An economic analysis of the German bankruptcy code in the context of the European reform movement

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The 2012 reform of the German bankruptcy code is shown to have contributed towards the goal of achieving legal parity with other major European economies in the competition of bankruptcy codes, especially due to improved access to self-administration and the provision of a pre-insolvency umbrella procedure. Case discussions further highlight the important role of the newly institutionalized debt-for-equity swap in in-court restructuring plans. The instrument contributes to the more flexible nature of the code, which more adequately addresses the needs of current restructurings in the light of more complex corporate capital structures. Shortfalls of the reform, especially with regards to claw-backs and court expertise, as well as cultural inertia will however likely prolong the transformation of the German bankruptcy landscape into a more turn-around facilitating jurisdiction. The more reliable and flexible UK code will preserve its role as the primary European restructuring destination.

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An economic analysis of the German bankruptcy code in the context of the European reform movement

With the implementation of the latest bankruptcy code reform of March, 2012[1], Germany has followed other major economies of the European Union (EU) which have implemented significant reforms of their corporate bankruptcy codes over the last 15 years. By and large, these countries replaced the antiquated and mostly punitive bankruptcy codes with more turn-around friendly procedures aimed at preserving the financially-distressed firm. The underlying rational of these reforms was to reduce welfare losses[2] by better providing financially distressed or insolvent firms with a viable commercial core with procedures to achieve a turn-around (Westpfahl, 2010). This stands in contrast to Continental European pre-reform codes, which resulted in the liquidation of around ninety percent of insolvent firms, on average (Celentani, et al., 2012; Blazy, et al., 2011; Jostarndt & Sautner, 2010), such that the vast majority of restructurings was negotiated out-of-court (Celentani, et al., 2012; Rodano, et al., 2011; Jostarndt & Sautner, 2010).In 2002 the European Commission reacted to this, urging member states to reform their codes based on the "gold standard" (Nomura, 2010), the US code, which strongly stress the preservation of the firm as a going-concern (European Council, 2000). All major European economies eventually passed reforms, which, by and large, complied with this request, most recently the discussed German reform. These reforms were catalyzed by an increasing "competition of bankruptcy codes" (Hasenheit, 2012) which was manifested by a small set of Continental European corporates which effectuated legal changes to obtain access to the UK code, which has long been perceived as the most reliable and effective bankruptcy code (Nomura, 2010). In spite of the small number of these firms, legislators were acutely aware of such changes and reforms were passed with the explicit intention to achieve competitive parity with other codes (see for instance Bundesregierung, 2011).

This paper seeks to provide an economic analysis of the new German bankruptcy code by analyzing it from both a financial as well as a legal perspective. Research in Europe on the welfare effects of bankruptcy codes has significantly been constrained by a set of factors, the most important one being data availability. Consequently, existing empirical studies often stand in isolation due to the specificity of the data. This paper seeks to provide a more homogenous framework of existing studies (Chapter 1). Before the insight of these studies on the welfare effects of bankruptcy codes, the new German code will be analyzed. The competitive dynamic between bankruptcy codes necessitates a European perspective. Consequently, the development of Germany's major economic peers, the UK, France, Italy and Spain will first be reviewed (Chapter 2). This discussion provides the benchmark for the subsequent analysis of the German code (Chapter 3). The theoretical analysis will be substantiated with the discussions of cases which set precedents for the practicability of bankruptcy codes, accounting for the important role of the practical use of a code, which can eliminate legal uncertainties and create a competitive advantage by itself (Baker & McKenzie LLP, 2009). The case discussion presents the European reforms in the light of the need for better coordination mechanisms due to changed corporate capital structures, driven by both the increasing disintermediation of the capital markets following an Anglo-Saxon financing pattern (Mullinieux, et al., 2010) and the growing presence of distressed debt investors with a distinctively Anglo-Saxon profile in Continental Europe.

Chapter 1 - Literature Review

Corporate bankruptcies and their legislative governance have long attracted researcher's attention. As the termination of a firm is part of the corporate lifecycle and not all companies simply decide to dissolve or are bought up, bankruptcies are a key

[1] *Gesetz zur weiteren Erleichterung zur Sanierung von Unternehmen* – Act for further simplification of the restructuring of companies
[2] In Europe, 50% of firms do not survive the first 5 years of which bankruptcies account for 15% (European Comission, 2011)

part of a capitalistic economy[3]. Extending the life of economically viable firms and quickly and efficiently ending the life of companies with a non-viable going concern value holds significant potential for positive welfare effects. While the former point derives from the preservation of the firm as a contributor to the economic wealth of the country as much as it does to the preservation of workplaces, the latter point relates to the efficient satisfaction of creditor's claims before more value of the firm is eroded. As will be seen below, it has been shown that creditors pass on these efficiency gains to the economy in the form of lower lending rates (Rodano, et al., 2011; Davydenko & Franks, 2008). Researchers thus focused on what function a bankruptcy code can take to determine the value-maximizing procedure to be applied to a bankrupt firm and how to achieve the most efficient satisfaction of the claims of the different parties involved. Methodologically, both theoretical models as well as empirical investigations have contributed to the knowledge on this issue.

1.1 Theoretical studies on the economics of bankruptcy codes

Jensen (1987), in a famous paper on the economies on leverage in LBO[4]s argues for the privatization of bankruptcy avoiding the "cumbersome court-supervised bankruptcy process that diverts management time and attention away..". This position has been interpreted by researchers as an enorsement of "non-interventionist" court systems focussing on the strict enforcement of debt contracts (Franks & Sussman, 2005). Researchers since have been trying to adress the question wether such a system creates economic efficiencies *ex-ante* as well as *ex-post*. Supporters of a market-based mechanism refer to the theorem of nobel price laureate Ronald Coase who famously argued that efficient outcomes obtainable given that contractual claims are clearly defined and enforced (Coase, 1960). Consequently, out of court settlements would achieve efficient outcomes, saving the involved parties time and money invoved with court proceedings, while the role of courts would be limited to the enforcement of the contracts (Franks & Sussman, 2005). Critics of this viewpoint have argued that debt contracts could insufficiently adress all eventualities arising under a bankruptcy scenario and that a purely contractual system would result in economic inefficiencies (Baird, 1996; Lakhal, 2011), especially given a dispersed debt structure due to the presence of public debt (Hege, 2003). Specifically, a set of considerations illustrate the usefulness of bankruptcy codes to alleviate imperfections in the composition and execution of debt contracts. These can essentially be summarized as adressing 1) creditor coordination 2) conflicts of interest and 3) information assymetry (Lakhal, 2011)[5]. These will subsequently briefly be reviewed.

Creditor coordination adresses essentially two issues; first a creditor race, in which upon default all creditors race to satisfy their claims in the most timely manner possible. This leads to economic inefficiencies especially when the going-concern value of the firm exceeds its liquidation value (Aghion, et al., 1992). Bankruptcy codes typically mitigate this by imposing a stay on creditors, stopping creditors from enforcing their claims, upon insolvency filing. Additionally, codes coordinate liquidations by prescirbing an order of payments, which generally follows the Absolute Priority Rule[6] but may differ due to a set of country specificities (see for instance section 2.2.1.6, and Appendix C). The second scenario of creditor coordination relates to the well-known free-rider problem. Grossman and Hart (1980) famously pioneered this problem in a takeover context ,which can easily be applied toa restructuring context; Under a restructuring agreement non-pivotal[7] debt holders are incentivized to hold out rather than participate in the agreement, hoping that the post-restructuring value of their claim will exceed the value offered under an agreement. This is aggravated by the presence of subordinated smaller creditors and most importantly public debt resulting in highly dispersed creditor structures with numerous non-pivotal creditors that are incentiviced to free-ride. Consequently, firms with complex debt structures have been found to prefer in-court restructurings,

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[3] In Europe, 50% of firms do not survive the first 5 years of which bankruptcies account for 15% (European Comission, 2011)

[4] LBO stands for Leveraged Buy-out

[5] The author also names contract incompleteness as a fourth factor. Given the sophistication of the European banking system, this factor should play a minor role.

[6] The Absolute Priority Rule (APR) stipulates that senior creditors are to be paid-off until satisfaction of their claim before junior creditors are paid out. Given all junior claims can be met, the residual assets are distributed to shareholders (Eberhart, et al., 1990).

[7] Non-pivotal means that each individual player is of such small size that her individual impact on the probability of success of the restructuring-vote is negligible.

granting them access to the coordinating power of in-court procedures (Asquith, et al., 1994). These most importantly consist of cram-down mechanisms[8], which can impose the vote of a pre-specified majority upon dissident creditors (Gertner & Scharfstein, 1991).

Secondly, conflicts of interests may arise between claimholders, which all seek to satisfy to the best extent possible their own claim and thus are incentivized to acelerate their claims to "be the first at the table", triggering bankruptcy even when a restructuring would have resulted in more economic value creation, known as the "common pool problem", or propose a set of different restructuring plans tailored to their own best interest (Brown, 1989). Conflicting interests may also result in coalition building (White (1981); Gertner & Scharfstein (1991)). Codes mitigate this especially by means of the stay on creditors and voting mechanisms as well as the definition of a structure which determines which group may make restructuring proposals at what time. In a private setting, conflicts of interests may be adressed by clauses of cross-aceleration and cross-default.

Thirdly, incumbent management and the owners[9] of the financially distressed firm may be better informed about its financial situation than creditors, giving rise to information assymetries, which may result in disagreements, or, more severly, misrepresentations by one party during the negotiation process (Senbet & Seward, 1995). In a private setting, both banking expertise in supervizing and handling distressed firms, such as in the case of UK banks (Franks & Sussman, 2005), as well as long standing relationships between borrower and lender, as in the case of Germany (Davydenko & Franks, 2008; Jostarndt & Sautner, 2010) may mitigate such assymetries. Current European codes generally require a set of independent expert opinions, as well as the appointment of administrators to mitigate assymentries.

A set of researchers have sought to contribute frameworks to resolve the debate between a contractualist and a court-contolled system. Ayotte and Yun (2009) provide a model that bases this decision on the available expertise of the judical authorities. Accoding to the authors debtor-friendly reforms along the lines of the US code, bear fruit when courts are expertised in identifying economically viable firms among the pool of insolvent corporates. The authors argue that, given sufficient expertise, these parties can act on recent events, such as the deterioration of cash-flows, which are not forseeable *ex-ante* and thus not contractible. Given inferior court expertise, creditor-friendly codes, aimed at the satisfaction of creditor claims provide superior economic welfare effects. The argument is in line with the finding that, creditor rights are generally lower in more economically developed countries (La Porta, et al., 1998). The model thus stresses the importance of combining more debtor-firendly codes with structural changes in the court system, allow the accumulation of knowledge.

Hege (2000) contributes another framework based on the role of the capital markets, specifically the dominance of either market-based debt in the form of bonds or bank-debt. While the former type of financing is prevalent in the US, the latter has for long dominanted Continental European economies. The intuitive trade-off from the firm's perspective between these is the relatively lower interest rates offered by bonds versus the more efficient debt renegotiations which can be achieved with a single-party bank lender, as previously descirbed. The model shows that creditor-friendly codes are efficient for firms with private debt, while firms with disperesed public debt restructure more efficiently under in-court procedures of debtor-friendly codes. Consequently, increasing the attractiveness of the bankruptcy code by shortening the duration of the procedure or decreasing costs will only result in positive welfare effects if a market-based lending system exists. This provides an interesting backdrop for this study as it aligns with the development in Europe over the last decade; the debtor-friendly reform movement of European bankruptcy codes ocurred over a similar time period over which financial markets

[8] These voting thresholds are sometimes referred to as "cram-down" mechanisms and different definitions of this concept are proposed by the literature. This paper defines a cram-down as a situation in which the court enforces that in a vote a minority of dissident creditors is overruled by the majority, or one dissident class of creditors is overruled by the majority of creditor classes.

[9] This holds in particular for private firms and tightly controlled firms with majority owners

proliferated, gradually allowing an increasing number of companies access to cheaper public debt (Vernimmen, et al., 2011) and will further be explored in subsequent sections.

1.2 Empirical studies on the economics of bankruptcy codes

This section will first briefly review the more extensive body of research that has been done both on a global basis and on the US, before zooming in on the empirical studies of the European codes.

1.2.1 Global studies

Acharya and Subramanian assess the relationship of creditor- versus debtor-friendly codes and innovation. It is found that creditor-friendly codes, which are associated with excessive liquidations, discourage corporate innovation, as firms are cautious to invest in fear of having to file for insolvency, which would make a termination of the firm too probable. Similarly, the development of innovative industries is slowed-down. Such a discouragement of corporate risk-taking intuitively results in welfare losses. The link of economically inefficient codes and firm innovation resonates strongly with pre-reform Continental European countries, and has been noted particularly with regards to Spain (section 1.2.3.3).

Djankov et al. (2008) provide a global review of the efficiency of debt enforcement in an in-court restructuring. The study relates this efficiency to the legal origins of the country, a link that has received significant attention (La Porta, et al., 1998; Ayotte & Yun, 2009). In line with previous studies, the authors find legal origins to be a key variable in determining efficiency as well as in the structure chosen. In particular German legal countries are found to rely heavily on liquidation. In terms of achieving the overall efficient result of keeping the firm as a going concern, common law codes are found to perform much better than German and French law codes, with French legal codes achieving the most inefficient results. Both findings align with country-specific and other cross-country empirical studies (section 1.2.3.4 and 1.2.4). Additionally, France and poor countries are found to belong to the same group in specific obstacles to debt enforcement such as breaking the Absolute Priority Rule (APR)[10]. In line with this, recovery rates are highest in the UK, countries (91%), lower in Germany (67%) and lowest in France (56%). These results are consistent with Franks and Sussman's (2008) findings[11] (see section 1.2.4). Notably, the study was administered in 2006, such that the survey of experts primarily reflects the pre-reform situation for the European segment of the study.

1.2.2 Studies on the USA

Research on the economic efficiencies of the US code has achieved the highest density and has yielded two opposing points of view. The first one criticizes the extensive turn-around potential of the *Chapter 11* procedure, resulting in the commitment of a type I error as non-economically viable firms are kept alive through costly restructuring processes only to re-file shortly after the first procedure. Additionally, it is argued that debtor-friendly aspects of the code, such as the stay on creditors, provide incumbent management with too much controlling power. (Baird, 1986; White, 1989, Jensen, 1991; Mooradian,1994; White, 1994) . Another criticism is that the involvement of the courts creates significant inefficiencies, where a regulation through the free market (via debt-contracts) would propose a better solution (Jensen, 1987). More recent studies, on the other hand, have increasingly portrayed *Chapter 11* as a code able to mitigate conflicting interests and effectively securing, and possibly enhancing, the economic value of the bankrupt firm (Wruck, 1990; Gilson, 1997). Aivazian and Zhou (2012) provide one of the most recent studies based on an extensive sample of 464 firms having filed for bankruptcy from 1985 to 2006. The authors employ a matching methodology pairing these firms with an extensive database of non-bankrupt firms over the same time frame to assess the relative performance of the firm post the restructuring. The study finds restructured firms to at least match, if not outperform their peers, underscoring *Chapter 11* as a strong restructuring procedure in line with the global perception of the code (Nomura, 2010). A remedial explanation for the diverging views of newer and older studies

[10] In France the APR is conflicted, among other issues, as employee claims are addressed before secured creditors (Appendix C).
[1111] Franks and Sussman (2008) find median recovery rates for secured creditors of 92% in the UK, 67% in Germany and 56% in France.

may be found in the dynamic aspect of accumulating court expertise. Following the argument by Ayotte and Yun (2009), the US Bankruptcy Reform Act of 1978, institutionalizing a highly debtor-friendly procedure, would have only shown positive effects once courts had acquired sufficient expertise.

1.2.3 Empirical Studies on Europe

As previously mentioned, empirical studies of welfare effects of bankruptcy codes in Europe have been significantly limited by data constraints. This is arguably driven by two factors; firstly, corporate financial distress is a highly sensitive issue and companies will generally attempt to keep this state confidential for as long as possible. This is because the announcement of corporate bankruptcy could alarm a wide set of stakeholders, including both suppliers, who will increasingly prefer to be paid in cash, as well as customers, who will worry about the validity of guarantees on their purchases (Vernimmen, 2011). Intuitively, both effects could catalyze the financial distress of the firm. Secondly, public information is not as readily accessible in the US as in Europe. This is in part due to the highly intermediated European lending landscape, where lending volumes from financial institutions are still three times higher than in the US (McKinsey, 2011), resulting in a dependence on these financial institutions for a range of information and affecting especially studies on the cost of financing (Davydenko & Franks, 2008; Rodano, et al., 2011). Both factors render the execution of empirical studies of representative very cumbersome and time consuming, such that even newer studies sample from a period that by now has become legally outdated.

In spite of these constraints, a set of empirical studies on European bankruptcies vis-à-vis the national bankruptcy code have been conducted. These can be separated in two groups; the first set of studies analyzes in-depth firm-level characteristics for distressed companies and their relation to the result of the financial distress within one bankruptcy code (1.2.3). While these studies do not directly consider the bankruptcy code as a variable, they make explicit references to the codes, due to their significant moderating impact. The second group of studies assumes a macro-perspective, analyzing the performance of the bankruptcy code for firms either on a cross-country basis or on a longitudinal basis (section 1.2.4). The aim of the studies is generally two-fold, first to provide a survey of the insolvency landscape in the particular country and second to identify best practices and trends that facilitate turnarounds in order to better undertstand the impact of bankruptcy codes on firms as well as to make policy reccommedations.

1.2.3.1 United Kingdom

Franks and Sussman (2005) analyze factors of the debt struture affecting the out-of-court insolvency process for private SMEs in the UK. Obtaining private data from three UK banks, the authors reveal some interesting points on the interaction between the lending practice, as evidenced by the firm-level debt contracts, and the bankruptcy code. Generally, it is found, that, in a purely contractualist setting debt contracts and bank lending practices have been structured in a manner that efficiently governs corporate insolvency scenarios. Specifically, liquidation rights are concentrated within the main bank and banks actively pursue restructurings but are tough negotiation partners that rarely accept debt forgiveness. Notably, the control of the creditors facilitated by the highly creditor-friendly UK code at the time (La Porta, et al., 1998). The control of a limited number of parties results in a reduction of creditor coordination problems as previously described (Section 1.1). This is evidenced by the apparent lack of asset grabbing, illustrating that a contractual organisation mechanism has been found. The second point too a large extend rejects the hypothesis that the prevalence of concentrated liquidation rights result in "lazy banking"[12]. In consequence, the majority of financially distressed firms emerges from the bankruptcy process and only 35% enter formal procedures[13]. Thus, when left to itself and with minimum outside intervention, lenders and borrowers are generally shown to be able to acount for the dynamics of the resturcturing processes contractually. By and large, this finding is in line with Jensen's (1989) argument in favour of a contractualist rather than an interventionist system, the former of which applied to the UK in the time frame of the study (1996-1998). Notably, however, private negotiations fail in a non-

[12] The habit of secured banks to act "lazy" and simply enforce their claims against an insolvent debtor prematurely.
[13] Specifically, 35.7%, 37% and 12.8% of the companies of the three banks sampled enter formal bankruptcy

trivial part of the sample (ca. 35%) illustrating a residual need for a coordinating process. This aspect bears even more important since the discussed firms, due to their size, have fairly simple capital structures and private negotiations may have been more complex to achieve for larger firms. The British legislator mitigated the creditor-focussed nature of the code with the abolition of the administrative recievership procedure in 2002, implementing attractive in-court restructuring procedures (section 2.1.2).

1.2.3.2 France

A set of country-specific studies have explored the French bankruptcy code, with the primary goal to provide a basis for an evaluation of the performance of the code, exploring the characteristics of the firms filing for a procedure under the code, as well as which procedure applied for and its final outcome. Kaiser (1996) finds the restructuring procedures to end in liquidation 94% of the time from 1987-1993 for France on average. Lakhal (2011) provides a further descriptive study based on data from the commercial court of Paris prior to the 2005 reform. The study highlights disparities in the expertise of the courts, finding the commercial court in Paris to be used in more than 11 percent of all national filings in spite of being one of circa 190 bankruptcy courts at the time[14]. It further provides an interesting quantification of the French corporate landscape, which is pervaded by SMEs; the study further finds only 1 percent of the firms to be large firms[15]. Finally, the study finds especially small firms to be highly levered, indicating that management holds out until the last moment before entering a court-supervised procedure, questioning the perception of the French bankruptcy legislature prior to the 2005 reform. Lastly, larger firms are found to be more likely to be continued through a sale.

Blazy et al. 2011 complement the review of the French code with a particular perspective on the social aspects of the code, specifically the goal of workplace preservation, constituting in its explicity a unique aspect of the French code in a global comparison. Like Lakhal (2011) the authors source from data of bankruptcy filings in courts around Paris prior to the 2005 reform (1989-2004) containing mainly SMEs and find a 90% liquidation rate. Interetstingly it is shown that the outcome hinges entirely on the entry conditions of the firm rather than the court-intervention itself, thus a profitable firm is more likely to be continued, than an insolvent firm. This indicates that the late filing rate under the pre-reform code constitutes the main rational for the high liquidation rate. The study further shows that smaller firms with less secured assets, or lower coverage rates, are more likely to be liquidated. This is likely because the recovery value for the creditors has eroded past a point in which the restructuring process would be attractive for the creditor (14.2% on average), again underscoring the late filing rate as well as the percieved inefficiency of the in-court process[16]. Secondly, the role of super-priority financing is confirmed as a key tool in achieving a continuation of the firm.. Additionally, the study shows that in liquidations the courts clearly prioritize the preservation of work places over the satisfaction of creditor's claims. As indicated by Davydenko and Franks (2008) this factor, in combination with the overall impracticability and uncertainty of the process, may be the key driver behind the high collateral that French banks require from their debtors, in comparison to the UK and Germany.

1.2.3.3 Spain

In a recent paper Celentani, et al. (2012) investigate the low relative insolvency rates[17] of Spanish firms vis-à-vis its European peers[18].The authors attribute this to the unattractiveness of the code, driving firms to actively seek to avoid having to file under the code and instead attempt for as long as possible to reach an out-of-court agreement. The authors argue that one repercussion of this practice is the impact on risk-taking reflected in innovative activity in the Spanish economy, as found by

[14] Blazy et al. (2011) find a similar superiority of expertise in researching the same court; for instance, the court had set-up several prevention units to facilitate out-of-court settlements.
[15] Defined as employing more than 250 employees and achieving more than EUR 50m in revenue.
[16] Reorganizations are found to take 14 months on average.
[17] Defined as the ratio of business bankruptcy filings to total firms in the economy
[18] Based on 2006 figures 3 out of 10000 firms filed for insolvency in Spain, whereas these numbers amounted to 26,96,115 and 179 for Italy, Germany, the UK and France.

