeding in the prior year and provided that it is or is likely to become unable to pay its debts. Where there is no QFC, the appointment will take effect immediately, but a QFC is entitled to 5 business days notice of an intended appointment. Similar forms are required to be completed as in the case of an appointment initiated by a QFC.

Administration – Court Appointment

Administration appointments are usually made out of court. This is a quicker and cheaper procedure and there is certainty of outcome as, unlike the court procedure, no element of discretion is involved. In some cases, however, a court application will instead be pursued. This may be appropriate if, for example, there is a risk of challenge as to the enforceability of a QFC's security or as to whether the applicant properly qualifies as a QFC. A court appointment may also be advantageous where the administrators expect to need to obtain recognition of their appointment and powers overseas. In practice, overseas jurisdictions not readily familiar with English insolvency procedures may more quickly respond to a court-stamped administration order rather than an out of court notice of appointment.

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Procedurally, unless the application is made by a QFC, an application can only be made if the company is or is likely to become unable to pay its debts. As to the mechanics of the appointment, a witness statement providing broad details of the debtor's financial position is filed with the court application and the proposed administrators must also complete a statement confirming their opinion that the purpose of administration will be achieved. The application is heard before the court and the judge has a discretion as to whether or not to make the order. An interim moratorium comes into effect when the papers are filed in court pending the hearing.

CVAs

A CVA can be relatively quickly formulated and implemented, although much will depend on the complexity of the individual proposal. The process is usually initiated by the debtor's directors (but can also be implemented by its administrator or liquidator). Existing management usually stays in place and selects a qualified insolvency practitioner to act as the nominee in relation to the CVA. The nominee in practice takes the lead in drafting the directors' CVA proposal and chairs the meetings of creditors and members which vote on the proposals. The proposal must include statutorily prescribed information which is necessary to ensure that the unsecured creditors and members are able to reach an informed decision on the proposal and the directors' explanation of why in their opinion unsecured creditors should vote in favour of the proposal. The nominee is required to file a report in court giving his opinion as to whether the proposal has a reasonable prospect of being approved and implemented and the date of the proposed meetings of creditors and members. These meetings are held within 28 days from the nominee filing his report at court. Creditors vote as a single class (in which a majority of 75% by value of unsecured creditors who attend and vote is required, as further discussed in the section below concerning proposals). A creditor can challenge the approval of a CVA in certain limited circumstances within a 28 day period of the CVA being approved.

Schemes of Arrangement

A scheme of arrangement usually takes longer and is more costly to implement than a CVA as it involves a number of stages and court applications. The first court hearing is commonly termed the "convening hearing" as at this hearing

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the debtor applies to court for permission to convene meetings of identified classes of creditor, and, where their rights are also affected, members. At that hearing the court will consider the terms of the proposed scheme, its accompanying explanatory statement and the way in which the debtor intends scheme classes to be constituted. The court also considers and makes directions as to any other preliminary issues.

Assuming that the court has made the order permitting meetings to be called, the scheme proposal is voted upon (see section below CVAs: Voting on the Proposals). Assuming the statutory voting majorities are obtained for all of the classes of creditor, and, where applicable, member, the debtor must then apply to court for an order sanctioning the scheme. The court has complete discretion whether or not to sanction the scheme. As well as being satisfied that all the procedural requirements have been followed, the court will consider whether the creditor classes were fairly represented by those attending the meetings and whether the scheme might reasonably be approved. The scheme of arrangement becomes effective when the court sanction order is filed at the central registry for English companies, Companies House.

Comparative Comment

The English court has a discretion as to whether to grant an order when a court application for an administration appointment is made and it also has a discretion as to whether it should sanction a scheme of arrangement after the statutory majorities have been obtained. Given the element of discretion, it follows that there is an element of uncertainty as to whether the approval will be given in either case. In contrast, under the provisions of chapter 11 of the US Bankruptcy Code the debtor can voluntarily file for chapter 11 and the case will automatically be opened. The court is not required to provide a formal endorsement or approval of the chapter 11 filing. A chapter 11 case may, however, later be dismissed if the court determines that the filing was in bad faith. The chapter 11 exit reorganisation plan must in any event be approved by the court. English courts have no involvement in CVAs unless a challenge is mounted as to its approval within 28 days. As is apparent from its terminology, the English court has no involvement in approving an "out of court" appointment of an administrator.

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Automatic Stay

Scope of the Automatic Stay

The filing of a bankruptcy petition immediately operates as a moratorium or "*automatic stay*" of certain actions against the debtor. The automatic stay is one of the fundamental protections the US Bankruptcy Code affords debtors because it provides an opportunity to restructure without the pressure of collection efforts and foreclosure actions. Actions that are stayed include:

- commencing or continuing a judicial, administrative or other action against the debtor that was or could have been commenced before the commencement date;
- enforcing a judgment against the debtor or property of the estate;
- any act to obtain possession or exercise control over property of the estate;
- any act to create, perfect or enforce a lien (i.e. security) against property of the estate;
- the set-off of any debt owing to the debtor that arose before the commencement date against any claim against the debtor arising in a different transaction.

The automatic stay only lasts until the chapter 11 case is closed or dismissed or a discharge, which operates like an injunction, is granted or denied. The discharge occurs when a plan of reorganisation is confirmed. The automatic stay does not extend to third parties such as the debtor's guarantors or co-debtors, although the court has power to extend the stay to non-debtors in certain circumstances.

Exclusions from the Stay

Excepted from the scope of the automatic stay are, amongst other things: criminal actions; police, regulatory, and other governmental acts; the presentment of a negotiable instrument; and the set-off by a swap participant of any mutual debt arising in connection with a swap agreement.

Relief from the Stay

The bankruptcy court has power to grant relief from the stay. Relief from the stay will be granted

English Restructuring Procedures

Statutory Moratorium

Scope of the Administration Moratorium

An interim moratorium takes effect when the court application to appoint an administrator is filed or when the notice of their intention to appoint is filed at court under the out of court appointment procedure. Once the administration commences the interim moratorium is termed the moratorium, but its scope is the same as the interim moratorium.

The moratorium restricts the ability of creditors to enforce their rights against the debtor. It does not alter those rights, but merely suspends them. The moratorium provides that:

- No steps can be taken to enforce security over the company's property;
- No steps can be taken to repossess goods in the debtor's possession under hire purchase agreements;
- Landlords are unable to forfeit the debtor's lease by peaceably re-entering the property;
- No legal proceedings or enforcement actions can be started or continued against the debtor;
- Alternative legal proceedings (such as voluntary or compulsory winding up) cannot be pursued whilst the moratorium is in force.

Exclusions from the Moratorium

Security which comprises "*financial collateral*" within the meaning of the Financial Collateral Arrangements (No 2) Regulations 2003, broadly comprising cash, shares and tradable bonds, can be freely enforced, notwithstanding the stay. This is a significant carve out as lenders will frequently have taken security over the shares of a holding company's subsidiaries.

Relief from the Moratorium

A creditor can apply to court for an order permitting the creditor to continue enforcement or other action otherwise caught by the moratorium. The burden is on the creditor to show that the stay should be lifted. Where the applicant can show that the giving of permission would not impede the

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to a party in interest for cause including, in the case of a secured lender, the lack of adequate protection of such party's interest in property. Secured creditors are entitled to adequate protection against a diminution in the value of their collateral during the bankruptcy (for example, because of depreciation, falling market values or a failure to maintain or insure the property). A party in interest also may be granted relief from the stay with respect to an act against property if the debtor does not have equity in the property (i.e. the sum of all liens exceeds the property's value) and the property is not necessary to an effective reorganisation.

An action in violation of the automatic stay is void (i.e., has no legal effect) against the debtor. The bankruptcy court also has power to impose sanctions, which can include orders to pay punitive damages, in cases of wilful violation of the automatic stay.

Extra-territorial Effect of the Stay

The automatic stay is not expressly limited to actions or entities with a US connection. While the stay applies worldwide, the ability to enforce the stay overseas is dependent upon whether the relevant foreign state will recognise it either under a treaty or under other principles or rules, such as comity under the common law.

With respect to actions of US citizens, the automatic stay applies to actions taken in foreign countries. Foreign entities with assets in the US are likely to voluntarily abide by the automatic stay as they otherwise risk having their assets in the US seized by way of punitive damages for violation of the stay.

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administration then permission will generally be granted. However, this can be a hard burden to surmount.

Extra-territorial Effect of the Moratorium

Although the terms of the statutory moratorium do not address the question of the extra-territoriality of the moratorium, the English courts have ruled that administration imposes a trust of the assets for the benefit of creditors and this results effectively in an extra-territorial jurisdiction which may be exercised in the court's discretion to prevent a creditor taking advantage of a foreign enforcement.

CVAs and Moratoria

Unless a CVA is initiated by an administrator (which is extremely rare) or, alternatively, has been implemented with an optional moratorium procedure available only for small companies⁸, (yet more rare), no moratorium comes into effect when a company initiates a CVA. The lack of a moratorium is a key reason why stand-alone CVAs have, at least until the onset of the global credit crisis, been relatively rare. Since the credit crisis in certain sectors, notably retail, there has been a growing trend in the use of CVAs. In the retail sector, CVAs have principally been used as vehicles to compromise claims of landlords at unprofitable sites, whilst the debtor generally continues to meet obligations to other unsecured creditors.

Schemes of Arrangement

No automatic stay takes effect where a scheme of arrangement is being implemented. However, in practice, schemes of arrangement usually affect the rights of financial creditors only and trade creditors usually continue to be paid (preserving the goodwill value of the debtor). The financial creditors often agree a formal standstill, or if not, will usually informally agree to hold off from taking enforcement action, having taken a view that their recovery prospects are likely to be improved by the proposed restructuring.

⁸ Companies falling within the section 382 Companies Act 2006 definition of small companies, and being a company which in the prior financial year satisfied two of the three requirements: (1) turnover of not more than £6.5 million; (2) balance sheet total of no more than £3.26 million; no more than 50 employees.

Comparative Comment

The automatic stay is a key characteristic of both chapter 11 and administration. The lack of a generally available moratorium under the English CVA procedure and in relation to schemes of arrangement has led to consultations between the UK government and interested stakeholders as to whether reforms should be introduced which would allow restructuring moratoriums to be obtained more widely. The outcome of the consultations is not yet known. Both jurisdictions show a reluctance on the part of the courts to lift the automatic stay, where it applies, unless there are compelling reasons for doing so.

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Control

Generally, chapter 11 allows a debtor to continue to operate its business as a debtor in possession and remain in control of its assets while attempting to restructure its affairs, rather than having a trustee appointed. Nevertheless, a trustee may be appointed to take charge of and operate a debtor's business on request of a party in interest for cause.

Although by no means universal, the prevailing view is that retaining existing management provides the most economical and efficient means of restructuring under the oversight of the bankruptcy court, the US Trustee, and any statutory committees. Moreover, many debtors in possession employ a chief restructuring officer (*CRO*) to provide crisis management experience and a fresh perspective on the reorganisation process.

For most purposes, the debtor in possession is the same entity as the debtor. However, the debtor manages, but no longer owns, the property it previously owned; the property becomes part of the debtor's estate. As long as the debtor keeps possession of that property (i.e., a trustee is not appointed), the debtor is a debtor in possession of the estate's property.

A trustee may be appointed to take charge of and operate a debtor's business on request of a party in interest for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement date, or if the appointment is in the interest of creditors or equity security holders. A trustee also may be appointed if grounds exist to convert or dismiss the case, but the bankruptcy court determines that the appointment of a trustee is in the best interests of creditors and the estate. The appointment of a trustee is an extraordinary remedy.

If the bankruptcy court has not appointed a trustee, the bankruptcy court has the power to appoint an examiner on the application of a party in interest or the US Trustee. The court will appoint an examiner if (i) such appointment is in the interests of creditors, equity security holders, and other interests of the estate or (ii) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5 million.

The examiner's role is to investigate the debtor, in

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Control

Administration

Complete control of the running of the business passes from the directors to the administrators immediately upon their appointment. Administrators must be licensed insolvency practitioners (which requires them to have specialist insolvency and restructuring qualifications and experience). Generally, insolvency practitioners are also qualified accountants.

Although directors' and employees' contracts do not automatically cease, administrators have power over whom to hire and fire and they take over the day-to-day management of the debtor whilst acting as agents of the debtor. Administrators' powers are set out in the Insolvency Act 1986 and are extensive. Administrators have a duty to act in the interests of all of the creditors and are also officers of the High Court and, as such, have further obligations to act in good faith. The debtor's directors in the meantime are required under provisions in the Insolvency Act 1986 to assist the administrators as required.

Administrators' powers can potentially be limited by the terms of the proposals they submit to creditors for approval. Those proposals may, for example, include mechanisms entitling creditors to approve certain decisions concerning the administration and the running of the business of the debtor. The administrators will, in any event, consult with any creditors' committee on key issues affecting the administrator.

CVAs

Where a CVA has been approved, existing management will usually remain in place. The insolvency practitioner who had acted as nominee in relation to the CVA proposal or another insolvency practitioner will become supervisor of the CVA and will oversee its implementation in accordance with its terms.

Schemes of Arrangement

As in the case of a CVA, existing management ordinarily stays in place whilst a scheme is being negotiated and implemented. In larger scale enterprises with complex capital structures, management may be bolstered with the appointment of a chief restructuring officer to oversee the restructuring, freeing up remaining management to deal with the operational aspects of

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particular, with respect to allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the debtor or by current or former management.

The US Trustee is required to appoint a committee of creditors holding unsecured claims as soon as possible. Although a creditors' committee generally consists of those creditors willing to serve that hold the seven largest unsecured claims, the size of a committee often depends on the different types of unsecured creditor constituencies in the particular chapter 11 case. Additional committees of creditors or equity security holders may be appointed under certain circumstances.

Committees typically consult with the debtor regarding the administration of the case and can investigate all aspects of the debtor's business. A statutory committee is a party in interest with the right to appear and be heard on any issue in a chapter 11 case. The fees and expenses of a committee's professionals are paid for by the debtor's estate. One of its significant roles is participating in the negotiation of a chapter 11 plan.

Major secured creditors frequently have a significant role in monitoring a debtor in possession. This typically occurs when there is one secured creditor holding a lien (security) on all, or substantially all, the property of the estate for a debt that exceeds the liquidation value of such property. The rationale is that if the business continues to accrue losses and the reorganisation fails, the losses will fall on the secured creditor. On the other hand, if the liquidation value is less than the secured debt, the secured creditor may be incentivised to have the debtor reorganise in a manner that will result in a higher distribution than under a liquidation scenario.

Comparative Comment

When administration and CVAs were first introduced in the 1980s, the prevailing view (and one which largely continued when the procedures were reformed in 2003) was that, as insolvency was in many cases caused by some weakness in management, it was appropriate that they be displaced from this position. It is apparent that there has, at least to some extent, been a shift in attitude since the onset of the credit crunch and this is evidenced by the significant increase in the use of CVAs and schemes of arrangements, both debtor in possession style procedures.

The approach in the US has been to intervene and bring in outside advisers (typically chief restructuring officers, often with skills similar to English insolvency practitioners) where management weakness was identified, and bearing mind that in the US the presumption in favour of a debtor in possession operates as intended only in the context of the significant level of creditor and court oversight in chapter 11. There is no comparable day to day oversight by the court or creditors in England where the insolvency practitioner is the creditors' oversight, and the English courts have repeatedly emphasised that it is the insolvency practitioner's role (rather than the court's) to make commercial decisions.

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the business. Creditors in different classes will frequently form committees and negotiate terms via these committees.

Creditors' Committees

Creditors in all forms of insolvency proceedings under the Insolvency Act 1986 are entitled to elect a creditors' committee consisting of between 3 and 5 creditors. In an administration they usually do so at the initial meeting called to approve the administrators' proposals. Similarly, in the case of CVAs, a creditors' committee is usually elected at the creditors' meeting to approve the proposals. The committees play a consultative and monitoring role and do not have statutory rights to be heard as a matter of course on court applications, nor to have their legal fees paid. In practice however, in the case of very large-scale restructurings and insolvencies, the creditors' committee will be permitted to instruct its own lawyers whose fees are likely to be paid as an expense of the debtor's estate.

In administration, individual creditors have a right to challenge the administrator's conduct of a company on the basis of unfair harm or lack of expedition. However, the English courts are generally very reluctant to uphold challenges under these provisions and will usually support the incumbent administrator.

In the case of schemes of arrangement there is no statutory provision for creditors to be constituted in committees but, in practice, creditors impacted by the scheme generally form ad hoc committees and look to the debtor for payment of their legal fees.

The loss of control by directors in the UK may explain why it is much more common in the US for the directors to choose to commence a chapter 11 case, where directors must consider all of the interests of the corporation's economic stakeholders. US directors are aware that the DIP will have the exclusive right to propose a chapter 11 plan. In some respects the presumption in favour of a debtor in possession is one of the key characteristics of chapter 11 which furthers the reorganisation objective. The DIP model does not penalise management (by loss of control) for seeking relief under chapter 11. The English scheme of arrangement, now increasingly used as a rescue mechanism, shares certain key characteristics with chapter 11. In particular, management stay in place (potentially supported by the appointment of a chief restructuring officer) and can drive forward the restructuring plan.

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Contracts

A debtor in possession may assume an executory contract or unexpired lease even if it contains a clause that provides for termination in the event of insolvency (a so-called "*ipso facto*" clause), provided the debtor cures any default, and if the debtor had been in default, provides adequate assurance of future performance by itself or its assignee. An executory contract generally means a contract as to which material performance remains due to some extent on both sides.

The assumption of a contract or lease gives a debtor all the benefits and all the burdens of the contract or lease and the debtor cannot cherry-pick parts of it. Where the debtor assumes a contract, the counterparty is entitled to be paid on an expense basis.

Alternatively, the debtor may reject an executory contract or lease, giving rise to breach as of the commencement date, and leaving the non-debtor party to such contract or lease with a pre-petition claim for damages from the breach.

The ability of a debtor in possession to accept or reject contracts provides the debtor with a valuable ability to extract value from favourable contracts by assuming and then assigning these contracts regardless of whether the contracts themselves prohibit or condition such assignment.

Special rules and exceptions apply to certain kinds of contracts, including collective bargaining agreements and intellectual property licences.

A debtor is able to sell and assign certain executory contracts and unexpired leases that are non-assignable under non-bankruptcy law because anti-assignment clauses generally are unenforceable. A debtor may not, however, assume and assign a contract or lease if applicable law excuses the other party from accepting performance from or providing performance to an entity other than the debtor, and the non-debtor party does not consent to the assumption or assignment, such as a personal services contract. A debtor may not assume or assign a financial accommodation contract, which is a contract to make a loan or extend other debt financing or financial accommodations to or for the benefit of the debtor.

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Contracts

Administration

There is no power to disclaim onerous contracts for an administrator (unlike a liquidator) in the UK, and the making of an administration order does not, of itself, terminate a contract. In practice, however, the administrators will likely choose either not to fulfil or to renegotiate any unprofitable contracts. This will usually leave the counterparty with only an unsecured claim for damages for breach of contract (where the debtor fails to abide by its obligations) as the English court will not readily grant injunctive relief to prevent the debtor from breaching a contract.

However, where a counterparty wants to elect to terminate a contract in reliance on a contractual termination clauses which is or can be triggered on the debtor's insolvency, such a clause is enforceable in the UK. Valuable assets such as licences are therefore usually at risk of termination in the UK if formal insolvency procedures are initiated. Due diligence on the impact of initiating insolvency proceedings should therefore be undertaken.

