

German rules on the appointment of the preliminary insolvency administrator: an obstacle to a successful restructuring?

BY DR ARTUR BUNK

When a company finds itself in difficult economic circumstances, usually there are sufficient signs visible for an experienced management team to receive and comprehend the warning message a long time before the company faces an actual shortage of cash flow, leading to a state of insolvency. A responsible management will under such circumstances tackle the situation in a proactive manner by contacting its major creditors in order to avoid the occurrence of defaults and will attempt jointly with the major suppliers and creditors to implement and re-engineer the financial basis in such a way that the company will be enabled to continue its operations. Where such implementation, due to legal or factual obstacles, proves impossible in an out-of-court settlement, the reorganisation within a restructuring procedure might prove a viable solution.

In order to prepare thoroughly for a reorganisation, the company management will usually involve an experienced team of advisers and entrust them with the preparation of a reorganisation package, ideally pre-approved and discussed with the major creditors and suppliers.

But all these laudable efforts might become futile and a vast waste of time and money for all parties involved if the to-be-appointed preliminary insolvency administrator simply declines to cooperate and implement the pre-approved, pre-packaged deal. Thus the appointment of the insolvency administrator presents a crucial turning point in a successful restructuring.

Legal basis for appointing an insolvency administrator

In more than 90 percent of the cases, the so-called preliminary insolvency proceedings, which usually precede the actual proceedings, are opened upon the filing of the company's management. Although German law provides for the opportunity of a creditor's filing, in practice this is actually a rare occurrence.

The petition is considered by the relevant court and usually granted. However, it must be realised that the power to appoint the so called preliminary insolvency administrator, which usually follows, rests with the court and the latter has full discretion with its choice.

Unfortunately, German law does not provide for the necessity of a hearing before the appointment and in practice any suggestions made in this respect, either by management or the creditors, are regularly rejected and often have the opposite effect. Although in theory the creditors do have the right to elect a new administrator of their choice in their first general assembly, in practice, due to the fact that such an assembly takes place approximately three to four months after the filing, this right is rarely exercised.

In the three to four months between filing and the first assembly, major events, such as the shut-down of the production, the search for an investor or a practical breakdown of business may have occurred. Therefore it is obvious that the preliminary insolvency administrator, appointed and chosen by the court at the moment of filing, has a fundamental impact on the implementation of the reorganisation plans and its success.

The preliminary administrator is usually chosen from an informal list (closed shops) of local professionals who present themselves to the court but who are not necessarily qualified nor experienced enough to handle major, complex or even cross-border proceedings. Since most of the 35,000 to 40,000 company insolvency proceedings occurring every year in Germany mainly involve local, small and mid-sized enterprises, most of the approximately 1,600 insolvency administrators have experience limited to such cases.

Out of those 1,600 persons, only 500 are considered professional administrators. Even among those, the bigger part consists of professionals who are appointed less than once a year.

On the other hand in the more than 180 insolvency courts all over Germany, insolvency cases are often handled by judges, whose main area of expertise lies with completely different matters and for whom insolvency law forms just a small part of their department. The unfortunate result is that in many cases the appointed insolvency administrator is simply not up to the task of a complex restructuring and reorganisation of a company and acts more like a simple liquidator than a restructuring manager.

These structural issues present a considerable risk for any professional restructuring approach and can hinder a serious attempt at reorganisation under the insolvency statutes. Originally the newly introduced Insolvency Act from 1999 has been regarded as a significant improvement in the direction of reorganisation of companies rather than mere liquidation. In fact, the material provisions are much friendlier and the required instruments (e.g., cram down provisions, special labour law privileges, flexible creditor voting rights, etc.) are more or less in place. However, a reorganisation and restructuring, where the insolvent estate re-emerges from the proceedings preserving its corporate identity only appears in approximately 2 percent of cases. In another 5-10 percent, the core business is preserved, but transferred to a new entity; thus leaving the former stakeholders empty-handed. Among professionals, there is common agreement that the fact that the appointment of the preliminary insolvency administrator remains an unpredictable procedure forms an important obstacle to an increase in the number of successful restructurings. The fact that all the efforts of management, shareholders, major creditors and advisers might prove futile, because the court appoints an administrator who declines to cooperate with the former advisers and to implement the well-prepared reorganisation plan, and instead uses the precious ensuing months to get personally accustomed with the company and to prepare his own plan, often proves fatal.

Reform suggestions

Various attempts, partly initiated by professional associations or the Federal Ministry of Justice, have been started to tackle the aforementioned issues.