Acharya & Subramanian (2009). Aditionally, it s illustrated how the relative inexperience of authorities in the mercantile courts contributes to the unattractiveness of the code. Inspite of this low expertise the 2004 reform institutionalized a relatively debtor-oriented code instilling a high amount of authority with the courts. As suggested by the model of Ayotte and Yun (2009), financial distress is in consequence primarily treated out-of-court.The authors show that this dynamic results in a set of economic inefficiencies vis-à-vis major Continental European economies[19]. First, Spanish firms hold signficantly higher levels of fixed assets, which can be used as mortgage collateral. The suggested rational is that banks require collateral as security against the inefficient bankruptcy process. Return on assets of Spanish firms, is much lower, driven by exceptionally low fixed asset turnover. This indicates that an overinvestment in fixed assets occurs to obtain bank credit.. Interestingly, Germany is found to rank just behind Spain in terms of the ratio of fixed assets to total assets and German banks primarily lend on a secured basis (section 3.1), indicating that a similar overinvestment may occur. Additionally, Spanish firms are found to be less levered, across size and industries, while having similar tax rates. This indicates that firms choose to incur opportunity costs in the form of debt-provisioned tax-shields to lower the probability of bankruptcy. One point of criticism is that the study sources from very aggregate data[20] for the cross-country comparison over a limited time frame (2007-2008) and shows a rather unhomogenous structure of the sample; the ratio of small firms for Spain is 99%, while being 86% for France, 65% for Germany and 41% for Italy. Comparing capital structures across this sample may be distorted by size factors, as larger firms can more easily access capital markets (Vernimmen, 2011), banks have been found to be more forthcoming in restrutcuring larger firms (Franks & Sussman, 2005) and going-concern sales are easier for larger firms (Blazy, et al., 2011; Jostarndt & Sautner, 2010).

1.2.3.4 Germany

Jostarndt and Sautner (2010) provide an insightful study on Germany, focussing on a set of firm-level characteristics and their impact on both out-of-court, as well as in-court insolvency process. The study is based on publically available and data, focussing on listed companies, which on average are larger than the firms considered in the previously discussed studies (section 1.2.5). The time frame of the study is from 1997-2004 and thus includes both a growing as well as a recessionary economic period. The study finds an even distribution of out-of-court workouts and insolvency filings (fifty-seven and fifty-nine firms, respectively). Of the in-court procedures only nine companies achieve a restructuring. Consequently, while the overall turnaround proportion of the sample is quite high (57%) the study casts the turnaound ability of the in-court insolvency process in a negative light - only 16% of companies survive the process. By and large, the study thus underlines the emerging image of a clear underperformance of pre-reform Continental European codes. This is aggravated by the larger size of the firms, which implies an above average work-out proportion, as previously explained (section 1.1).

The authors further find that debt forgiveness, followed by debt modifications, is the most frequentely used tool employed in restructurings. This stands in stark contrast with the UK-specific study by Frank and Sussman (2005), which found only one case of debt forgiveness in a sample of 600 firms. This difference may be attributable to the smaller size of the non-public SMEs in comparison to the public firms of Jostarndt and Sautner (2010), as previouslt explained. More generally an explanation may also be found in corporate'capital structure. While bonds are prevalent in UK corporate balance sheets (Asquith, et al., 1994) only 8% of firms hold public debt in the German study. As outlined in section 1.1, a limited set of bank lenders facilitates a retructuring of debt at "arm-length", whereas such attempts tend to fail with a dispersed bond holder base. Similarly, the authors observe a positive link between secured debt and liquidation. As in the case of Blazy, et al. (2011) the difference to the UK study may be related to the inclusion of the highly ineffective in-court restructurings in the German study, reflecting a "factual bias […] against in court reorganizations" (Jostarndt & Sautner, 2010). Additionally, coorination failures between German banks due to the non-centralized handling of restructurings, as opposed to the centralization through

[19] As in this paper, the cases of Germany, France, Italy and Spain are considered.
[20] Based on the BACH database, provided by the European Comission and the European Committee of Central Balance-sheet data offices

BSUs[21] in the UK, may contribute to the liquidation-focus (Davydenko & Franks, 2008). Notably, corporates lending via a lending-consortium are significantly less likely to be liquidated[22], underlining the role that coordination mechanisms could play in determining the course of the insolvency process. Brunner and Krahnen (2008) confirm the prevalence of this coordination mechanism in Germany. Lastly, debt-for-equity swaps are found to play only a minor role in restructurings[23], highlighting a set of regulatory difficulties with this instrument under the German pre-reform code (section 3.1.4).

1.2.4 Comparative European studies – across countries and time

Davydenko and Franks (2008) contribute a unique study due to its cross-sectional data set, comparing corporate defaults in France, UK and Germany, based on data from banks in each of the three countries. This allows for a direct comparison of the economic impact of national bankruptcy codes. As the majority of country-specific studies, the paper is based on pre-reform data, sampling defaulted SMEs[24] from 1993/1996 to 2003. Unlike in Franks and Sussman (2005) the study considers firms which have acctually defaulted on their debt, rather than financially distressed firms in gerneral.The study determines the UK procedure to be the most creditor friendly, France to be the least creditor friendly, and Germany to range in the middle. French banks are found to adjust for this by requiring more collateral but to achieve this only insufficiently resulting in recovery rates much below those of their German and British peers[25]. The study further finds that both formal bankruptcy and piecemeal liquidations in the UK were signifcantly lower than in Germany and France (see table 1 in section 1.2.5). The first finding can be linked to the legal requirement to file for bankruptcy within a specified window upon breach of certain insolvency triggers in France and in Germany. The second finding confirms the superiority the British code in preserving the going-concern of the firm, a finding that had already emerged in the review of the country specific studies mentioned previously. One explanation to this could be the effect of coordination failures in France and Germany. In France multi-bank lending e is more prevalent. While German banks frequently form bank pools, which should help to mitigate coordination problems (Djankov, et al., 2008), coordination failures may derive from the previously mentioned non-centralized handling of bankruptcies.

Rodano et al. (2011) study how reforms in the Italian bankruptcy code affect the cost of financing on a longitudinal basis. The authors are able to establish a clear link between reforms and the cost of financing, a link that had been distorted by country-specific factors in the previously discussed cross-sectional study. The staggered nature of the reforms allows the authors to achieve an interesting separation of the effects of a reorganization (*Decreto-Legge 35* in 2005) and a liquidation reform (*Legge V* in 2006), which typically go together as the entire bankruptcy code is overhauled by the legislator. Interestingly, as a result of the implementation of the earlier reform of the re-organization procedure interest rates charged to distressed firms verus a control group acttually slightly widened. The authors interpret this as two offsetting effects. First the effect of efficiency gains from greater creditor coordination, lowering rates, and secondly an incentive for debtors to act more opportunistically, a behavior which creditors would offset with higher rates in an efficient market. On the other hand, the implementation of *Legge V*, the liquidation reform, which significantly facilitated creditor's control on their collateral, had an intuitive diminishing effect on the required rates. Overall, it is found that cost-constraint on capital has been relaxed as a result of the reforms, while the use of the provided re-organization procedure increased signficantly. The study reveals that even when controlling for country specific factors, empirical studies on the impat of bankruptcy code reforms on the cost of

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[21] Business Support Unit

[22] 36% of liquidated firms had a banking pool, while 80% of those firms achieving a successful workout lent from a banking pool.

[23] Specifically, they occur only in 7 out of 57 cases.

[24] SMEs are defined as firms with annual sales turnover of EUR 75m and outstanding liabilities in excess of EUR 0.1m. This is relevant especially because bankruptcy codes prescribe simplified procedures for firms below a certain threshold. Based on the firm characteristics provided in table 1 of the study, for instance median turnovers, it would indeed appear that part of the sample could have been handled under simplified procedures. Since this point is not further addressed on the study the impact of it is hard to gauge.

[25] Specifically, reported rates are 92% in the UK, 67% in Germany and 56% in France

financing are troubled by the anogonistic effect inherent in re-organization reforms aimed at benfitting both the creditor and the lender.

From a methodological perspecive, the macro-perspective studies have shown the trade-off between significant external validity by comparing across codes or time, but impaired measurability due to the myriad of exogenous factors distorting such ambitios studies. Before this light it is highly desirable for national and European authorities to facilitate the access to a more homogenous data set to enrich the important insights which the comparative studies have yielded so far. Better data would lead to better research which could enable more-informed legislature and ultimately drive economic gains.

1.2.5 Discussion

While a direct comparison of the country-specific studies is difficult, due to differences in the sampling criteria, time-frame and methodology, the studies have provided empirical footing to the dichotomy of pre-reform bankruptcy landscapes that emerged in the theoretical discussions. Based on the general workout ability, the Continental European economies, under civil law, with a prevalence of bank debt and occassionally questionable court expertise seem to have underperformed the UK as a capital markets oriented economy, based on common law.

Table 1 summarizes the findings of the sub-segment of the discussed studies that focus primarily on the turnaround capability of the code (rather than on the financing costs or balance-sheet structures). The table indicates that firms in the UK address financial distress more proactively than, for instance, German banks as evidenced by the comparatively lower leverage with which UK firms enter the bankruptcy process. This could be due to better debt monitoring by UK banks, as a result of the previously described centralized monitoring process. In consequence, insolvency procedures are significantly shorter. German banks, which, unlike UK banks, monitor debt decentrally seem to notice the need for restructurings later. This is aggravated by the cultural stigmatization of insolvency in Germany, deterring firms from alarming their creditors (Jostarndt & Sautner, 2010; Westpfahl, 2010; Hirte, 2011). This may in part contribute to the higher proportion of firms needing to enter formal procedures, although the lack of any legal requirement to file for insolvency in the UK may also contribute to the lower rate. It can be concluded that both aspects of the banking system as well as the legislature contribute to the better performance of the UK. Arguably, this is aggravated by the significantly smaller size of the firms in the UK study, given the negative relationship of size and workout-probability. The outperformance of the UK might thus be expected to be even more significant on a like-for-like basis and notably also holds for other Continental European economies; Blazy et al (2011) show that the liquidation rate for in-court procedures is even higher than the German study[26], likely driven by the average size of the firms in the sample, which are even smaller than those of the UK study. As can be seen firms enter the in-court procedure with significant over-indebtness, based on average coverage ratios of only 22%, while the few firms which survive via sales or restructurings have significantly higher rates (42.1% and 63.8%). Complementing the picture, the in-court process can also be ended signficantly earlier for these firms (under a year vs. 2 years for liquidations). Anecdotal evidence confirms the hesistance to file for insolency prior to the 2006 reform, similar to the German case (Lakhal, 2011).

The cross-counttry comparison of Davydenko and Franks (2008) underlines the pattern that emerged in the country-specific studies. Corporates in default survive insolvency procedures signficantly more often in the UK than in France and Germany. Especially German corporates are shown to delay a restucturing excessively, such that they have to file for formal insolvency, rather than achieving a private workout, and enter the process with a higher debt burden.It should be noted that the German firms of the sample are almost twice as large as the French and UK cases by turnover, which likely boosts the workout ratio for Germany. Overall, the subsequent review of the reform process in Europe can now be made before the background of comaprative economic inefficiencies of the Continental European codes, due to a signficant liquidation bias. These relate not

[26] A comparison with Franks and Sussman (2005) is difficult as the performance of companies eventually entering in-court procedures is not reported.

only to the termination of potentially safeable companies but may impact the innovativeness and risk-taking in the economy as well as an overinvestment in assets (Celentani, et al., 2012) and indirectly higher costs of financing due to higher colateral requirements (Davydenko & Franks, 2008) and higher lending rates (Rodano, et al., 2011).

Table 1, Summary of studies on turnaround capability of European insolvency landscape

	Turn-around ratio	Time-frame of the sample	Size proxy	Median leverage	Median duration
Germany - Jostarndt and Sautner, 2010	57% out-of-court, 15% in-court (50% of sample)	1997-2004	Median assets EUR 86.98m	0.72	3 years for in-court procedure
UK – Franks and Sussman, 2005	65% out-of-court	1997-1998	Median turnover: GBP 0.8 – 5.5m; Median no. of FTEs: 20-75	0.65	7.5 months for out-of-court procedure
France – Blazy et al., 2011	6% in-court	1989-2004	Average turnover: EUR 0.8m; Average no. of FTEs: 7-34	NA; Average coverage rate: 22%	2 years for in-court procedure
Davydenko and Franks, 2008					
UK	57.1%	1996-2003	Median turnover: EUR 5.46m	0.66	NA
Germany	43.1%	1996-2003	Median turnover: EUR 11.72m	0.79	NA
France	38%	1993-2003	EUR 5.73m	0.63	NA

Chapter 2 - Review of the development of the French, Italian, British and US bankruptcy codes and their reforms over the last 15 years

Given that the US code held an exemplary role in the ensuing European reform process, this section will first briefly review the code, to understand the most relevant aspects in the forming of the European reforms. Similarly, the British code arguably provided a guiding light in the reform process that will be analyzed in section 2.2. As will be seen this can in part be attributed to the UK common law tradition, which helped to instill a high level of practicability of the code, as it was able to continually provide new answers to the ever evolving questions of corporate bankruptcy. Following the EC Regulation on Insolvency Proceedings of 2002, which will be elaborated on below, Continental European codes stood in direct competition with the British code, such that reforms were also tailored to achieve competitive parity with the UK as a bankruptcy landscape. This process will then be specified in the review of the reform process of the insolvency codes of the major Continental European economies.

2.1 Review of the Anglo-Saxon codes of Britain and the US

2.1.1 The US bankruptcy code

Paralleling the political and economic influence of the US, its bankruptcy code has been described as "perhaps the best established and influential of all currently existing bankruptcy regimes" (Nomura, 2010). It traces its roots to the US constitution, which explains the overlap with the British code, and has last been signficantly updated with the 1978 *Bankruptcy Act.* At the heart of the code is the preservation of the going-concern value of the financially distressed firm if this econimically viable or a timely liquidation if it is not. The two main procedures for achieveing either of these objectives, *Chaper 11* and *Chapter 7* respectively, will be reviewed below.

2.1.1.1 *Chapter 11*

Chapter 11 is a restructuring procedure that is filed unilaterally by the debtor with the court[27]. Importantly the procedures may be used either by an insolvent or by a solvent firm, an important distinction to the pre-reform Continental European codes (Baird, 1996). Management remains control under the auspices of a US trustee, an independent official. An automatic stay is implemented on both secured and unsecured creditors, compelling the former group to participate in the restructuring process. The procedure allows management to obtain post-insolvency financing which is granted super-priority status[28] (DIP[29] financing), allowing for a cash injection when the company most needs it (11 U.S.C. §365). Within 120 days the debtor must produce a restructuring plan, and obtain acceptance by the creditor committee within another two months (11 U.S.C. §1121). In practice bankruptcy judges are lenient in the enforcement of these deadlines and will agree to extend the period if the debtor makes a believable effort to implement the plan (Nomura, 2010). Creditors are to be separated in different classes according to the priority of their claims (i.e. secured, unsecured etc.). The plan is approved if two-thirds of creditors by value and the majority by number approve the plan within each creditor class and if the APR is not violated (11 U.S.C. §1129). If the debtor has not produced an acceptable plan for 18 months, an alternative plan, such as one composed by the creditors will be adopted.

The procedure instills an unparalleled degree of power with incumbent management, especially in comparison with the pre-reform European codes. The strong position of the debtor in the America legislation can be traced back as far as the first settlers in Georgia, which themselves were exiled debtors (Baird, 1996). Creditors are essentially represented through the court, which assumes a supervising role. Specifically, the court needs to approve new financial operations and will approve DIP financing only if secured lenders have been "adequately protected".

2.1.1.2 *Chapter 7*

Creditors can reject the proposed plan and convert it into a *Chapter 7* procedure which is equivalent to liquidation. Notably, around two-thirds of *Chapter 11* applications eventually result in liquidations (Davydenko & Franks, 2008), with an increasing proportion for smaller firms (Baird, et al., 2006). Under the liquidation procedure "super-priority" financing ranks first, administrative claims, including legal fees for both debtor and creditor rank second, third come wage claims and employee benefits and only on the fourth and fifth place come secured and unsecured creditors, respectively. This contrasts starkly with Germany, where secured creditors typically rank first. Important here is the absolute priority rule, which prescribes that senior claims are to be met in their entirety before any satisfaction of junior claims may be given. Weiss and Capkun (2007) show the increasing role this rule plays in *Chapter 7* liquidations.

[27] Creditors may however induce a filing by the manager by threatening to enforce a personal guarantee (Baird, 1996).

[28] Depending on the country post-insolvency finance may not rank before all pre-insolvency debt or may do so only partly. Consequently, the term "super-priority financing" may be misleading for some bankruptcy codes and "post-insolvency finance" will be used as the general term throughout this analysis.

[29] DIP stands for debtor-in-possession

2.1.2 The UK bankruptcy code

The bankruptcy code of England and Wales constitutes one of the most attractive bankruptcy legislation in Europe (Nomura, 2010). The code in its current form provides a variety of pre-insolvency and insolvency restructuring procedures. With the implementation of recent legislative reforms, most importantly the Enterprise Act (2002) and the Company Act (2006), the code has partly reconciled its previously strictly creditor-friendly position, in part due to the end of the *Administrative Receivership* procedure (Nomura, 2010).

Insolvency is attested both via a balance-sheet test, testing whether assets exceed liabilities, and secondly of a cash-flow test, testing whether debt can be paid as it falls due. The test however bears little legal relevance as a state of insolvency does not per se require the debtor to file for an in-court procedure, similar to the US code. Rather, company directors are obliged to act under good faith, as stipulated by the 2006 Companies Act. Failure of this is "wrongful trading" constitutes a criminal offence.

2.1.2.1 *Administration*

Introduced with the Insolvency Act of 1986, the *Administration* procedure was significantly reformed with the Enterprise Act of 2002 (Chapter 40) that effectuated a more even power distribution between unsecured creditors and financial creditors (Nomura, 2010). Both debtors and creditors have the choice between appointing an independent administrator out-of-court, or applying for an *Administration* order in-court (Par. 2, Par. 12). In the former case, the holder of a floating charge may appoint the administrator, a power attributed to creditors, typically banks[30], reflecting the general creditor-friendliness of the system. Alternatively the debtor might appoint an out-of-court administrator himself. In the latter case the court needs to prove whether the company either faces insolvency or will face it in the near future and if the primary objective of the procedure, to preserve the going-concern value of the firm (Par. 3), can be achieved. With the appointment of the administrator incumbent management is replaced - the procedure allows for no self-administration of the financially distressed firm (Par. 41). Notably, the administrator is to act in the interest of both secured and unsecured creditors (Par. 3). This is an important change implemented with the 2002 *Enterprise Act* which sought to reign in the power of floating-charge creditors - prior to the 2002 reform the administrator's sole objective was the maximization of the claims of secured creditors (Davydenko & Franks, 2008).

With the opening of the procedure a stay on secured and unsecured creditors as well as lease and rent contracts is imposed (Par. 43). This stay may however be conditionally lifted upon consent of the administrator and court approval, given that the lift of the stay would not jeopardize the restructuring process. Notably, holders of financial collateral are excluded from the stay. The procedure further allows for super-priority financing.

The independent administrator has to produce a proposal for the conduct of administration as soon as possible but in any case within eight weeks (Par. 49). The proposal is voted on in a creditor's meeting. The administrator may also call a preliminary creditor's meeting (Par 51-52), which may suggest modifications (Par.53). In the creditor meeting, the proposal requires a simple creditor majority to be accepted and will generally only involve unsecured creditors as secured creditors are only allowed to vote, if their claims are not fully covered via secured assets (Nomura, 2010). Notably, the extent to which the procedure may affect the claims of secured creditors is limited, and may, without agreement of the creditor, only occur in combination with a *CVA* or a *Scheme of Arrangements* (Par 73). Consequently, the procedure is often combined with one of the latter two (Weil, 2012).

[30] Banks provide the bulk of financial credit and typically hold floating and fixed charges (Franks & Sussman, 2005)

Pre-pack Administrations

Since *Administration* provides limited power for incumbent management, as a "debtor-in-possession" procedure is not provided for, its typical use is a "pre-packed" sale of the company rather than an actual turn-around[31] (Frisby, 2006). In this application of the procedure the administrator is contacted prior to the official start and a plan for the sale of the company is discussed. Upon the initiation of the process this sale is then executed in a timely manner. The sale could also be to a new company owned by current management, to benefit from the stay on creditors as well as the administrator's authority to deal with secured assets. Consequently under certain circumstances, the procedure may rid the business of a significant part of its secured debt, effectively ending the company but saving the business. The increasing number of cases that aimed at achieving such a debt write-down has cause some controversy as described by Sims and Cranston (2007); "…the cynical view is that it is the mechanism of default for deviant directors to buy back the same business at a knock-down price leaving behind a trail of unpaid creditors". The authors counter this however by saying that, by organizing the sale prior to the opening of the procedure, the value-eroding nature of a lengthy insolvency process could be avoided. This results on average in better results for interested parties. The procedure is illustrated by the Wind Hellas case (section 2.1.2.5).

2.1.2.2 *Scheme of Arrangement*

While the *Administration* procedure is primarily applied for sale processes, the *Scheme of Arrangement* constitutes an important restructuring procedure. It has been reformed with the 2006 *Companies Act* (Part 26) and emulates the US *Chapter 11* procedure in a set of ways: First, no entry test of insolvency is required, underscoring the pro-active nature with which this procedure is to be used. Secondly, current management is left in place and no insolvency practitioner is appointed, unless the procedure is combined with an *Administration* procedure. Thirdly, management is allowed discretion as to which creditor classes are affected by the plan and which classes should be invited by the court to the creditor meeting to approve it (Par. 896). While the correct definition of the creditor classes can be difficult, this structure essentially allows to effectuate restructurings with financial creditors, while excluding trade creditors from the agreement, potentially allowing for an uninterrupted day-to-day course of business during the restructuring process (Nomura, 2010). Additionally, a "cram-down mechanism" is provided, as a majority in number representing seventy-five percent of creditors and potentially shareholders, or their respective classes, can allow the agreement to be sanctioned by the court[32] (Par. 899). One of the key differences is the absence of a stay on creditors, allowing secured creditors to exercise their security prior to the passing of the agreement[33]. Secondly in contrast to *Chapter 11* no super-priority financing is allowed under the procedure (Nomura, 2010). Finally the application for the procedures is bilateral versus *Chapter 11* which allows only the debtor to submit an application (Par. 896).