CVAs and Schemes of Arrangement

Existing contracts will continue notwithstanding that a CVA or a scheme of arrangement is being implemented, unless or except to the extent that the relevant proposals provide otherwise. A scheme of arrangement will commonly involve significant amendments to the finance terms of the debtor together with terms for the provision of new monies. Ordinary trade creditors typically continue to be paid and existing contractual arrangements generally remain in place.

Comparative Comment

Chapter 11 provides the debtor with wide-ranging and valuable powers with which it can reject, assume or assign executory contracts and unexpired leases. This power, especially when combined with the ability to sell assets and borrow money, enables the debtor in possession very effectively to address its business and operational issues. The UK administration procedure has no direct equivalent to these provisions. One very significant difference between the insolvency regimes in the two jurisdiction is the treatment of ipso facto clauses, which, are unenforceable in chapter 11 cases, but will be enforced in an English administration, CVA or scheme. In English jurisprudence there is a strong tradition, even bordering upon a presumption, that contractual arrangements are to be upheld.

The ability of counterparties to terminate contracts will, in some cases, make administration in particular an unattractive strategy, unless a pre-pack administration is contemplated.

US Chapter 11

Proposals to Creditors, Voting and Effect of Approval

For the first 1 Comparison of Chapter 11 of the US Bankruptcy Code with English rescue procedures Comparison of Chapter 11 of the US Bankruptcy Code with English rescue procedures 20 days after a chapter 11 filing, the debtor (where there is no trustee) has the exclusive right to file a chapter 11 plan. The debtor also has an exclusive right for 180 days in which to solicit acceptances from impaired creditors and shareholders. The court may extend or reduce this exclusivity period for cause, for a maximum period of 18 months (20 months in the case of acceptances) following the filing. After the end of this period the creditors' committee or any individual creditor can propose its own reorganisation plan. Extensions are frequently granted in very large cases so that the debtor has sufficient time to stabilise operations and formulate a plan.

Before acceptances of a plan can be solicited, the plan proponent must provide creditors and shareholders with a disclosure statement approved by the bankruptcy court as containing adequate information of a kind and in sufficient detail to enable a hypothetical investor typical of a creditor or shareholder to make an informed judgment about the plan.

A chapter 11 plan must set out classes of claims and interests and provide details of any class that is not impaired (modified) under the plan. If a class of creditors is unimpaired under the plan, it is conclusively presumed to have accepted the plan; if a class will not receive or retain any interest in property under the plan, it is deemed to have rejected the plan. In either case, solicitation of such class is not required.

For a class of creditors to accept a plan, it must be accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class voting on the plan. A bankruptcy court may designate any entity whose acceptance or rejection was not in good faith (this might include for example, where a party has purchased claims against a debtor in possession competitor with a motive to block the chapter 11 plan). Designated entities are excluded from the calculation of acceptances by a class of claims or equity interests.

English Restructuring Procedures

Proposals to Creditors, Voting and Effect of Approval

Administration: Voting on the Proposals

The administrator must send his written proposals for achieving the purpose of administration to creditors within 8 weeks of the start of the administration. Those proposals are voted on at a creditors' meeting. Acceptance of the proposals requires a simple majority in value of those creditors present and voting. If the proposals are accepted, the administrator must manage the affairs of the company as provided in the proposals. If the proposals are rejected then the court may discharge the administration or make such other order as it thinks fit.

An administration will expire after 12 months unless the creditors agree to an extension (up to a maximum of 6 months) or the court makes an order extending the administration.

CVAs: Voting on the Proposals

Approval of the CVA proposal requires a simple majority vote of the debtors' members and a majority in excess of 75% by value of the unsecured creditors who attend and vote at the meeting of unsecured creditors convened for the purposes of voting (disregarding connected creditors). If these majorities are obtained, the CVA takes effect and becomes binding on all unsecured creditors (for these purposes irrespective of whether their rights have been affected by the proposal). Creditors vote as a single class and their votes are calculated according to the value of their claim at the creditors' meeting.

For liquidated debts, voting is straightforward. Creditors are also permitted to vote on unliquidated claims (such as landlords' claims for rent and dilapidations) and in such cases the vote will be presumed to be valued at £1 unless the chairman of the meeting agrees to put a higher value on it. The chairman will not be in a position to put a higher value on a claim unless there is evidence upon which he can reach a conclusion as to minimum value. Some CVAs have included indicative discounted rent formulas within their terms as guidance as to how claims are likely to be dealt with for voting purposes.

At the shareholders' meeting, voting takes place in accordance with the company's articles of association and, subject to their provisions may

US Chapter 11

A claim or interest may be placed in a particular class in a plan only if it is substantially similar to the other claims or interests of such class. Separate classification of similar claims or interests is sometimes seen as an attempt to manipulate acceptance and will not be allowed unless there is a legitimate business or economic justification.

A plan must be proposed in good faith. If a class is impaired, the plan must ensure that each holder within that class accepted the plan or will receive or retain property having a value not less than would have been received in a liquidation of the debtor (i.e., the best interests of creditors test.)

A chapter 11 plan may provide for the sale of all or substantially all property of the estate and the distribution of the proceeds to holders of claims or interests.

A chapter 11 plan must provide adequate means for its implementation. The plan proponent must demonstrate that confirmation of the plan is not likely to be followed by the liquidation or need for further financial reorganisation of the debtor unless this is envisaged in the plan.

If a plan is rejected by one or more impaired classes, the plan proponent may choose to "*cram down*" the plan with respect to each such class. To do so, at least one impaired class must accept the plan, disregarding votes of insiders. The plan proponent must also demonstrate that the plan does not discriminate unfairly and is fair and equitable with respect to each class. This is also known as the absolute priority rule.

If the plan is confirmed, all property of the estate vests in the debtor unless the plan provides otherwise. The provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such person is impaired under the plan or such person accepted the plan.

Confirmation of a plan generally discharges the debtor from any debt that arose before the confirmation date, including debts deemed to have arisen before that date, whether or not a proof of claim is filed, the claim is allowed, or the holder has accepted the plan. It also terminates all rights and interests of equity security holders and general partners provided for by the plan unless the plan or confirmation order provides otherwise.

English Restructuring Procedures

be passed by a simple majority.

Where the decisions of the meetings of creditors and members differ, the decision of the creditors' meeting prevails, subject to the right for members to apply to court within 28 days of the date of the creditors' decision or the members' decision, if the members' decision is made later, and the court has wide powers including powers to revoke or suspend any decision approving the CVA.

Schemes of Arrangement: Voting on the Scheme

There is no prescribed timetable for the three core stages involved in implementing a scheme of arrangement: (i) the court convening hearing; (ii) creditor and member meetings; and (iii) sanction hearing. These elements of the process usually takes at least 6 weeks. However, they are preceded by a variable and sometimes substantially longer time period during which the scheme proposals and accompanying explanatory statement. are formulated. It may also be necessary to obtain certain regulatory approvals or waivers and this may impact the time-frame.

A scheme is only capable of being sanctioned by the court if each class of creditors and members has voted in favour of the scheme by a simple majority in number of those participating in each class vote and a majority of 75% or more in value of those voting in each class.

Unlike the position in the US, the English court has no power to sanction a scheme of arrangement where a class of creditors whose rights are affected by the scheme has voted against the scheme. As a consequence, issues often arise (and should be dealt with at the convening hearing) as to class composition. The broad principle established through the case law on this issue is that classes must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest. Issues will also often arise as to where "value breaks" given that, in the case of schemes, only creditors whose rights

are affected are entitled to vote on the scheme proposals.

In most cases schemes will affect the rights of finance creditors only and ordinary trade creditors will continue to be paid in full, thereby preserving

US Chapter 11

English Restructuring Procedures

the goodwill value of the debtor.

Where the necessary approvals of each class of creditor and of the shareholders have been obtained, the scheme will not take effect unless it has been sanctioned by the court as being just and equitable and the court order sanctioning the scheme has been filed at the companies registry.

Comparative Comment

The US voting requirements are much more complex and court approval is required. The scope of the plan, however, is very broad and can also address, amongst other issues, settlements of litigation, asset sales and rejection of contracts. Chapter 11 also has provisions which integrate securities and insolvency laws. These provisions permit debtors to issue public securities under a plan, subject to certain exceptions, that are exempt from the registration process upon issuance and subsequent sale. In the US, tax laws are also integrated with chapter 11. This provides an ability to monetise tax benefits. In some respects, this result can be captured in the UK through an administration followed by a scheme of arrangement or through a stand-alone scheme of arrangement.

US Chapter 11

Accelerated Chapter 11 Cases

In recent years there has been an increasing number of accelerated chapter 11 cases, many of which were pre-packaged or pre-negotiated cases or expedited sales pursuant to section 363 of the US Bankruptcy Code. These stem from many factors, including lenders that are unwilling to advance further funds and direct an expedited sale of assets or tightened credit markets precluding the availability of debtor in possession financing.

Pre-packaged and Pre-negotiated Cases

In pre-packaged and pre-negotiated chapter 11 cases, a consensus between the debtor and its major constituencies regarding the outcome of the case is reached prior to the commencement of the case. This significantly shortens the length of the case. In a pre-packaged case, the debtor negotiates and solicits votes on a plan of reorganisation before commencing its chapter 11 case, while in a pre-negotiated case, the debtor files a plan of reorganisation on the commencement date, but does not solicit votes on the plan until afterwards.

The time spent under chapter 11 is short in a pre-packaged case because, generally, the only significant task while in chapter 11 is obtaining approval of a disclosure statement and confirmation of a chapter 11 plan. Trade creditors typically are less concerned about the outcome of the case as there is significantly less uncertainty about the prospects of the debtor's business. It should be noted, however, that although the time spent in chapter 11 is shorter than in a traditional case, the total restructuring period, including the period prior to the actual commencement of the case, may not be shorter because extensive negotiations regarding the chapter 11 plan occur during that pre-petition period.

Pre-packaged cases can produce benefits similar to out of court restructurings. There is very little risk of loss of control because pre-packaged cases are significantly shorter than traditional chapter 11 cases and impose less risk to the business. As the debtor has reached agreement with all or almost all major creditor groups, the pressure of negotiating a chapter 11 plan is effectively removed.

English Restructuring Procedures

Pre-packaged and Pre-negotiated Restructurings and Accelerated Procedures

Administration

In recent years there has been a significant increase in the use of pre-packaged administrations; transactions in which the terms of distressed asset sales have been negotiated and agreed by prospective administrators ahead of the formal start of an administration. The sale is then implemented by the administrators immediately following their appointment, often to existing management or to existing senior lenders (the administrators in particular satisfying themselves as to the proper value of the assets and their marketing.)

The pre-pack procedure is not expressly provided for in the legislation, but has developed in response to inherent limitations in the classic administration procedure which reduce its effectiveness as a rescue procedure. The main limitations include:

- the ongoing ability of counterparties to terminate contracts with the debtor when it contemplates or whilst it is in administration;
- the handover of control of the running of the business from directors to administrators, leaving the former in limbo as to their future role and presenting administrators with a steep learning curve (and expense) in order to get up to speed with the business;
- the continuing stigma surrounding the classic administration procedure and the connected adverse effect that it immediately has on business goodwill and value.

The English courts have effectively blessed the concept of pre-packaged administrations by confirming that administrators have power to sell a debtor's business in advance of the creditors' meeting and without needing a court order to do so. The English courts are very wary of getting involved in approving the specific terms of any pre-pack sale, and consider that these terms are a matter for the commercial judgment (and insurance-protected risk) of the administrators.

The fact that a pre-pack short-circuits the requirement to obtain creditor approval of the

US Chapter 11

Section 363 Sales

Section 363(b) of the US Bankruptcy Code permits a debtor to sell all or substantially all of its assets outside a plan of reorganisation, where it can provide an appropriate business justification. A section 363 sale cannot contain provisions that, effectively, would equate to the terms of a plan of reorganisation as the section 363 sale process includes fewer creditor protections than the plan of reorganisation process. A section 363 sale is usually implemented before the filing of a chapter 11 plan. A section 363 sale must be approved by the court and often involves an auction process, with a starting bid submitted by a stalking horse bidder to set the minimum level. A lienholder is entitled to credit bid and offset its claim against the purchase price.

The factors courts consider in determining whether a business justification exists include: (i) the proportionate value of the assets to the estate as a whole; (ii) time elapsed since the bankruptcy filing; (iii) the likelihood that a plan of reorganisation will be proposed and confirmed in the near future; and most importantly; (iv) whether the asset is increasing or decreasing in value.

Section 363(f) gives the debtor the ability to sell property free and clear of liens, claims, and encumbrances in limited circumstances, including where the lienholder consents, where the property to be sold has value in excess of the liens against the property or where the lienholder could be compelled to accept money satisfaction. Unless the sale is stayed pending an appeal against its authorisation, a sale to a good faith purchaser will remain valid and free of all third party claims, even if the court order is later reversed on appeal.

Reversal or modification on appeal of an authorised sale does not affect the validity of the sale to a good faith purchaser unless the sale was stayed pending appeal.

Comparative Comment

English administrations rarely result in company rescue, but in some cases they can be effectively used as mechanisms through which to rescue the business. In order most effectively to protect the goodwill value of a business, in many cases the best outcome is obtained when administration is conducted on a pre-pack basis. It is interesting to note that accelerated chapter 11 cases, whether pre-packaged, pre-negotiated or 363 asset sales, have also gained popularity in the US.

English Restructuring Procedures

administrator's proposal has led to criticisms as to a lack of transparency of the process and concerns as to whether in all cases proper value is being obtained for the assets sold. In response to these concerns, procedures have been put in place by the bodies responsible for regulating insolvency practitioners requiring detailed information regarding pre-pack sales to be given to creditors after the event, particularly covering valuation and marketing of the business. The UK Government is also consulting stakeholders as to whether these steps are sufficient or further changes to the pre-pack procedure should be introduced.

US Chapter 11

Costs

Chapter 11 is expensive.

A debtor in a traditional free-fall chapter 11 case is responsible for the fees and expenses of its attorneys, accountants, investment bankers and other professionals it engages. Moreover, a debtor is required to pay not only the expenses of its own professionals, but also the expenses of the professionals of the statutory creditors' committee, as well as any other committees that may be appointed, all without any certainty regarding the outcome of the case. Each team of professionals must take the time to understand the financial position of the debtor and try to reach agreement on a restructuring. This is one consideration that debtors make in deciding whether or not to go down the route of a pre-packaged chapter 11 case, which is significantly shorter.

English Restructuring Procedures

Costs

Administration

Administration involves incurring the additional costs in using insolvency practitioners (and their team). The company's creditors and shareholders will, in effect, pay for the learning curve of the insolvency practitioners in managing the business. In the US, as management is not displaced, this additional cost is not incurred. However, once administrators are appointed, the English court usually has a much more limited involvement in the conduct of the administration than is the case under US Chapter 11, with the administrators only seeking the court's direction if novel points of law or other disputes arise, rather than on the ongoing basis upon which the US bankruptcy court is involved.

CVAs

The fees of an insolvency practitioner will also be incurred and will need to be provided for within the terms of a proposal where a CVA is pursued. Fees will be incurred by the insolvency practitioner who as nominee will be involved in working with the directors and creditors and drawing up the proposal for the CVA before it is voted on. Once the proposal is approved, the insolvency practitioner's role as supervisor of the arrangement, is generally (as suggested by its title) limited, involving monitoring the implementation of the CVA (although the precise scope of the role is a matter to be determined within the terms of the CVA itself.) Generally the costs of a CVA are likely to be lower than those incurred in a classic trading administration, but the level of fees will vary from transaction to transaction.

Schemes of Arrangement

Although schemes of arrangement do not involve the formal appointment of an insolvency practitioner, as existing management stay in place, there are other significant expenses to cover. These include fees of legal and financial advisers in negotiating and drafting the scheme proposals and steering the scheme through the court process leading to implementation. It is also usual for the debtor to pay the fees of the main creditors' committees. Additionally, it is very common for the debtor to appoint a chief restructuring officer to oversee the restructuring process, freeing up time for existing management

to focus more on operational matters.

Comparative Comment

In both jurisdictions the costs involved are significant and must be taken into account when determining whether or not to commence proceedings.

US Chapter 11

Financing Chapter 11 Cases

A debtor must be able to obtain access to sufficient funds to either continue operating or to liquidate its assets in an orderly manner. The inability to obtain such debtor in possession financing is fatal to a successful rehabilitation or the maximisation of assets in a liquidation. The US Bankruptcy Code provides a means to induce creditors and other entities to extend credit to a debtor.

A debtor is authorised to obtain unsecured credit and incur unsecured debt as a first priority administrative expense. If such unsecured financing is not available, a debtor will be authorised by the court to obtain financing on a super-priority basis (i.e. having priority over administrative expenses, secured by a lien on unencumbered property or secured by a junior lien on property that is encumbered). If such financing is not available, the court may grant a post-petition lender a lien on encumbered property that is senior or equal to existing liens on the property as long as adequate protection is provided to existing lienholders.

The reversal or modification on appeal of an order authorising debtor in possession financing does not affect the validity or priority of the indebtedness or any collateral granted to an entity that extended credit in good faith.

Comparative Comment

Chapter 11 funding is more advanced than in the UK where bank lenders have not generally supported the introduction of priority rescue finance in the context of the formal insolvency procedures and the existing legislative provisions do not permit the same degree of flexibility as to ranking. In both informal workouts and schemes of arrangement, lenders have shown increased willingness to agree terms allowing for priority terms for rescue finance.

English Restructuring Procedures

Financing English Restructurings


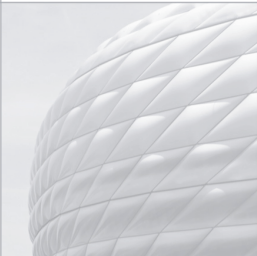


Administration

The company is likely to continue to look to its existing lenders for continued funding whilst it contemplates a rescue or other administration outcome, rather than to look for third party funding. Whilst an administrator has the power to borrow and to grant security, there is no provision enabling such borrowings to rank equally or ahead of existing fixed charge creditors, although new monies can be paid as an expense ahead of floating charge security. Any such new monies also rank to be paid ahead of the administrators' remuneration. Clearly, an administrator will only wish to arrange further borrowings if he is confident that his remuneration will be covered which will generally mean that he will look for an indemnity to cover remuneration from existing lenders.

CVAs and Schemes of Arrangement

The proposal and scheme documentation will set out whatever terms have been agreed as to ongoing financing. There are no applicable statutory provisions covering this area. In schemes, existing lenders will usually agree to advance new monies on terms that such loans are to enjoy a priority in payment over existing indebtedness.

Comparison of Chapter 11 of the US Bankruptcy Code with French Restructuring Procedures

				
				
				
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Comparison of Chapter 11 of the US Bankruptcy Code with French Restructuring Procedures

US Chapter 11

Overview and Purpose of Chapter 11 of the US Bankruptcy Code

Chapter 11 of the US Bankruptcy Code provides a means for financially-distressed entities to restructure their finances so they can continue operating. It enables a debtor to remain in control of its business operations while it conducts restructuring negotiations. Chapter 11 provides for an orderly process for negotiating in a central forum governed by rules and procedures for administering the case.

In light of the United States' credit-oriented society, the US Bankruptcy Code was enacted to create a mechanism to enable distressed entities to have a fresh start and reorganise their business. Chapter 11 is based on the fundamental principle that reorganisation is preferable to liquidation because a reorganisation preserves going concern value, protects jobs, and generally provides greater recoveries to creditors.