Detmold model. In 2004, the insolvency court in Detmold (German) ►►

city in Northrhine-Westphalia) introduced a procedure, whereby an informal hearing of the major parties (management, major creditors and works counsel) takes place before the appointment. The court takes notice of the input given by the parties and then tries to identify the best possible insolvency administrator available, who is able to deal with the complexity of problems involved. However an informal hearing depends entirely on the good will of the judge in question and there are no legal provisions by which a judge could be obliged to follow this procedure. Many judges – unfortunately – simply reject any attempts to discuss the case prior to their decision.

Consens model. The Consens model is based on the idea that any insolvency proceedings can in fact only be successful if they have the approval of the major creditors and the employees. Therefore this model suggests providing these parties with a major say in the appointment of an administrator. Again, this model is only a proposal presented by professional associations and it does not create any legally binding obligations on the judge.

Uhlenbruck Commission. In 2006, a panel was set up, consisting of insolvency judges, insolvency administrators, lawyers and others, and was named after a former insolvency judge of the Cologne’s insolvency court, Prof. Dr. Uhlenbruck. This panel suggested the introduction of so called pre-selection lists. In order to be included in those lists, the applicant must inter alia prove experience and theoretical knowledge and education, as well as independency and the availability of a strong back office. Institutional creditors should be granted the right to command the applicants. In the case of a filing, the creditors should be allowed to make suggestions as to the administrator to be appointed and the court must not bar this person solely because he was chosen by the creditors. However, the independency of the administrator must be established and any person chosen must not have advised the debtor and/or the creditor within the four years prior to the filing.

The proposals of the Uhlenbruck Commission have in practice been only partially adopted. Once again, these rules are not legally binding and any court may deviate from them at its own discretion. All above mentioned suggestions have the disadvantage that they only form the beginning of a best-practice consensus among insolvency professionals (judges, lawyers, administrators and restructuring advisers) and are not legally binding. The implementation of this consensus is further complicated by the federal system of Germany.

GAVI. In November 2007, the Federal Assembly presented a draft amendment to the Insolvency Act, in which suggestions were made to improve the efficiency of insolvency proceedings. The draft, among others, suggested the introduction of a pre-preliminary creditors’ committee (the preliminary creditors’ committee is often appointed after the opening of the proceedings, regularly three months after filing; the final creditors’ committee is appointed at the first general assembly of creditors) to be appointed at the earliest possible stage (possibly even just after filing). Originally, the creditors’ committee was to be authorised to deviate from the court’s decision and appoint a different pre-

liminary administrator. However, these suggestions did not come into force and effect as originally envisaged.

At present the Insolvency Act provides for the possibility of a pre-preliminary creditors’ committee to be appointed by the court. However, this committee does not have any power to make binding proposals on the appointment of the preliminary insolvency administrator, nor the election of a new one. Therefore, the aforementioned issue remains unsolved.

How to deal with the issue

Any creditor, shareholder or board member should be aware of the issue and take it into careful consideration, even before choosing the restructuring adviser. The potential risk of a non-cooperative preliminary insolvency administrator can be reduced by a careful and considered choice. At first, the probable *lex fori* must be reflected upon. Depending on the court of filing (in Germany, usually the registered office of the company) enquiries should be made as to the practice currently applied by the responsible court. If the court follows any of the practices described above, the filing should be prepared in the appropriate manner in joint collaboration with the court and/or potential administrators.

However, if the court does not follow any of those practices (and there are many that do not), any attempt of contact with the court and in particular the suggestion of a potential insolvency administrator might only result in an exclusion of such an administrator, because the court will regard him as prejudiced. In any case, one should be aware that the adviser chosen and entrusted with the preparation of a pre-packaged deal will most certainly not be the party implementing it. Under certain circumstances the parties might try to appoint the chosen adviser as managing director or chief restructuring officer (CRO) into the board of directors. However, there is no guarantee that the appointed preliminary insolvency administrator will cooperate and respect this decision. German law provides for the possibility of appointing a so-called “strong preliminary insolvency administrator”, whereby immediately after filing and well before the opening of the actual proceedings, all powers of representation are fully transferred to the preliminary insolvency administrator and the chosen (and highly paid) CRO becomes a toothless tiger. The same risk of course exists in the main proceedings. Only in the rare circumstances of an *Eigenverwaltung* (debtor-in-possession proceedings), which account for less than 1 percent of proceedings, the former management retains its power of representation. In most cases these powers are transferred to the administrator.

All these circumstances should be carefully considered when choosing a restructuring adviser. ■

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