2.1.2.3 *Company Voluntray Agreement*

The CVA was introduced with the 1986 *Insolvency Act* and updated significantly in the 2000 *Insolvency Act* (Chapter 39). It is primarily used early in a period of financial distress, where a significant chance of preserving the company as a going-concern exists and typically results in a delay, or a reduction of debt repayments (Nomura, 2010). The procedure is initiated unilaterally by the debtor and is executed in self-administration, unless the restructuring plan provisions for the appointment of an administrator. The latter point hints to the original rational, which sought to provide a quicker and more flexible procedure than the *Scheme of Arrangements* (Westpfahl, 2010). Similarly, unlike the *Scheme of Arrangements* procedure, the 2000 *Insolvency Act* has implemented the possibility of a stay in the *CVA*, if only for SMEs (section 3.3.2.10). The voting mechanism also distinguishes the CVA from the previous procedure. Specifically, creditors are not separated into classes and 75% of all creditors excluding secured creditors are required to approve the plan, unless secured or preferred creditor's rights are affected by the plan. Additionally, shareholders need to improve the plan via a simple majority vote, which may however be overruled (Nomura, 2010). One aspect that complements the structural flexibility of the procedure is its timeliness; for

[31] Frisby (2006) shows that as much as 70-80% of Administrations were pre-packed in 2006.
[32] Compare to the US code, which also provisions a double-criteria, both by value and by number
[33] The securities may also be excercised post implementation of the plan if it did not disenfranchise the securities of the creditors.

instance, upon agreement the creditors need to be given only a 28 day challenge period. This makes the process significantly faster than many of its European peers (Chase Cambria, 2007).

While some structural similarities exist between the *Scheme of Arrangement* and the *CVA*, they are subject to a crucial legislative difference. While the former is based on Company Law, the latter roots in Insolvency Law and falls under the *EC Regulation on Insolvency Proceedings* of 2002. As a result of this, it better lends itself to use by non-UK firms and has been employed by a set of firms which shifted their Center of main interest (COMI) to the UK[34]. This will further be explored in section 3.2 and is illustrated in the subsequent study of the *Wind Hellas* restructuring (section 2.1.2.5).

2.1.2.4 Discussion

As previously explained, the code used to be perceived as implementing a strict enforcement of debt contracts (Franks & Sussman, 2005) and thus primarily benefitting creditors (La Porta, et al., 1998). As has been seen, since the beginning of the 21st century a set of reforms have been implemented that have yielded some highly attractive restructuring procedures for the debtor and have served as a paragon for the reform movement in Continental Europe. These have yielded three distinct processes, suitable for different restructuring needs. In practice, the *Administration* procedure is advantageous especially to effectuate a debt write-down by means of a sale to a new legal shell controlled by current management (see the below case). The use of the *CVA* is a function of its inability to bind secured creditors on the one hand and the benefit of forcing unsecured creditors to vote as a single class on the other. As such it is regarded as a useful tool to restructure this form of debt (see section 3.2.2 for an illustration) . Lastly, the *Scheme of Arrangement* procedure constitutes the primary tool for financial restructurings. As such it is framed by a considerable amount of case law, providing guidance on its use, a significant benefit. Structurally it is supported by its the ability to summon specific classes of creditors, most frequently financial creditors, while leaving trade creditors unaffected. Arguably, this allows for a more normal operation of the day-to-day business during the restructuring procedure.

The variety of procedures may seem complex in comparison to the singular US *Chapter 11* restructuring procedure. With regards to the significant power of the debtor under the US code, the UK procedures all incorporate a few of the debtor-friendly mechanisms, but none provides the entire range. Consequentially, the code, in general, remains less attractive from the viewpoint of the debtor than its US counterpart. As will be seen the converse holds in comparison to the Continental European pre-reform bankruptcy codes. Where Continental European countries have not been quick enough in matching the UK reforms, which arguably best applies to Germany, they have seen financially distressed companies change their COMI to the UK in order to benefit from the code, a strong evidence of its perceived superiority.

2.1.2.5 Wind Hellas Case

The restructuring of Wind Hellas in 2009, then the third largest Greek mobile telecommunications company, was one of the precedent cases in establishing the procedure of the *Pre-Pack Administration,* as described in section 2.1.2.1. It involved the company owners buying back the business without a substantial part of the subordinated public debt. Interestingly, the case also involved a COMI shift from Luxembourg to England, in order to benefit from the procedure, indicating the attractiveness of the procedure.

Wind Hellas at the time was owned by Weather Investments SpA, controlled by Egyptian tycoon Naguib Sawiris, who had purchased it from two private equity firms for EUR 3.4bn (The Telegraph, 2009). The purchase was financed via high yield bonds (originally EUR 925m) and structurally and contractually subordinated PIK[35] notes. Helas II the Luxembourg based

[34] However as illustrated by the La Seda de Barcelona case, access to the *Scheme of Arrangement* procedure can also be achieved by a non-British company (2.2.3.6) .

[35] PIK stands for payment-in-kind, and essentially refers to debt which capitalizes the interest due, such that periods of low cash-inflow can be bridged. It is generally a costly source of financing associated with LBOs (Vernimmen, 2011).

fiancé company controlled Wind Hellas and had issued originally EUR 1170m subordinated notes. With the onset of the crisis Wind Hellas suffered operationally from price competition and a reduction in mobile termination rate and roaming rates (The Telegraph, 2009). On the financial side interest rates were rising. It became apparent that the company needed to cut the level of debt to induce much needed liquidity. Based on Wind Hellas's unaudited financial statements leverage in 2008 was around 9 times[36], the company had incurred significant losses for two years and equity had been entirely used up, and the high interest payments were rapidly reducing cash reserves (Wind Hellas, 2009). The Investment bank *Morgan Stanley* was hired as an advisor in May 2009. Together with the management team in the form of Weather SpA a COMI shift of the holding company Hellas II to England was planned to benefit from the restructuring flexibility under the UK bankruptcy code. (Baker & McKenzie LLP, 2009)

While the operating company was not shifted, a new HoldCo ("NewCo"), Hellas Telecomunications Ltd, was established and a new head office was opened in London. Hellas II was registered as a foreign company and NewCo was given the status of a general partner to Hellas II. Once this had been put in place creditors were informed that the company pursued a restructuring. The legal position of the shift was strengthened further by holding all creditor negotiations in England. As previously noted, the Scheme of Arrangements is not included in the recognized EU insolvency proceedings. However, British Law allows companies access to the procedure if they can proof sufficient "connection" with Britain. This in general is perceived as a low threshold, illustrated by the rather cosmetic changes that Wind Hellas needed to make to gain access to the procedure. (Baker & McKenzie LLP, 2009; Joubert, 2012; White & Case, 2011)

Subsequently, the capital structure was "marked to market" via an auction process. This essentially revealed that the subordinated bond holders were perceived to be out of the money, with the value of the debt shrinking to 20 cents on the dollar. Both Weather SpA as well as junior bondholders submitted a bid for the company. Weather SpA prevailed as it had the support of the majority of senior bond holders, including hedge-fund *OchZiff*[37]. (Baker & McKenzie LLP, 2009; White & Case, 2011)

Once the preference of creditors had been established, the pre-pack administration procedure was initiated. Senior creditors had previously submitted waivers to avoid triggering default with the opening of the procedure. The company was sold for EUR 125m to Weather SpA, which can essentially be seen as an equity injection by the owner. The holder of subordinated and PIK debt were left behind, facing losses on their entire claim to the tune of EUR 1235m. (Nomura, 2010; Joubert, 2012) Figure 1 illustrates the effect of the restructuring.

The case illustrates the power of the procedure in writing off out-of-the money subordinated debt. Section 2.2.3.6 discusses another debt-laden Continental European company (*La Seda de Barcelona*) that sought to benefit from the potential of the procedure.

[36] The leverage ratio is defined as Debt/EBITDA and roughly measures how long the company would need to repay debts.
[37] The creditor structure voting on the bids consisted of senior notes, senior secured loans and a revolving credit facility

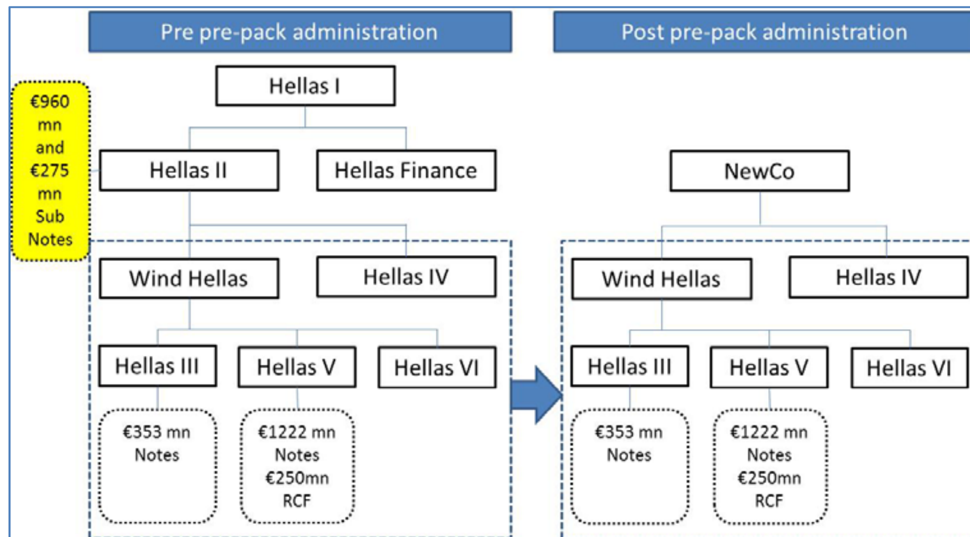

Figure 1, Source: Joubert, 2012

2.2 Review of the Continental European codes of France, Italy and Spain

At the heart of the development of the codes of the major Continental European economies was the realization at the end of the last millennium that the mechanisms provided by the bankruptcy codes at that time were generally inadequate and highly dysfunctional. They generally also resulted in potential criminal liabilities for management, given that the court found fraudulent behavior, including a late filing of insolvency with the court based on a set of, arguably vague, insolvency criteria. Consequentially, company's management often sought to avoid the declaration of insolvency as long as possible, aiming to achieve a private workout instead. Accordingly, by the time insolvency was declared, the going-concern value of the companies had frequently been dissolved below the critical point such that a restructuring could not be achieved anymore and banks would prefer to realize their secured claims via liquidation rather than risk a restructuring. This in turn stigmatized the procedures provisioned in the respective codes as unpractical. By the end of the 90s a European reform movement began that resulted in the gradual transition from a debtor-adverse (and in its very beginning even penalizing) nature of the code towards debtor friendly procedures, aimed at the preservation of the going-concern value.

2.2.1 The French bankruptcy code

2.2.1.1 Prior to the 2005 reform

The French Code traces its origins to the founding of the French Republic and the emergence of the modern French legal system in the 18th century. The code in its current form was originally enacted in 1985 and reviewed in 1994. The primary objective is the preservation of the firm as a going-concern value (Nomura, 2010). The second objective is workplace preservation, a rather unique feature of the code and an aspect that continues to pervade the code (Blazy, et al., 2011). Overall, the code has long been been perceived as one of the most creditor-unfriendly codes, as reflected in a global comparison of the creditor rights by La Porta, et al. (1998). As will be seen, the new procedures implemented under the 2005 reform improved the turn-around possibilities under the code. This has, indirectly, also improved the recoverable amount for creditors (Fried Frank, 2005).

Unlike the Anglo-Saxon codes, the French code defines an alert procedure in which the insolvent firm is criminally liable to alert the *Banque de France* of its insolvent status within 45 days. Insolvency (*cessation de paiements*) is defined via a cash-flow test, which measures whether cash and cash equivalents sufficiently cover ongoing liabilities (Nomura, 2010).

Prior to the reform the code provided only for a very limited pre-insolvency procedures, (*regelment amiable* and *mandat ad hoc)*, which lacked significant power. Consequently, the *redressment judiciaire* (judicial restructuring)*,* a post-insolvency restructuring procedure, constituted the most common court-supervised insolvency procedure (Nomura, 2010). This procedure has in its core remained unaffected by the reform and will be elaborated on below (section 2.2.1.5). Overall, the pre-reform code significantly disfavored creditors and suffered from the impracticability and uncertainty that troubled most of the pre-reform insolvency codes of Continental Europe. This was shown as early as in 1996 by a study by Kaiser (1996) who found the restructuring procedures to end in liquidation 94% of the time from 1987-1993. As outlined in section 1.2.2.2, this ratio was reported to still be around 90% in 2005 (Blazy, et al., 2011). Fried Frank (2005) aptly summarized: "[The French] system was widely seen as overly rigid and time-consuming. Nine out of ten bankruptcies in France resulted in the liquidation of the debtor".

2.2.1.2 Post the 2005 reform

The previously described competitive dynamic resulted in sufficient impetus for the legislator to effectuate a reform of the defunct bankruptcy code, in order to better comply with the primary objective of preserving the going-concern status of the company. Consequently, *la loi de sauvegrade des enterprises*, was passed in 2005 and implemented on January 1, 2006 (Westpfahl, 2010). The reform implemented, as many as four pre-insolvency proceedings[38], discussed below[39]. Additionally, the reform streamlined the liquidation procedure and provided a simplification of liquidations of SMEs, overall amounting to a significant reform (Fried Frank, 2005).

2.2.1.3 *Mandat ad hoc* and *Procédure de conciliation*

The new version of the *mandat ad hoc*, which has only slightly been modified by the reform, is a voluntary agreement between debtors and creditors, under the auspices of a court appointed administrator (*mandataire ad hoc*). In practice the debtor often recommends a restructuring professional who is already familiar with the company (Fried Frank, 2005). The procedure may only be used pre-insolvency, i.e. pre-*cessation de paiements*. Like its predecessor the procedure provisions only limited power to the financially distressed company; it provides neither a stay nor a cram-down mechanism. Consequently, it is frequently necessary to compensate junior debt-holders, typically in the form of equity, to achieve unanimous consent among the parties (Nomura, 2010). Given an agreement can be achieved, no court approval is necessary to validate this. This seeming simplification becomes treacherous once an official insolvency procedure commences, under which the previously made decisions may be questioned (commonly referred to as claw-back actions). As a remedy the *mandat ad hoc* is often combined with a *procédure de conciliation* (Article L. 611-4 et seq., CC[40]).The procedure is available for financially distressed firms prior to legal insolvency. Similar to the *mandat ad hoc*, the court appoints a mediator negotiating an agreement with the creditors. The process is short and informal and may take only five months (Nomura, 2010). The key benefit of this procedure is that the agreement is confirmed by the court, providing legal security from claw-backs in an official insolvency process. The *procédure de conciliation* effectively replaces the pre-reform "legal workout" (Fried Frank, 2005). The procedure is important also because it facilitates an asset sale, similar to the UK pre-pack *Administration* (Assaya & Rotenberg, 2010). The two methods, in combination, have come to play an important role in pre-insolvency procedures (Westpfahl, 2010).

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[38] The *procédure d'alerte* is of minor significance here and will not be discussed.

[39] Notably the 1985/1994 code had also provided for some pre-insolvency procedures, such as the *regelment amiable* (see i.e. Davydenko (2008)). However, they were perceived as largely dysfunctional (Fried Frank, 2005). For instance, the *regelement amiable* provided neither a stay on creditor's claims nor a cram-down mechanism on dissident creditors (Nomura, 2010).

[40] CC stands for *Code de Commerce* (French Commercial Code)

2.2.1.4 *Procédure de sauvegarde*

The safeguard procedure (Arts L. 620-1 to L. 625-9, CC) was one of the corner stones of the 2006 reform, and has been dubbed "a debtors dream" (Joubert, 2012). However, it partly also reconciles the right of creditors, vis-à-vis the status-quo prior to the reform.

The procedure may only be initiated by a company that can prove "insurmountable difficulties that it cannot overcome" (Nomura, 2010). Notably, this applicability criterion has been significantly diluted by a 2008 amendment to the reform and now does no longer require these difficulties to eventually result in insolvency, enhancing the applicability of the procedure. A company that has already become insolvent may not apply and, given that *cessation des paiements* occurs during the procedure, it is transformed into judicial reorganization. (Fried Frank, 2005; Nomura, 2010)

The procedure leaves current management in place, providing the parties up to 18 months to work out an agreement, which may be extended by the court upon request (Art. L. 621-3, CC). During this process management is supervised by an administrator (Arts. L. 622-1, L. 621-4, and L. 622-20, CC), an expert representing the creditors, and potentially up to five creditors as inspectors, which are authorized to bring actions against the creditor (Art. L. 621-9, CC). The latter two points arguably seek to reallocate some of the control over the process to the creditors and reflects the role of the bankruptcy code as a mediator of information asymmetries (section 1.1). Importantly, the procedure is an "entity-rescue" procedure that provides for the continuation of the same entity post restructuring, as opposed to a "business-rescue" procedure such as the *procédure de conciliation*, where in the business may be sold and take a new legal shell. The creditor-unfriendly tradition of the French code is reflected in a comprehensive stay on both secured and unsecured creditors as well as a freeze on acceleration and debt payments (Art. L. 622-28, CC). As under the US Chapter 11, the administrator has the right to reject commercial contracts and leases (Art. L. 622-13, CC). She may, however, not reject employment agreements, as originally provisioned in a draft of the law, which was overcome with heavy opposition (Fried Frank, 2005), reflecting the special role of employee rights (section 1.2.3.2). The restructuring agreement may include changes to the debtor's capital structure, management changes, the sale of assets or entire divisions, although explicitly not the entire business itself, and a demerger of the business (Art. L. 626-1 and 626-3, CC; Fried Frank, 2005).

Given that certain thresholds of the company's size are passed, the agreement is voted on by two committees, of trade creditors and financial creditors as well as bond holders, if these have been issued (Art. L. 622-30 et seq., CC). Notably, this veto-right for bondholders is perceived as an obstacle that might derail proposals agreed upon by financial institutions (SNR Denton, 2011). Importantly parties who purchased bank-debt in the secondary markets are also represented on the creditor committee. This aspect allowed for the emergence of a French distressed debt market. It also made debt-buy-backs an attractive option (Joubert, 2012). Creditors must be convened at least 30 days after filing (Art. L. 626-30, CC) and a restructuring plan must be presented within two months after the convention (Fried Frank, 2005). In contrast to the previously described pre-insolvency mechanisms, a cram-down mechanism has been incorporated into the procedure, 50 percent of the creditors by number, representing two-thirds of the claims, are needed within each class to approve the plan (Art. L. 626-30, CC). In case the plan is not approved, proceedings continue with an individual consultation of creditors on the debt repayment proposals by the court, reflecting a more consensus-oriented attitude towards creditors vis-à-vis the previous code. Additionally, in this case debt forgiveness is excluded. Similarly, the court needs to approve major transactions, providing some protection to undue value extraction from creditors through asset sales or excessive risk taking. Lastly, the court, in its final decision to approve a plan that has found the sufficient agreement of the committees, is obliged to review the plan regarding the fair representation of all creditor's interests, again reflecting the modest counterbalance of creditor control instilled in the procedure. (Fried Frank, 2005)

In the beginning of 2011 the French legislator implemented an evolutionary reform of the *procédure de sauvegarde*, providing a fast-tracked option, the *sauvegarde financière accélérée* (L. 628-1 and L.628-7, CC). This drew from practical

experience and essentially offered an option that would allow a restructuring with financial creditors, while excluding trade creditors from the discussion. Consequently, the trade creditor group is not summoned to vote on the plan and only financial creditors and potentially bondholders vote on the plan. To exclude trade creditors a *mandat-ad-hoc* or a *conciliation* procedure would have previously needed to be employed, both of which lack a cram-down mechanism. The reform anticipated a wave of leveraged transactions that needed restructuring in 2009, the most severe year of the financial crisis.

2.2.1.5 *Redressement judiciaire*

Once the *procédure de sauvegarde* has failed, the court can initiate the *redressement judiciaire,* which is a distinctly post-insolvency in-court restructuring procedure. It is similar to the *procédure de sauvegarde* in some aspects. One difference is that the procedure may also be initiated by a creditor and even the court. Additionally, the court has the discretion to replace management with a receiver or appoint an assistant receiver. Notably, the replacement of incumbent management is the preferred practice in French courts (Fried Frank, 2005). Even though a restructuring is technically still possible under this procedure the legislator clearly sought to make the *procédure de sauvegarde* the prevalent restructuring procedure (Fried Frank, 2005; Nomura, 2010). Given that no agreement can be reached, a sale as a whole or in part may be effectuated (Art. L. 631-22, CC), as described in the next section. The court is charged with taking a final decision if no agreement can be reached after the maximum procedure of 18 months. In general, it must choose for either the debtor's restructuring plan or the purchase proposals of third parties.

2.2.1.6 *Liquidation judiciaire*

Once all other procedures failed, a court-administered liquidation is implemented. The case of liquidation (*liquidation judiciaire*) best reflects the commitment to workplace preservation under French legislature. Administrators are encouraged to effectuate a sale of the entire firm rather than a piecemeal liquidation, which would mechanically result in the termination of the workplaces. Once the company has either been sold as a going-concern or piecemeal, France, as one of few countries world-wide, places employees as the first on the list in terms of attributions from sale proceeds, an aspect which again reflects the creditor-unfriendly nature of the code. As shown by Blazy et al. (2011) this instruction is strictly abided by in practice (Section 1.2.2.2). This finding is further confirmed by Djankov et al. (2008) who find that countries under the French legal code are far more likely to break the Absolute Priority Rule (APR) to the benefit of employee claims.

2.2.1.7 Discussion

Overall the 2005 reform served to significantly strengthen the position of France as a bankruptcy location. By implementing a debtor-in-possession pre-insolvency procedure with an automatic stay France now possesses a procedure that better serves to preserve the going concern of the company and has reconciled the previously significant divide between the parties (Fried Frank, 2005). As illustrated in section 1.2.3.2, it has been found that the high liquidation rates of French in-court restructurings could chiefly be attributed to the entry conditions of the financially distressed firm, rather than a malfunction of the in-court process (Blazy, et al., 2011). Before the background, the implementation of an attractive pre-insolvency procedure seems like an adequate legislative response. Additionally, as shown in section 1.2.4 Davydenko (2008) found that financial creditors, i.e. French banks, could insufficiently adjust for their unfavorable position under the pre-reform code. It may then be concluded that the reform may have alleviated some market inefficiencies as it partly reconciled the position of both parties.