The major benefits the US Bankruptcy Code provides to debtors, many of which are discussed more fully below, include:

- The "*automatic stay*," imposed by the US Bankruptcy Code as soon as a bankruptcy case is commenced (the "commencement date"). The automatic stay provides a breathing space in which a debtor can try to reorganise by restructuring its business or selling its assets without being pressured by the commencement of lawsuits or the seizure of assets.
- The presumption that the debtor's management will remain in place, rather than be replaced by a trustee.
- The ability to obtain post-petition financing.
- The ability to obtain access to trade credit by paying post-petition creditors in full as an administrative expense.
- The ability to sell property of the debtor's estate free and clear of liens, claims and encumbrances.
- The ability to reject burdensome executory contracts and unexpired leases and

French Restructuring Procedures

Overview of French Restructuring Procedures

A corporate debtor in financial difficulties and within the French courts' jurisdiction can potentially access one of the following procedures with a view to achieving a rescue:

- Mandataire ad-hoc;
- Conciliation;
- Sauvegarde proceedings (including Accelerated Financial Sauvegarde); and
- Redressement judiciaire (the "Judicial Administration procedure").

The legislation applicable to each of these proceedings is set out in Book VI of the French Commercial Code.

In this section we set out a brief description of these procedures. In later sections of this part of the guide we focus in more detail on key characteristics of the sauvegarde and the judicial administration procedures (and we highlight key points of comparison with US chapter 11), as both are procedures which are capable of binding a minority to the terms of a restructuring. These procedures also both have as their objectives:

- preserving jobs;
- continuing the operation of the debtor or its business; and
- settling creditors' claims.

Mandat Ad-Hoc Proceedings

This is a court supervised, but informal pre-insolvency procedure in which a specialist advisor (usually the debtor's choice of officer from the register of insolvency administrators) is appointed as mandataire ad hoc, with a view to implementing an out of court voluntary restructuring. The existing management remains in control as debtor in possession. This procedure is only available before the debtor reaches a point of "*cessation des paiements*", i.e. broadly before it is cash-flow insolvent.

US Chapter 11

assume and assign executory contracts and unexpired leases to third parties notwithstanding contractual assignment prohibitions.

- The exclusive right to propose a chapter 11 plan during the initial 120 days of a chapter 11 case and solicit and obtain acceptances of the plan during the initial 180 days.
- The ability to restructure financial obligations on a non-consensual basis pursuant to the "cramdown" provisions of the US Bankruptcy Code.
- The discharge of a debtor from any debt that arose before the date of confirmation of a plan of reorganisation, regardless of whether a proof of claim was filed or the creditor accepted the plan.

In addition to protecting the interests of a debtor, the US Bankruptcy Code concurrently includes provisions aimed at protecting the interests of other stakeholders, including creditors. Over the years the US Bankruptcy Code has been amended to expand creditor protections in certain special interest areas, for example derivatives.

Chapter 11 cases fall into two general categories: (i) "free fall" cases or (ii) pre-packaged or pre-arranged/pre-negotiated cases. In a traditional "free fall" case, the chapter 11 filing is made without an exit strategy having been agreed between the debtor and at least a critical mass of its creditors. In a pre-packaged case, the debtor negotiates and solicits votes on a plan of reorganisation before commencing its chapter 11 case, while in a pre-negotiated case, the debtor files a plan of reorganisation on the commencement date, but does not solicit votes on the plan until afterwards.

In either scenario, chapter 11 enables a wide range of proposals to be implemented in a plan. While one scenario has the debtor and its management survive the process, a chapter 11 plan could, however, encompass any of the following:

- a consensual "stand-alone" plan, in which the creditors (secured and unsecured) and, if applicable, the company and its equity security holders, agree on a means of reorganising the debtor's business without the need to sell the business. A

French Restructuring Procedures

It is a very flexible procedure which can be used for a variety of purposes including, for example diagnosis of business difficulties, strategic planning and assisting the business to find new partners with a view to its survival, refinancing and amending existing finance facilities, and compromising including rescheduling of debt repayments.

Conciliation Proceedings

Conciliation proceedings are available to companies which are either solvent or which have not been in *cessation des paiements* for more than 45 days. These proceedings are initiated with a view to the debtor and its creditors entering into a conciliation agreement ("*protocole de conciliation*") under the supervision of a court appointed agent ("*conciliateur*"). The conciliation procedure is limited to four months with an extension of up to one month by the court possible (in contrast to *mandataire ad hoc* which continues for such time as the court decides). If a conciliation agreement is concluded, its confidential terms will become public if and at the point that it is officially recognised as a judgment or 'homologated' by the court.

Both *mandat ad-hoc* and conciliation proceedings are confidential, pre-insolvency procedures which are intended to remove the need to open insolvency proceedings. Although no formal or automatic stay applies, in practice creditors participating in negotiations pursuant to these procedures usually hold off from taking enforcement action whilst the negotiations are in progress. *Mandat ad-hoc* and conciliation proceedings can only deliver a voluntary, contractual restructuring and creditors opposing the restructuring cannot be bound - a restructuring can only be imposed on dissenting creditors via a *sauvegarde* or a judicial administration procedure. However, creditors may be motivated to participate in either of the pre-insolvency rescue procedures given that the French courts have power under the French Civil Code to sanction a delay of up to two years in paying creditors. The pre-insolvency procedures may therefore offer a quicker and hence more attractive solution to creditors.

Sauvegarde Proceedings

A debtor who is facing financial difficulties that cannot be overcome, but which has not yet reached the point of *cessation des paiements* may initiate *sauvegarde* proceedings. This

US Chapter 11

stand-alone plan could take the form of certain creditors agreeing to accept less than 100% payment or to take a combination of debt and equity issued by the reorganised company in satisfaction of their claims;

- a plan which effects a sale of all or substantially all of the debtor's assets as a going concern and distributes the consideration to creditors in accordance with the US Bankruptcy Code's priority scheme;
- a plan which relies on a capital infusion from an investor;
- a liquidating plan which sells all of the debtor's assets and provides for a distribution of the sale proceeds to creditors in accordance with the US Bankruptcy Code's priority scheme;
- a plan which includes a litigation trust to pursue and prosecute causes of action belonging to the debtor; or
- a combination of the above.

In recent years, debtors have increasingly used chapter 11 to sell substantially all of their assets shortly after the commencement date outside of a chapter 11 plan pursuant to section 363(b) of the US Bankruptcy Code. The predominance of section 363 sales has raised the question whether the objective of chapter 11 has morphed from its original purpose of rehabilitating a debtor to promptly disposing of viable or "good" assets and business operations to be continued by the purchaser, while leaving the less desirable or "bad" assets with the debtor to be liquidated in chapter 11.

French Restructuring Procedures

procedure is the French procedure most closely analogous to US chapter 11, upon which it was broadly modelled when first introduced in 2006. In particular, the *sauvegarde* procedure has the following similar characteristics to US chapter 11:

- existing management remain in place;
- automatic stay on enforcement action;
- ipso facto provisions are unenforceable by the counterparty;
- ability to bind creditors is based on similar majorities as those required under chapter 11;
- (i) loans made available during the observation period and (ii) claims arising out of on-going contracts continued in the observation period and in respect of which the counterparty agrees to accept deferred payment with respect to amounts due as from the start of the procedure will enjoy a priority status (provided that those loans or deferrals are allowed by the supervising judge and are deemed necessary for the continuation of the business during the observation period).

The *sauvegarde* procedure involves the court in a lighter touch supervision than is the case in the judicial administration procedure and is intended to be accessed as a procedure at an earlier stage in the debtor's financial difficulties. The court usually appoints an administrator to assist or supervise the debtor's negotiations with creditors.

The *sauvegarde* procedure involves the debtor's management preparing a rescue plan ("*plan de sauvegarde*") which may not exceed ten years. If the plan is approved by the creditors' committees (suppliers and credit institutions) and also by a general meeting of bondholders (if any) it takes effect provided that it is also adopted by the court. The court will only adopt the *sauvegarde* plan if it is satisfied that there is a prospect of the debtor remaining solvent and being able to discharge its liabilities on an ongoing basis. The plan may provide for the cessation or sale of part of the business of the debtor, if this is considered necessary for its successful reorganisation.

In March 2011 a new accelerated financial *sauvegarde* procedure was introduced which only applies to financial creditors, and which is dubbed

US Chapter 11

French Restructuring Procedures

by some as the 'French pre-pack'. Further details of this procedure are included below.

Judicial Administration Proceedings

This procedure is available in circumstances where, although the debtor is cash-flow insolvent, there may be some prospect of achieving a rescue. The court appoints an administrator to assess the debtor's position and to advise on a rehabilitation plan ("*plan de redressement*"); which is similar to a *plan de sauvegarde*. If this is not feasible, the focus of the procedure may instead consist of a plan to sell all or part of the debtor's assets on a going concern or break-up basis through a *plan de cession*.

The scope of the administrator's powers and duties (and also those of the existing management) is variable and determined in any particular case by the court, but generally the administrator enjoys greater powers in judicial administration proceedings than in *sauvegarde* and may take over the management and control of the debtor in some cases.

Many of the provisions applicable to the *sauvegarde* proceedings also apply to the judicial administration proceedings.

Comparative Comment

A wider range of rescue procedures are potentially available in France than in the US. The *sauvegarde* procedure is the most analogous procedure to US chapter 11. The *sauvegarde* procedure more readily lends itself to protecting the debtor's business and is generally less disruptive of the debtor's ongoing business than is the case where the judicial administration procedure is pursued. The *sauvegarde* procedure is, nevertheless, less frequently used than the judicial administration procedure (records as of Spring 2011 record 1264 *sauvegarde* procedures and 9526 judicial administration procedures having been opened in the prior 12 month period). It should be noted, however, that judicial administration proceedings do not necessarily deliver a rescue, with many operating as realisation vehicles.

US Chapter 11

Qualifying Criteria and Jurisdiction

An individual, partnership or corporation may be a chapter 11 debtor so long as it resides or has a domicile, a place of business, or property in the United States at the time proceedings are opened. Corporations are domiciled in the state of their incorporation.

Insolvency is not a requirement for commencing a voluntary chapter 11 case because the open access policy of the US Bankruptcy Code encourages debtors to commence a case before their condition deteriorates to the point that it is too late to reorganise. However, lack of good faith in filing a chapter 11 petition is cause for dismissal of the case. A chapter 11 filing generally would not be in good faith absent some present or anticipated financial distress.

Although a chapter 11 petition must be filed in the bankruptcy court, the federal district courts have original and exclusive jurisdiction of all cases under the US Bankruptcy Code. The district court has exclusive jurisdiction of all of the property of the debtor (wherever located) and over the property of the estate as of the commencement date.

A chapter 11 case may be commenced in the district court for the district in which (i) the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the debtor have been located for the 180 days immediately prior to the commencement date or for a longer portion of such 180 day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of the debtor were located in any other district; or (ii) there is a case pending under the US Bankruptcy Code concerning the debtor's affiliate, general partner, or partnership.

Comparative Comment

There are very limited threshold requirements applicable for the filing of a voluntary chapter 11 case, making the procedure readily available and accessible to management before the finances of a company have entered into a state of terminal decline. An involuntary chapter 11 filing is also possible under the US Bankruptcy Code. The French sauvegarde procedure can only be accessed voluntarily and is required to be accessed before a debtor reaches a point of cash-flow insolvency. This makes good sense as it is likely in

English Restructuring Procedures

Qualifying Criteria and Jurisdiction

Sauvegarde Proceedings

Virtually all entities carrying out a business activity can be subject to the sauvegarde procedure, provided that the debtor is not currently subject to any other judicial restructuring or liquidation proceeding.

The sauvegarde procedure is available to debtors facing financial difficulties that they are unable to overcome on their own, provided that they have not reached a point of cash flow insolvency (*cessation des paiements*). The original criteria which required the debtor to show that its financial difficulties were likely to lead to its insolvency have been relaxed, making the sauvegarde procedure now accessible at an earlier stage of financial distress.

The sauvegarde procedure must be converted into an insolvency procedure if it becomes apparent during the sauvegarde observation period that the debtor was insolvent prior to initiating the sauvegarde procedure or became insolvent thereafter.

Judicial Administration Proceedings

Directors are under an obligation to file for a judicial administration or a judicial liquidation within 45 days of a debtor becoming cash-flow insolvent (unless it has instigated conciliation proceedings within that time-frame). A petition can also be filed by a creditor, the public prosecutor or the court. A judicial administration procedure can not be commenced until the point that a debtor has become insolvent.

Jurisdictional Requirements

Both the sauvegarde and judicial administration proceedings are rescue proceedings falling within the scope of the EIR. Where a debtor has its centre of main interests (COMI) within the territory of the EC Member States it follows that main proceedings can only be opened where the debtor has its COMI.

many cases to be more difficult to achieve a rescue after that point, and coincides with the point at which a chapter 11 filing is likely to be made. The judicial administration procedure, in contrast, can only be accessed late in the day when the debtor has already become cash-flow insolvent. It is not a surprise then that the judicial administration procedure is often unable to deliver a debtor rehabilitation via a *plan de redressement*, but more commonly results in a sale of its assets, whether on a going concern basis or break up basis.

The qualifying criteria for chapter 11 cases are also otherwise very wide in scope, and whilst a filing not made in good faith can be the subject of a later challenge, there is no requirement as such for a connection to the jurisdiction beyond a residence, place of business or a property holding in the US. This has on some occasions enabled chapter 11 cases to be strategically accessed by debtors headquartered outside the US leading to the implementation of a chapter 11 plan.

Although French courts are permitted a degree of discretion as to their jurisdiction within applicable French private international law rules, the French rescue procedures are principally designed for French registered companies carrying on business in France, or companies which have their COMI in France within the meaning of the EIR. Further, whilst there is the potential for companies to strategically move their COMIs to France to access the *sauvegarde* and judicial administration procedures, in practice such moves are rare. Indeed, there is some evidence of 'double Lux Co' structures being formulated (in which two layers of Luxembourg holding companies are put in place over a French group, with the lender taking a charge or pledge of the share in the immediate Luxembourg holdco). As well as delivering certain tax advantages, these structures are in some cases put in place with the intention of allowing the lender to pursue enforcement options at the intermediate holdco level, under Luxembourg law with the intention of avoiding the operation of French restructuring or insolvency law, although such a move may be challenged by the French liquidator or administrator.

US Chapter 11

Directors' Duties and Mandatory Filing Requirements

The US Bankruptcy Code does not require an entity or its directors at any point to initiate a Chapter 11 filing.

However, corporate directors and officers owe fiduciary duties to the corporation. State statutes and the common law of the state of incorporation govern these duties. As the vast majority of businesses have selected Delaware as their state of incorporation, the Delaware statutes and decisions interpreting such statutes establish the general governing principles.

With respect to solvent corporations, the duties of loyalty and care run to the shareholders. The duty of loyalty requires the abstention from actions that could be detrimental to the corporation and its shareholders or which are intended to benefit the interests of the directors, officers, or a third party. The duty of care requires the exercise of the degree of care that a person of ordinary prudence would exercise under the same or similar circumstances. It incorporates an obligation to be informed about all material information reasonably available, including the responsibility to consider alternatives and get professional advice where necessary. In discharging these duties, directors and officers are protected by the business judgment rule. The business judgment rule is a presumption that, in making a business decision, the directors and officers acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation. The effect is that unless there are clear grounds for rebutting this presumption, courts will typically not question the business decisions of the corporation's directors and officers.

Once a company enters the "zone of insolvency", however, the fiduciary duties are to the company rather than any particular constituency. Actions taken in the best interests of the company will benefit its residual stakeholders. When a corporation is insolvent, directors and officers must take into account all the interests of the corporation's economic stakeholders.

Directors and officers of distressed corporations may need to choose from different restructuring options that could limit creditor recoveries or dilute, if not eliminate, equity interests. As a result, out-

French Restructuring Procedures

Directors' Duties and Mandatory Filing Requirements

Sauvegarde Proceedings

The sauvegarde procedure is an optional procedure which a debtor can, but is not obliged to initiate if its opening criteria are satisfied.

Assuming that the sauvegarde procedure successfully results in the debtor's rehabilitation, claims for breach of duty are unlikely to arise. Claims against directors may arise if the sauvegarde procedure is unsuccessful and is followed by judicial liquidation and the directors are later found to have mismanaged the company and to have created a shortfall of assets.

Judicial Administration Proceedings

Directors are under an obligation to file for a judicial administration or a judicial liquidation within 45 days of a debtor reaching the point of *cessation des paiements*. A debtor is deemed to be in *cessation des paiements* when it is unable to face its due and payable debts with its available assets, for example cash. If directors fail to meet this filing requirement, this may be held to amount to mismanagement and breach of duty and the directors may be made personally liable for all or part of the debtor's shortfall of assets. Liability can be imposed on persons who, whilst nominally not directors, are in effect responsible for the debtor's management.

A failure to file for judicial administration or liquidation can also result in a director being disqualified from acting as a director of an entity other than the debtor. In any case, the court has power to make orders which have the effect of backdating the claw-back period in respect of certain transactions which are capable of being avoided. This may in any particular case result in further claims being made against the directors.

Directors are generally subject to a duty to act in the best interests of the company and orders can be made against *de jure* and *de facto* directors where it is established that their mismanagement has caused or contributed to the debtor's shortfall. Mismanagement can cover a wide range of actions and omissions ranging from gross incompetence to negligence and failure to comply with company law requirements.

In cases of wilful or reckless mismanagement, and failure to act in the interests of creditors, the

US Chapter 11

of-the-money creditors and/or equity security holders may carefully scrutinise which options were or were not chosen by the company's directors and officers, with directors and officers potentially subject to claims for breach of their fiduciary obligations.

In the past decade, a new concept of liability, called "*deepening insolvency*," developed. This concept is premised on the fiduciary duty concept and the notion that the corporation itself may be harmed when directors and officers cause the corporation to deplete its assets and accrue excessive debt. The theory is that directors and officers have a duty to protect the corporation from further unnecessary losses. Whether deepening insolvency constitutes a valid theory of damages is a matter that is uniquely subject to state law principles. While some courts have recognised a cause of action for deepening insolvency, this theory of liability as a separate cause of action has been rejected in Delaware. Nevertheless, some courts may permit deepening insolvency to be considered as a measure of damages.

Comparative Comment

Unlike the US Bankruptcy Code, which does not require a director to commence a chapter 11 case, directors are obligated to file for a judicial administration or a judicial liquidation within 45 days of *cessation des paiements*. The failure to do so may result in a breach of duty and other consequences. Directors in the US generally are at less risk to claims for breach of fiduciary duty, although there is a potential risk in certain court districts of such claims arising in the context of "deepening insolvency."

French Restructuring Procedures

courts can declare that directors will not be permitted to continue to act as directors of other entities for a period of up to five years. The courts also have power to impose criminal sanctions on directors in cases of serious mismanagement of insolvent companies. The various provisions are complex (and derive from a number of different sources) and extensive.

US Chapter 11

Procedure

A voluntary or involuntary chapter 11 case is started by filing a chapter 11 petition with the bankruptcy court.

A chapter 11 corporate debtor must file: (i) a list of creditors; (ii) unless the bankruptcy court orders otherwise, a schedule of assets and liabilities, a schedule of executory contracts and unexpired leases, a statement of financial affairs and a list of equity security holders; (iii) a corporate ownership statement; and (iv) a list of creditors holding the twenty largest unsecured claims, excluding insiders.

Generally, a debtor is permitted to continue to operate its business as a debtor in possession (DIP) after a chapter 11 case has commenced, and to remain in control of its assets. However, a trustee may be appointed to operate a debtor's business if grounds for making such an appointment are established.

French Restructuring Procedures

Procedure

Sauvegarde Proceedings

The sauvegarde procedure can only be initiated through a voluntary filing by the debtor and can not be initiated by creditors.

Following filing of the petition, a hearing is scheduled at which the court considers representations on behalf of the debtor, representatives of its Works Council acting on behalf of its employees, and such other interested parties as the court considers should be heard. The hearing takes place in private in the judge's chambers. The court has a discretion whether or not to grant an order opening sauvegarde proceedings. If the petition is refused, the court can order that judicial administration or judicial liquidation proceedings instead be opened, alternatively the court may decline to make an order.