The new procedure to some degree emulates the US Chapter 11 process, chiefly due to the ability of the administrator, to decide over commercial contracts, the "debtor-in-possession" procedure and the forming of creditors committee. Unlike the *Chapter 11* procedure however, the French code stresses the solvency state of the firm and the procedure may only be implemented pre-insolvency. Another difference is that, under *Chapter 11* creditors are separated according to the claim's nature rather than the creditor's nature, as is the case under the *procédure de sauvegarde*. Lastly, the capacity to reject prior contracts does not extend to employee contracts under the French procedure. The strong representation of employee rights

thus remained a constant even under significant regulatory reform. Key to the reform was further the competition with the UK code, in particular with its pre-insolvency mechanisms, especially the *CVA* and the *Scheme of Arrangements*. French legislators have not concealed this competition between insolvency codes and the code has been advertised as a valid and attractive procedure (Westpfahl, 2010). It is notable that, of the European COMI shoppers, none of the financially distressed companies was French.

2.2.2 The Italian bankruptcy code

In Italy, the reform of the outdated 1942 Bankruptcy Act was initiated already in the nineties, but failed for a number of reasons. The reforms were then catalyzed by the Parmalat corporate governance scandal of 2003, based on the immediate need to provide financially distressed companies with greater flexibility in negotiating with their creditors, triggering the Marzano Decree of 2003. The Marzano Decree, in turn, has been credited with catalyzing the review of the ordinary bankruptcy procedure, as it highlighted the antiquated status of the law. The inadequacy of the previous code eventually resulted in two significant reforms.

2.2.2.1 Prior to the 2005 and 2006 reforms

As with its Continental peers, the pre-reform insolvency code of Italy provided procedures, which, theoretically, could have enabled a restructuring, but which in practice rarely achieved this as they were too riddled with uncertainty, in part due to an over-allocation of power to the courts and the administrators, which more often than not were perceived to make economically inefficient decisions (Rodano et al., 2011) a well as a stigmatization of the proess which was readily apprent in its title, *Fallimento*[41] (Maganelli, 2010). This is also reflected in the significant criminal liabilities that could be brought against the debtor upon filing for bankruptcy.

The ineffectiveness of the pre-reform procedures may best be illustrated with the *concordato preventivo,* the prevalent pre-reform in-court insolvency procedure. Firstly, the implementation of the procedure was subject to acceptance by the courts. This acceptance was given if the court found the firm "deserved" the procedure based on the honesty of the firm's management, an arguably highly subjective judgment and a reflection of the social perception of managers of financially distressed firms as untrustworthy and incapable. Secondly, the provided restructuring plan needed to address all secured and forty percent of the unsecured creditors' claims, severely restraining the alternatives for negotiations between the parties and the permissible solutions in the plan. And lastly, as the pre-reform *regelment amiable* in France, the *concordato preventivo*, lacked significant power in that it did not provide for a stay on creditors. In conclusion, the pre-reform code inadequately addressed the problems of financially distressed firms. (Rodano, et al., 2011; Nomura, 2010).

2.2.2.2 After the 2005 and 2006 reform

Unique to Italy the reform process took a staggered form, as the legislator first implemented a reform of the reorganization procedure, and then a reform of the liquidation procedure. In 2005 the *Decreto-Legge 35* aimed at providing a remedy to the most apparent flaws of the restructuring procedures. The main achievements were firstly the limitation of claw-back procedures in out-of-court restructurings, which, similar to France, had constituted the main impediment of this procedure. Secondly, a major reform of the *concordato preventivo* was implemented, and amended with the *Decreto-Legge 169* in 2007 (Maganelli, 2010). In 2006 the *Legge V* reformed the liquidation procedure, significantly increasing the representation of creditor's rights vis-à-vis the decisions of the trustee as well as the order of the priority of claims.

Italian law prescribes a cash-flow test for insolvency. Additionally, insolvency is triggered in case of a fire-sale of assets and when creditors are paid in an unusual matter. Typical for a country with a civil law tradition, the bankruptcy code stresses the

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[41] "*Fallimento*" means "failure" in English

distinction between insolvent and solvent, or soon to be insolvent firms, providing different procedures depending on this criterion.

While an out-of-court restructuring is possible, it firstly requires the unanimous consent of all creditors, which can form an insurmountable obstacle and secondly, can be questioned under a subsequent in court insolvency. Especially the latter point is addressed by two quick and informal pre-insolvency procedures, the *piano di risanmento* and *accordo di ristrutturazione dei debiti*. The *concordato preventivo* provides a more formal pre-insolvency procedure.

2.2.2.3 *Piano di risanamento* and *accordo di ristrutturazione dei debiti*

Article 67 3(d) of the reform introduced a set of out-of-court restructuring procedures, which have emerged as the most frequently used procedure due to the confidentiality and the avoidance of the costs of court procedures (Maganelli, 2010). The *piano di risanamento* is practically independent of any court involvement. It provisions the validation of a restructuring plan by an independent expert, appointed by the company. If both parties agree on the plan it is implemented and only those creditors agreeing are bound by the plan. Unlike the French *mandat ad hoc,* the agreements of the procedure are sheltered from claw-back actions in a subsequent bankruptcy filing, if they form part of the plan and it has been approved by the expert. This approval-based claw-back shelter is primarily aimed at protecting creditors (IFR, 2009), reducing a significant source of uncertainty vis-à-vis the pre-reform code.

Unlike the previous procedure, the *accordo di ristrutturazione dei debiti,* regulated by Article 182*bis*, requires court-approval and needs to address at least sixty percent of all creditors (IFR, 2009). Creditors not party to the agreement remain unaffected by it (Maganelli, 2010). The procedure essentially prescribes that an agreement between the parties be found, which, accompanied by an expert report on its feasibility, may then be validated by the court. The agreement, as well as its potential approval, needs to be filed in the company's registry, such that confidentiality is only kept during the initial discussions with the creditors. Importantly, the procedure provides a stay on creditor claims, even before the plan is filed[42] and also precludes claw-back actions. It has gained in importance since 2009 due to both the onset of the financial crisis as well as the ruling on *Risanamento SpA*, which essentially established that the filing may be granted priority to ordinary bankruptcy filings (Nomura, 2010; Maganelli, 2010). Its primary use has been for small companies with a limited and simple creditor structure, allowing negotiations with each single creditor (Maganelli, 2010).

2.2.2.4 *The concordato preventivo*

While the review of the previously discussed informal insolvency procedures formed the first pillar of the 2005 reform, the pre-insolvency agreement (*concordato preventivo*[43]) was the second pillar. Of all procedures, this one bears most similarity with the US *Chapter 11*. It is employed where both the *Piano di risanamento* and *accordo di ristrutturazione dei debiti* would be ineffective (Maganelli, 2010). The procedure is only available to companies passing certain size thresholds and prescribes that the debtor be in a state of "financial distress", a broader prerequisite than the insolvency requirement (IFR, 2009). A key change to the procedure is that only the debtor may apply for the procedure. As with all Italian pre-insolvency procedures the filing of the plan needs to be complemented by the evaluation of an independent expert. The debtor, upon approval of the application (*omologazione*), continues to run the company under a stay on creditor's claims (Nomura, 2010) and the auspices of a court-appointed judicial commissioner (IFR, 2009). The filing is made with the court, where the firm has its registered office. Office shifts that have occurred less than a year after filing are considered irrelevant now (IFR, 2009). The reform has removed some significant restrictions of the plan, such that it may now prescribe a large set of actions to achieve a restructuring, including the compensation of restructured creditor claims with shares or other financial instruments. The proposed plan is voted on by creditors in the creditor meeting. Depending on the debt structure classes of creditors can be

[42] This last point is due to a recent amendment, Law Decree no. 78, which came into effect in 2010 (Maganelli, 2010).
[43] Article 160 and following of Italian Insolvency Law

devised, according to economic interests. The delineation of creditors may however not counter the legal priority treatment. Secured creditors may be affected by the plan and consequently vote on the plan to the extent that their claim is affected. To pass the plan, the majority of creditor classes needs to accept it. Within a class, a majority is obtained from the majority of the claims admitted to vote in each class. If a majority can be found, the court approves the plan, given that the plan is feasible and a dissenting class of creditors does not receive less than under "any other practicable alternative". This constitutes a significant cram-down mechanism differentiating the procedure from the informal procedures. The *concodrato preventivo* further stands out due to its ability to reduce payments to secured creditors to the market value of the secured assets (Maganelli, 2010). Finally, claw-backs are largely precluded and the procedure allows for super-priority financing of bank loans and eighty percent of shareholder loans. (Maganelli, 2010; IFR, 2009).

2.2.2.5 *Concordato fallimentare* and liquidation

Upon declaration of bankruptcy the Bankruptcy agreement (*concordato fallimentare*) allows for a court-administered restructuring process. It mirrors the French *redressment judiciare* – the company loses control and a court-appointed trustee produces a restructuring plan, which is voted on by creditors. Assent of the plan requires a majority of creditors in number representing two-thirds- of the claims in value within in each class and among all creditors. Unlike any of the other countries under review, Italy ascribes the fees of the liquidation procedure the highest rank in the payout list (Articles 126-141, *Codice de la Lege Fallimentare*), encouraging creditors to contribute to time-efficient proceedings (Maganelli, 2010).

2.2.2.6 *Amministrazione Straordinaria – Prodi* and *Marzano*

The *Legge Prodi* of 1979 was the first reform of the Italian code, providing an Extraordinary Administration procedures for large companies, aimed at preserving the entity or the business of the firm to mitigate the economic consequences of such corporate failures. In practice, however, this objective usually failed and resulted in liquidation (Maganelli, 2010). The complex and sizeable failure of *Parmalat* in 2003 resulted in the creation of an additional extraordinary procedure, the *Legge Marzano*, passed in 2004. After its initiation, and immediate utilization by *Parmalat*, the law has evolved according to the specificities of the subsequent dominant Italian restructuring cases, such as *Alitalia* in 2008. Based on the current code, *Prodis* apply to companies of more than 200 employees where total indebtedness exceeds two-thirds of the assets and the revenues of the previous fiscal year, while *Marzanos* address firms employing more than 500 employees, where debts exceed EUR 300m. Of the two, *Marzanos* are more relevant for large corporate restructurings (Nomura, 2010) and will briefly be reviewed.

The procedure is filed with both the appropriate court as well as the Minister of Economic Development. The latter appoints an Extraordinary Administrator who is charged with presenting a restructuring plan within 180 days. The goal of the preservation of the firm is prevalent in the procedure in several ways; a comprehensive stay on both secured and unsecured creditors is initiated, claw-backs can be prevented by the administrator and post-insolvency financing is given priority ranking and a cram-down mechanism by creditor majority, either in classes or as one group is provisioned (Nomura, 2010). These strongly workout-oriented aspects illustrate the departure from the punitive Italian system (Maganelli, 2010) and the significant discrepancy with the pre-reform bankruptcy procedure for ordinary firms that led to the subsequent reform of the ordinary bankruptcy process. Unlike some of the previously discussed procedures however, the administrator replaces current management, an aspect that can be traced back to the *Parmalat* bankruptcy which was driven by extensive fraudulent behavior of management.

2.2.2.6 Discussion

With the *Decreto-Legge 35* Italy devised a powerful restructuring procedure. It is striking that the reform of the restructuring procedures was passed in the same year as the French *procédure de sauvegarde*, with which it bears significant resemblance. Both countries seem to have aimed at preserving competitive parity in terms of their attractiveness as insolvency locations. Especially the *concordato preventivo* emulates to a large extent the key aspects of US Chapter 11 proceedings, such as the

unilateral application by the creditor, the debtor-in-possession management of the distressed firm and the stay on creditor's claims (Maganelli, 2010).

As found by Rodano et al. (2011) the reforms both had a notable impact in that the number of in-court restructurings increased and the average duration of the liquidation process decreased[44]. As discussed, the authors of the study show that the efficiency gain resulting from a speedier liquidation was passed on from the creditors to the economy via lower lending rates, illustrating the economic gains a more efficient insolvency code can provide.

In spite of subsequent amendments a set of criticisms remain, which mainly relate to inconsistencies between the new procedures, both the *concordato preventivo* and the *extraordinary procedures*, and the ordinary bankruptcy procedures. For instance, Maganelli (2011) points out that new credit extended under an Article 182*bis* restructuring could be treated as an unsecured claim in a subsequent ordinary restructuring, hindering the willingness of creditors to collaborate. In line with the conclusion of the author, it can be argued that, while the reform has *prima facie* provided the legal structure to significantly improve the defunct nature of the Italian insolvency landscape, it depends on the willingness of practitioners to take the risk to use these procedures, such that legal inconsistencies can be clarified via court rulings. As evidenced by Rodano et al. (2011), which find the use of opened restructuring procedure rise from one percent of total procedures in 2005 to over 10 percent in 2009, this willingness seems apparent among Italian practitioners.

2.2.3 The Spanish bankruptcy code

Spain bears some significant similarities with Germany in terms of the bankruptcy landscape as well as in lending practices, as banks hold a dominant position in the provision of debt and loans are typically secured. Due to the significant prevalence of secured bank lending, Spain, for a long time, was perceived as one of the most debtor-unfriendly insolvency regimes among the codes under review (Pallares, et al., 2012; Alonso & Madrid, 2007). Additionally the pre-reform bankruptcy of the code was perceived as "notoriously chaotic and inefficient" (Celentani, et al., 2012).

The *ley concursal* of 2004 sought to provide a reform that, like Italy and France, aimed at better preserving the going-concern of (potentially) insolvent firms. However, it was perceived as being far too timid and inferior to other bankruptcy codes, in particular to the UK (IFR, 2009). Critics saw this confirmed in the high rate of liquidations and the low rate of bankruptcy applications of, reflecting the low level of trust firms instilled in the code (Celentani, et al., 2012). A COMI shift that received much popular attention further underlined this perception, and will round of the analysis of the Spanish code (section 2.2.3.6). Spanish legislators have been responsive to these critics and have implemented two reforms, in 2009 and 2012.

Under the Spanish code insolvency is diagnosed via a cash-flow test, judging whether liabilities can be met on an ongoing basis. A declaration of insolvency needs to be filed within two months (Nomura, 2010). A 2009 reform has provided the court with the option to provide a three month moratorium if the financially distressed debtor notifies the court. This option is available to both solvent and insolvent firms. The 2012 reform has extended this period to four months and explicitly confirmed the validity of the moratorium (5*bis* of the SIA[45]). This seeks to provide breathing-space for the debtors' discussion with its main creditors. Before the amendment of 2009, unsecured creditors had sometimes filed for in-court insolvency while the discussions were still ongoing in order to exert pressure on the parties (Alonso & Madrid, 2007).

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[44] Rodano et al. (2011) find the ratio of restructuring procedures to total procedures to increase from 1% in 2005 to 10% in 2009. At the same time the percentage of liquidation procedures finished within 18 months increased from 2% to 25% after the reform.

[45] SIA stands for Spanish Insolvency Act

2.2.3.1 *Concurso de acreedores*

The Spanish insolvency code provisions a single-entry point for in-court insolvency proceedings, the *Concurso de acreedores* that can be initiated bilaterally, and must be filed within two months upon insolvency[46] (Nomura, 2010). Celanti, et al. (2012) report that 87% of filings are initiated by the debtor[47]. Debtors can dispute the rare filings for insolvency by a creditor in a hearing in court. The courts involvement is to a large extent reduced to deciding whether to initiate the procedure based on an insolvent or nearly insolvent state of the firm. One key criticism of the filing procedure is the excessive focus on "legal certainty", referring to the detailed report on the debtor's assets and liabilities as well as its creditor structure, required at the opening of an in-court-insolvency process. As previously described this is a reflection of the civil law tradition in Continental Europe, stressing compliance with the "written word" of law (Fernandez, 2009). Interestingly, creditors are incentivized to actively monitor the financial situation of the debtor as the first creditor to launch the procedure will receive an upgrade of its claim to privileged status. The 2012 amendment has raised the proportion of this creditor's debt from 25 percent to 50 percent. (Pallares, et al., 2012)

The administrator is charged with producing a report on the company within one month, the common period. Based on this report the creditor committee then either decides that a restructuring or liquidation should be pursued. A simple majority of unsecured creditors at the meeting needs to be present for it to be relevant. The prevalent role of unsecured creditors arguably illustrates the attempt of the code to shelter this group from the dominant and liquidation-oriented secured creditors in the Spanish system. If the creditor committee votes in favor of a restructuring during the creditors meeting based on the report provided by the administrator, a restructuring proposal can be provided via two procedures, the *Convenio Anticipado* and the *Convenio Ordinario*. 97% of plans are initiated by the debtor (Celentani, et al., 2012). If a restructuring is not supported by a majority vote, the liquidation process is initiated.

With the opening of the procedure an automatic stay on unsecured creditors occurs and interests cease to accrue until the end of the process. Progressively, reforms to the code have extended this stay also to secured creditors. The court may now stay secured creditors over assets that are integrated in the production process of the firm for a period of one year. This stay applies to both the common period as well as the subsequent restructuring procedure. The significant power of creditors has also been reduced with regards to the control over the procedure, which now allows for a self-administration mechanism. Prior to the 2012 amendment, this was carried out under the auspices of three administrators, consisting of a lawyer, a representative of unsecured creditors and an economists. This has now been limited to one creditor, the specialization of which is at the discretion of the court.

A key aspect of the 2009 reform was the limitation of claw-backs regarding refinancing agreements. This addressed a key point of criticism of the 2003 code. Celantini et al (2012) report that especially after a few cases in which courts had eliminated the securities granted to financial creditors, the financial sector reacted alarmed. The prevalence of bank-debt on corporate balance sheets explains why the 2009 reforms addressed the concerns of this essential source of finance. The 2012 amendment continued along the same evolutionary lines, providing more certainty on the limitation of claw-backs. Essentially, a refinancing agreement may not be challenged if its impact is "substantial" and it is executed by creditors whose claim represents 60 percent of the company's liabilities, effectively precluding the residual 40 percent of creditors from challenging the agreement post the agreement.

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[46] The court may then extend this period for another three months to allow discussions to continue
[47] Based on the *Consejo General del Poder Judicial*

2.2.3.2 *Convenio anticipado* and *Convenio ordinario*

The *Convenio anticipado* constitutes a quick procedure that provides a plan composed either by at least 20 percent of the unsecured creditors by the end of the common period[48] or by the debtor[49]. The plan may include practically any restructuring mechanisms. Additionally, the 2012 amendment has implemented a US-type "DIP-financing" mechanism: Half of the amount of "fresh money" is now provided with a claim on the debtor's estate and half of it is ranked as privileged debt (84.2.11 of the SIA, Pallares, 2012).

If no *Convenio anticipado* is proposed, or can be agreed on, the *Convenio ordinario* procedure sets in at the end of the *common period*. Under this procedure both the debtor, as well as creditors holding at least 20 percent of debt at the end of the *common period,* propose a plan. Importantly, the plan is more restricted in its restructuring mechanisms – it may not include a change of priority of creditors, a debt write-down in excess of fifty percent of an unsecured creditor's claim or debt cancellations beyond five years.

An often lamented shortfall of the 2003 reform was its failure to implement a cram-down mechanism. Like the lack of the claw-back preclusion it can be explained with the prevalence of bank-based debt which helped to mitigated creditor coordination problems (see section 1.1). In practice, this turned out to be a major weakness of the code, perhaps best illustrated by the COMI-shift of *La Seda de Barcelona* to the UK due to the inability to overrule a small percentage of dissident trade creditors (section 2.2.3.6). Even the 2009 reform failed to address this and only the 2012 amendment instituted a cram-down mechanism, allowing 25% of financial creditors to be overruled if a majority in excess of 75% of financial creditors by value can be found (the same percentage as the competing UK *Scheme of Arrangement*). Notably, *in rem* creditors[50] cannot be overruled, fortifying the position of financial creditors, which have established secured lending as a prevalent practice in Spain. Court approval is needed for any agreement overruling dissident creditors. The court is to impose the agreement unless it implies a "disproportionate sacrifice"[51] on the financial creditors. With the court approval of the plan a three year stay on enforcement actions is provided. (Art. 198 *Ley 38/2011*)

Historically, distressed debt investors, who had acquired debt post the onset of the procedure did not have a right to vote on the plan, an aspects that was linked to the lack of a Spanish distressed debt market (Nomura, 2010). As before, the legislator has corrected this with the passing of the most recent reform. The forfeiture of voting rights of the buyer of distressed debt post insolvency filing has been abolished such that the buyer of the distressed debt retains the right to vote on the restructuring plan, effectively providing access to distressed debt investors pursuing a "loan-to-own" strategy.

2.2.3.3 Liquidation

If the creditor committee votes against a restructuring, the administrator devices a liquidation plan. As in France, the focus of the liquidation is on preserving the going-concern value of the firm by effectuating a sale of the firm rather than a piecemeal liquidation. The proceeds are first allocated to *créditos contra la masa*, consisting of legal costs, administrator's fees, DIP debts and a limited amount of wages. Subsequently the claims of incumbent creditors are addressed (*créitors concursales*). Privilege is given to secured creditors, who may satisfy the part of their debt that is not covered by a security out of the remaining asset pool as well as a limited amount of wages. Ordinary and, subsequently, subordinated claims rank only after the privileged claims. Again, the 2012 amendment has reformed this process through a set of new regulations which by and large help to speed-up the liquidation process, partly by reducing the amount of authorizations needed by the court to implement asset sales. (Pallares, et al., 2012; Nomura, 2010)

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[48] Or 10 percent, if the plan is filed at the beginning of the period.
[49] Based on a 2009 amendment of the law
[50] Creditors which are secured via a mortgage or a pledge
[51] "*Sacrificio desproporcionado"* (Art. 198, Par. 3, *Ley 38/2011*) in Spanish.

In case of liquidation, the court, upon inspection of the liabilities of the debtor, may rule management to be criminally liable, resulting in the preclusion from leading a company, payment of damages and even the obligation to fulfill unmet claims of creditors. These charges could come on top of procedures for criminal behavior such as embezzlement and fraud.

2.2.3.4 Discussion

As in Italy, the first reform was ambitious but suffered from a set of shortfalls that kept it from significantly changing the liquidation biased nature of the Spanish bankruptcy landscape. The inertia in the adoption of the new code could in part be attributed to the prevalence of bank debt in corporates' capital structures, as previously discussed. To the benefit of the current code however, practitioners have not hesitated to voice their criticism of the code, which was given further urgency by the particular severity of the crises in Spain. This resulted in a peak of bankruptcy filings, driven by the combination of a large number of leveraged transactions and the global financial crisis (Appendix A). This pushed the newly created specialized bankruptcy courts to the capacity limit and necessitated some significant simplifications of the code. The continued economic crisis also triggered the 2012 reforms (Celentani, et al., 2012). As has been shown, the 2009 and 2012 reforms have addressed key issues of concern in the structural deficits of the code, a perception shared by practitioners (Pallares, et al., 2012).

The adoption of the code may further be fueled by the precarious state of the Spanish economy. Additionally, the code has implemented steps to counter the habit of "lazy-banking", as coined by Franks and Sussman (2005), in which the dominant banks do not engage in active monitoring of its debtor due to the secured nature of their claim. As indicated by the high liquidation rate and anecdotal evidence, this was a prevalent habit prior to the reform (Celentani, et al., 2012). The significant upgrade of the debt tranche that the first filing creditor receives, incentivizes active monitoring, and may increase the use of insolvency procedures.

2.2.3.5 La Seda de Barcelona Case

La Seda de Barcelona (LSB) engages in plastic containers and PET resin manufacture. With the onset of the financial crisis in 2008 and competition from the Far and Middle East the highly leveraged company saw its operational performance deteriorate significantly. To aggravate the situation, accounting irregularities were found, resulting in a write down of EUR 550m EBITDA in 2008[52]. Debt at this point exceed EUR 1bn. In 2009, the firm breached the covenants on its EUR 612m senior facility. The group subsequently appointed *Carlos Gila*, a leading Spanish restructuring specialist, who in turn hired *BT&T*. The experts began restructuring talks with its 54 member bank syndicate headed by *Deutsche Bank* and *HSBC* and various bilateral holders including regional banks and hedge funds. The team working on the restructuring realized that an out-of-court agreement was not likely to be achieved. This was due to a group of dissident bank creditors standing in the way of the 100% senior creditor consent, which would have been required under the Spanish code (prior to the 2012 reform). Instead, the company could obtain only a 80% majority in favour of the plan. Additionally, the previously described uncertainties surrounding out-of-courts agreements under the pre-reform Spanish code further questioned the viability of a restructuring in Spain. Instead, the team determined that the ideal procedure would be the UK *Scheme of Arrangements*, due to its extensive use and flexibility and in particular its cram-down mechanism. (La Seda de Barcelona, 2011; Nomura, 2010; La Seda de Barcelona, 2010)

To obtain the right to restructure under the *Scheme of Arrangement* it was reasoned that, due to the subsidiaries of LSB in the UK and the composition of the legal documents in English, there was sufficient "connection" with the UK – the required criterion, given that the chosen procedure is not part of the EU framework[53]. The UK High Court agreed with this reasoning,

[52] EBITDA stands for earnings before interests, taxes, depreciation and amortization
[53] Compare with the *Wind Hellas* case

allowing the crucial access to the procedure. With the help of the cram-down mechanism, the plan could be approved[54]. It transformed the EUR 612m senior facilities into a EUR 236m senior loan with a modified repayment schedule over eight years, starting in the third year, a PIK branch of EUR 226m repayable in three annual payments as of the fifth year by an amount based on average historical annual EBITDA and net debt, a EUR 117m debt-to-equity swap at a EUR 0.1 per share subscription price and a EUR 33m cash payment on the loan. The debt-to-equity swap included an issue of EUR 300m new capital, of which EUR 117m were allocated to creditors providing them with a 32.3% stake[55]. Overall, the restructuring provided LSB with crucial breathing space as can be seen in the right-hand panel of figure 2. The left-hand panel illustrates the effect of the restructuring on the capital- and ownership structure (La Seda de Barcelona, 2011; La Seda de Barcelona, 2010).

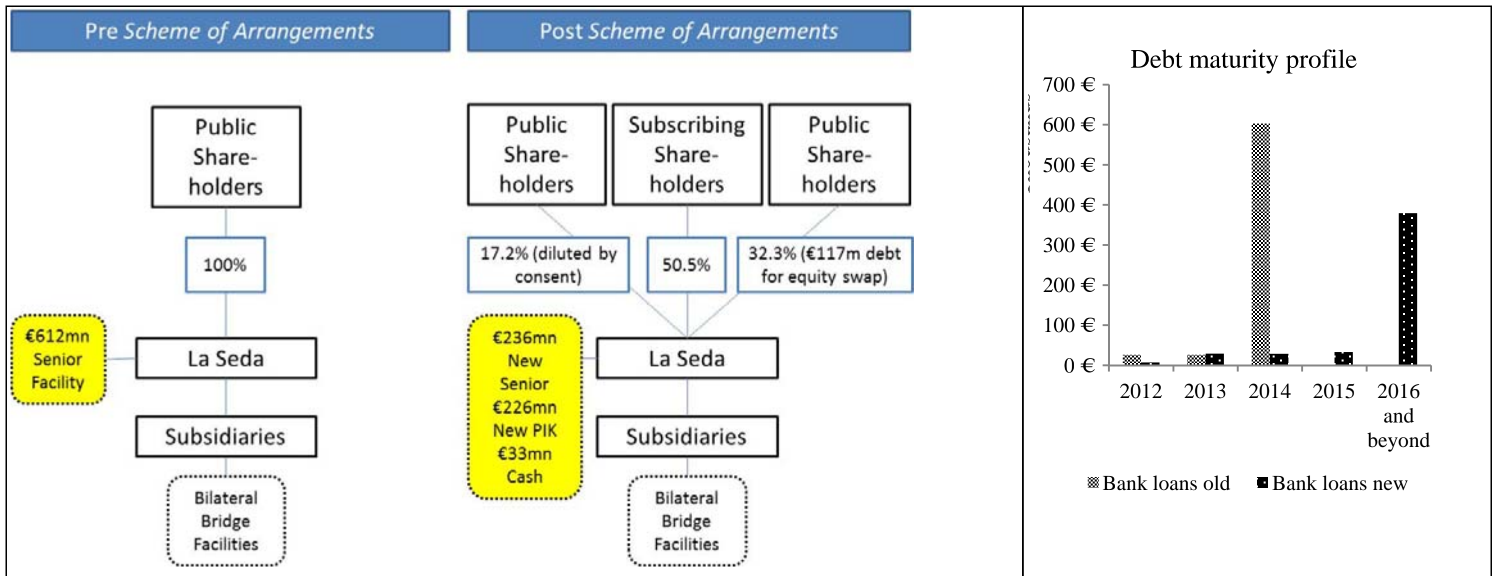

Figure 2, Source: Joubert, 2012; LSB Annual Reports 2009, 2010 and 2011

The restructuring illustrates the relative ease with which Continental European companies can achieve such a shift of jurisdiction, especially when owning UK subsidiaries. It can further be credited with contributing to the eventual incorporation of a cram-down mechanism in the Spanish code with the 2012 amendment.

Chapter 3 - The German bankruptcy code

This chapter will first analyze in-depth the 1999 *Insolvenzordnung*, highlighting its main flaws. These contributed to a set of German "COMI-shoppers" which will be analyzed in the second section. The third section will analyze the 2012 reform of the code and frame it in the previously discussed current insolvency landscape of major European economies.

3.1 The German bankruptcy code before the 2012 reform

3.1.1 The prevalence of out-of-court restructurings

Based on the 1999 *Insolvenzordnung*, financially distressed companies may restructure out of court if they are solvent or have been insolvent for less than three weeks and if full creditor consensus can be obtained. The prevalence of bank-lending, which in Germany is typically provided by one main bank (*Hausbank*) or a bank pool headed by this main bank, simplifies an

[54] 95% of creditors eventually voted in favour of the plan

[55] Share capital was written down via reserves and a capital decrease to EUR 63m. EUR 300m were raised by a capital increase, of which EUR 177m were allocated to creditors and the rest was paid for in cash-contributions.

out-of-court restructuring process due to the limited numbers of parties involved, as previously discussed[56] (section 1.1). Catalyzed by the perceived unattractiveness and apparent ineffectiveness of the bankruptcy code, the vast majority of successful restructurings consequently occurred out-of-court; Jostarndt and Sautner (2010) report that only 0.4% of all in-court insolvencies resulted in restructurings over the period from 1999-2004 according to data from *Creditreform Datenbanken*. Similarly, among the study's own sample of significantly larger public companies in a timeframe from 1997-2004 only 16% of firms survive in-court restructuring. As shown in Appendix A, only a small fraction of insolvency procedures are filed by large firms such that the overall rehabilitation rate of in-court processes will be closer to the *Creditreform* figure. On the other hand, studies taking into account both out-of-court and in-court procedures find turnaround ratios around 50% (Jostarndt & Sautner, 2010; Davydenko & Franks, 2008). The crude difference in the numbers clearly illustrates that an out-of-court agreement was the first choice of German corporates to achieve a successful restructuring.

As has been seen in the previous chapter, the cases of other Continental European countries are comparable here as bank-based economies with a civil code tradition[57]. Spain in particular bears similarity due to the especially strong dominance of bank finance and a rigid and ineffective pre-reform code. Notably however, German banks have been shown to be more willing to restructure (Jostarndt & Sautner, 2010; Brunner & Krahnen, 2008), whereas Spanish banks historically have preferred liquidation (Celentani, et al., 2012). One explanation may lay in the high fraction of Spanish secured debt, inducing "lazy-banking" of Spanish financial creditors, although the German proportion of secured debt is found to be almost as high (Celentani, et al., 2012). Other aspects, such as the close relationship which German corporates have traditionally cultivated with their main bank, as well as *ex-ante* coordination via bank pools may provide an answer here (Brunner & Krahnen, 2008).

3.1.2 The preliminary process

If full creditor consent could not be obtained or the company had become legally insolvent, in-court proceedings had to be initiated. The old, as well as the new code prescribe two insolvency tests. The first one is a cash-flow test that triggers insolvency upon failure or impending failure to adequately service debt payments (§ 17, *InsO*[58]) or the likelihood that failure to service debt payments will occur (§ 18).This test is similar to Continental European peers. The last (and much rarer one) is a balance-sheet based test for over-indebtedness[59] of the firm (§ 19), an article that is unique in Continental Europe. Eroding asset values in the wake of the 2009 financial crisis forced the legislators to pass a law that significantly diluted the article and now precludes the insolvency trigger if "the survival of the firm is largely probable"[60] (§ 19, sentence 2). While the amendment was initially designed to be temporary, lasting until the end of 2013, the legislator made this contingent upon an evaluation survey of practitioners, which is reported to show large support for the permanent implementation of the amendment or even the entire eradication of § 19 (Jahn, 2012). Consequently, the relevance of § 19 has been increasingly limited. If the financial situation of the firm has decayed past a state in which assets could unlikely cover the costs of bankruptcy proceedings the filings were rejected (§ 26). The article primarily affects small firms (Westphal, 2010; see also Appendix A). Lastly, of the codes under review Germany prescribes the strictest notice period of only three weeks upon breach of one of these criteria under criminal liability (*Insolvenzverschleppung* according to § 15a)

Prior to the most recent reform, an insolvency filing resulted in a preliminary process beginning with the appointment of a preliminary administrator, who investigated whether the company met the insolvency requirements. Notably, the court had final discretion over the appointment of the preliminary administrator. The review process could take up to three months and

[56] See Behr and Güttler (2007) for some further impacts of the *Hausbank* principle especially on SME's in Germany

[57] Following the typology of Antoniou et al., (2009) this group stands opposed to capital-based economies with a common law code, exemplified by the US and the UK

[58] Unless otherwise specified all subsequent articles refer to the German insolvency law (*Insolvenzordnung*) which can be accessed online via: http://www.gesetze-im-internet.de/inso/

[59] Over-indebtness is defined as a situation where liabilities exceed assets.

[60] *"…die Vortführung des Unternehmens [ist] zu Grunde zu legen, wenn diese überwiegend wahrscheinlich ist."* (§ 19, sentence 2)

the filing could be disputed by the debtor if it was initiated by the creditor. The process prescribed a set of regulations that, at their heart, attempted to freeze the operative and financial situation of the debtor to allow the court sufficient time to determine the appropriate proceedings (§ 21). Of these procedures the crucial ones were first that the preliminary administrator could either supervise management or take control (respectively a weak or a strong administrator), a decision which was at the discretion of the court. Additionally, during this period a stay on creditors could be imposed by the court, including secured creditors. While this specifically excluded executions of immovable securities, these can be stayed by an order of the court upon application by the preliminary administrator (Gottwald, 2010). The last point is of importance as mortgages are the primary security of bank lending (Nomura, 2010; Jostarndt & Sautner, 2010).

The significant uncertainties of the 1999 code are already well reflected in the preliminary process. Just for the establishment of conformity with the written law a significant amount of time was used up. As has been seen this contrasts with Germany's Continental European peers which, in general, started to follow the Anglo-Saxon example, simplifying the procedural aspects around the entry requirements or implementing procedures practically devoid of entry condition (i.e. the French *procédure de sauvegarde* or the Italian *concordato preventivo*). The code further allows the debtor to appeal a filing, which has been linked with reducing the overall efficiency of bankruptcy processes (Djankov, et al., 2008).

3.1.3 Insolvency procedure - *Insolvenzverfahren*

Once proceedings were opened, the court appointed an administrator, who could replace the preliminary administrator. While both debtors and creditors were consulted, the court made the final decision. With the appointment of the administrator management was no longer in control. The blatant lack of control in the appointment of both administrators, who could even be different people, was one of the key criticisms launched against the code[61] (Westpfahl, 2010). While the 1999 reform also allowed for management to petition to remain in place, this rarely ever occurred (Nomura, 2010; Jostarndt & Sautner, 2010). The *IhrPlatz* restructuring of 2005 constitutes a prominent yet isolated exception (section 3.1.5).

A stay on unsecured creditors (as defined in §§ 38 and 39) was implemented, but secured creditors generally could enforce claims against immovable assets and movable assets in their possession unless the court imposed a stay upon request of the administrator (Nomura, 2010). As mentioned in section 2.2, a universal stay is imposed in France and Italy and the UK[62]. Germany's situation prior to the reform is again most comparable to Spain, where the claims of the powerful banks were also left untouched with the 2004 code. Even here, however, the legislator has over time implemented reforms allowing secured creditors to be stayed based on the courts discretion.

The administrator maintained the company until the first creditor's meeting. A set of mechanisms have been put in place to ensure the company remains operational until the creditor's meeting. These generally are perceived as the (limited) turnaround-friendly aspects of the code (Westpfahl, 2010; Nomura, 2010), and have not been altered with the current code; Firstly, the state secures employee wages for the first three months (§ 183 *SGB*[63]). The special role of employee claims resembles France to some extent. However, the German mechanism ensures that the APR is left intact, unlike the case of France (section 2.2.1.6). Another difference is that the German code extends the privileged termination of commercially unviable contracts to employee contracts (§§ 113 and 120-128). As its European peers, the German code allows for post-insolvency financing, which is applied for by the administrator and recives priority over existing claims (§55). Notably however, the objective of this mechanism is to avoid the coming to halt of the companies daily proceedings. Large new loans to finance new investments, such as under the *Chapter 11* procedure, are generally not provided by lenders (Westpfahl, 2010).

[61] Westpfahl (2010) quotes Rattunde (2003) who stated: "German in-court insolvency proceedings are like a life-threatening operation with a randomly assembled operating team"
[62] In the case of the *Administration* which bears most similarity with the German in-court restructuring process.
[63] SGB stands for *Sozialgesetzbuch* (German Social Insurance Code)

The creditor meeting decided and still decides either upon restructuring or liquidation. Creditors are divided into groups according to economic interests (§ 222). These must include groups for the secured creditors (§§ 49 – 51), given their rights are affected by the plan, the non-subordinated creditors (§§ 38, 52) and subordinated creditors (§ 39) unless their claims are considered void (§ 225). Creditors at the same legal position may be grouped, based on criteria defined in the plan. If employee claims are significant, the formation of a special group is also prescribed for them.

Within a class a simple majority by value and by number was, and is, needed to achieve a vote and generally the agreement of all groups was needed to accept the plan (§ 244). However, given that a single group did not consent to the plan, this group could be overruled by the court if none of the creditors within the dissenting creditor class were either allocated a share of the economic value in excess of the original claim or was treated worse than in a liquidation scenario (§ 245). The debtor had the right to be heard but could be overruled on the same grounds as dissident creditor classes (§ 247). Given that a going-concern restructuring plan would almost mechanically imply a higher value than liquidation, the control of the debtor was small in this respect.

3.1.4 Key shortfalls of the 1999 Insolvenzordnung

While the 1999 *Insolvenzordnung* made a tentative transition from a mere administration of liquidation proceedings towards the more Anglo-Saxon understanding of bankruptcy as a turn-around opportunity (Nomura, 2010), it would be a fallacy to consider Germany the pioneer of the reform process across Europe. Similar to the previously discussed Continental European cases, a general flaw pervading the procedure was that the court and the court-appointed trustee held significant control over the insolvency process, resulting in a perceived impracticability and uncertainty for both incumbent management and creditors at a sensitive point in the firm's history, aggravated by the previously mentioned perceived lack of expertise by the courts.

The tedious and time-consuming preliminary process, the lack of a stay on secured creditors, the *de facto* lack of DIP financing and the significant authority that the 1999 code vested in the courts have already been discussed as aspects that contributed to the negative perception of Germany as an insolvency location. This was aggravated by a set of further shortcomings, as subsequently discussed.

Out-of-court restructurings, the clear majority of restructurings, were fraught with a set of limitations in their practicability. First, the administrator had large authorities to modify existing contracts given bad faith could be shown (*§§ 103–147*) such that certain parts of pre-insolvency restructuring agreements could be challenged upon filing of in-court insolvency proceedings. As such, the buyer of distressed assets, purchased as part of an out-of court restructuring could find this transaction and his ownership of these assets challenged upon official insolvency proceedings (*§§ 129–147, Insolvenzanfechtung*). Before agreeing to a purchase, potentially interested buyers thus were incentivized to hold out for the opening of the significantly more liquidation biased in-court procedure. Secondly, the provision of new senior debt for a financially distressed company could render the financial creditor liable to other creditors if the financing benefited the bank due to a delay of the insolvency filing (*§§ 17-19, Insolvenzverschleppung*). Similarly, creditors' claims could be subordinated (*Eigenkapitalersatzregeln*) and even face criminal liability if the court found them to have provided debt when a "prudent and reliable" capital provider would have provided equity (*§§ 39 I No. 5* and *135 InsO*). (Westpfahl, 2010)

These significant risks illustrate that the out-of-court restructuring as the prevalent turn-around procedure in Germany required a strong degree of trust and consent among the different creditor parties as well as the debtor. Brunner and Krahnen (2008) show that bank-pools play a key role as a coordination device to achieve *ex-ante* efficient outcomes. As will be shown in section 3.2 however, the rising complexity of corporate capital structures increasingly inhibits that sufficient lender coordination could be attained in a private setting.

While the cram-down mechanism compares favourably with the other codes under review, Jostarndt (2010) reports anecdotal evidence that administrators were extremely cautious of its use, especially in the years following the implementation of the 1999 code. This was partly because they were used to the pre-1999 proceedings and partly because overruling dissident creditors to achieve a restructuring was more risky to them, as their personal liability of fulfilling the fiduciary duties increased if a restructuring was effectuated.

Another deficit of the code is reflected in the limitations regarding the insolvency plan. Most importantly, shareholders stakes could hardly be altered as result of the plan. The typical transfer of creditor claims into shareholder stakes (debt-for-equity swap), as illustrated, for instance, in the LSB case (section 2.2.3.6), was thus very difficult to implement under the German code. Specifically, a swap required unanimous creditor consent, based on the 1899 *Schuldverschreibungsgesetz* ("Debt-incurrence law"). In comparison, a qualified majority suffices in the UK. Furthermore, §§ 5, 19 and 56 *GmbHG*[64] prescribe that the transfer of creditor claims into equity stakes via an asset-based capital contribution as part of a capital increase must be based on the market-value of the debt, which may have been eroded to the level of the security. If this value is found to be overestimated, the investor is liable to reimburse the difference. More severely, in the case of cash-based contributions, a failure of the insolvency process could render the creditor liable to fully pay the cash leg of the swap, while receiving only the typical proportionate compensation on her debt claim. Lastly, financial creditors which only transferred part of their debt into equity stakes could see the rest of the debt subordinated in an insolvency process (§ 39 *InsO*; § 32a *GmbHG*, §§ 129a, 172a *HGB*[65]). Due to this difficulty in involving equity holders in the restructuring plan, these could theoretically result in creditors accepting a write-down of their stake to the benefit of incumbent shareholders, as the company's equity value turned positive again. Naturally, even the option that a restructuring plan could imply such a value-transfer could trigger the rejection of the plan by senior creditors (Westpfahl, 2010; Paulus, 2008).

Given this set of shortfalls a frequent path of in-court restructurings, beside the termination of the business via a piecemeal liquidation or a continuation of the business via a restructuring plan, were asset deals according to § 162 ("*übertragene Sanierung*"). Subsequent to the opening of the procedure an administrator would sell (parts of) the assets of the insolvent firm to an investor, who obtained the business free of claw-back risks and significantly reduced liabilities[66] (Weil, 2012). An additional benefit is that the consent of incumbent shareholders was not needed, such that the procedure had been described as the German equivalent of a debt-equity swap (Paulus, 2008). Notably however, the implementation of this procedure was hindered by similar procedural burdens as the in-court restructurings and was not applicable where certain assets or contractual agreements (such as licenses) were not transferable (Westpfahl, 2010).

3.1.5 Ihr-Platz self-administration restructuring

The restructuring of German retailer *IhrPlatz* is considered a precedent case, as it constitutes one of the few occasions in which an in-court restructuring did not result in the loss of control of management to a court-appointed administrator and because it was the first major restructuring to successfully implement the procedure at the time.

IhrPlatz was the fifth largest German drug store, with a staff count of 9000 at the time of the restructuring. Having suffered half a decade of losses and seen its sales reduced by 40 percent over the same period, the company first underwent an out-of-court restructuring in 2004. Internal factors, such as overly frequent management changes, misguided acquisitions as well as increasing competition and an overall downturn in the retail industry contributed to the financially distressed situation of the firm. In line with the previously laid-out dynamic of German out-of-court restructurings, the lenders were mostly banks that agreed to write down 40% on their debt against the share pledge of current shareholders. The shares were placed in a trust.

[64] GmbHG stands for "Gesetz betreffend die Gesellschaften mit beschränkter Haftung" - company law for companies of limited liability (GmbH)

[65] HGB stands for Handelsgesetzbuch – German trade law

[66] Secured creditors could transfer their claims to the new entity to the extent of the value of their securities.