If the court grants the sauvegarde order an administrator is usually appointed for the purposes of reporting to the court. An initial observation period follows during which time the administrator makes an assessment of the debtor with a view to recommending how it should be reorganised. This initial observation is for a period of up to 6 months. This 6 month period can be renewed once, and in exceptional circumstances, is capable of a further 6 months extension.

During the observation period the debtor, in cooperation with the administrator, will prepare a sauvegarde plan which is submitted to creditors for approval.

Judicial Administration Proceedings

Although directors are under an obligation to file for judicial administration or judicial liquidation within 45 days of a debtor becoming cash-flow insolvent, they do not enjoy exclusive standing to open these proceedings and a petition can also be filed by a creditor, the public prosecutor or the court.

Following the appointment of an administrator an observation period follows (as is the case in sauvegarde), during which period the administrator will assess whether a *plan de redressement* can be put in place or whether a *plan de cession* is the appropriate course. The observation period can be for a period of up to 12

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months and, in exceptional circumstances, can be extended for a further 6 months.

Comparative Comment

Under chapter 11 the debtor has a right voluntarily to commence a chapter 11 case by filing a petition with the bankruptcy court. In contrast, the French court has a discretion whether or not to open sauvegarde proceedings, but in practice will readily do so if there is a prospect of company rescue and saving jobs. Once a debtor has reached the point of cash-flow insolvency, the court will either order that judicial administration or judicial liquidation proceedings should be opened.

US Chapter 11

Automatic Stay

Scope of the Automatic Stay

The filing of a bankruptcy petition immediately operates as a moratorium or "*automatic stay*" of certain actions against the debtor. The automatic stay is one of the fundamental protections the US Bankruptcy Code affords debtors because it provides an opportunity to restructure without the pressure of collection efforts and foreclosure actions. Actions that are stayed include:

- commencing or continuing a judicial, administrative or other action against the debtor that was or could have been commenced before the commencement date;
- enforcing a judgment against the debtor or property of the estate;
- any act to obtain possession or exercise control over property of the estate;
- any act to create, perfect or enforce a lien (i.e. security) against property of the estate;
- the set-off of any debt owing to the debtor that arose before the commencement date against any claim against the debtor arising in a different transaction.

The automatic stay only lasts until the chapter 11 case is closed or dismissed or a discharge, which operates like an injunction, is granted or denied. The discharge occurs when a plan of reorganisation is confirmed. The automatic stay does not extend to third parties such as the debtor's guarantors or co-debtors, although the court has power to extend the stay to non-debtors in certain circumstances.

Exclusions from the Stay

Excepted from the scope of the automatic stay are, amongst other things: criminal actions; police, regulatory, and other governmental acts; the presentment of a negotiable instrument; and the set-off by a swap participant of any mutual debt arising in connection with a swap agreement.

Relief from the Stay

The bankruptcy court has power to grant relief from

French Restructuring Procedures

Automatic Stay

Scope of the Automatic Stay

Sauvegarde Proceedings and Judicial Administration Proceedings

Creditors are barred from initiating legal proceedings or taking actions against the debtor company from the time of the court order initiating the *sauvegarde* procedure and throughout its duration (and a *sauvegarde* plan can continue for a period of up to ten years). The stay extends to prohibit most security from being enforced. The stay covers claims arising before the start of the proceedings, as well as certain claims arising after commencement of the proceedings where they are not within the debtor's ordinary course of business. Breach of the automatic stay provisions can result in civil and criminal claims being brought against the relevant creditor and the debtor.

Exclusions from the Automatic Stay

Creditors are permitted to enforce retention of title claims and to set off connected debts (arising both before and after the start of proceedings)

The stay does not prevent enforcement of claims against third parties, including claims against guarantor.

However, security falling within the scope of EC Financial Collateral Directive (as implemented in France by Articles L.211-36 and *seq.* of the French Monetary and Financial Code), can still be enforced, even if the defaulting party is subject to a *sauvegarde* procedure. This applies to any security that guarantees the repayment of financial obligations under a financial collateral arrangement entered into by certain parties (including, without limitation, credit or insurance institutions and investment services providers).

The stay does not prevent parties from claiming declaratory or other forms of relief which do not require the debtor to make a monetary payment. Further, the stay does not prevent the debtor from making payments on an ongoing basis for goods and services supplied during the observation period which are necessary to ensure that the debtor can continue its operations whilst it tries to put in place a restructuring.

Relief from the Automatic Stay

Subject to few exceptions (including the repayment

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the stay. Relief from the stay will be granted to a party in interest for cause, including in the case of a secured lender, the lack of adequate protection of such party's interest in property. Secured creditors are entitled to adequate protection against a diminution in the value of their collateral during the bankruptcy (for example, because of depreciation, falling market values or a failure to maintain or insure the property). A party in interest also may be granted relief from the stay with respect to an act against property if the debtor does not have equity in the property (i.e. the sum of all liens exceeds the property's value) and the property is not necessary to an effective reorganisation.

An action in violation of the automatic stay is void (i.e., has no legal effect) against the debtor. The bankruptcy court also has power to impose sanctions, which can include orders to pay punitive damages, in cases of wilful violation of the automatic stay.

Extra-territorial Effect of the Stay

The automatic stay is not expressly limited to actions or entities with a US connection. While the stay applies worldwide, the ability to enforce the stay overseas is dependent upon whether the relevant foreign state will recognise it either under a treaty or under other principles or rules, such as comity under the common law.

With respect to actions of US citizens, the automatic stay applies to actions taken in foreign countries. Foreign entities with assets in the US are likely to voluntarily abide by the automatic stay as they otherwise risk having their assets in the US seized, by way of punitive damages for violation of the stay.

Comparative Comment

The automatic stay is a key characteristic of each of the US chapter 11 procedures and the French sauvegarde and judicial administration procedures. In the US, the stay remains in effect until a chapter 11 plan is confirmed, whereupon the stay is replaced by a discharge. Similarly, in France, this stay will be effective during the observation period and will last for the whole duration of the sauvegarde plan. However, if the debtor does not comply with the terms and conditions of the sauvegarde plan, the court may terminate such a plan and the stay imposed on creditors will end (unless a new insolvency procedure is opened at the same time as the termination).

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of a retention of title claim provided that the retained asset is deemed necessary for the continuation of business), French law does not provide for any lifting of the stay as all creditors must be treated equally as a matter of public policy.

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Control

Generally, chapter 11 allows a debtor to continue to operate its business as a debtor in possession and remain in control of its assets while attempting to restructure its affairs, rather than having a trustee appointed. Nevertheless, a trustee may be appointed to take charge of and operate a debtor's business on request of a party in interest for cause.

Although by no means universal, the prevailing view is that retaining existing management provides the most economical and efficient means of restructuring under the oversight of the bankruptcy court, the US Trustee, and any statutory committees. Moreover, many debtors in possession employ a chief restructuring officer ("CRO") to provide crisis management experience and a fresh perspective on the reorganisation process.

For most purposes, the debtor in possession is the same entity as the debtor. However, the debtor manages, but no longer owns, the property it previously owned; the property becomes part of the debtor's estate. As long as the debtor keeps possession of that property (i.e. a trustee is not appointed), the debtor is a debtor in possession of the estate's property.

A trustee may be appointed to take charge of and operate a debtor's business on request of a party in interest for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement date, or if the appointment is in the interest of creditors or equity security holders. A trustee also may be appointed if grounds exist to convert or dismiss the case, but the bankruptcy court determines that the appointment of a trustee is in the best interests of creditors and the estate. The appointment of a trustee is an extraordinary remedy.

If the bankruptcy court has not appointed a trustee, the bankruptcy court has power to appoint an examiner on the application of a party in interest or the US Trustee. The court will appoint an examiner if (i) such appointment is in the interests of creditors, equity security holders, and other interests of the estate or (ii) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an

French Restructuring Procedures

Control

Sauvegarde Proceedings

Management remain in possession and continue to act on behalf of the debtor. The court-appointed administrator will only have limited authority in most cases (a supervisory or assistance role only) but may, in certain instances, be requested to assist the debtor in certain management operations that are not within the ordinary course of business. In such a case, both the signatures of the administrator and the management will be necessary to bind the debtor.

Judicial Administration Proceedings

The scope of the administrator's powers and duties will vary on a case by case basis and will be specified by the court, which may vary those powers, if appropriate, during the course of the proceedings. The role of the administrator in a judicial administration is likely to be very similar to that of the sauvegarde administrator in those cases where there is prospect of achieving a debtor rehabilitation in the judicial administration proceedings, through a *plan de redressement*.

Although the administrators in both the sauvegarde and judicial administration proceedings may apply to court for directions during the course of proceeding (for example, for clarification on points of law), the administrators and existing management are generally given a free hand to get on with putting together the plan and running (or winding down) of the business and the French court's do not adopt an interventionist approach. However, the court's approval is required for the debtor's sauvegarde, *plan de redressement* or *plan de cession*.

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insider, exceed \$5 million.

The examiner's role is to investigate the debtor, in particular, with respect to allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the debtor of or by current or former management.

The US Trustee is required to appoint a committee of creditors holding unsecured claims as soon as possible. Although a creditors' committee generally consists of those creditors willing to serve that hold the seven largest unsecured claims, the size of a committee often depends on the different types of unsecured creditor constituencies in the particular chapter 11 case. Additional committees of creditors or equity security holders may be appointed under certain circumstances.

Committees typically consult with the debtor regarding the administration of the case and can investigate all aspects of the debtor's business. A statutory committee is a party in interest with the right to appear and be heard on any issue in a chapter 11 case. The fees and expenses of a committee's professionals are paid for by the debtor's estate. One of its significant roles is participating in the negotiation of a chapter 11 plan.

Major secured creditors frequently have a significant role in monitoring a debtor in possession. This typically occurs when there is one secured creditor holding a lien (security) on all, or substantially all, the property of the estate for a debt that exceeds the liquidation value of such property. The rationale is that if the business continues to accrue losses and the reorganisation fails, the losses will fall on the secured creditor. On the other hand, if the liquidation value is less than the secured debt, the secured creditor may be incentivised to have the debtor reorganise in a manner that will result in a higher distribution than under a liquidation scenario.

Comparative Comment

Generally, under French sauvegarde proceedings and those judicial administrator proceedings which are proposing to deliver a rescue solution, existing management remain in possession and the court appointed administrator provides expertise to put in place a restructuring plan. The French courts, however, have a much more hands off approach during the course of these procedures than is the case for the US bankruptcy court.

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US Chapter 11

Contracts

A debtor in possession may assume an executory contract or unexpired lease even if it contains a clause that provides for termination in the event of insolvency (a so-called "*ipso facto*" clause), provided the debtor cures any default, and if the debtor had been in default, provides adequate assurance of future performance by itself or its assignee. An executory contract generally means a contract as to which material performance remains due to some extent on both sides.

The assumption of a contract or lease gives a debtor all the benefits and all the burdens of the contract or lease and the debtor cannot cherry-pick parts of it. Where the debtor assumes a contract, the counterparty is entitled to be paid on an expense basis.

Alternatively, the debtor may reject an executory contract or lease giving rise to breach as of the commencement date, and leaving the non-debtor party to such contract or lease with a pre-petition claim for damages from the breach.

The ability of a debtor in possession to accept or reject contracts provides the debtor with a valuable ability to extract value from favourable contracts by assuming and then assigning these contracts regardless of whether the contracts themselves prohibit or condition such assignment.

Special rules and exceptions apply to certain kinds of contracts, including collective bargaining agreements and intellectual property licences.

A debtor is able to sell and assign certain executory contracts and unexpired leases that are non-assignable under non-bankruptcy law because anti-assignment clauses generally are unenforceable. A debtor may not, however, assume and assign a contract or lease if applicable law excuses the other party from accepting performance from or providing performance to an entity other than the debtor, and the non-debtor party does not consent to the assumption or assignment, such as a personal services contract. A debtor may not assume or assign a financial accommodation contract, which is a contract to make a loan or extend other debt financing or financial accommodations to or

French Restructuring Procedures

Contracts

Executory Contracts

Sauvegarde Proceedings

The administrator is entitled to decide whether or not contracts entered into by the debtor before the opening of sauvegarde proceedings should be assumed or rejected. If the administrator elects to assume contracts, he must be satisfied that the debtor's operations will generate sufficient cash to enable ongoing payments to be met as they become due as debts arising while the business continues during the observation period enjoy priority to other debts, whether secured or not, with the exception of (i) super-privileged labour claims, (ii) judicial costs that have arisen after the start of the procedure and are linked to the conduct of the procedure and (iii) new-money claims granted in a conciliation procedure

If the administrator has not given his opinion on a contract, the contract is automatically terminated once a formal notice has been sent to the administrator by the counterparty and has remained unanswered for one month.

Special rules and exceptions apply to certain kinds of contracts including employment contracts, leases and trusts ("*fiducie*").

Judicial Administration Proceedings

Identical provisions apply.

Ipso Facto Clauses and Contractual Termination Rights

The French courts do not permit counterparties to enforce contractual terms purporting to entitle a counterparty to an agreement with the debtor to terminate the contract on the basis of an insolvency-related trigger. In this respect, French law is similar to the US law's prohibition on ipso facto clauses.

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for the benefit of the debtor.

Comparative Comment

Chapter 11 provides the debtor with wide-ranging and valuable powers with which it can reject, assume or assign executory contracts and unexpired leases. This power, especially when combined with the ability to sell assets and borrow money, enables the debtor in possession to address its business and operational issues. Similar provisions apply under the French restructuring procedures. Further, the debtor's prospects of restructuring are increased in both jurisdictions as a result of the invalidity of ipso facto provisions.

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Proposals to Creditors, Voting and Effect of Approval

For the first 120 days after a chapter 11 filing, the debtor (where there is no trustee) has the exclusive right to file a chapter 11 plan. The debtor also has an exclusive right for 180 days in which to solicit acceptances from impaired creditors and shareholders. The court may extend or reduce this exclusivity period for cause, for a maximum period of 18 months (20 months in the case of acceptances) following the filing. After the end of this period the creditors' committee or any individual creditor can propose its own reorganisation plan. Extensions are frequently granted in very large cases so that the debtor has sufficient time to stabilise operations and formulate a plan.

Before acceptances of a plan can be solicited, the plan proponent must provide creditors and shareholders with a disclosure statement approved by the bankruptcy court as containing adequate information of a kind and in sufficient detail to enable a hypothetical investor typical of a creditor or shareholder to make an informed judgment about the plan.

A chapter 11 plan must set out classes of claims and interests and provide details of any class that is not impaired (modified) under the plan. If a class of creditors is unimpaired under the plan, it is conclusively presumed to have accepted the plan; if a class will not receive or retain any interest in property under the plan, it is deemed to have rejected the plan. In either case, solicitation of such class is not required.

For a class of creditors to accept a plan, it must be accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class voting on the plan. A bankruptcy court may designate any entity whose acceptance or rejection was not in good faith (this might include for example, where a party has purchased claims against a debtor in possession competitor with a motive to block the chapter 11 plan). Designated entities are excluded from the calculation of acceptances by a class of claims or equity interests.

A claim or interest may be placed in a particular class in a plan only if it is substantially similar to the other claims or interests of such class. Separate classification of similar claims or

French Restructuring Procedures

Proposals to Creditors, Voting and Effect of Approval

Sauvegarde Proceedings

One of the features of the sauvegarde procedure is a requirement to establish two creditors' committees for any companies whose accounts are certified by an auditor and which have more than 150 employees or a turnover of more than EUR 20M. One committee consists of all of the credit institutions with exposure to the debtor and the second committee comprises the main suppliers of the company. Bondholders, if any, are convened as a single general class at a creditors meeting.

The committees and the general meeting of bondholders must approve or reject the sauvegarde proposal within six months of the opening of the sauvegarde proceeding. Consent must be given by each committee and at the general meeting of bondholders, if any, and requires a majority of two thirds in value of claims of those creditors exercising their voting rights. Only those creditors whose rights are impaired (essentially modified) by the plan can vote. Creditors in each committee and the bondholders vote as a single class, irrespective of the security interest they may hold against the debtor.

If the sauvegarde plan is agreed by both committees and the bondholders, the court may adopt the plan and approve the continuation of the debtor's business in accordance with the plan. The court has to be satisfied that there is a prospect for the debtor to remain solvent and be able to discharge its liabilities. The court must also satisfy itself that the interests of all of the creditors are sufficiently protected, but this does not require that in all cases creditors in each committee must be treated the same if their different treatment can be objectively justified. The sauvegarde plan is very flexible and may contain provisions dealing with:

- compromise and rescheduling (or writing off) of claims;
- debt for equity swap;
- other modifications to share capital;
- the sale of part of the business;
- a reduction in the workforce;

US Chapter 11

interests is sometimes seen as an attempt to manipulate acceptance and will not be allowed unless there is a legitimate business or economic justification.

A plan must be proposed in good faith. If a class is impaired, the plan must ensure that each holder within that class accepted the plan or will receive or retain property having a value not less than would have been received in a liquidation of the debtor (i.e., the best interests of creditors test.)

A chapter 11 plan may provide for the sale of all or substantially all property of the estate and the distribution of the proceeds to holders of claims or interests.

A chapter 11 plan must provide adequate means for its implementation. The plan proponent must demonstrate that confirmation of the plan is not likely to be followed by the liquidation or need for further financial reorganisation of the debtor unless this is envisaged in the plan.

If a plan is rejected by one or more impaired classes, the plan proponent may choose to "*cram down*" the plan with respect to each such class. To do so, at least one impaired class must accept the plan, disregarding votes of insiders. The plan proponent must also demonstrate that the plan does not discriminate unfairly and is fair and equitable with respect to each class. This is also known as the absolute priority rule.

If the plan is confirmed, all property of the estate vests in the debtor unless the plan provides otherwise. The provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such person is impaired under the plan or such person accepted the plan.

Confirmation of a plan generally discharges the debtor from any debt that arose before the confirmation date, including debts deemed to have arisen before that date, whether or not a proof of claim is filed, the claim is allowed, or the holder has accepted the plan. It also terminates all rights and interests of equity security holders and general partners provided for by the plan unless the plan or confirmation order provides otherwise.

French Restructuring Procedures

- amendments to the terms of existing financing facilities.

The *sauvegarde* plan, once approved by the court, takes effect and binds all members of the creditors' committees and the bondholders, including any minority of those constituencies rejecting the plan. Creditors not eligible for membership of the committees (for example minor suppliers, taxation authorities and employees) will enter into bilateral agreements with the debtor regarding their claims. If terms cannot be agreed between the parties, the French courts have a discretionary power to order a deferral in payment for a period of up to ten years.

If the preparation of a *sauvegarde* plan is impossible, the court may order either the closure of the *sauvegarde* procedure or, if the company is cash-flow insolvent, may place the debtor into judicial administration or into judicial liquidation, where rescue is manifestly impossible. The French courts do not have powers equivalent to the "*cram down*" powers of the US courts and are not able to impose the plan on creditors unless each of the relevant creditors' committees and the general meeting of bondholders have voted in favour of the plan, in compliance with the statutory majorities.

Judicial Administration Proceedings

The same rules as apply in *sauvegarde* proceedings generally apply concerning the preparation and sanctioning of the *plan de redressement*.

One significant difference is that, in judicial administration proceedings, a simplified redundancy procedure applies (which cannot be utilised in *sauvegarde* proceedings) – and this may make the *sauvegarde* procedure less appropriate where extensive redundancies are contemplated.

Where a judicial administration procedure is in process, potential buyers may also prepare and submit proposals for consideration by the court, alongside the debtor's own reorganisation plan.

If, at the end of the observation period and having considered the administrators reports, the court concludes that the continuation of the business is not possible, it will require the sale of all or part of the business of the debtor via a "*plan de cession*." A *plan de cession* will provide for the sale of assets on a going concern basis. If a *plan de*

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French Restructuring Procedures

cession cannot be implemented, the debtor will be placed into judicial liquidation.

A *plan de cession* may be imposed on creditors without them being able to vote on it. However, the court must choose the proposal which enables the debtor to repay its debts as far as possible.

Comparative Comment

A similar level of creditor consent is required for approval of the proposals in each jurisdiction and in both jurisdictions the court also has a role in confirming the plan, before it can be approved. There is no equivalent in France to the US' concept of "*cram down*".

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Accelerated Chapter 11 Cases

In recent years there has been an increasing number of accelerated chapter 11 cases, many of which were pre-packaged or pre-negotiated cases or expedited sales pursuant to section 363 of the US Bankruptcy Code. These stem from many factors, including lenders that are unwilling to advance further funds and direct an expedited sale of assets or tightened credit markets precluding the availability of debtor in possession financing.

Pre-packaged and Pre-negotiated Cases

In pre-packaged and pre-negotiated chapter 11 cases, a consensus between the debtor and its major constituencies regarding the outcome of the case is reached prior to the commencement of the case. This significantly shortens the length of the case. In a pre-packaged case, the debtor negotiates and solicits votes on a plan of reorganisation before commencing its chapter 11 case, while in a pre-negotiated case, the debtor files a plan of reorganisation on the commencement date, but does not solicit votes on the plan until afterwards.

The time spent under chapter 11 is short in a pre-packaged case because, generally, the only significant task while in chapter 11 is obtaining approval of a disclosure statement and confirmation of a chapter 11 plan. Trade creditors typically are less concerned about the outcome of the case as there is significantly less uncertainty about the prospects of the debtor's business. It should be noted, however, that although the time spent in chapter 11 is shorter than in a traditional case, the total restructuring period, including the period prior to the actual commencement of the case, may not be shorter because extensive negotiations regarding the chapter 11 plan occur during that pre-petition period.

Pre-packaged cases can produce benefits similar to out of court restructurings. There is very little risk of loss of control because pre-packaged cases are significantly shorter than traditional chapter 11 cases and impose less risk to the business. As the debtor has reached agreement with all or almost all major creditor groups, the pressure of negotiating a chapter 11 plan is effectively removed.

French Restructuring Procedures

Pre-packaged and Pre-negotiated Restructurings and Accelerated Procedures

The Accelerated Financial Sauvegarde

Experience to date of the use of the *sauvegarde* procedure has shown that it usually takes several months to implement a *sauvegarde* plan, bringing the risk in some cases of a serious deterioration in the value of the debtor's business. In March 2011 a new variant of the original *sauvegarde* procedure was introduced which is expected to accelerate the procedure. The new law is termed the *accelerated financial sauvegarde* ("AFS"), but is becoming known colloquially as the French pre-pack.

The AFS procedure is capable of imposing a restructuring plan relatively speedily on minority hold-out financial creditors, as the procedure provides for the implementation of what is, essentially, a pre-negotiated plan.

This procedure only applies to financial creditors (i.e. credit institutions and bondholders.) Suppliers of goods and services continue to be paid according to their applicable contract terms and are not subject to the moratorium on enforcement action applicable to the financial creditors. The procedure is only available in the context of existing, confidential conciliation proceedings where the court is satisfied that, whilst the conciliation proceedings do not enjoy the unanimous support required to conclude a restructuring through the conciliation procedure, the proposed restructuring plan nevertheless enjoys sufficient support from financial creditors, such that it is likely to be approved within one month (extendable by the court to two months) by a two-thirds majority in value of those voting at both the credit institutions committee and the general meeting of bondholders.

The speedy time-frame contemplated under the new procedure looks to be an important development which will make this procedure an attractive and effective restructuring mechanism, although it remains to be seen how great an uptake there will be in the use of the AFS procedure.

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French Restructuring Procedures

Section 363 Sales

Section 363(b) of the US Bankruptcy Code permits a debtor to sell all or substantially all of its assets outside a plan of reorganisation, where it can provide an appropriate business justification. A section 363 sale cannot contain provisions that effectively, would equate to the terms of a plan of reorganisation as the section 363 sale process includes fewer creditor protections than the plan of reorganisation process. A section 363 sale is usually implemented before the filing of a chapter 11 plan. A section 363 sale must be approved by the court and often involves an auction process, with a starting bid submitted by a stalking horse bidder to set the minimum level. A lienholder is entitled to credit bid and offset its claim against the purchase price.

The factors courts consider in determining whether a business justification exists include: (i) the proportionate value of the assets to the estate as a whole; (ii) time elapsed since the bankruptcy filing; (iii) the likelihood that a plan of reorganisation will be proposed and confirmed in the near future; and most importantly; (iv) whether the asset is increasing or decreasing in value.

Section 363(f) gives the debtor the ability to sell property free and clear of liens, claims, and encumbrances in limited circumstances, including where the lienholder consents, where the property to be sold has value in excess of the liens against the property or where the lienholder could be compelled to accept money satisfaction. Unless the sale is stayed pending an appeal against its authorisation, a sale to a good faith purchaser will remain valid and free of all third party claims, even if the court order is later reversed on appeal.

Reversal or modification on appeal of an authorised sale does not affect the validity of the sale to a good faith purchaser unless the sale was stayed pending appeal.

Comparative Comment

Pre-packaged restructurings have not been common in France to date. Although not providing as speedy a potential time-frame as is possible in the US, the new AFS procedure provides a mechanism which looks to be capable of delivering a restructuring fairly rapidly. However, access to this procedure is conditional upon the pre-existence of a conciliation procedure and upon a turnover or employees threshold criteria which may prevent many holding companies from applying for it.

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Costs

Chapter 11 is expensive.

A debtor in a traditional free-fall chapter 11 case is responsible for the fees and expenses of its attorneys, accountants, investment bankers and other professionals it engages. Moreover, a debtor is required to pay not only the expenses of its own professionals, but also the expenses of the professionals of the statutory creditors' committee, as well as any other committees that may be appointed, all without any certainty regarding the outcome of the case. Each team of professionals must take the time to understand the financial position of the debtor and try to reach agreement on a restructuring. This is one consideration that debtors make in deciding whether or not go down the route of a pre-packaged chapter 11 case, which is significantly shorter.

Comparative Comment

In both jurisdictions the costs involved must be factored into the decision as to whether or not to commence proceedings. The light court involvement in sauvegarde proceedings generally results in lower fees than in chapter 11 cases.

French Restructuring Procedures

Costs

Sauvegarde Proceedings

The sauvegarde procedure generally requires light court involvement, typically at the outset of the procedure and then at the end of the observation period when the court's approval of the plan de sauvegarde, or some other outcome, is sought. This lighter court involvement makes for lower fees than would be the case in a more court-interventionist procedure, such as US chapter 11.

Additionally, the debtor will be responsible for discharging the remuneration and expenses of the administrator.

The extent of fees will, of course, vary in each case, depending primarily on the extent and complexity of the issues raised and time spent resolving them.

Judicial Administration Proceedings

Fees are likely to be similarly variable from case to case.

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Financing Chapter 11 Cases

A debtor must be able to obtain access to sufficient funds to either continue operating or to liquidate its assets in an orderly manner. The inability to obtain such debtor in possession financing is fatal to a successful rehabilitation or the maximisation of assets in a liquidation. The US Bankruptcy Code provides a means to induce creditors and other entities to extend credit to a debtor.

A debtor is authorised to obtain unsecured credit and incur unsecured debt as a first priority administrative expense. If such unsecured financing is not available, a debtor will be authorised by the court to obtain financing on a super-priority basis (i.e. having priority over administrative expenses, secured by a lien on unencumbered property or secured by a junior lien on property that is encumbered). If such financing is not available, the court may grant a post-petition lender a lien on encumbered property that is senior or equal to existing liens on the property as long as adequate protection is provided to existing lienholders.

The reversal or modification on appeal of an order authorising debtor in possession financing does not affect the validity or priority of the indebtedness or any collateral granted to an entity that extended credit in good faith.

French Restructuring Procedures

Financing Restructurings

French law does not have fully developed principles of debtor in possession finance equivalent to those applicable under the US bankruptcy regime. In certain circumstances however, those providing new monies and providing essential services will be entitled to be paid in priority.

Finance facilities agreed at the outset of the lending relationship will often provide for any additional monies lent to facilitate a refinancing or restructuring to be paid in priority to monies already lent. Alternatively, and commonly terms prioritising the repayment of new monies may be agreed or revised at the outset of the restructuring talks. However, this priority status will require the supervising judge's authorisation and approval if monies are made available during the observation period. If the new monies are made available in connection with the plan this will require the approval of creditors' committees and the general meeting of bondholders and the court's authorisation if monies are made available in connection with the plan. As an inter-creditor issue between financial creditors, the grant of super-priority status to rescue monies is not unusual.




In the context of conciliation proceedings, provided that the resultant restructuring agreement has been formally homologated by the French courts, the French courts have power to formally approve the provision of new monies as enjoying super-senior priority status in the event of a subsequent judicial liquidation. In such a case, lenders of new money would be entitled to repayment before all other creditors, including secured creditors, but behind claims for arrears of wages in the 60 last days of work prior to the start of the liquidation proceedings and the expenses of the liquidation proceedings.

Monies advanced by lenders to pay for necessary services in respect of contracts can qualify for priority repayment status. However, these monies will rank after any new money granted within the context of a conciliation procedure. Where the administrator has elected to assume a contract but the debtor is unable to generate enough cash to be able to make on-going payments, the relevant contract will be terminated unless the contrary is agreed with the counterparty and the procedure may be converted into a liquidation procedure.

Comparative Comment

French law does not have fully developed principles of debtor in possession finance equivalent to those applicable under the US bankruptcy regime. In certain circumstances, however, those providing new monies and providing essential services will be entitled to be paid in priority.

Comparison of Chapter 11 of the US Bankruptcy Code with German Restructuring Procedures

				
				
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Comparison of Chapter 11 of the US Bankruptcy Code with German Restructuring Procedures

US Chapter 11

Overview of Chapter 11 of the US Bankruptcy Code

Chapter 11 of the US Bankruptcy Code provides a means for financially-distressed entities to restructure their finances so they can continue operating. It enables a debtor to remain in control of its business operations while it conducts restructuring negotiations. Chapter 11 provides for an orderly process for negotiating in a central forum governed by rules and procedures for administering the case.

In light of the United States' credit-oriented society, the US Bankruptcy Code was enacted to create a mechanism to enable distressed entities to have a fresh start and reorganise their business. Chapter 11 is based on the fundamental principle that reorganisation is preferable to liquidation because a reorganisation preserves going concern value, protects jobs, and generally provides greater recoveries to creditors.

The major benefits the US Bankruptcy Code provides to debtors, many of which are discussed more fully below, include:

- The "automatic stay," imposed by the US Bankruptcy Code as soon as a bankruptcy case is commenced (the "commencement date"). The automatic stay provides a breathing space in which a debtor can try to reorganise by restructuring its business or selling its assets without being pressured by the commencement of lawsuits or the seizure of assets.
- The presumption that the debtor's management will remain in place, rather than be replaced by a trustee.
- The ability to obtain post-petition financing.
- The ability to obtain access to trade credit by paying post-petition creditors in full as an administrative expense.
- The ability to sell property of the debtor's estate free and clear of liens, claims and encumbrances.
- The ability to reject burdensome executory contracts and unexpired leases and

German Restructuring Procedures

Overview of German Restructuring Procedures

The German insolvency code ("*Insolvenzordnung*") (the "German Code") provides for judicial insolvency proceedings ("*Insolvenzverfahren*") if a legal entity or a natural person is insolvent and the German courts have jurisdiction. The German Code does not provide for non-judicial out of court restructuring proceedings. In particular, there is no procedure allowing a debtor to restructure its debt in general with the consent of only a majority of its creditors outside of judicial insolvency proceedings. Only debt arising from bonds issued under German law may be restructured with the consent of a 75% majority of bondholders under the New German Bond Act if the bonds' terms allow such majority decision-making ("*Schuldverschreibungs-gesetz*", which has been in effect since August 2009).

Under the German Code, the aim of insolvency proceedings is not to protect the corporate debtor from its creditors, but to maximise the insolvency dividend payable to the creditors. To achieve this aim, judicial insolvency proceedings are organised on the basis of the following principles:

Par conditio creditorum: In order to prevent a creditors' race for the debtor's assets, the debtor's management is under a duty to file for the opening of judicial insolvency proceedings if a debtor is over-indebted (i.e., its liabilities exceed its assets) or illiquid (i.e., it is unable to pay its debts as they fall due) and the financial distress cannot be remedied within a period of three weeks. Management can incur both civil and criminal liability for non-compliance with this duty. Upon management's filing, the competent insolvency court immediately takes measures to secure the debtor's assets. Usually, the court appoints a preliminary insolvency administrator ("*vorläufiger Insolvenzverwalter*") whose consent is required for any future disposal over the debtor's assets, and the court prohibits creditors from enforcing against the debtor's assets.

Creditors' autonomy: Under the German Code, it is the creditors (and not the court) who take the main decisions in the proceedings. Thus, the creditors' meeting resolves by a simple majority in value of votes to confirm (or replace) the insolvency administrator and the creditors'

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assume and assign executory contracts and unexpired leases to third parties notwithstanding contractual assignment prohibitions.

- The exclusive right to propose a chapter 11 plan during the initial 120 days of a chapter 11 case and solicit and obtain acceptances of the plan during the initial 180 days.
- The ability to restructure financial obligations on a non-consensual basis pursuant to the "cramdown" provisions of the US Bankruptcy Code.
- The discharge of a debtor from any debt that arose before the date of confirmation of a plan of reorganisation, regardless of whether a proof of claim was filed or the creditor accepted the plan.

In addition to protecting the interests of a debtor, the US Bankruptcy Code concurrently includes provisions aimed at protecting the interests of other stakeholders, including creditors. Over the years the US Bankruptcy Code has been amended to expand creditor protections in certain special interest areas, for example derivatives.

Chapter 11 cases fall into two general categories: (i) "free fall" cases or (ii) pre-packaged or pre-arranged/pre-negotiated cases. In a traditional "free fall" case, the chapter 11 filing is made without an exit strategy having been agreed between the debtor and at least a critical mass of its creditors. In a pre-packaged case, the debtor negotiates and solicits votes on a plan of reorganisation before commencing its chapter 11 case, while in a pre-negotiated case, the debtor files a plan of reorganisation on the commencement date, but does not solicit votes on the plan until afterwards.

In either scenario, chapter 11 enables a wide range of proposals to be implemented in a plan. While one scenario has the debtor and its management survive the process, a chapter 11 plan could, however, encompass any of the following:

- a consensual "stand-alone" plan, in which the creditors (secured and unsecured) and, if applicable, the company and its equity security holders, agree on a means of reorganising the debtor's business without the need to sell the business. A

German Restructuring Procedures

committee members which have been appointed by the court on a preliminary basis. Creditors further, by majority vote: (i) determine whether the debtor's business shall be continued or liquidated; (ii) resolve to accept or reject an insolvency plan ("*Insolvenzplan*"); and (iii) confirm or terminate the debtor's self-administration ("*Eigenverwaltung*"), in the rare circumstances in which the court has sanctioned this in lieu of the usual administration by an insolvency administrator.

In practice, however, as the first creditors' meeting is not usually convened until between three to five months after the insolvency filing, the court and the preliminary insolvency administrator steer the proceedings in this important initial stage and thereby effectively pre-determine the direction of the restructuring and the subsequent creditors' meeting decisions.

Liquidation proceedings: The German Code primarily provides for the liquidation of the debtor. The debtor's business operations are either sold as a going concern to an investor or the business is wound up and the individual assets sold. The proceeds of such sales are then distributed pro rata among the unsecured creditors after priority creditors (for example, secured or administrative claims) have been paid in full. Where possible (i.e., where the going concern value of the business exceeds the liquidation value of its individual assets), insolvent businesses are sold as a going concern by means of an asset deal to an investor ("*übertragende Sanierung*").

If the debtor or the creditors consider that there are realistic prospects of rescuing and reorganising the debtor's business, they can initiate the drafting of an insolvency plan ("*Insolvenzplan*"), which, similar to the plan of reorganisation under US chapter 11, attempts to create more value for the creditors than a mere liquidation and requires the approval of the creditors' meeting resolving by a simple majority in each class of creditor.

The German Code came into force on 1 January 1999 and in the intervening years certain shortcomings in its operation have become apparent leading to calls for reform of the procedure. Changes to the legislation which have as their core aim improving prospects of restructuring businesses in financial difficulty were adopted by the lower house of the German parliament on 27 October 2011 and are known as the "*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*" (Law for the further

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stand-alone plan could take the form of certain creditors agreeing to accept less than 100% payment or to take a combination of debt and equity issued by the reorganised company in satisfaction of their claims;

- a plan which effects a sale of all or substantially all of the debtor's assets as a going concern and distributes the consideration to creditors in accordance with the US Bankruptcy Code's priority scheme;
- a plan which relies on a capital infusion from an investor;
- a liquidating plan which sells all of the debtor's assets and provides for a distribution of the sale proceeds to creditors in accordance with the US Bankruptcy Code's priority scheme;
- a plan which includes a litigation trust to pursue and prosecute causes of action belonging to the debtor; or
- a combination of the above.

In recent years, debtors have increasingly used chapter 11 to sell substantially all of their assets shortly after the commencement date outside of a chapter 11 plan pursuant to section 363(b) of the US Bankruptcy Code. The predominance of section 363 sales has raised the question whether the objective of chapter 11 has morphed from its original purpose of rehabilitating a debtor to promptly disposing of viable or "good" assets and business operations to be continued by the purchaser, while leaving the less desirable or "bad" assets with the debtor to be liquidated in chapter 11.

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facilitation of the restructuring of enterprises) (*ESUG*.) The changes to German insolvency law contained in the *ESUG* will come into effect on 1 March 2012. The main provisions of the *ESUG* consist of the following:

- (i) Strengthening creditors' influence during the early stage of preliminary insolvency proceedings (being the critical period which often pre-determines a debtor's chances for restructuring) by:
 - granting creditors influence on the appointment of the preliminary insolvency administrator; and
 - regularising the preliminary creditors' committee (whose numbers are representative of the various classes of the debtor's creditors) during the preliminary insolvency proceedings of debtors whose business is of some importance (i.e., where two of the following three thresholds are exceeded: EUR 4.84M balance sheet total, EUR 9.68M turnover and yearly average of 50 employees);
- (ii) Improving the chances for a successful restructuring of a distressed business by incentivising the debtor to initiate insolvency proceedings as early as possible, in particular by:
 - facilitating the debtor's access to self-administration;
 - introducing a new pre-insolvency restructuring proceeding ("*Schutzschirmverfahren*") allowing the debtor to prepare an insolvency plan while being protected from creditors enforcing their claims, provided, however, the debtor is imminently illiquid but not insolvent and evidences a realistic chance of restructuring via an insolvency plan; and
 - improving the attractiveness of the insolvency plan by facilitating the integration of debt-equity-swaps and reducing the plan's exposure to legal remedies for dissenting creditors.

The amendments which will be implemented by the *ESUG* are discussed in more detail where relevant in later sections of this guide.