New management was put in place with the objective to effectuate a sale of the company. Following the restructuring, the commercial banks divested the EUR 110m debt, which was purchased by a consortium headed by *Goldman Sachs* (GS), which aimed at entering the distressed debt market in Continental Europe with its London-based restructuring team (Nomura, 2010; Alvarez & Marsal, 2005).

In 2005 the company was again in financial distress. In March 2005 restructuring specialist *Alvarez&Marsal* (A&M) was hired by the shareholder trustees in collaboration with the consortium and replaced incumbent management, a common step in restructurings of large cases in Germany (Nomura, 2010). Unlike the first restructuring, it became apparent that consent from a range of dissident creditors was needed. This group included, for instance, employees, who feared the closure of a set of retail outlets and subsequent job losses as well as the new lender consortium headed by GS. With unanimous consent on any out-of-court restructuring plan out of question, the A&M management team prepared to file for insolvency. A&M composed a restructuring plan highlighting how a quick and efficient restructuring could preserve the company as a going concern. Crucially, creditors would receive more under the restructuring plan than under other scenarios, such as liquidation. This plan was handed in together with the insolvency filing. By appointing the A&M expert team as management continuity throughout the process could be achieved, which would likely not have been the case if the experts had been appointed as preliminary administrators. This is because the 1999 code required administrators to be independent, and the courts judged a prior advisory relationship, as here with the drafting of the restructuring plan, as a breach of this independence. As a first sign of success of the plan, only a "weak" preliminary administrator was appointed, leaving the expert team in place. (Westphal & Wilkens, 2006; Alvarez & Marsal, 2005)

The strategy proved successful when the court ruled to leave incumbent management in place for the official procedure on 1 September 2005. On November 17 the plan, which provisioned a reduction of 20 percent in the stake of secured creditors, and 95% of the unsecured debt, was voted on and accepted by the creditor committee. The acceptance of the plan constituted another milestone. It secured the continuity of the business, a crucial aspect for a firm that heavy depended on the several hundred lease contracts for its retail outlets. Overall only 10 percent of work places needed to be cut, a relatively low number in comparison to other restructurings. On January 1st, 2006 the court closed the insolvency filing. *IhrPlatz* had transitioned out of deep financial distress in only six months. (Westphal & Wilkens, 2006; Alvarez & Marsal, 2005)

With the "self-administration" restructuring of *IhrPlatz* Germany had shown that it possessed a viable in-court rehabilitation procedure at a time when the momentum for more debtor-friendly bankruptcy codes was taking a hold of major economies across Continental Europe. At the same time however, the restructuring benefitted from a set of special conditions. Notably, the process was helped through a set of special factors. Specifically, GS provided post-insolvency financing of EUR 7.5m to the firm (*Massedarlehen*), providing a crucial boost to liquidity throughout the process (Westphal & Wilkens, 2006). The financing of employee wages further provided significant help, weighing particularly heavy for an employee-intensive retail business. Additionally, it can be argued that both GS and A&M tackled the case without the cultural stigma that German parties may have approached it with, contributing to the implementation of the case in record time. Under the *Insolvenzordnung,* A&M were further able to reject burdensome contracts, terminate certain leases and speed up the process of closing down the most unprofitable outlets and reduce the workforce, a process which would have manifested itself to be significantly more burdensome outside the code (Westphal & Wilkens, 2006). The role of Anglo-Saxon investors in German distressed debt markets is generally perceived rather critically (Paulus, 2008). It needs to be kept in mind that, what has been described as the "model implementation of an insolvency plan" (Westpfahl, 2010) is to a significant part due to the expertise of this type of investors.

3.2 The role of COMI shifts as a catalyst for reform

As has been seen, a significant discrepancy in the turnaround potential of the European bankruptcy codes existed just a decade ago. Where this difference was not adequately addressed by reforms a few financially distressed companies attempted

to shift their COMI to the UK due to the flexibility and reliability of the provided procedures, in particular the *CVA* (Nomura, 2010). This applies primarily to Germany due to both to the previously highlighted shortfalls of the 1999 *Insolvenzordnung* and the long delay of reforms of the German code. While most "forum-shoppers" were indeed German, LSB (section 2.2.3.6) constitutes a Spanish case, while *Eurofood* aimed to avoid a restructuring under the Italian code. Consequently, an analysis of the COMI shifts is instructive because it can be interpreted as a "market-based" testimony of the competitiveness of a countries bankruptcy code.

While the group of COMI shifts consisted of only a few cases (see table 2), the impact on the public perception was such that the practice of COMI shifting was explicitly mentioned as a rational for the 2012 reforms (Bundesregierung, 2011). As will be seen, the effort that companies needed to endure to effectuate a COMI shift to the UK provides a high threshold, such that the limited number of cases should not be underestimated. Rather, it can be interpreted as an indicator of a more pervasive distrust in the bankruptcy codes at the time, especially the German code of 1999.

European COMI shifts		
Deutsche Nickel	2004	Successful
Eurofood[67]	2006[68]	Successful
Schefenacker	2006	Successful
Hans Brochier Holding	2007	Unsuccessful
Monier	2009	Considered
La Seda de Barcelona	2009	Succesful
Wind Hellas	2009	Completed

Table 2, German COMI shifts shaded, all shifts were made to the UK or Ireland

The applicable law on COMI shopping in the EU is based on the 2002 EC Regulation on Insolvency Proceedings, which sought to provide a framework by which EU member states could recognize the codes of other EU states. The regulation attempted to fill the legal hole which had previously allowed European companies to "forum-shop" countries' bankruptcy codes, based on the perceived attractiveness of the code. This practice had resulted in significant legal uncertainty and confusion (Nomura, 2010). To solve this, the regulation stipulated that companies were to have access to a country's primary proceedings if its center of gravity, the COMI, was located in that country[69]. This was determined via two principles. Firstly, the COMI should be in the country of the company's registered office "*in the absence of any proof to the contrary*" and secondly it should be located where the company would conduct its administration and would therefore be ascertainable by third parties (European Council, 2000). Based on the italicized part of these principles, the regulation continued to provide legal room for maneuver (Nomura, 2010). To solve complicated cross-border insolvencies the regulation attempted to allow companies to open the proceedings at their COMI first, which would then preclude the opening of other procedures in other countries (Nomura, 2010). The court of the filing would then have the authority to decide on the conformity of the COMI shift. This provided COMI shifters with a significant "first-mover advantage", as a timely COMI shift could divert authority away from the courts of the home country.

The new regulation achieved notoriety and a degree of legal clarity with the 2006 ruling on the insolvency of *Eurofood* in the wake of the 2003 *Parmalat* insolvency (Paulus, 2008). *Eurofood*, a wholly-owned subsidiary of *Parmalat* in charge of financing and based in Ireland, filed for Insolvency with the High Court of Ireland briefly after *Paramalat* had entered extraordinary administration in Ireland. Subsequently, a legal battle between the Italian Minister handling the extraordinary

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[67] As the discussion has shown, it could be discussed whether the case of Eurofood can be counted as a COMI shift. It is mentioned here primarily due to the precedent character that the ruling on this case had.
[68] The year refers to the ruling of Euopean Court of Justice, establishing the COMI of the company in Ireland rather than in Italy
[69] For companies registered in several European countries, the primary proceedings would be opened in the jurisdiction of the COMI and secondary proceedings would be opened in the other countries, applying local laws to the assets of the company.

administration of *Parmalat* and the High Court of Ireland over the jurisdiction of the insolvency process of *Eurofood* ensued. The process was finally settled by the European Court of Justice, ruling that "the COMI of that subsidiary is situated in the member state where its registered office is situated, can be rebutted only if factors that are both objective and ascertainable by third parties indicate". Given that the registered office and the companies activities were in Dublin (which was ascertainable) the ruling was in favour of the High Court of Ireland (Nomura, 2010). Notably, the 2006 reform of the *concordato preventivo* in Italy stipulated that the shift of the main office less than one year prior to the filing is considered irrelevant, a measure which seems to have been aimed at precluding a similar case.

The COMI shifts will subsequently be further detailed by discussing the case of *Schefenacker* and *Monier*, arguably the two prevalent German COMI shifts. Building on the theoretical analysis of the shortfalls of the 1999 codes (section 3.1.4) the case discussions will allow to assess these practically.

3.2.1 Schefenacker

In 2006 *Schefenacker*, the German manufacturer of rear-view mirrors and a global Tier 1 automotive supplier, suffered economically. Its customers, five leading global auto manufacturers implemented cost-cutting measures while raw material prices were rising (Global Turnaround, 2007). The economics of the value chain precluded a transfer of the increased input prices and *Schefenacker* saw its margins increasingly squeezed. At the same time, *Schefenacker* was highly leveraged. The financial debt structure of the group was comprised of 1) a EUR 50m senior secured RCF facility 2) a EUR 150m second-lien term-loan and 3) a EUR 200m senior subordinated guaranteed retail bond, issued in 2004. A refinancing in 2005 found a significant amount of first- and second-lien debt in the hands of hedge funds. At the time of the onset of the financial distress, *Schefenacker* was a globally operating firm, employing 7900 workers worldwide. *Schefenacker AG*, the ultimate holding company, was wholly owned by Dr. Albert Schefenacker, the grandson of the firm's founder. (Chase Cambria, 2007)

Concerned by the high leverage and the challenging economic situation, management hired *Allen & Overy*, *Alix Partners* and ultimately *Alvarez and Marsal* to implement a comprehensive restructuring programme and assess the sustainability of its debt. In collaboration with management, the experts devised a comprehensive restructuring plan, which was accepted under the condition that a balance-sheet restructuring could be achieved. (Chase Cambria, 2007)

To address the latter point, the company subsequently approached its creditors regarding a COMI shift to the UK. The decision for the UK was due to 1) the comparative legal advantage of effectuating a debt-for-equity swap 2) the ability of the procedure in binding creditors with a 75% vote as opposed to the German code in which a hold-out of a minority creditor group was perceived as more likely 3) the potential to release the guarantees of the bonds, given by the operating companies without an initiation of insolvency filings against the guarantor 4) the avoidance of the tight legal window to file for insolvency and 5) to avoid, in general, the legal uncertainties attributed to the German code, which had only experienced little testing and benefit from the speed of the procedure (Nomura, 2010; Chase Cambria, 2007). The second point was critical as the holders of the retail bonds, upon realizing that the economic performance had eroded the value of the securities, organized under *Rotter*, a law firm specialized in group actions, actively opposing the restructuring (Global Turnaround, 2007). The *CVA* thus constituted an apt measure as the goal of the balance-sheet restructuring was the modification of the unsecured bondholders, which have to vote as one class in a *CVA* procedure (section 2.2.2.3). Additionally, given the multi-national nature of the company, a *CVA* was preferred to a *Scheme of Arrangement*, as the former would be accepted throughout Europe[70] (Chase Cambria, 2007).

The COMI switch was facilitated through the nature of *Schefenacker AG*, which, as a mere holding company, was neither employer of the German workforce nor owner of the German factories. (Nomura, 2010) Additionally it was privately owned

[70] Except for Denmark

and had achieved the profile of a global, rather than a German company. Furthermore, it did not have trade creditors as primary creditors. Lastly, the subsequent *Schefenacker plc* was structured such that it both employed a workforce in the UK and held offices, with no connection to Germany. (Chase Cambria, 2007) Under these circumstances the COMI shift was successful. The set of conditions illustrate, however the significant requirements of such a COMI shift.

Shareholders approved the switch, in line with their previous consent with the plan, *Schefenacker AG* turned into *Schefenacker plc* and filed for insolvency under a *CVA*. As both the unsecured creditors as well as the bondholders were to vote on the plan in the procedure, but only the bondholders would be affected by the proposed plan, the court imposed an additional criteria, namely that at least 75 percent of the bondholders needed to vote in favour of the plan, illustrating the flexibility of the procedure. Similarly, when it appeared that the initially proposed restructuring plan would not find the required support of the bondholders, the High Court granted an adjournment period, a unique step in a *CVA* (Chase Cambria, 2007).

The final plan provisioned the write-off of both the shareholder loans of EUR 100m and the EUR 200m bonds, erasing EUR 300m in debt from the balance-sheets. The shareholders, upon injecting an additional EUR 20m, would receive 25 percent in equity as compensation, fulfilling the goal of the incumbent shareholder to preserve as much as possible of his equity stake. The amended plan had been improved for the bondholders which now were compensated with EUR 7.5m in cash, 5% of equity and an additional 10% in performance-based warrants. (Chase Cambria, 2007). Second-lien lenders, hedge funds, retained 70% of the equity for a EUR 35m cash injection (Clowry, 2008). Senior lenders were refinanced. The proposal was passed with 75.9% barely passing the prescribed threshold and reflecting the opposition of the retail bondholders represented by *Rotter* (Global Turnaround, 2007). Figure 3 provides a simplified representation of the agreement.

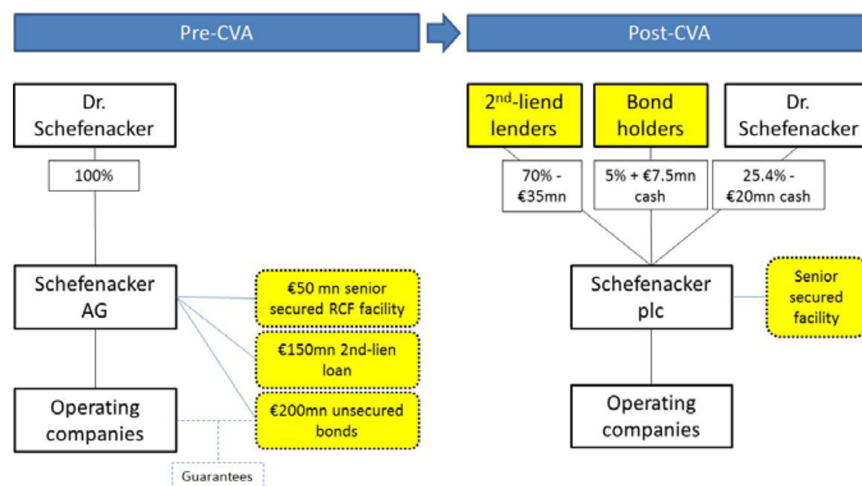

Figure 3, Source: Clowry, 2008; Chase Cambria, 2007. "+" indicates a receipt, "-" a payment of cash.

As no challenge was received in the 28 day challenge period following the passing of the vote, the plan was approved and immediately became effective. Arguably the restructuring was facilitated by a set of specificities of *Schefenacker*, such as the holding structure the shareholder structure and the concentration of the key stakeholders in the UK, allowing for a good understanding of the bankruptcy code. Similar to the *IhrPlatz* case, the changed reality of the balance sheet of German *Mittelstand* corporates is reflected in the case, but unlike *IhrPlatz*, the dispersed debt structure introduced a complexity that could better be addressed with the flexible UK code. (Chase Cambria, 2007; Global Turnaround, 2007). In particular, the flexibility due to both the simple debt-for-equity swap procedure, as well as the choice in a set of procedures with different voting mechanisms contributed to the competitive advantage of the UK code.

3.2.2 Monier

Although in the case of *Monier* an out-of-court restructuring could eventually be achieved within the German jurisdiction, a COMI shift was seriously considered during the restructuring process (Nomura, 2010). The case of *Monier* is further illustrative as it forms part of a group of targets of leveraged buyouts that occurred between 2004 and 2007 which struggled with the onset of the financial crisis in 2008 as the deteriorating performance threatened the adequate service of their highly leveraged positions. In particular, the acquisition of *Monier* from *Lafarge* by *PAI Partners* (PAI) in 2007 occurred at the height of the LBO wave, when transactions were the most levered. The transformative effect that this group of restructurings had has already surfaced throughout this analysis, for instance in the discussion of the 2009 reform of the Spanish code (section 2.2.3) and the 2011 amendment of the French code, which provided the *sauvegarde financière accélérée* (section 2.2.1)

Monier, one of the largest producers of roofing tiles and a German company, was bought by *PAI* in February 2007, in an LBO for EUR 2.4bn, backed by EUR 2.07bn debt financing, implying an equity contribution of only 14 percent. The acquisition debt was comprised of senior debt consisting of a EUR 125m seven-year revolving credit facility, a EUR 175m seven-year capital expenditure facility, a EUR 200m seven-year term loan A and a EUR 622.5m eight-year term loan B. Additionally, the purchase was financed via a junior debt in the form of EUR 325m of a nine-and-a-half year second-lien loan. (Nomura, 2010). The group of banks providing the financing included *BNP Paribas*, the previous owner of *PAI*, *GE Commercial Finance*, *Societe Generale* and *Royal Bank of Scotland*. After the purchase, *PAI* held 65% of the company's equity, while Lafarge held 35% (Monier, 2009). The significant leverage post-acquisition stands against an EBITDA of EUR 250m in 2007 that deteriorated to EUR 192m in 2008 (Monier, 2009), resulting in ca 8x leverage in 2007 and 11x leverage in 2008. Current LBO transactions typically fail to attract financing beyond 5-6x leverage (Tassart & Poirson, 2012), which illustrates the highly-levered nature of the capital structure that turned from aggressive to unsustainable with the onset of the financial crisis and the global economic slow-down. Specifically, the company found itself economically squeezed by rising raw material prices on the one hand and a down-turn of the 2008 German, UK and US property markets on the other hand. Foreseeing a breach of its covenants, *Monier* advised PAI that a debt restructuring was needed. PAI subsequently approached senior creditors in December 2008 (Financial News, 2009) and delayed the covenant compliance certificate, which resulted in the technical avoidance of debt acceleration due to covenant breach (Nomura, 2010).

By 2009 a set of specialized investors[71] ("the consortium") had acquired some of *Monier's* distressed debt in the secondary loan market. First-lien lenders consequently consisted of more than 100 institutions ranging from commercial banks to hedge funds. As the company was not technically insolvent the stakeholders sought to agree on a restructuring out-of-court. A first restructuring plan, submitted by *PAI*, was dismissed by senior creditors as being too opportunistic for PAI and too restrictive for creditors, as PAI provisioned to retain a part of its equity stake that was perceived as excessive. Instead, the steering committee, advised by *Houlihan Lokey*, and ATY, advised by *Lazard,* submitted an alternative plan. The plan reduced the primary and secondary debt from EUR 2.07bn to EUR 650m, which, together with the interest free credits of EUR300m accumulated to post-restructuring debt of ca. EUR 1bn.The plan further deferred 80 percent of interest payments by two years and established a EUR 150m credit line to bridge the traditionally slow 2009/2010 winter season. First-lien creditors were compensated with majority equity stakes, effectively removing the previous owners, *PAI* and *Lafarge* and replacing them with the creditors. This debt-to-equity swap was facilitated by the registration of a new Holding Company of *Monier* in Luxembourg, where the application of such a swap was simpler than in Germany (see section 3.1.3). Between 20 and 25% of equity, as well as four out of eleven seats in the new board were allocated to the consortium in compensation for the write-down of its accumulated claims. Other creditors made up the rest of the new owners. Notably, the incumbent management

[71] The distressed debt investors were Apollo Global Management, Towerbrook Capital Partners and York Capital Management. They headed a group of more than 130 lenders in total. (Financial News, 2009)

was left in place, partly because the initiated operational restructuring objectives established in 2008 were perceived as beneficial (Frankfurter Allgemeine Zeitung, 2009; Financial News, 2009).

In order to implement this plan, for a while, a legal transfer of *Monier* to the UK was considered, to bind potentially dissenting senior creditors. As in the LSB case the goal would have been a shift to the UK to file for a *Scheme of Arrangements* in order to achieve a restructuring of some of the senior debt, which could have technically not been achieved through a COMI shift, but rather through sufficient "connection" (compare section 2.2.3.6). The shift was not implemented however as the plan eventually found 99% approval in October 2009 (Nomura, 2010; Financial News, 2009).

The *Monier* restructuring highlights a set of important points. First of all, it illustrates the group of LBO acquisitions made at the height of the LBO period with highly leveraged acquisition structures, which struggled and often had to be restructured with the onset of the financial crisis. Secondly, the role of specialized hedge funds, perpetrating "loan-to-own" investment strategies by buying the distressed debt of German house banks, which has already been illustrated by the *Schefenaker* case, is further illustrated. In particular the case has been described as an inflection point in the negotiations between equity sponsors and debt holders, the latter of which assumed a more proactive approach in handling debt, resulting in more leveled negotiation positions with equity sponsors (Real Deal, 2010). The considered COMI shift highlights the importance of bankruptcy codes to achieve ex-post efficient outcomes in the light of more complex restructuring scenarios.

3.2.3 Discussion

The case discussions of COMI shifts in this section have highlighted that the German code was ill-fitted to the complexity of the restructurings that emanated from a much more fragmented debt structure with a more heterogeneous set of creditors. The change in the capital structure of German corporate balance sheets, extending down to the discussed medium sized firms, occurred as traditional European financial lenders sold risky debt on the secondary market, mostly to specialized distressed debt investors with a distinctly Anglo-Saxon background, following a "loan-to-own" strategy, of purchasing distressed debt at a significant discount from the main banks. Having acquired a sufficient amount of debt the parties gain a certain level of control over the creditor vote, allowing them to push for a transfer of the debt into new equity, if necessary via a COMI shift. This transfer typically results in a significant reduction, if not obliteration, of the stake of incumbent shareholders. The *Ihr Platz* and *Monier* cases illustrate this practice and have shown that in particular the flexibility in the implementation of debt-to-equity swaps, an experienced and flexible court system, as well as an array of procedures with voting mechanisms tailored to different restructuring needs can be identified as key factors in determining the competitive advantage of the UK code. Notably, certain legal procedures under the 1999 German code, which could achieve a similar outcome as a debt-for-equity swap, received little attention due to the unfamiliarity with the code and were often more difficult to implement (Paulus, 2008).

The case-based evidence of more complex German debt structures is underlined by more global numbers; The Economist (2007) reports the share of institutional investors in non-investment grade companies to have increased from less than 5% in 1999 to more than 50% in 2007 in Europe. Paulus (2008) reports, that more than ninety-five percent of German "distressed debt"[72] is held by specialized investors. Additionally, the size of the Mezzanine financing during the height of the LBO cycle from 2004 to 2007 resulted in subordinated debt of more than EUR 4.7bn on German balance-sheets (Bork, 2012). Over the same period, as especially the *Schefenacker* case has shown, the evolving disintermediation across the bank-based systems of Continental Europe (Mullinieux, et al., 2010) increasingly drove in German medium-sized firms to issue public debt[73] (Economist Intelligence Unit, 2009). Thus, the achievement of private workouts become more complex driving the imminent

[72] In Germany these are referred to as "*Problemkredite*" (problem credits), the more negative connotation is arguably attributable to the previously described cultural stigmatization of financial distress and insolvency.
[73] A recent spike in issues of SME bonds (*Mittelstandsanleihen*) provides anecdoctal evidence here such as in the cases of Bastei Lübbe in October 2011, Katejes and Singulus in early 2012 as well as the planned issue by Golifino (Euroweek, 2012).

need for a more flexible and powerful legal framework. Consequently, a key assessment factor of the 2012 reform is its ability to meet this requirement.