Comparative Comment

German and US bankruptcy proceedings follow different priorities. While the US Bankruptcy Code aims at providing distressed debtors with a breathing space, enabling them to have a fresh start and reorganise their business, the German Code focuses on maximising the satisfaction of the creditors' claims. As a result, the US Bankruptcy Code leaves the debtor in possession of its business and balances the interests of the debtor and its creditors, while the German Code generally shifts control over the debtor's business from the debtor to an insolvency administrator charged with safeguarding the creditors' interests. Although the German Code allows the court to leave the debtor in possession (in lieu of appointing an administrator), the debtor's management cannot be certain to stay in possession when filing for insolvency. Management's expectation that it will lose control is one of the main reasons for debtors not filing for insolvency at an earlier stage and this is one of the key areas which the law reform (ESUG) addresses.

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Qualifying Criteria and Jurisdiction

An individual, partnership or corporation may be a chapter 11 debtor so long as it resides or has a domicile, a place of business, or property in the United States at the time proceedings are opened. Corporations are domiciled in the state of their incorporation.

Insolvency is not a requirement for commencing a voluntary chapter 11 case because the open access policy of the US Bankruptcy Code encourages debtors to commence a case before their condition deteriorates to the point that it is too late to reorganise. However, lack of good faith in filing a chapter 11 petition is cause for dismissal of the case. A chapter 11 filing generally would not be in good faith absent some present or anticipated financial distress.

Although a chapter 11 petition must be filed in the bankruptcy court, the federal district courts have original and exclusive jurisdiction of all cases under the US Bankruptcy Code. The district court has exclusive jurisdiction of all of the property of the debtor (wherever located) and over the property of the estate as of the commencement date.

A chapter 11 case may be commenced in the district court for the district in which (i) the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the debtor have been located for the 180 days immediately prior to the commencement date or for a longer portion of such 180 day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of the debtor were located in any other district; or (ii) there is a case pending under the US Bankruptcy Code concerning the debtor's affiliate, general partner, or partnership.

German Restructuring Procedures

Qualifying Criteria and Jurisdiction

Insolvency proceedings can only be opened through a written application to court by the debtor or one of its creditors.

German courts will only have jurisdiction in accordance with the provisions of the EIR (see above). Outside of the application of the EIR, the conflict of laws principles of the German Code determine the circumstances in which its provisions can be applied to a foreign-incorporated or centred debtor. Broadly, the German Code provides that the courts of the jurisdiction in which a debtor has the centre of its independent economic activity will have jurisdiction to open insolvency proceedings in respect of a debtor. This is usually the jurisdiction in which such debtor takes and implements its main strategic business decisions or in which it generally enters into transactions. It is very similar to the COMI concept in the EIR.

Currently there are 191 local courts ("*Amtsgerichte*") across Germany which are authorised to deal with insolvency proceedings.

Germany has not, to date, implemented the UNCITRAL Model Code on Cross-border Insolvency. However, German courts will recognise the commencement of insolvency proceedings by a foreign court, unless: (i) the relevant foreign court lacked jurisdiction (which is to be determined applying German law); or (ii) the recognition of the foreign proceedings would result in a violation of fundamental principles of German law, in particular fundamental rights ("*Grundrechte*").

The court will open insolvency proceedings if it is satisfied that with regard to the debtor any one or more of the following insolvency grounds have occurred:

Illiquidity ("*Zahlungsunfähigkeit*"): the debtor is unable to pay its debts when they become due, although a liquidity gap of less than 10% of all due liabilities in a period of up to three weeks will not amount to illiquidity;

Imminent illiquidity ("*drohende Zahlungsunfähigkeit*"): the debtor will more likely than not be unable to fulfil its payment obligations when due. Whilst the debtor can file for insolvency on the basis of this ground, no creditor can file on the basis of imminent illiquidity; and

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German Restructuring Procedures

Over-indebtedness ("Überschuldung"): the debtor's assets are not sufficient to cover its liabilities. Under the German Financial Markets Stabilisation Act this insolvency ground has been temporarily suspended until 31 December 2013 if the debtor has a going concern prognosis (i.e., if the debtor will likely stay liquid during its current and the immediately following financial year). The German parliament can be expected to consider again whether this suspension should be further extended.

Comparative Comment

While insolvency is not a requirement for commencing a voluntary chapter 11 case, the opening of insolvency proceedings pursuant to the German Code requires that the debtor is either illiquid, over-indebted or at least imminently illiquid. The court will only commence proceedings when such an insolvency ground has been evidenced.

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Directors' Duties and Mandatory Filing Requirements

The US Bankruptcy Code does not require an entity or its directors at any point to initiate a Chapter 11 filing.

However, corporate directors and officers owe fiduciary duties to the corporation. State statutes and the common law of the state of incorporation govern these duties. As the vast majority of businesses have selected Delaware as their state of incorporation, the Delaware statutes and decisions interpreting such statutes establish the general governing principles.

With respect to solvent corporations, the duties of loyalty and care run to the shareholders. The duty of loyalty requires the abstention from actions that could be detrimental to the corporation and its shareholders or which are intended to benefit the interests of the directors, officers, or a third party. The duty of care requires the exercise of the degree of care that a person of ordinary prudence would exercise under the same or similar circumstances. It incorporates an obligation to be informed about all material information reasonably available, including the responsibility to consider alternatives and get professional advice where necessary. In discharging these duties, directors and officers are protected by the business judgment rule. The business judgment rule is a presumption that, in making a business decision, the directors and officers acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation. The effect is that unless there are clear grounds for rebutting this presumption, courts will typically not question the business decisions of the corporation's directors and officers.

Once a company enters the "zone of insolvency", however, the fiduciary duties are to the company rather than any particular constituency. Actions taken in the best interests of the company will benefit its residual stakeholders. When a corporation is insolvent, directors and officers must take into account all the interests of the corporation's economic stakeholders.

Directors and officers of distressed corporations may need to choose from different restructuring options that could limit creditor recoveries or dilute,

German Restructuring Procedures

Directors' Duties and Mandatory Filing Requirements**Mandatory Filing Duty of Management and Other Obligors**

Generally, the German Code imposes a duty on the management of certain debtors (legal entities or a partnership without legal personality of which no personally liable partner is a natural person) to file for insolvency in such debtors' insolvency:

This duty is to be fulfilled without undue delay and in any event within three weeks from the occurrence of insolvency. Practically, this means that upon the occurrence of insolvency, the debtor's management has a three week window of opportunity in which, as long as the prospects of achieving a rescue are more likely than not, attempts can be made to turn the company around. If the debtor's management has resigned or vacated office the requirement to file for insolvency extends to shareholders and, in the case of a stock corporation ("*Aktiengesellschaft*"), members of a supervisory board ("*Aufsichtsrat*").

Non-compliance with the mandatory filing duty may expose the obligors of such duty to civil liability vis-à-vis the debtor and its creditors, as well as to criminal sanctions.

The obligor can be made liable to reimburse the debtor for payments made after the point at which the insolvency filing should have been initiated, unless those payments were consistent with their duty of care (for example, management must ensure their actions are in keeping with the actions of a prudent and diligent businessman.) If the payment was made to a shareholder, the obligor is liable to the debtor for reimbursement, even for payments made when the debtor was not already insolvent, if those payments resulted in the debtor's insolvency and the insolvency was foreseeable.

Non-compliance with the duty to file for insolvency (for example, filing too late or incorrectly) is a criminal offence.

Potential Liability of Lenders Financing an Insolvent Debtor

While a lender generally has an unfettered discretion as to whether to advance monies to a debtor, the lender may be exposed to liability for damages vis-à-vis other creditors of an insolvent

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if not eliminate, equity interests. As a result, out-of-the-money creditors and/or equity security holders may carefully scrutinise which options were or were not chosen by the company's directors and officers, with directors and officers potentially subject to claims for breach of their fiduciary obligations.

In the past decade, a new concept of liability, called "*deepening insolvency*," developed. This concept is premised on the fiduciary duty concept and the notion that the corporation itself may be harmed when directors and officers cause the corporation to deplete its assets and accrue excessive debt. The theory is that directors and officers have a duty to protect the corporation from further unnecessary losses. Whether deepening insolvency constitutes a valid theory of damages is a matter that is uniquely subject to state law principles. While some courts have recognised a cause of action for deepening insolvency, this theory of liability as a separate cause of action has been rejected in Delaware. Nevertheless, some courts may permit deepening insolvency to be considered as a measure of damages.

Comparative Comment

The US Bankruptcy Code does not require a debtor or its management at any point to initiate a chapter 11 filing. However, corporate directors and officers owe fiduciary duties (duties of loyalty and care) to the corporation, which may suggest the filing under chapter 11 if such filing is in the best interests of the corporation's economic stakeholders. However, the breach of such fiduciary duties is not sanctioned as a criminal offence.

The German Code, in contrast, imposes a duty to file for insolvency on a debtor's management if such debtor is a legal entity or a partnership without legal personality of which no personally liable partner is a natural person. This duty is to be fulfilled without undue delay and in any event within three weeks from the occurrence of insolvency. Management's non-compliance with the duty to file for insolvency (for example, filing too late or incorrectly) is a criminal offence.

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borrower. If, at the time the loan was granted, the borrower's distress was foreseeable and the new loan granted or existing loan extended to such borrower was insufficient to remedy the borrower's insolvency and instead only extended its struggle to survive and further depleted its assets to the detriment of all creditors, such lender can be held liable for damages caused to other creditors relying on the borrower's apparent creditworthiness. In addition, the insolvency administrator may re-claim any collateral granted by the borrower to the lender in those circumstances.

Lenders prepared to provide fresh money or extend existing loans are well advised to do so under the protection of one of the following two scenarios in which the German Federal Supreme Court has exempted lenders from such liability:

- (i) **Restructuring loan** – A creditor can safely provide a loan to a distressed or insolvent borrower provided that first, the loan is intended, and secondly at the time of its payment, it objectively appears to be sufficient to fully remedy the borrower's financial crisis. In practice, in order to rely on this exception the lender will need to engage a third party restructuring advisor to conduct a detailed analysis of the borrower's financial status and the causes of its financial difficulties and how they can be effectively remedied, culminating in an outline restructuring plan and opinion.
- (ii) **Bridge loan** – Where the borrower imminently needs liquidity, the lender may temporarily, until the completion of the outline restructuring plan and opinion, grant a loan bridging such imminent liquidity need. Such bridging loan may be secured but the collateral must not serve to secure any other outstanding loans of that lender.

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Procedure

A voluntary or involuntary chapter 11 case is started by filing a chapter 11 petition with the bankruptcy court.

A chapter 11 corporate debtor must file: (i) a list of creditors; (ii) unless the bankruptcy court orders otherwise, a schedule of assets and liabilities, a schedule of executory contracts and unexpired leases, a statement of financial affairs and a list of equity security holders; (iii) a corporate ownership statement; and (iv) a list of creditors holding the twenty largest unsecured claims, excluding insiders.

Generally, a debtor is permitted to continue to operate its business as a debtor in possession (DIP) after a chapter 11 case has commenced, and to remain in control of its assets. However, a trustee may be appointed to operate a debtor's business if grounds for making such an appointment are established.

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Procedure

Preliminary Insolvency Proceedings

When the court receives an insolvency filing, it will commence preliminary insolvency proceedings ("*Eröffnungsverfahren*") with the aim of determining whether the two main pre-conditions for the opening of insolvency proceedings are met: (i) an insolvency ground has occurred; and (ii) the debtor's assets are sufficient to cover the costs of the insolvency proceedings (fees payable to court and administrator). If the debtor's assets are insufficient to cover the costs of insolvency proceedings, the court will resolve not to open insolvency proceedings and creditors are free again to pursue their claims against the debtor. Preliminary proceedings will usually extend over a period of several weeks and, where the debtor's business has employees, the preliminary proceedings will usually be maintained until no more funds are available from the Federal Employment Agency ("*Bundesagentur für Arbeit*") to compensate employees for unpaid salaries ("*Insolvenz-ausfallgeld*"). Such compensation is available for up to three months' of salaries (which includes salaries unpaid at the time of filing and salaries accruing until the opening of proceedings), often allowing the preliminary insolvency administrator to generate a positive cash-flow from the debtor's business. For this economic reason, preliminary insolvency proceedings over the assets of labour intensive businesses are in practice often extended to up to three months from filing.

Whilst the preliminary insolvency proceedings are in effect, the court takes all necessary steps to protect the debtor's assets and to ensure, in particular, the continuation of the debtor's business. Usually, the court appoints a preliminary insolvency administrator and prohibits the debtor from disposing of its assets without the preliminary administrator's approval. Under current law, the preliminary insolvency administrator must be independent from the debtor and the creditors. The courts interpret this requirement very narrowly and usually do not appoint a person proposed by the debtor and/or the major creditors. In addition, the court usually prohibits creditors from taking steps to enforce against the debtor's assets. The court may also prohibit creditors from liquidating their collateral, where such collateral is of material importance for the business. Financial collateral in the meaning of the EU directive on financial collateral arrangements (2002/47/EC) is exempt from such

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court orders. The court also has power to prohibit the debtor from disposing of its assets and may order that authority to undertake such transactions is transferred to the preliminary administrator.

In practice, the court often appoints a preliminary creditors' committee (*"vorläufiger Gläubigerausschuss"*) if the preliminary administrator requests its establishment, to support him in the continuation of the debtor's business, or in relation to other key issues which may arise e.g. a decision on the urgent sale of certain assets or the shut-down of the debtor's business operations.

Insolvency Proceedings

When the court is satisfied that the debtor is insolvent and has sufficient assets to cover the costs of proceedings, it opens insolvency proceedings by appointing an insolvency administrator empowered to administer the debtor's assets. This will usually be the person previously acting as the preliminary administrator. The court also directs the creditors to file their claims with the insolvency administrator, who produces a table of all assets and liabilities of the debtor. In the past, the courts have only rarely allowed the debtor to stay in possession of its business supervised only by a court-appointed trustee (*"Eigenverwaltung"*) *in lieu of appointing an insolvency administrator*.

The first creditors' meeting is scheduled to occur between six weeks and not later than three months after the opening of proceedings. At that meeting, the insolvency administrator reports to the creditors on the status of the debtor's financial situation and the chances of rescuing the debtor's business and potentially an insolvency plan aimed at also preserving the debtor as a legal entity. The creditors then vote on the following forms of resolution:

- confirmation or substitution of the insolvency administrator,
- confirmation or substitution of the preliminary creditors' committee; and
- the proposed rescue and/or realisation strategy for dealing with creditors' claims.

Where the debtor's business (or parts of the business) are capable of being disposed of on a going concern basis, the insolvency administrator

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will propose such an asset sale to the creditors. Where the debtor's business is intimately linked to the debtor as legal entity (for example, where the debtor has entered into numerous lease agreements or license agreements which would be difficult to transfer to an acquirer as part of an asset deal or where such agreements need to be renegotiated or terminated using the tools available in an insolvency proceedings, the administrator may propose an insolvency plan ("*Insolvenzplan*") aimed at maintaining and restructuring the debtor's legal entity. Where the debtor is no longer a going concern, the administrator will propose liquidating the debtor's assets and distribute the proceeds in accordance with the priority scheme provided for by the German Code.

Amendments to be implemented through the ESUG

The ESUG is intended to incentivise debtors to restructure by way of an insolvency plan (*Insolvenzplan*) and to file for insolvency earlier than is currently the case, essentially at the point of the debtor's imminent illiquidity (as opposed to illiquidity). Therefore, the ESUG allows the debtor access to self-administration (*Eigenverwaltung*) supervised only by a court-appointed preliminary trustee, for the duration of the preliminary insolvency proceedings and ESUG offers a new pre-insolvency restructuring proceeding ("*Schutzschirmverfahren*") in which the court has power to allow the debtor a period of up to three months to prepare an insolvency plan in self-administration. During this period creditors are prohibited by court order from enforcing their claims against the debtor. Upon completion of the insolvency plan, the court opens insolvency proceedings and the creditors vote on the insolvency plan.

Further, responding to criticism mainly voiced by foreign investors who were instrumental in migrating several German groups into the English jurisdiction for the purpose of implementing English restructuring concepts (for example, *Deutsche Nickel*, *Schefenacker*), the ESUG law reform is intended to strengthen the creditors' influence during the early stage of preliminary insolvency proceedings by:

- requiring the court to establish a preliminary creditors' committee in preliminary insolvency proceedings if the debtor's business is of some importance,

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and

- requiring the court to appoint the candidate unanimously proposed by the creditors' committee as preliminary insolvency administrator, unless the candidate lacks either the skills and experience required for this office or the required independence from the debtor and the creditors.

Comparative Comment

The US Bankruptcy Code aims at giving the debtor a "breathing space" immediately upon the debtor's filing and enables the debtor to continue to operate its business while conducting restructuring negotiations.

The German Code provides for a court proceeding aimed at the best possible satisfaction of the creditors' claims from the insolvent debtor's estate. Upon the debtor's filing, the court commences preliminary insolvency proceedings in order to examine whether the debtor actually is insolvent and whether the debtor's assets are sufficient to cover at least the court's and the administrator's fees. From this time and until the court decides to open insolvency proceedings, the debtor will remain in possession and continues its business subject to the preliminary administrator's approval with regard to disposals. Once satisfied that the pre-conditions are met, the court opens insolvency proceedings and appoints the insolvency administrator to whom the control over the estate transfers from the debtor.

Unlike the US Bankruptcy Code, where the debtor typically remains in possession, under the German Code the debtor loses control over its business upon filing for insolvency. Therefore, the debtor does not perceive German insolvency proceedings as an alternative to out of court restructuring. The debtor will usually file for insolvency as a last resort knowing that, as a result of such filing, any further restructuring attempt will no longer be under his control.

The law reform (ESUG) attempts to remedy this perceived lack of breathing space by introducing a new pre-insolvency in-court restructuring proceeding providing a debtor, who is imminently illiquid, with up to three months protection from creditors' enforcement actions. This allows the debtor a breathing space to draft an insolvency plan to be voted upon in subsequent insolvency proceedings.

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Automatic Stay

Scope of the Automatic stay

The filing of a bankruptcy petition immediately operates as a moratorium or "*automatic stay*" of certain actions against the debtor. The automatic stay is one of the fundamental protections the US Bankruptcy Code affords debtors because it provides an opportunity to restructure without the pressure of collection efforts and foreclosure actions. Actions that are stayed include:

- commencing or continuing a judicial, administrative or other action against the debtor that was or could have been commenced before the commencement date;
- enforcing a judgment against the debtor or property of the estate;
- any act to obtain possession or exercise control over property of the estate;
- any act to create, perfect or enforce a lien (i.e. security) against property of the estate;
- the set-off of any debt owing to the debtor that arose before the commencement date against any claim against the debtor arising in a different transaction.

The automatic stay only lasts until the chapter 11 case is closed or dismissed or a discharge, which operates like an injunction, is granted or denied. The discharge occurs when a plan of reorganisation is confirmed. The automatic stay does not extend to third parties such as the debtor's guarantors or co-debtors, although the court has power to extend the stay to non-debtors in certain circumstances.

Exclusions from the Stay

Excepted from the scope of the automatic stay are, amongst other things: criminal actions; police, regulatory, and other governmental acts; the presentment of a negotiable instrument; and the set-off by a swap participant of any mutual debt arising in connection with a swap agreement.

Relief from the Stay

The bankruptcy court has power to grant relief from the stay. Relief from the stay will be granted

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Automatic Stay

Preliminary Insolvency Proceedings

When the debtor (or any of its creditors) files for the opening of insolvency proceedings over the debtor's assets, this does not automatically stay pending forced execution procedures ("*Zwangsvollstreckungsverfahren*") nor prevent creditors from enforcing/realising their collateral. However, as part of the measures aimed at securing the debtor's estate, the court usually (by court order) prohibits forced execution and stays pending execution procedures with regard to movables. If required to prevent further deterioration of the debtor's asset situation, the preliminary insolvency administrator can apply to court for more extensive orders prohibiting creditors from (i) re-claiming assets belonging to them, or (ii) liquidating or enforcing against assets secured in their favour, provided such assets are of substantial importance for the continuation of the debtor's business. Where the debtor makes use of secured assets during the preliminary administration, creditors are entitled to be compensated to the extent that such use has resulted in a depreciation in the value of the collateral.

Insolvency Proceedings

At the point that full insolvency proceedings are opened, an automatic stay comes into effect pursuant to which:

- (i) forced execution against the debtor's assets is prohibited;
- (ii) any rights acquired by forced execution during the period of one month prior to the insolvency filing until the opening become ineffective;
- (iii) litigation regarding the debtor's assets is suspended, although the administrator can elect to continue to pursue the debtor's claims and creditors may be permitted to pursue certain claims against the debtor;
- (iv) assets belonging to third parties have to be returned to them on their demand, even if the assets are needed in the business. If the insolvency administrator refuses to return the assets, the third parties can sue for their return and may demand payment of interest for any delay under general German civil law;

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to a party in interest for cause, including in the case of a secured lender, the lack of adequate protection of such party's interest in property. Secured creditors are entitled to adequate protection against a diminution in the value of their collateral during the bankruptcy (for example, because of depreciation, falling market values of a failure to maintain or insure the property). A party in interest also may be granted relief from the stay with respect to an act against property if the debtor does not have equity in the property (i.e. the sum of all liens exceeds the property's value) and the property is not necessary to an effective reorganisation.

An action in violation of the automatic stay is void (i.e., has no legal effect) against the debtor. The bankruptcy court also has power to impose sanctions, which can include orders to pay punitive damages, in cases of wilful violation of the automatic stay.

Extra-territorial Effect of the Stay

The automatic stay is not expressly limited to actions or entities with a US connection. While the stay applies worldwide, the ability to enforce the stay overseas is dependent upon whether the relevant foreign state will recognise it either under a treaty or under other principles or rules, such as comity under the common law.

With respect to actions of US citizens, the automatic stay applies to actions taken in foreign countries. Foreign entities with assets in the US are likely to voluntarily abide by the automatic stay as they otherwise risk having their assets in the US seized by way of punitive damages for violation of the stay.

Comparative Comment

In a significant contrast to the provisions of the automatic stay applied following a chapter 11 filing, during German preliminary insolvency proceedings creditors can liquidate collateral in their possession or receivables security-assigned to them. The court has power to prohibit such actions, but that requires an application satisfying the court that the respective collateral is of substantial importance for the continuation of the debtor's business, until the opening of the insolvency proceedings.

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and

- (v) movables in the debtor's possession and receivables of the debtor encumbered with third party collateral rights will be realised/liquidated by the administrator and the liquidation proceeds will be distributed to the secured party. However, the administrator will retain 9% of the net proceeds, as a contribution to the expenses of the insolvency, unless the costs actually incurred by the estate are substantially higher or lower, in which case the amount retained is adjusted.

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Control

Generally, chapter 11 allows a debtor to continue to operate its business as a debtor in possession and remain in control of its assets while attempting to restructure its affairs, rather than having a trustee appointed. Nevertheless, a trustee may be appointed to take charge of and operate a debtor's business on request of a party in interest for cause.

Although by no means universal, the prevailing view is that retaining existing management provides the most economical and efficient means of restructuring under the oversight of the bankruptcy court, the US Trustee, and any statutory committees. Moreover, many debtors in possession employ a chief restructuring officer ("CRO") to provide crisis management experience and a fresh perspective on the reorganisation process.

For most purposes, the debtor in possession is the same entity as the debtor. However, the debtor manages, but no longer owns, the property it previously owned; the property becomes part of the debtor's estate. As long as the debtor keeps possession of that property (i.e., a trustee is not appointed), the debtor is a debtor in possession of the estate's property.

A trustee may be appointed to take charge of and operate a debtor's business on request of a party in interest for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement date, or if the appointment is in the interest of creditors or equity security holders. A trustee also may be appointed if grounds exist to convert or dismiss the case, but the bankruptcy court determines that the appointment of a trustee is in the best interests of creditors and the estate. The appointment of a trustee is an extraordinary remedy.

If the bankruptcy court has not appointed a trustee, the bankruptcy court has power to appoint an examiner on the application of a party in interest or the US Trustee. The court will appoint an examiner if (i) such appointment is in the interests of creditors, equity security holders, and other interests of the estate or (ii) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5 million.

The examiner's role is to investigate the debtor, in

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Control

Immediately following its insolvency filing, the debtor's control over its business is subject to important restrictions and, whilst management is not removed from office, control in dealing with the debtor's assets and in running its business is transferred to the insolvency administrator.

Preliminary Insolvency Proceedings ("Eröffnungsverfahren")

The debtor is prevented from disposing of its assets without the consent of any appointed preliminary insolvency administrator and the court may formally transfer power to dispose of the assets to such administrator where the debtor's management is uncooperative or untrustworthy.

Insolvency Proceedings ("Insolvenzverfahren")

The debtor is automatically deprived of its authority to dispose of its assets when insolvency proceedings are opened by the court and such authority is vested in the court-appointed insolvency administrator.

Creditors' Committee

When opening the insolvency proceedings, the court may establish a creditors' committee in order to support, assist and supervise the insolvency administrator in the debtor's administration. Since key decisions with a long-lasting impact on the insolvency estate will often be taken in the course of the preliminary insolvency proceedings, the preliminary administrator often asks the court to establish a preliminary creditors' committee during the preliminary insolvency proceedings. The court (upon the preliminary administrator's suggestion) nominates the preliminary committee's members, which usually consists of one representative of each of the secured creditors, the creditors with the highest claims, the creditors with small claims, and of the debtor's employees (if they have significant claims).

The creditors' committee meets as often as is required during the course of the proceedings and is consulted by the (preliminary) insolvency administrator in matters of particular importance. The creditors' committee resolves by majority vote, each member having one vote.

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particular, with respect to allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the debtor of or by current or former management.

The US Trustee is required to appoint a committee of creditors holding unsecured claims as soon as possible. Although a creditors' committee generally consists of those creditors willing to serve that hold the seven largest unsecured claims, the size of a committee often depends on the different types of unsecured creditor constituencies in the particular chapter 11 case. Additional committees of creditors or equity security holders may be appointed under certain circumstances.

Committees typically consult with the debtor regarding the administration of the case and can investigate all aspects of the debtor's business. A statutory committee is a party in interest with the right to appear and be heard on any issue in a chapter 11 case. The fees and expenses of a committee's professionals are paid for by the debtor's estate. One of its significant roles is participating in the negotiation of a chapter 11 plan.

Major secured creditors frequently have a significant role in monitoring a debtor in possession. This typically occurs when there is one secured creditor holding a lien (security) on all, or substantially all, the property of the estate for a debt that exceeds the liquidation value of such property. The rationale is that if the business continues to accrue losses and the reorganisation fails, the losses will fall on the secured creditor. On the other hand, if the liquidation value is less than the secured debt, the secured creditor may be incentivised to have the debtor reorganise in a manner that will result in a higher distribution than under a liquidation scenario.

Comparative Comment

Chapter 11 of the US Bankruptcy Code generally allows a debtor to continue to operate its business as a debtor in possession and remain in control of its assets. The German Code, in contrast, shifts control over the debtor's business from the debtor to an insolvency administrator appointed by the court. Although the German Code allows a court to leave the debtor in possession and control of its assets subject only to the supervision of a court-appointed trustee (self-administration), courts have been reluctant to make use of this power. The German law reform (ESUG) is intended to facilitate the debtor's access to self-administration in an attempt to increase the attractiveness of in-court restructurings for debtors.

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Self-administration ("*Eigenverwaltung*")

Upon the opening of insolvency proceedings, the court may allow the debtor to remain in possession and control of its assets subject only to the supervision of a court-appointed trustee ("*Sachwalter*"). The trustee's role would encompass supervising the running of the debtor's business and the debtor would be required to obtain the trustee's approval for any transactions proposed by the debtor outside its ordinary course of business.

Self-administration has, in practice, only been used on rare occasions. These were mainly large debtors, where key management was replaced by professional advisors prior to the insolvency filing with a view to preparing the insolvency filing, working out an insolvency plan and restoring the creditors' and the court's confidence in the debtor's ability to self-manage its insolvency proceeding.

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Contracts

A debtor in possession may assume an executory contract or unexpired lease even if it contains a clause that provides for termination in the event of insolvency (a so-called "*ipso facto*" clause), provided the debtor cures any default, and if the debtor had been in default, provides adequate assurance of future performance by itself or its assignee. An executory contract generally means a contract as to which material performance remains due to some extent on both sides.

The assumption of a contract or lease gives a debtor all the benefits and all the burdens of the contract or lease and the debtor cannot cherry-pick parts of it. Where the debtor assumes a contract, the counterparty is entitled to be paid on an expense basis.

Alternatively, the debtor may reject an executory contract or lease giving rise to breach as of the commencement date, and leaving the non-debtor party to such contract or lease with a pre-petition claim for damages from the breach.

The ability of a debtor in possession to accept or reject contracts provides the debtor with a valuable ability to extract value from favourable contracts by assuming and then assigning these contracts regardless of whether the contracts themselves prohibit or condition such assignment.

Special rules and exceptions apply to certain kinds of contracts, including collective bargaining agreements and intellectual property licences.

A debtor is able to sell and assign certain executory contracts and unexpired leases that are non-assignable under non-bankruptcy law because anti-assignment clauses generally are unenforceable. A debtor may not, however, assume and assign a contract or lease if applicable law excuses the other party from accepting performance from or providing performance to an entity other than the debtor, and the non-debtor party does not consent to the assumption or assignment, such as a personal services contract. A debtor may not assume or assign a financial accommodation contract, which is a contract to make a loan or extend other debt financing or financial accommodations to or for the benefit of the debtor.

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Contracts

General Rule

Neither the filing nor the opening of insolvency proceedings affects the debtor's contractual relationships. While the creditor's contractual claims against the debtor generally remain in effect, they are no longer enforceable upon the opening of insolvency proceedings, and where the debtor does not continue to perform the contract the creditor has a claim in damages against the debtor.

Insolvency Administrator's Right to Elect Whether or not to Perform under Executory Contracts ("*gegenseitige Verträge*")

In the case of executory contracts ("*gegenseitige Verträge*"), (for example, a sale and purchase agreement under which the parties have not completely performed their respective mutual obligations at the time of the opening of insolvency proceedings), the insolvency administrator has the option to perform under the agreement, in which case the debtor can demand performance from the counterparty. The counterparty to an executory contract will be entitled to be paid on a privileged expense basis, to the extent that it is required to perform its contractual obligations after the point of opening of insolvency proceedings. If the insolvency administrator has rejected the contract, the counterparty has a claim for damages due to non-performance which ranks as an ordinary unsecured claim in the insolvency.

While the German Code aims at protecting the insolvency administrator's election right, it does not generally prevent creditors from terminating executory contracts in the event of a debtor's insolvency. It is the prevailing view that a counterparty may reserve the right to terminate a contract in circumstances where its continuation is intolerable (e.g. due to material deterioration of the debtor's financial status) as long as the provision is not aimed particularly at a termination in the event of insolvency.

Continuation of Agreements Vital for the Debtor

Certain agreements are presumed vital for the debtor and its business and are therefore exempted from the administrator's election right. They automatically continue to be binding for the estate upon opening of insolvency proceedings

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(creating administrative claims), ("Masseverbindlichkeiten"), but may be terminated by either party irrespective of a breach of contract by either party. Types of agreement falling within these categories include:

- **Lease agreements on real estate** - Where the debtor is lessee, the lease cannot be terminated by the landlord upon the debtor's filing for insolvency on the basis of arrears of rental due prior to the filing. However, the landlord is not prevented from exercising its termination rights for breaches of the terms of the lease made after the insolvency proceedings are opened. Upon the opening of insolvency proceedings, the administrator may terminate the lease, irrespective of its express provisions, by giving three months notice; and
- **Employment agreements** - Either the insolvency administrator or the employee may terminate an employment contract where insolvency proceedings have been opened in respect of the employer. Irrespective of the terms of the contract, the termination will be effective on the giving of three months notice.

Termination of Agreements Authorising Third Parties to Administer Assets of the Debtor

In order to cement the insolvency administrator's exclusive authority to administer the assets of the insolvency estate, any powers or authorisations given by the debtor to third parties regarding any of the debtor's assets automatically terminate upon the opening of insolvency proceedings.

Termination of Agreements During a "Schutzschirmverfahren" Proceeding

While the *Schutzschirmverfahren* under the pending law reform (ESUG) envisages the protection of the debtor from creditors' enforcement actions, it does not prevent creditors from exercising contractual termination rights to which they may be entitled. Thus, the creditor may terminate a contract but may not be able to enforce the resulting claim against the debtor.

Comparative Comment

Under the US Bankruptcy Code the debtor may elect to assume or reject executory contracts and unexpired leases even if they provide for termination in the event of insolvency. The German Code provides the insolvency administrator with a similar election right to be exercised upon the opening of proceedings. Under both laws, the debtor's or insolvency administrator's election of rejection or non-performance results in a damages claim of the creditor, which is a pre-petition or mere insolvency claim.

Unlike the US Bankruptcy Code, the German Code does not generally prevent creditors from terminating executory contracts in the event of a debtor's insolvency where the counterparty has reserved the right to terminate in circumstances which would render continuation of the contract from their point of view intolerable. The effect is that a contract may validly allow termination if the debtor's financial status materially deteriorates or if the debtor files for insolvency. An important exception applies to lease contracts where the debtor is lessee. A creditor may not terminate such a contract subsequent to the debtor's filing, unless the debtor defaults in complying with its payment obligations after the insolvency filing.

The German Code exempts from the insolvency administrator's election right lease agreements on real estate as well as employment agreements, because these types of agreements are judged as vital for the debtor and its business and should therefore not be subject to an election right. Instead, upon the opening of insolvency proceedings, should the insolvency administrator view a real estate lease agreement as unfavorable to the estate, he can terminate it by giving three months prior notice, irrespective of the contractual terms. An employment agreement may be terminated by either the debtor or the employee, giving three months prior notice irrespective of the contractual terms.

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Proposals to Creditors, Voting and Effect of Approval

For the first 120 days after a chapter 11 filing, the debtor (where there is no trustee) has the exclusive right to file a chapter 11 plan. The debtor also has an exclusive right for 180 days in which to solicit acceptances from impaired creditors and shareholders. The court may extend or reduce this exclusivity period for cause, for a maximum period of 18 months (20 months in the case of acceptances) following the filing. After the end of this period the creditors' committee or any individual creditor can propose its own reorganisation plan. Extensions are frequently granted in very large cases so that the debtor has sufficient time to stabilise operations and formulate a plan.

Before acceptances of a plan can be solicited, the plan proponent must provide creditors and shareholders with a disclosure statement approved by the bankruptcy court as containing adequate information of a kind and in sufficient detail to enable a hypothetical investor typical of a creditor or shareholder to make an informed judgment about the plan.

A chapter 11 plan must set out classes of claims and interests and provide details of any class that is not impaired (modified) under the plan. If a class of creditors is unimpaired under the plan, it is conclusively presumed to have accepted the plan; if a class will not receive or retain any interest in property under the plan, it is deemed to have rejected the plan. In either case, solicitation of such class is not required.

For a class of creditors to accept a plan, it must be accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class voting on the plan. A bankruptcy court may designate any entity whose acceptance or rejection was not in good faith (this might include for example, where a party has purchased claims against a debtor in possession competitor with a motive to block the chapter 11 plan). Designated entities are excluded from the calculation of acceptances by a class of claims or equity interests.

A claim or interest may be placed in a particular class in a plan only if it is substantially similar to the other claims or interests of such class. Separate classification of similar claims or interests is sometimes seen as an attempt to manipulate acceptance and will not be allowed

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Proposals to Creditors, Voting and Effect of Approval

Creditors' autonomy, one of the fundamental principles underlying German insolvency proceedings, means that the creditors take the key decisions whether ordinary insolvency proceedings are in place, in which case their decisions may relate to liquidating the debtor's assets or whether the debtor's restructuring is contemplated by means of an insolvency plan ("*Insolvenzplan*").

Ordinary Insolvency Proceedings (Liquidation)

The creditors' influence is coordinated in two bodies, the creditors' meeting and the creditors' committee:

Creditors' Meeting ("*Gläubigerversammlung*")

The insolvency court schedules the first creditors' meeting and this will take place between six weeks and up to three months after the opening of insolvency proceedings. At that meeting creditors will in particular:

- (i) approve (or replace) the insolvency administrator nominated by the court;
- (ii) approve (or replace) the members of the creditors' committee nominated by the court; and
- (iii) approve the course of the insolvency proceedings as proposed by the administrator (usually either to shut-down or temporarily continue the debtor's business pending its sale).

Each creditor has the right to attend and vote according to the amount of their claim. Resolutions are taken by majority of claim amounts represented by the voting creditors.

A second creditors' meeting (the examination hearing) ("*Prüfungstermin*") takes place after the creditors have filed their claims and the purpose of this meeting is to agree the amount and rank of each filed claim. At the examination hearing, any creditor and the insolvency administrator can reject a claim filed by a creditor. A creditor whose claim is rejected may pursue such claim against the rejecting party in court, as the case may be, either against the insolvency

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unless there is a legitimate business or economic justification.

A plan must be proposed in good faith. If a class is impaired, the plan must ensure that each holder within that class accepted the plan or will receive or retain property having a value not less than would have been received in a liquidation of the debtor (i.e., the best interests of creditors test.)

A chapter 11 plan may provide for the sale of all or substantially all property of the estate and the distribution of the proceeds to holders of claims or interests.

A chapter 11 plan must provide adequate means for its implementation. The plan proponent must demonstrate that confirmation of the plan is not likely to be followed by the liquidation or need for further financial reorganisation of the debtor unless this is envisaged in the plan.

If a plan is rejected by one or more impaired classes, the plan proponent may choose to "*cram down*" the plan with respect to each such class. To do so, at least one impaired class must accept the plan, disregarding votes of insiders. The plan proponent must also demonstrate that the plan does not discriminate unfairly and is fair and equitable with respect to each class. This is also known as the absolute priority rule.

If the plan is confirmed, all property of the estate vests in the debtor unless the plan provides otherwise. The provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such person is impaired under the plan or such person accepted the plan.

Confirmation of a plan generally discharges the debtor from any debt that arose before the confirmation date, including debts deemed to have arisen before that date, whether or not a proof of claim is filed, the claim is allowed, or the holder has accepted the plan. It also terminates all rights and interests of equity security holders and general partners provided for by the plan unless the plan or confirmation order provides otherwise.

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administrator or against the rejecting creditor. All approved claims are registered in an insolvency table ("*Insolvenztabelle*") and creditors participate pro rata in distributions from the proceeds of the estate. Further creditors' meetings may be required in particular circumstances, for example, to approve the sale of the debtor's business to a party 'related' to the debtor, such as one of the debtor's major creditors or shareholders.

Creditors' Representation in the Event of an Insolvency Plan (*Insolvenzplan*)

The concept of an insolvency plan ("*Insolvenzplan*"), designed to facilitate the debtor's restructuring as opposed to its liquidation, was introduced into the German Code in 1999. While US chapter 11 served as its blue-print, the insolvency plan deviates from its US role-model in several material respects, which have substantially reduced its attractiveness and partly explain why it has not been used as widely as chapter 11:

Under this procedure the debtor or the administrator is required to submit an insolvency plan to court containing the terms of the restructuring. The insolvency plan becomes binding between the debtor and all creditors when approved by those creditors voting in classes, and approved by the court. In general, the plan is approved by a class of creditors when a majority vote in favour of number of creditors voting on the plan, provided that such creditors represent a majority of claims by aggregate amount. The insolvency plan may be "*crammed-down*" and imposed on a non-approving class of creditors if (i) the plan treats the creditors of such class no worse than they would be without the plan, for example, in a liquidation; (ii) the plan provides that the creditors of such class participate fairly in the economic value to be distributed to the creditors on the basis of the plan, and (iii) a majority of creditors' classes has approved the plan.