3.3 Analysis of the German bankruptcy code post the 2012 reform in the context of the reform movement across Continental Europe

This section will start by embedding the German reform within the reform movement that took hold of Europe over the last fifteen to twenty years. Subsequently, the key aspects of the reform will be analyzed and benchmarked to the respective mechanisms of the codes of Germany's peers.

3.3.1 The momentum for reform of European bankruptcy codes

The previous review of the reform movement that occurred across Germany's European peers, illustrates the significant momentum towards a more turn-around-oriented European restructuring landscape that built up around the middle of the last decade and occurred within a timespan of just 4 years. The EC Regulation in favor of more turnaround-oriented European bankruptcy regime was passed in 2002, the same year that saw the UK pass the Enterprise Act of 2002 abolishing the bank-led *Administrative Recieversship* in oder to "facilitate corporate rescue and produce better returns for creditors as a whole" (Armour & Mokal, 2004). Spain was the first regime to overhaul its hugely defunct bankruptcy code with the *ley concursal,* passed in 2004 and Italy passed the *Decree 35* in 2005, significantly reforming its restructuring procedures, catalyzed by the legislative issues in the wake of the *Parmalat* bankruptcy. Similarly, France overhauled its bankruptcy code with the introduction of the *procédure de sauvegarde* as a strong new restructuring procedure. That same year Italy complemented the process with the *Law 5* resulting in a more time-efficient liquidation procedure. These first reforms provided significant structural changes which were subsequently refined with a set of amendments that sought to address practical shortfalls, or that sought to cope with a radically changed economic environment in the wake of the financial crisis and the sovereign debt crisis. Especially Spain passed two subsequent reforms, in 2009 and 2012 that provided amendments to the code that crucially impacted its workout friendliness (Pallares, et al., 2012). Similarly, France induced more flexibility into its code with the 2009 amendment of the *procédure de sauvegarde* (Nomura, 2010) and Italy experienced the increased use of a previously neglected procedure that has been instituted as early as 1942 (The Article 182*bis* proceeding) after its courts clarified a set of uncertainties (Paul Hastings, 2010).

As has been seen, the reforms not only had to overhaul the defunct procedures under the current codes but also to counteract the cultural bias. Arguably, in cases where the latter point was insufficiently addressed, the immediate impact of the reforms was marginal. This is best reflected in the case of Spain, where practitioners even long after the 2004 reforms remained highly skeptical of the bankruptcy code (Fernandez, 2009; Alonso and Madrid, 2007), which was only beginning to be alleviated with the most recent amendment to the code (Pallares, et al., 2012). In spite of different levels of acceptance, the reforms across Continental Europe by and large provided the legal basis for a significant amelioration of the European restructuring landscape. One key achievement that pervaded all reforms was the provision of at least one pre-insolvency restructuring procedure encapsulating the objective of better catering to still solvent firms which proactively sought to evade more severe financial distress. Intuitively, the provision of a debtor-friendly procedure which could shelter the firm from impeding financial distress was a critical aspect of conveying the idea of financial distress as the chance for rehabilitative change and a new start. For the subsequent discussion of the German code it is instructive to note that, prior to the 2012 reform, the legal provision of pre-insolvency procedures marginalized Germany as one of the major Continental European countries that lacked this process. Westpfahl (2010) laments the lack of such a procedure in the German code based on the *Insolvenzordnung* of 1999 as a key shortfall.

Figure 4 illustrates the development of the reform process of European bankruptcy codes[74]. It is striking that bankruptcy codes especially in the Continental European countries remained at the margin of the legislative development throughout a large part of the 20th century. This is maybe best seen in the case of Spain, which sourced from procedures which to a large extent dated back to the 19th century[75] and which were so distinctly based in a different time that they arguably conflicted with the national constitution of 1978 (European Comission, 2002).

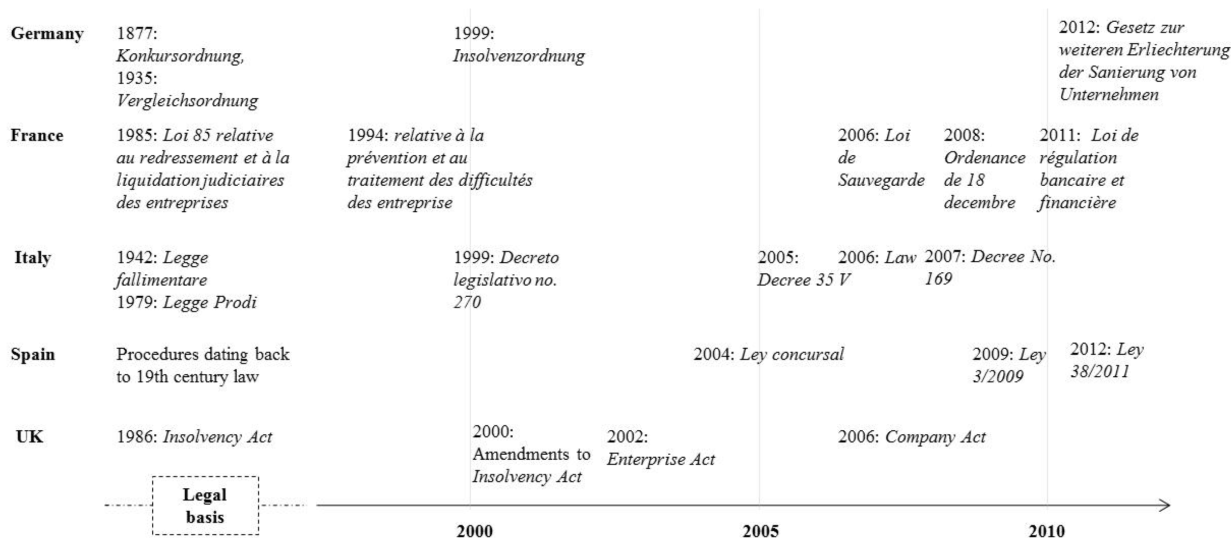

Figure 4: Structural reforms of the European bankruptcy codes, source: Noumra, 2010; Jostarndt & Sautner 2011; Blazy et al., 2011; Research on Internet site of national legislators

Why did Germany "miss" the wave of reforms in the middle of the last decade[76] and what led to the 2012 reform? One reason that has previously surfaced lies in the low number of in-court restructurings and few major restructuring cases (i.e. the lack of a "German *Parmalat*"), which kept the bankruptcy code out of the legislative focus (Westpfahl, 2010). To the contrary, in 2005, at a time of significant legislative reform in Continental Europe, *IhrPlatz* was successfully restructured in self-administration (section 3.1.5). Additionally, unlike in Spain, where special, mercantile courts, were assigned authority over insolvency cases, the main court in the region of the headquarters of the company was assigned jurisdiction over the insolvency process. The geographical dispersion of companies could result in few previous insolvency cases having been processed at the respective court, as illustrated in Appendix A. As such a concentrated center of expertise that could fuel the reform process could not develop. Additionally, the willingness of banks to accommodate restructurings provides an explanation to the inertia in the German reform process. The legislator may have not seen the need to implement more debtor-friendly legislation, as the established practice of restructuring out-of- court was not seen as overly liquidation-biased as, for instance, in Spain[77]. In other words, the system of out-of-court restructurings may have been perceived as adequate in the private lending environment of Germany. This would follow the argument proposed by Hege (2000) (section 1.1) and the study by Brunner and Krahnen (2008), finding that *ex-ante* efficient outcomes can be achieved with the help of bank-pools. However, as the discussion of the COMI cases has shown (section 3.2.3) German corporate balance sheets have become more

[74] Minor reforms aimed at streamlining the administrative aspects of the procedures in place are not displayed.
[75] The only reform of the 20th century was the Suspension of Payments Act of 1922.
[76] Minor reforms were implemented, most importantly the 2007 *Gesetz zur Vereinfachung der Insolvenzordnung*. These focused primarily on reforms to mitigate formal and procedural deficiencies which had been gradually revealed by practice, rather than changing the procedures of the law.
[77] Note that liquidation rates for in-court restucturings are still very high (Jostarndt, 2010). The argument here however refers to out-of-court restructurings.

complex, reflecting the increasing importance of the capital markets even for medium-sized companies, as well as an active secondary distressed debt market, as became readily apparent in the financial crisis. While the crisis triggered a set of urgently passed reforms especially among Germany's Continental peers, where the economy did not prove as resilient as the German one, only a minor immediate modification of the entry conditions for insolvency was passed in 2009.

In the same year however the first discussions for the comprehensive 2012 reform began (Westpfahl, 2010). The emerging debate was fueled by legal and financial experts, who argued that there was an imminent need for a more efficient bankruptcy code to handle the insolvency of a set of highly levered corporates that were surprised by the crisis[78] (Jaffe & Friedrich, 2008) and that illustrated the previously discussed changed realities of corporate capital structures. This argument can be extended to the potential for a further spike in bankruptcies due to the significant refinancing need that impedes a set of German (and European) companies as early as 2013, heralding from debt that was incurred at low costs in the middle of the last decade (Joubert, 2012). Additional to the need to accommodate imminent restructurings, it has been argued that the turnaround capability of a bankruptcy code impacts the attractiveness of the particular country to Anglo-Saxon investors and their capital, a perspective that has gained increasing resonance in the analyses of the European codes (Maganelli, 2010; Paulus, 2008), all the more so since the new regulatory environment has put a strain on banks' lending ability (Vernimmen, et al., 2011).

3.3.2 Analysis of the post-reform German bankruptcy code vis-à-vis its European peers

On March 2012, the reform of the 1999 *Insolvenzordnung* came into effect. Per its title the *Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*[79] readily indicates the reform's objective to simplify the preservation of financially distressed firms as a going-concern including the amelioration of the legal basis of out-of-court restructurings. The 2012 reform of the German insolvency law explicitly named this practice of "COMI-shopping" as a reason for its inception, and attempts to "improve the competitiveness of the insolvency process in Germany" (Bundeswirtschaftsministerium, 2012, p. 1).

The previous review of the European reform movement has highlighted the role the country-specific factors have played in driving structural differences in the procedures allowed under the different codes. A non-exhaustive list of ten of the most influential aspects will subsequently be reviewed. It consists of 1) the provisioning of pre-insolvency workout procedures 2) the stay on creditors post-filing 3) the nature of the voting mechanism and the potential existence of a cram-down mechanism 4)the regulation of claw-backs 5) the access to post-insolvency financing 6) the legal and cultural acceptance of self-administration procedures 7) the flexibility of the restructuring plan with regards to shareholder's claims 8) the expertise of the judicial authorities 9) the extent of control that the involved stakeholders hold vis-à-vis the courts and 10) the regulation of procedures for SMEs. Of these, especially the possibility for incumbent management to remain in place, the provision of a sheltered period in which debtors could restructure free from the pressure of creditor's claims as well as the precise definition of the cram-down mechanism, are perceived to play a critical role in determining the rehabilitative nature of a particular bankruptcy code and have played a recurring theme in the evaluation of the bankruptcy codes (Nomura, 2010; Fernandez, 2009; European Parliament, 2010). The case discussions have highlighted particularly the important role of the flexibility of the procedure both in terms of the implementation of a debt-for-equity swap as well as through experienced courts that facilitate a restructuring. These factors will subsequently be reviewed, introducing them first for the German case and benchmarking these findings subsequently against the European insolvency landscape.

[78] The set of bankruptcies which occurred with the beginning of the crisis in 2008 included SinnLeffers and Wehmeyer, textile retailers which were restructured in in-court processes, as well as department-store-chain Hertie, which was liquidated. Notably all firms declared insolvency within a few weeks, which raised public awareness. Additionally all were subsidiaries of the retailer Karsatdt, which subsequently underwent a restructuring itself in 2009.

[79] Act for the further facilitation of the restructuring of companies

3.3.2.1 The provision of a preliminary restructuring procedure – “*Schutzschirmverfahren*”

One of the key aspects of the reform is the provision of an in-court pre-insolvency umbrella procedure. The lack of such a procedure had been one of the key criticisms of the pre-reform code (Westpfahl, 2010; Nomura, 2010). According to § 270b the court now grants the debtor a three month grace period as of the day of filing for the delivery of a restructuring plan, while continuing to operate the company. Crucially, creditor claims are stayed, providing the company with important breathing space. Access to the umbrella procedure is tied to a set of conditions and limitations. One of the key conditions is that the debtor may not yet be insolvent. To proof this she must attach to the court-filing an expert report illustrating why the debtor is either likely to be insolvent or over-indebted (the two alternative reasons for insolvency filing under the German code, section 3.1.2), why she is not likely to become insolvent over the three month grace-period and most importantly why a restructuring would not be “obviously unsuccessful” (“*offensichtlich aussichtslos*”). In a late amendment to the reform, the legislator has ruled that the procedure is also not to stop if insolvency occurs during the procedure, although the court needs to be informed immediately (Hasenheit, 2012). The ensuing period is supervised by an administrator. Care has been taken not to use the traditional title for the administrator, which included the word insolvency (*Insolvenzverwalter*) in favour of a more neutral tile (*Sachverwalter*) (§ 270c), reflecting the legislator’s intention to mitigate the cultural stigmatization of the bankruptcy process. Notably, the administrator must be a different person from the expert who drafted the report attached to the filing. The court must however follow the proposal of the debtor unless the proposed administrator is insufficiently qualified (§ 270b). At the end of the three month period, the court officially opens the insolvency process. The debtor is left in charge under self-administration and the creditor committee either accepts or rejects the “pre-packaged” plan. Notably, the power of the creditors is not limited to just this vote; the preliminary creditor committee can request the end of the umbrella procedure and effectuate the appointment of the preliminary administrator if it wishes (§ 270b). This would commence a process similar to the traditional insolvency process under the 1999 reform.

Umbrella processes and pre-insolvency proceedinsg in the European insolvency landscape

In an international comparison, the *Schutzschirmverfahren* is most similar to the Spanish bankruptcy code. With its most recent amendment, Spain, allows the debtor a more generous time frame of four months in which an advanced proposal for an agreement or a formal out-of-court refinancing agreement may be found, thus following a similar two step procedure as Germany. Italy provides different court-supervised procedures depending on whether the firm is either solvent or insolvent. This focus on the solvency-status of the financially distressed firms reflects the character of the civil law that pervades Continental Europe. Arguably, for the case of insolvency procedures, this often results in more inflexible and time-consuming practices, as a significant amount of documentation needs to be provided to establish the compliance of the firm with the pre-specified legislative norms. For instance, practitioners have criticized the extensive documentation requirements of a filing under the German code (Frind & Gärnter, 2010). The tradition has been criticized for focusing more on the procedural aspects of the parties rather than identifying where the vale lies (Pallares, et al., 2012).With the *procédure de sauvegarde* France, on the other hand, stands out among the civil law jurisdictions, having transcended the tedious distinction between pre-insolvency and insolvency. The French procedure thus provides a similar level of flexibility in this regard as the main restructuring procedures of the UK, the *CVA* and the *Scheme of Arrangements*, where a distinction between solvent or insolvent firms is generally not made and procedures are accessible to all firms. Notably, however, some momentum for reform providing a three month umbrella period prior to the *Administration* procedure has built up on the legislative side in the UK. In July 2010, the government solicited suggestions for a reform of the process in July 2010, the (mixed) answers to which were published in 2011[80]. The similarity of the discussed procedure with the new German *Schutzschirmverfahren*

[80] For an overview of some of the answers see: The Insolvency Service, 2011, “Proposals for a restructuring moratorium”, accessed 19.05.2012, available at : http://www.bis.gov.uk/assets/insolvency/docs/insolvency%20profession/consultations/restructuring-response/restructure-response-2-summaryofresponses.pdf

which was already discussed at the same time is no coincidence but again reflects the increasing momentum for reform driven by intra-European country competition for the attractiveness of the bankruptcy code (Financial Times, 2010).

Overall, the implementation of the procedure has been well perceived (Hirte, 2011; Westpfahl, 2010; Hasenheit, 2012), as strengthening the self-administration procedure as an attractive, integrated new aspect of the procedure. While judges had also previously sometimes stayed claims on companies in self-administration for two or three months, §270b has removed the uncertainty around this stay. Critics of this new law have pointed out that per *status quo* applications due to impeding insolvency constitute the rare occasion (Frind & Gärnter, 2010). The broad application of the procedure is thus subject to a cultural change among firms to use the in-court procedures more proactively, arguably a process that will require time.

3.3.2.2 The stay on creditors

As explained in section 3.1.3, the German pre-reform bankruptcy code primarily provided a stay on unsecured creditors leaving the enforcement rights of the dominant financial creditors, which were typically secured, unchanged (§21), unless so requested by the (strong) administrator (Nomura, 2010). The 2012 reform has not altered the nature of this stay but it has been extended to the new umbrella procedure (§ 270b). Crucially, under the procedure the debtor is essentially endowed with the rights of the strong administrator and can induce the court to implement a comprehensive stay on claims (§ 270b).

The Stay on creditors in the European insolvency landscape

A stay on secured and unsecured creditors is only imposed under the *Administration* procedure in the UK. The stay is imperfect however, in that creditors may still cancel contracts with the debtor. Given that the procedure implies the loss of control of management, it does not constitute the typical route for actual restructurings. Since the *CVA* does not provide for a stay, a significant part of restructurings need to be implemented without one. Nomura (2010) quotes the High Yield Asscociation arguing that: “The absence of a stay [for *CVAs*] allows customers and suppliers to walk away, or extort punitive amendments, which can severely compromise the restructuring effort”. Lastly, the *Scheme of Arrangement*, the major procedure for lengthy restructuring procedures does not prescribe a stay but may exclude certain creditor classes, which could alleviate the need for a stay. UK practitioners have lamented the lack of a comprehensive stay as a key weakness of the code and are actively lobbying for an automatic stay similar to the *Chapter 11* procedure (R3 Association of Business Recovery Professionals, 2010). In comparison with the overall timid approach to a stay on creditors in the UK, the major French rehabilitation procedure, the *Procédure de sauvegarde* fares better, imposing a comprehensive stay. The same holds for the *redressment judiciaire*. Even the pre-insolvency workout schemes *mandat ad hoc* and *conciliation* may result in a stay if imposed by the court. Overall, the comparison between the French and the UK code well reflects the two traditionally opposite orientations of the code, as the UK as a creditor friendly and the France as a creditor unfriendly jurisdiction, which has been well established in the literature (La Porta, et al., 1998; Davydenko & Franks, 2008). As France, Italy, with the passing of the *Decree 35,* provides a comprehensive automatic stay on creditors, including secured creditors, which is imposed at the onset of the main restructuring procedure. The Spanish code again reflects the significant dominance of financial creditors, which provide lending primarily on a secured basis. Only unsecured creditors are automatically stayed under the *convenio anticipado* or *convenio orinario*. Even post the 2012 amendment to the bankruptcy code, a stay on secured creditors remains at the discretion of the court, which may only implement a stay under a set of limitations and if this is crucial for the continuation of the firm (Pallares, et al., 2012). The Spanish regulation again is most similar to the German one due to the limitation on the automatic stay of creditors with a security over an immovable asset. However, the 2012 reform has allocated the control over the stay from the administrator to the debtor, due to the strengthened self-administration procedure, a competitive advantage of the German code. With regards to the strength of the mechanisms the two codes range between the extremes of the UK legislature and the French and Italian codes in the European comparison.

3.3.2.3 Improving the power and time efficiency of the procedure: Cram-down mechanisms

Section 1.1 has outlined the importance of a cram-down mechanism to reign in the obstruction potential of dissident creditors and validate viable restructuring plans in a time-efficient manner. Since a cram-down mechanism was already provided for under the 1999 *Insolvenzordnung* (section 3.1.3), the 2012 reform only amended the existing mechanism to incorporate shareholders, which now are summoned as a separate group (§ 222) and included in the vote if their stake is affected by the plan (§ 244). Their claims are defined by the value of their shareholding rather than their voting rights (§ 238a), which would have disenfranchised preferred shareholders without voting rights. Notably, the voting and cram-down mechanism is also extended to retail and smaller creditors as well as shareholders, holding a claim or a stake of less than EUR 1000 or one percent of the capital, which can form their own group (§ 222). The consistent application of the voting mechanism to the group of the shareholders has been received positively by practitioners (Walker, 2012).

Beside the logical extension of the cram-down mechanism to the shareholders, the reform allows for some other mechanisms that can help to speed up the process, which could previously surpass years due to the obstructive rights attributed to individual claimholders (Hirte, 2011; Davydenko & Franks, 2008). Specifically, preferred claims (*Masseverbindlichkeiten*) now do not need to be satisfied before the process can be terminated. Instead a financing plan for the future satisfaction of the claim suffices to address this point (§ 258). This eliminates a hurdle to the completion of the process. Similarly, claims of minority stakeholders of a position of disadvantage under the restructuring plan will not halt the passing of the plan if the plan provisions capital for the imbursement of these claims, the settlement of which lays outside of the insolvency process (§ 251). While this protection of minorities is extended to shareholders, the criteria for a “disadvantage” of minority parties, which would invoke indemnification is based on liquidation, rather than rehabilitation scenarios, a scenario under which minority shareholders would receive very little, if anything (Hirte, 2011). By reducing the uncertainty around potential hold-outs in implementing the plan, the reform addressed one of the key shortfalls of the mechanism, as the *Schefenacker* case (section 3.2.1) has shown.

Cram-down mechanisms in the European insolvency landscape

All bankruptcy codes of the major European economies allow for a form of cram-down of dissident creditors. Differences exist however in the specificities of the overruling majority, the segmentation of the different claimholders into voting groups as well as the treatment of secured creditors. The latter aspect is especially relevant due to the prevalence of bank lending, which is typically effectuated on a secured basis. Cram-down mechanisms on secured creditors thus often occurred against, or failed because of the opposition of the banking system. An overview of the voting and cram-down mechanisms of the European and the US codes can be found in Appendix C.