One major flaw of the current law is that it does not provide for shareholders' participation in the insolvency plan and related voting requirements and a "*cram down*" mechanism. Therefore, the plan cannot deliver debt for equity swaps, unless the shareholders cooperate and implement any necessary capital increases, transfer of shareholdings and related alteration of shareholder rights in accordance with the usual corporate law principles (usually a shareholders'

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resolution by a qualified majority is required). Another perceived weakness of the current law is the ability of individual dissenting creditors to delay the entering into effect of the insolvency plan by exercising the legal remedies available against the insolvency plan. This reduces the attractiveness of the insolvency plan as a restructuring tool, since the insolvency plan proceeding is not predictable in its outcome and timing, even where the consent of a majority of creditors has been secured.

Amendments to be Implemented by the ESUG

In order to facilitate a debt for equity swap, the ESUG will allow the inclusion of the debtor's shareholders in the insolvency plan (and the voting process) as a separate class. If the shareholders do not approve of the proposed insolvency plan, it may be "*crammed-down*" under conditions analogous to the creditor "*cram down*" rules. However, even where the insolvency plan has been approved by the stakeholders, the debt for equity swap will only apply to those creditors' claims who have consented to such swap because the German legislators consider that, as a policy principle, no creditor should be forced to become a shareholder of the debtor. Thus, only those claims of creditors who have consented to such swap are swapped into equity.

In order to reduce the hold-out value of individual dissenting creditors or shareholders (where the debtor's shareholders are included in the proposed plan), the ESUG increases the thresholds for successful remedies against the plan. Under the ESUG, the plan can become effective even if it is to the detriment of individual creditors if it provides for compensation payments and for respective funds.

Comparative Comment

Both the US Bankruptcy Code and the German Code include provisions enabling a restructuring of the debtor's business to be put together. While both require creditors' approval by creditors voting in classes, a German insolvency plan only requires a one-half majority in number of creditors and amounts of claims in each class, whereas a US plan of reorganisation requires a majority of two-thirds in amounts and a one-half majority in number of allowed claims voting on the plan. There is provision in both jurisdictions for the court to impose the plan in certain circumstances notwithstanding that a class of impaired creditors has rejected the plan. Dissenting creditors may, however, considerably delay the entering into effect of an insolvency plan by exercising legal remedies available to them. The ESUG law reform attempts to reduce this hold-out value by allowing an insolvency plan to enter into effect, even though a creditor may be impaired, provided that the plan provides for adequate compensation.

Unlike a chapter 11 plan of reorganisation, the debtor's shareholders cannot be made parties to a German insolvency plan. Therefore the insolvency plan may only deliver a debt for equity swap to the extent that shareholders cooperate and implement the required corporate actions. The law reform, ESUG, includes provision which will permit the debtor's shareholders to be included in the insolvency plan as a separate voting class, but subject to "*cram down*."

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Accelerated Chapter 11 Cases

In recent years there has been an increasing number of accelerated chapter 11 cases, many of which were pre-packaged or pre-negotiated cases or expedited sales pursuant to section 363 of the US Bankruptcy Code. These stem from many factors, including lenders that are unwilling to advance further funds and direct an expedited sale of assets or tightened credit markets precluding the availability of debtor in possession financing.

Pre-packaged and Pre-negotiated Cases

In pre-packaged and pre-negotiated chapter 11 cases, a consensus between the debtor and its major constituencies regarding the outcome of the case is reached prior to the commencement of the case. This significantly shortens the length of the case. In a pre-packaged case, the debtor negotiates and solicits votes on a plan of reorganisation before commencing its chapter 11 case, while in a pre-negotiated case, the debtor files a plan of reorganisation on the commencement date, but does not solicit votes on the plan until afterwards.

The time spent under chapter 11 is short in a pre-packaged case because, generally, the only significant task while in chapter 11 is obtaining approval of a disclosure statement and confirmation of a chapter 11 plan. Trade creditors typically are less concerned about the outcome of the case as there is significantly less uncertainty about the prospects of the debtor's business. It should be noted, however, that although the time spent in chapter 11 is shorter than in a traditional case, the total restructuring period, including the period prior to the actual commencement of the case, may not be shorter because extensive negotiations regarding the chapter 11 plan occur during that pre-petition period.

Pre-packaged cases can produce benefits similar to out of court restructurings. There is very little risk of loss of control because pre-packaged cases are significantly shorter than traditional chapter 11 cases and impose less risk to the business. As the debtor has reached agreement with all or almost all major creditor groups, the pressure of negotiating a chapter 11 plan is effectively removed.

Section 363 Sales

Section 363(b) of the US Bankruptcy Code permits

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Pre-packaged and Pre-negotiated Restructurings and Accelerated Procedures

Under German law, the pre-packaging or pre-negotiating of a restructuring concept between the debtor and its creditors relies entirely on the consensus of the participants. Outside insolvency proceedings, there is no mechanism relying on a majority vote or similar approval that would allow the imposition of a restructuring concept upon parties who have not consented to it. As an exception to this rule, the New German Bond Act ("*Schuldverschreibungsgesetz*") provides that the terms of a bond issued under German law may allow the holders of such bond to resolve by majority, representing 75% in aggregate of the total claim amount, to amend substantial provisions of the bond's terms, such as partial debt-waivers or debt for equity swaps.

Out of court Restructuring (prior to, and aimed at Preventing, the Debtor's Insolvency Filing)

A restructuring of the debtor's debt outside of insolvency proceedings requires the consensus of a sufficient number of creditors supporting the proposed restructuring, as only the consenting creditors will be bound by its terms. In this respect, the debtor's management's duty to file for insolvency is a significant practical hurdle to any out of court restructuring: If the debtor is illiquid ("*zahlungsunfähig*"), the debtor's management is forced to establish such consensus within three weeks, failing which it will have to file for insolvency. Upon filing, the debtor's management may continue to seek a consensus for an out of court restructuring and, if successful, withdraw the filing, provided the debtor's liquidity has been restored. In practice, however, the debtor loses control over the preparation of its restructuring to the court-appointed preliminary insolvency administrator and the insolvency filing (and the inevitable negative publicity) usually result in a loss of confidence among the debtor's customers and creditors. This often causes the debtor and/or its creditors to abandon negotiations for an out of court restructuring.

Court Restructuring (as part of Insolvency Proceedings)

Transfer of (parts of) the Debtor's Business to an Investor

The path most frequently taken in German insolvency proceedings is the sale and transfer of

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a debtor to sell all or substantially all of its assets outside a plan of reorganisation, where it can provide an appropriate business justification. A section 363 sale cannot contain provisions that, effectively, would equate to the terms of a plan of reorganisation as the section 363 sale process includes fewer creditor protections than the plan of reorganisation process. A section 363 sale is usually implemented before the filing of a chapter 11 plan. A section 363 sale must be approved by the court and often involves an auction process, with a starting bid submitted by a stalking horse bidder to set the minimum level. A lienholder is entitled to credit bid and offset its claim against the purchase price.

The factors courts consider in determining whether a business justification exists include: (i) the proportionate value of the assets to the estate as a whole; (ii) time elapsed since the bankruptcy filing; (iii) the likelihood that a plan of reorganisation will be proposed and confirmed in the near future; and most importantly; (iv) whether the asset is increasing or decreasing in value.

Section 363(f) gives the debtor the ability to sell property free and clear of liens, claims, and encumbrances in limited circumstances, including where the lienholder consents, where the property to be sold has value in excess of the liens against the property or where the lienholder could be compelled to accept money satisfaction. Unless the sale is stayed pending an appeal against its authorisation, a sale to a good faith purchaser will remain valid and free of all third party claims, even if the court order is later reversed on appeal.

Reversal or modification on appeal of an authorised sale does not affect the validity of the sale to a good faith purchaser unless the sale was stayed pending appeal.

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the viable parts of the business by the insolvency administrator to an investor by way of an asset deal ("*übertragende Sanierung*"). By purchasing the debtor's assets from the insolvency administrator subsequent to the opening of insolvency proceedings, the investor acquires the debtor's business free of claw-back risks and free of the debtor's liabilities.

However, the asset sale cannot, in practice, be pre-negotiated prior to the debtor's insolvency filing, because the court appoints the insolvency administrator only when opening the proceedings (some several weeks after the filing) and has full discretion as to whom to appoint. In addition, although the person appointed as preliminary administrator will usually also continue in office as insolvency administrator and could theoretically therefore enter into agreements with creditors as a condition precedent to his appointment, he will be reluctant to enter into future undertakings with regards to the estate, since he is obliged to administer the estate in the interest of all creditors and will therefore wish to make strategic decisions on the basis of the facts as they are presented upon the opening of insolvency proceedings and in conjunction with the creditors' committee.

Insolvency Plan and Self-administration ("*Insolvenzplan und Eigenverwaltung*")

In 1999, two new concepts were introduced into the German Code, the combination of which was designed to facilitate the debtor's restructuring as opposed to its liquidation. The restructuring of the debtor by way of an insolvency plan ("*Insolvenzplan*") and the self-administration of the debtor ("*Eigenverwaltung*") are an alternative to the administration of the debtor's assets by a court-appointed insolvency administrator. While the chapter 11 served as blue-print for both concepts, the detailed workings of both concepts deviate from their US role model in several respects, which have substantially reduced their attractiveness and partly explain why they have been less widely used:

When filing for insolvency, the debtor may apply for self-administration and submit an insolvency plan to the insolvency court. If the court allows self-administration (and does not appoint an insolvency administrator), the debtor remains authorised to dispose of its assets and manage its business, supervised only by a court-appointed trustee ("*Sachwalter*"). In practice, the courts have been very reluctant to allow the debtor to continue disposing over its assets after his insolvency

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filing. Cases where the courts have allowed self-administration mainly concern debtors who had restored/ preserved confidence in their management by appointing a well-respected restructuring professional to manage the debtor in the interim and assist with preparing an insolvency plan for the debtor. The main hurdle to pre-negotiating an insolvency plan prior to the debtor's insolvency filing is the same as described above for the out of court restructuring. Once the debtor files for insolvency (compelled by the management's filing duties in the event of illiquidity), the debtor loses control over the process to the court-appointed preliminary insolvency administrator. This is likely to result in a loss of confidence among the debtor's customers and creditors and a further deterioration of the debtor's financial status and, if the preliminary administrator does not support the debtor's initiative to restructure by way of an insolvency plan, the plan is even less likely to be realised. Under the current law, the debtor's temporary loss of control is inevitable, because even where the debtor envisages proceeding on the basis of self-administration, the court has no power to order this before full insolvency proceedings have been opened. In any event the court will usually appoint a preliminary insolvency administrator and pending the opening of insolvency proceedings any disposal of the debtor's assets will be subject to the approval of the preliminary insolvency administrator.

In summary, the German Code does not offer to the debtor's management a predictable court alternative to an out of court restructuring.

Amendments to be implemented through the ESUG reforms

The ESUG attempts to reform the law so as to remove key barriers which prevent or restrict the debtor from implementing a pre-packaged or pre-negotiated restructuring.

First, the ESUG recognises the debtor's difficulty of not being afforded enough time to pre-negotiate an in-court restructuring with its creditors (in view of the strict filing requirements) and the consequent loss of control over the restructuring negotiations which would follow on the appointment of a preliminary insolvency administrator. To resolve this difficulty the ESUG introduces a new pre-insolvency restructuring proceeding ("*Schutzschirmverfahren*") which will allow the court to grant to the debtor, upon its filing for insolvency, up to three months to prepare

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an insolvency plan in self-administration ("*Eigenverwaltung*") supervised by a preliminary trustee ("*Sachwalter*") and protected against creditors' enforcement actions by a limited stay imposed by court order. The *Schutzschirmverfahren* procedure will only be available where the debtor is imminently illiquid, but not insolvent and where there is a realistic prospect of achieving a restructuring by means of an insolvency plan. The court may not overrule the debtor's choice of preliminary trustee unless the debtor's candidate lacks the qualification required for the office of trustee or is not independent from the debtor and the creditors. Upon completion of the insolvency plan, the court will open insolvency proceedings and the creditors will vote on the insolvency plan.

Although the ESUG reforms when implemented will empower the court to prevent creditors from enforcing debts where a *Schutzschirmverfahren* proceeding has been opened, this will not prevent or restrict creditors accelerating or terminating their loan facilities and other contracts, where those contractual rights have become enforceable.

The new proceeding will not be as extensive as the chapter 11 automatic stay preventing creditors from exercising their contractual rights in the event of default or insolvency. It is, therefore, designed to facilitate those debtors' attempts to restructure which have reached a consensus with their key creditors.

Secondly, the ESUG also provides that, where the debtor applies for self-administration and such application is not obviously without merits, the court should leave the debtor in control of its business and only appoint a preliminary trustee (rather than a preliminary insolvency administrator).

Thirdly, the ESUG improves the creditors' influence on the course of the insolvency proceedings. Where the debtor's business is of some importance, the court will be required to establish a preliminary creditors' committee and must appoint the person nominated by that committee as the preliminary insolvency administrator, unless such person lacks the required capacity or independence from the debtors and creditors. Where the court considers that establishing a preliminary creditors' committee and awaiting its decision as to choice of insolvency administrator would take too much time it can go ahead and appoint a preliminary

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administrator. Once a preliminary creditors' committee is appointed it could, by a unanimous resolution substitute the court-appointed administrator with its own candidate. The court is required to terminate a pre-insolvency restructuring proceeding if the preliminary creditors' committee decides that the debtor should no longer be protected under that proceeding. In addition, the court must allow the debtor's self-administration in insolvency proceedings, if the debtor's application is supported by a unanimous resolution of the preliminary creditors' committee.

In summary, the changes to be implemented by the ESUG are a step in the right direction. While the ESUG will improve mainly the creditors' influence on the key decisions in the insolvency proceedings, it still will not provide the debtor's management with an entirely predictable alternative to a consensual out of court restructuring. As long as the German Code does not provide for a proceeding comparable to the US pre-negotiated bankruptcy, filing for insolvency or for the new *Schutzschirmverfahren* will likely be perceived as the debtor's last resort rather than as a real alternative to an out of court restructuring.

Comparative Comment

Unlike US bankruptcy law, German insolvency law does not provide for a pre-packaged court restructuring, the outcome of which is predictable for the debtor when filing for insolvency. Upon filing the debtor usually loses control over its business as it cannot be certain to be allowed to restructure in self-administration. Further, any consensus achieved by the debtor with its creditors on a future insolvency plan does not bind such creditors in the subsequent vote in insolvency proceedings. While the adopted ESUG law reform is a step in the right direction, it will likely not provide a debtor who has pre-negotiated an insolvency plan with the requisite number of creditors, with sufficient certainty that following an insolvency filing, the pre-negotiated insolvency plan will actually be implemented. Chapter 11 achieves such certainty by the mechanism of the pre-voted bankruptcy.

Where out of court restructurings fail (due to lack of sufficient creditors' consensus), German insolvency proceedings usually result in a sale and transfer of the viable parts of the business to an investor by way of an asset deal ("*übertragende Sanierung*"). The US Bankruptcy Code provides for a similar sale process in section 363 of the US Bankruptcy Code as part of the regular chapter 11 case.

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Costs

Chapter 11 is expensive.

A debtor in a traditional free-fall chapter 11 case is responsible for the fees and expenses of its attorneys, accountants, investment bankers and other professionals it engages. Moreover, a debtor is required to pay not only the expenses of its own professionals, but also the expenses of the professionals of the statutory creditors' committee, as well as any other committees that may be appointed, all without any certainty regarding the outcome of the case. Each team of professionals must take the time to understand the financial position of the debtor and try to reach agreement on a restructuring. This is one consideration that debtors make in deciding whether or not to go down the route of a pre-packaged chapter 11 case, which is significantly shorter.

Comparative Comment

The costs of insolvency proceedings in Germany can be expected to be less dominated by professional advisors' fees than is the case in the United States. German insolvency proceedings do not always require a creditors' committee and, if required, only one creditors' committee is established. Further, the fees for committee members are not substantial and it is not common practice that a creditors' committee has its own professional advisors (separate from those advising the estate). The lion's share of the costs are the fees and expenses (in particular for legal advice) of the insolvency administrator. Such fees are assessed by the court on a sliding scale percentage of the value of the estate.

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Costs

The costs of the insolvency proceedings are payable from the estate ahead of payments to creditors ranking as administration expenses ("*sonstige Masseverbindlichkeiten*") and ahead of distributions to creditors of unsecured claims.

Costs of the insolvency proceedings include court fees, fees and expenses of the insolvency administrator and of the members of any creditors' committee. The lion's share of costs are the fees and expenses of the insolvency administrator which are assessed by the court.

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Financing Chapter 11 Cases

A debtor must be able to obtain access to sufficient funds to either continue operating or to liquidate its assets in an orderly manner. The inability to obtain such debtor in possession financing is fatal to a successful rehabilitation or the maximisation of assets in a liquidation. The US Bankruptcy Code provides a means to induce creditors and other entities to extend credit to a debtor.

A debtor is authorised to obtain unsecured credit and incur unsecured debt as a first priority administrative expense. If such unsecured financing is not available, a debtor will be authorised by the court to obtain financing on a super-priority basis (i.e. having priority over administrative expenses, secured by a lien on unencumbered property or secured by a junior lien on property that is encumbered). If such financing is not available, the court may grant a post-petition lender a lien on encumbered property that is senior or equal to existing liens on the property as long as adequate protection is provided to existing lienholders.

The reversal or modification on appeal of an order authorising debtor in possession financing does not affect the validity or priority of the indebtedness or any collateral granted to an entity that extended credit in good faith.

Comparative Comment

Unlike the US Bankruptcy Code, the German Code does not provide for specific measures to obtain financing to continue the debtor's business operations. However, in practice, the preliminary administrator can temporarily (until the opening of insolvency proceedings) secure the financing of continued business operations by entering into agreements with the debtor's secured creditors and by organising financial aid from the German Federal Employment Agency to continue to pay salaries to the debtor's employees for a period of up to three months.

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Financing Restructurings

Upon the debtor's filing for insolvency, the debtor will no longer have access to existing loan facilities, as the debtor's lenders will usually accelerate their loan claims and attempt to enforce collateral in their possession. The debtor must not, however, repay any such loans since they are insolvency claims to be satisfied by distributions from the estate.

The preliminary administrator is charged with continuing the debtor's business operations. He usually secures the debtor's ability to continue its business by entering into agreements with the secured creditors whereby such creditors continue to allow the debtor to use assets in its possession. Such agreements with creditors effectively have a financing function ("*unechte Massekredite*").

To the extent the debtor's assets are encumbered with security interests to existing creditors, the debtor or the insolvency administrator will have no access to further financing from third parties.

There is, however, a German law provision which substantially reduces the debtor's need for liquidity, in particular if the business is employee intensive. Upon the opening of insolvency proceedings, the debtor's employees have a claim against the Federal Employment Agency ("*Bundesagentur für Arbeit*") to be indemnified for up to three months of unpaid salaries ("*Insolvenzausfallgeld*"). To ensure the employees' continued support, the preliminary administrator usually makes arrangements with a bank to provide sums equivalent to the three month wage bill to the debtor in return for an assignment of the employees' claims against the *Bundesagentur für Arbeit*. Such financing arrangements usually allow the debtor to continue its business during preliminary insolvency proceedings for up to three months which usually results in a positive cash-flow during such period.

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