As mentioned in section 2.2.3.6, the lack of a cram-down mechanism under the Spanish *convenio anticipado* was at the heart of the COMI shift by La Seda de Barcelona (LSB) to the UK to benefit from the *Scheme of Arrangement*. Coincidentally, a cram-down mechanism with the same voting power as the *Scheme of Arrangement*, was enforced with the 2012 amendment to the law, allowing for a cram-down of dissident financial creditors if a majority of 75% could be found. The right of Spanish banks as secured lenders has been left untouched, as *in rem* creditors cannot generally be overruled. The dominance of financial creditors is further apparent in the structure of this mechanism, as trade creditors are not consulted, differentiating the code from other European codes such as Germany and France. The exclusive focus on facilitating agreements with financial creditors has been criticized as too restrictive especially with regards to SMEs, the backbone of the Spanish economy (Pavon, 2011).

The Italian code resembles its German counterpart in that it provisions a delineation of creditor classes according to economic interest, although in Italy this is not obligatory. As outlined in section 2.2.2.5, the voting threshold for the *concordato preventivo* is similar to the one in Germany - a simple majority by size of claim is needed to effectuate a vote within a creditor class, while the threshold of the *concordato fallimentare* is slightly higher (IFR, 2009). Given the required majorities

in sufficient groups can be achieved, both procedures provide for a cram-down mechanism on dissident creditor classes. Similarly, both procedures enable the restructuring plan to affect senior creditors, which consequently have a right to vote to the extent that they are affected. Similar to the German code, the court needs to confirm that the decision does not disenfranchise dissident secured creditors beyond the market value of their assets. Both codes thus set the benchmark to the theoretical liquidation scenario.

A cram-down on secured creditors is possible under the French *procédure de sauvegarde*As a traditionally creditor-unfriendly code, the French reform could be implemented without being affected by secured creditor's special interests. As in Germany creditors are separated into different groups, even though the segmentation is not as granular, distinguishing between financial creditors, trade creditors and potentially bondholders (Weil, 2012). The restructuring plan is accepted given that it finds the acceptance of 66.67% by value of the creditors within each committee (Nomura, 2010). France has further instilled flexibility into its code with the 2009 reform which introduced a fast-track safeguard procedure only involving financial creditors (*sauvegarde financière accélérée*). This allows to operate the day-to-day business of the company under as normal as possible circumstances, leaving the trade creditors unaffected. As with the introduction of the *procédure de sauvegarde*, the French legislator seems to have followed the example of the UK code.

Lastly, all restructuring procedures allow for dissident creditors to be overruled in the UK. To pass a plan under the Administration procedure only 50% of unsecured creditors are needed, resulting in a strong cram-down mechanism to effectuate pre-pack Administration procedures, while the *Scheme of Arrangements* requires a majority by number representing 75% in value of all creditors or creditor classes, and the *CVA* requires an agreement by 75% of unsecured creditors, without any separation into classes. The vote also includes the shareholders, if their claim is affected. Consequently, traditional restructuring agreements aimed at continuing the business can best be effectuated via *Scheme of Arrangements* as secured creditors can be bound, while the *CVA* is best suited to restructure trade debt, as unsecured creditors are not separated into different classes[81]. This has made the latter procedure specifically attractive to the retail sector an onerous lease commitments could better be restructured (Weil, 2012).The different agreements that can be achieved due to the range of procedures and their specificities has been mentioned as one of the key benefits of the UK code (Nomura, 2010).

The international comparison renders the German voting mechanism in a rather inflexible light. This derives from the fact that majorities need to be found within each group rather than allowing a majority achieved in a set of groups to accumulate and overrule all other groups, as heralded by the US code (Hirte, 2011). Additionally, the obligatory separation of creditors into certain groups appears overly prescriptive. In Europe, the German mechanism is perhaps most comparable to the one of the Italian code, even though here the split up of creditors into different groups in contingent on the plan. Spain's cram-down mechanism has been criticized as being too focused on financial creditors. On the other hand, the French code appears more flexible with a less granular separation of creditors, especially with the recent fast-track safeguard procedure. Lastly, the UK code with its wide range of restructuring procedures with different cram-down mechanisms tailored to the disparate needs of financially distressed firms presents itself as even more superior and workout friendly. Next to the easy implementation of debt-for-equity swaps, the variable and reliable voting mechanisms of the UK code have been one of the primary motivations for COMI shifts. The easier implementation of a cram-down in German only partly mitigates the competitive disadvantage in this respect.

3.3.2.4 The exclusion of the possibility of claw-backs

As has been shown, parties will be more hesitant to agree on a plan out-of-court if the plan can be questioned in court in subsequent processes. While the legal shelter to ascertain the involved parties that this could not occur was not at the heart of the 2012 reform, it constitutes a defining aspect of the attractiveness of pre-insolvency procedures, as illustrated by the

[81] As previously explained the *Administration* procedure is used more for pre-packaged sales rather than a continuation of the business.

discussion of the Spanish code. Given that the pre-insolvency "*Schutzschirmverfahren*" constitutes a key innovation of the reform, the regulation on claw-backs bears significance.

In Germany claw-backs can be extensive, ranging up to 10 years prior to the insolvency petition (European Parliament, 2010). Section 3.1.4 provides a detailed review of the main claw-backs, instilling uncertainty into pre-insolvency contractual agreements, asset sales and credit extensions (Westpfahl, 2010). While a review of these regulations would have arguably helped the rehabilitative nature of the pre-insolvency procedure, the 2012 reform has not addressed these issues. Future court rulings may provide more certainty at least with respect to the equity purchase of creditors. At the same time the previously described asset sale (*übertragene Sanierung*, *§ 162 InsO*) remains a viable option that alleviates the threat of claw-backs (Paulus, 2008).

Regulation on claw-backs in the European insolvency landscape

Uncertainty induced by claw-backs has been mentioned as one of the key source of apprehension of the 2003 Spanish bankruptcy code (Celentani, et al., 2012; Pallares, et al., 2012; IFR, 2009; Fernandez, 2009). The claw-back period used to extent to a 2 year period and transactions done both in good and bad faith could be declared void, but would be ranked differently in terms of claims against the insolvent company (European Parliament, 2010).The 2009 and 2012 reforms addressed this issue, inhibiting claw-backs for a two year period based on a set of conditions which, in summation, impose that the nature of the restructuring agreement is substantial, supported by 60 percent of the creditors, and accompanied by an independent expert opinion. Especially the 2012 amendment has been perceived as providing significant legal certainty on this issue (Pallares, et al., 2012; Ashurst, 2012). While § 39 *InsO* provides a similar exclusion of claw-backs if a creditor purchases equity "for the purpose of a restructuring" (§ 39 Sentence 4, *InsO*) this remains a lot more open to judicial interpretation in comparison to the clearly outlined requirements under the Spanish code. Similarly, Italy provided a strong shelter from claw-backs with the 2006 reform of its bankruptcy procedures, a major impediment to pre-insolvency procedures prior to the reform (Rodano, et al., 2011). The reform *inter alia* halved the claw-back period from 2 and 1 year to 1 year and 6 months (European Parliament, 2010). The criterion for claw-backs in Italy is knowledge of the creditor of the state of insolvency, which can be likened to the German concept of criminal liability for a fraudulent delay of insolvency (*Insolvenzverschleppung*). Notably the law instituted a set of exemptions of transactions excluded from claw-backs[82]. These include debt transactions providing substantial support to a restructuring plan, encouraging the participation of creditors under these plans (International Insolvency Institute, 2005), again resembling § 39 *InsO*. In France, a 6 month period of exemption of claw-backs upon filing is provisioned (European Parliament, 2010). Failure to file for insolvency within the allowed 45 day window may however, result in a back-dating of the claw-back period, potentially allowing contractual partners of the firm to bring further action against it (Weil, 2012). Prior to the 2006 reform, liability for French banks, extending credit to financially distressed firms was extensive (*soutien abusif*) (Fried Frank, 2005). The reform has significantly limited this liability, which now only applies to cases of fraud, interference with the management of the company, and for excessive securities for the credit (Art. L. 650-1, *CC*). The UK allows for claw backs post insolvency filing for transactions occurring 2 years prior to insolvency for preferred parties and 6 months for non-preferred parties. Under liquidation and the *Administration* procedure claw-backs can also extend to floating charges (European Parliament, 2010). Overall, all of the discussed codes now regulate the tenability of contracts and agreements post-insolvency. Legal uncertainty is arguably limited most where the legal room for claw-backs is defined most precisely. *Prima facie*, France limits this potential most, with Spain also providing a clear definition. In Germany much room is left for judicial interpretation as the 2012 reform failed to address this point and thus remove an important source of uncertainty. Arguably, however, given the

[82] See European Parliament (2010), p. 103 and International Insovency institute (2005) for a list of exemptions from claw-backs granted under the current code.

role of judicial interpretation, most certainty can be provided by previous court rulings, where the UK has a clear competitive advantage (Nomura, 2010).

3.3.2.5 The provision of post-insolvency financing

Post-insolvency financing, together with the previously discussed stay on creditors can significantly contribute to ensuring the viability of the restructuring process, injecting capital when it is most needed. For the case of Germany, where insolvency filings typically occur at a very late, and often too late point of time (Frind & Gärtner, 2010), the provision of "fresh money" plays an even more significant role as the reserves of the company by the time of filing will be close to depletion. The *Ihr Platz* case has illustrated the important role of post-insolvency finance (section 3.1.5). As explained in section 3.1.3, however, only a minimum amount of "emergency-liquidity" is typical provided in German insolvency procedures, falling short of the true US type of financing allowing for significant investments. The 2012 reform has not significantly addressed this aspect in the formal insolvency process, such that the previously discussed practice will likely prevail. The issue of post-insolvency financing is reflected in the reform only to the extent that the umbrella procedure now also allows for post-insolvency financing which the court may order upon the request of the debtor (§270). There is no reason why this should change the timid use of this practice, as it is more for cultural reasons rather than legal shortfalls (Westpfahl, 2010).

Post-insolvency finance in the European insolvency lanscape

In Italy, post-insolvency financing in the form of super-priority financing is available under the *concordato preventivo* and *accordo di ristrutturazione dei debiti* for certain loans and 80 percent of shareholder loans. Similarly, while it used to be available only to a very limited extent in Spain, this has been significantly ameliorated with 2012 Amendment of the Insolvency Act (84.2.11 of the SIA). While only 50 percent of claims are now ranked as claims against the debtor's estate[83], the change still constitutes a significant step given the influence of Spanish secured creditors. Practitioners have judged it a good starting point (Ashurst, 2012). Notably, however the post-insolvency loans may not be provided by the debtor or persons with a special relationship, including shareholders. France, on the other hand, imposes a set of severe restrictions on the provision of "fresh money", significantly reducing its availability. For instance, the pre-insolvency *procédure de conciliation* grants credit extended during the period higher priority, ranking even before secured claims, but only if the approval of the agreement is ratified via a court judgment, making it public (Nomura, 2010). Even more restrictive, the UK allows super-priority financing only under *Administration*, which provisions the loss of control of management and thus will only be applied in severe restructuring scenarios[84]. The lack of post-insolvency financing for the more debtor-friendly restructuring procedures of the UK code, the *CVA* and the *Scheme of Arrangement*, has been a key point of criticism of the UK code (Fried Frank, 2005). Similarities with the shortfall of the UK code with regards to the stay on creditors can be noted and may again be attributed to the creditor-friendly tradition of the code. In conclusion, European codes have been hesitant to fully follow the example of the US with regards to post-insolvency financing. Italy, followed by Spain and Germany, could be considered as most progressive in terms of the legal framework in support of "fresh money". Indirectly, the German code offers a considerable advantage through the previously mentioned financing of employee claims, which may help to alleviate the need for new funds.

3.3.2.6 Strengthening debtor access to self-administration

Except for a set of prominent cases, in-court proceedings under the 1999 code resulted in the loss of control by incumbent management (Frind & Gärnter, 2010), one of the key shortfalls of the German bankruptcy landscape and a significant driver for COMI shifts (Westpfahl, 2010; Nomura, 2010; Bork, 2012). Consequently, the reform has sought to improve the access of

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[83] The other 50 percent are ranked as preferred claims, superseding junior and subordinated claims but ranking below special preferred claims and other general preferred claims.

[84] Pre-packed administrations can be ignored here as they generally aim at selling the company in a timely manner and are thus unlikely to use super-priority financing.

incumbent management to self-administration with § 270. The article addresses both the preliminary process and the official process. For the case of the preliminary process, it rules that, if incumbent management petitions for self-administration of the restructuring process in the filling for insolvency, courts are to grant this unless this is "obviously unpromising[85]". The court further needs to communicate to the financially distressed firm, which is not yet insolvent, any doubt about granting the right to self-administration such that the firm can retract its filing. This may, however, be more of a cosmetic change as the option to withdraw the filing practically existed before (Frind & Gärnter, 2010). With respect to the official opening of the process, the pre-reform legislation stipulated that the creditors needed to consent to self-administration. This has now practically been turned around, and the court may now grant self-administration if it is unaware of any disadvantages that this may cause for the creditors. While the influence of creditors may seem to have been reduced with this change, § 271 and § 272 rule that the creditor committee may retroactively petition for the advanced termination of the procedure[86]. While the improved access to self-administration contributes to mitigating one of the major shortcomings of the code, a set of reservations remain. In particular, the practical interpretation of an "obviously unpromising" self-administration (in the case of the preliminary process) as well as a "disadvantage to creditors" (in the case of the official process) is a source of legal uncertainty (Hirte, 2011).

Self-administration in the European insolvency landscape

Allowing incumbent management to continue steering the financially distressed firm through the restructuring procedure was one of the key aspects that differentiated the US *Chapter 11* procedure from the bulk of the procedures under Continental European codes. Consequently, all reforms addressed this issue, such that all countries under review now feature a viable self-administration procedure, however with different limitations. In the UK, an administrator replaces management under the *Administration* procedure. As has been explained this results in the procedure being primarily used for quick pre-pack company sales rather than actual debt restructurings. France leaves management in place for all restructuring methods but assigns a supervisor with a varying degree of control, depending on the chosen restructuring procedure (Nomura, 2010). Spain, until recently, assigned as many as three administrators of different backgrounds to supervise management, which could arguably slow-down the process quite significantly. It has only recently remedied this and now appoints only one administrator (Pallares, et al., 2012). In Italy, the special category of extraordinary procedures, designed for large corporates, results in the loss of control by management and the appointment of an extraordinary commissioner, who reports to the Minister of Economic Development (Nomura, 2010). This specialty of the Italian bankruptcy code reflects the political importance that is attributed to the preservation of national champions. Overall, the regulation of the self-administration mechanism appears more competitive in Germany following the reform.

3.3.2.7 Allowing shareholder rights to be affected by the plan – the institutionalization of the debt-for-equity swap

Both anecdotal evidence as well as empirical studies have underscored the minor role of debt-to-equity swaps in the pre-reform German code (Jostarndt & Sautner, 2010). As illustrated primarily by the case discussions, the inability to restructure shareholder claims constituted a key shortfall of the 1999 code, as the instrument provides a crucial facilitator in the pursuit of distressed debt investor's investment strategy (section 3.2.3). Beside the ability to uphold the APR, the debt-for-equity swap is commonly attributed with a set of beneficial effects that contribute to the facilitation of the restructuring process. Specifically benefits of this instrument include 1) the alleviation of the interest and amortization burden by exchanging interest-bearing and amortizing debt into equity 2) improved credit-characteristics allowing for cheaper future refinancing rounds through a more equity-financed capital structure[87] 3) potentially beneficial tax impacts 4) attracting specialized

[85] "*offensichtlich aussichtslos*" in German
[86] The creditor committee can make these decisions with a majority in value of claims as well as in number of the voting creditors §76 and §271/§272.
[87] An effect that is catalyzed by the implementation of the Basel II rules on the one hand and the already comparatively low equity ratio of German firms on the other.

distressed debtors with an expertise in restructurings and a willingness to execute them and 5) inducing trade creditors and customers with reassurance based on the investment by a new creditors (Paulus, 2008). To address this criticism the reform has effectuated a paradigm shift with regards to the legal position of shareholders. These are now considered to be within the same legal realm as creditors[88] and may consequently be affected in the restructuring plan for incorporated companies (§ 217). Within this new regulation, debt-for-equity swaps are addressed explicitly by stating that the restructuring plan may include the transfer of debt holder claims into shareholder rights, given the consent of debt holders (§ 225 a). The law further prescribes that this may be executed via capital reductions or increases, non-cash capital contributions, exclusion of preemptive rights and the indemnification of fully diluted shareholders[89]. Importantly,§ 254 now explicitly rejects the right of the debtor to sue that the conversion ratio of claims to equity stakes was disproportionate, alleviating the risk for the new equity holder to be liable to reimburse the difference between a proportionate evaluation of her claim and the actual valuation. Similarly, as previously discussed in section 3.3.2.4, the claims of creditors, who have acquired shares may now not be subordinated if the debt-for-equity transfer was made in the context of a restructuring, removing another important risk of the procedure (Hirte, 2011). Lastly, § 225a, as a result of a late amendment of the legislative process also bans change of control provisions, which would have previously resulted in the possible termination of contracts (involving banks, suppliers, landlords etc.) if a new equity holder passed certain ownership thresholds (Latham & Watkins, 2012).

Given the paradigm shift that underlies this new mechanism, a set of external regulations need to be adapted. For instance, the ability of restructuring plans to induce capital reductions interferes with the privilege of the shareholder meeting to decide such reductions. Additionally, the new reform needed to reduce the liability under a non-cash asset contribution, which *prima facie* could be perceived as a negative signal for creditor protection (Hirte, 2011). Overall however, it can be argued that the explicit regulation of the *debt-to-equity* swap attentively addresses a major practical shortfall of the bankruptcy code.

Debt-to equity swaps in the European insolvency landscape

As a market-based economy, the UK deserves special attention, as arguably the jurisdiction that provides most flexibility in the implementation of debt-for-equity swaps, as the case discussions have shown. Both the CVA as well as the Scheme of Arrangements allow for debt-for-equity swaps and the range of possible procedures has been mentioned as one of the key advantages of the UK code (Weil, 2012). Most importantly, swaps could be implemented comparatively faster and with a legally stronger footing than in Germany prior to the latest reform (Paulus, 2008). Similar to the German code post the 2012 reform, the appropriate voting mechanisms are applied to dissident creditors and/or shareholders and plans provisioning a debt-for-equity swap may not be prejudicial against minority shareholders. This however is measured against majority shareholders rather than a liquidation scenario. Arguably, given the typically significant size of the debt write-downs as well as the subordinated ranking of equity, the required equity compensation will result in a significant dilution of both groups of incumbent shareholders (Weil, 2012). France allows for debt-to-equity swaps in the restructuring agreements of its main procedures, the *procédure de conciliation* and the *procédure de sauvegarde*. The provision of the instrument has been a key aspect of the bankruptcy reforms and arguably helped to mitigate the creditor adverse nature of the code. Specifically, prior to the reforms, creditors were limited to essentially one mechanism to effectuate debt restructurings namely to accept either immediate or deferred cash payments for significant debt write-downs, with limited creditor protection. Debt-to equity swaps have been used especially in the previously discussed cluster of more complex restructurings of leveraged transaction in 2009 such as the restructuring of *Autodis*, a major distributor of car and heavy vehicle parts. Generally, incumbent shareholders need to validate the restructuring plan (Assaya & Rotenberg, 2010). Spain also sets few limits to the content of the

[88] Hirte (2011) points to a 2010 BGH ruling interpreting shareholders as "sub-subordinated insolvency creditors". T address the counterparties in a restructuring, the new code no employs the term "*Beteiligte*" (stakeholders) rather than "*Gläubiger*" (creditors)

[89] In general terms a debt-to-equity transaction under German law would first involve a capital reduction to the residual value of the equity capital. Subsequently the claims of debt holders would be exchanged as non-cash asset contribution for shareholder claims under exclusion of the preemption rights of existing shareholders.

restructuring agreements of either the *convenio anticipado* or the *convenio ordinario,* but imposes as set of preconditions and consequences. Analogous to the German case, both debtors exchanging their claims for shareholder stakes, as well as incumbent shareholders need to agree to the plan. Additionally, at least 25 percent of the restructured debt must be due and payable. Lastly, a debtor holding 10% or more of a private, and 5% or more of a public company is subordinated to the claims of other creditors (CMS, 2011). Similarly, Italy allows for debt-for-equity swaps, or more generally the compensation of creditor claims with shares and other financial securities, post the 2006 reform. Initial inconsistencies with other laws where streamlined with a subsequent reform, The precedent case was arguably set by the *Parmalat* restructuring which employed this instrument in 2005 (Maganelli, 2010).

With the inclusion of a debt-to-equity swap in the German bankruptcy code, the legislator has addressed another key shortfall of the pre-reform code in Germany. To achieve competitive parity with its European peers, however, the legal groundwork needs to be followed by successful practical applications to instill the procedure with routine and legal certainty.

3.3.2.8 Improving the expertise of the courts

The review of the pre-reform German code drew the picture of a highly complex process that was implemented by a dispersed system of 182 courts (Hallberg, 2009) in which company's filed at their judicial or, if it differed, at the court of their economic center (*§ 3 InsO*). Given the notoriously low filing rate, there was significant doubt among practitioners if the ample authority granted to the courts was matched with the right expertise on the side of the authorities, not only in the legal realm but also with regards to the financial skills needed for sound judgment. This skepticism surfaced in the development of the 2012 reform. For instance, Frind and Gärtner (2010) in their critique of a draft reform quote courts that witness as few as 20 cases opened per year as an indication of an acute lack of practical experience. Based on *InDAT* data, Appendix B illustrates that the vast majority of courts and administrators process a low number of cases over a 6 month period. A related point of criticism addressed the appointment of the administrator, which some perceived to be arbitrary or even biased by personal relationships (Reuter, 2011).

The reform in its first draft tackled the issue on three levels; by concentrating the number of courts with authority to handle insolvency cases (§ 2 RegE-InsO[90]), by obliging judges to routinely train themselves in the specificities of insolvency cases (§ 22 RegE-GVG[91]) and by increasing the required detail of disclosure in the initial insolvency filings (§ 13 RegE-InsO). The draft proposal was perceived favourably by practitioners (Hirte, 2011; Frind & Gärtner, 2010), but countered by representatives of the judicial system. The opposition argued especially against the first point as they perceived a concentration of the courts to conflict with the paradigm of maintaining court rulings on a local level, close to the citizens[92]. While the link between this local concept and a more expertized court system may not seem intuitively obvious, critics eventually prevailed. Consequently, the suggestions are only reflected to a very limited extent in the current law: The reform prescribes that cases are only to be allocated to judges with sufficient expertise or to judges likely to obtain this expertise in the near future[93] (§ 22 GVG). The regulation of detail of disclosure was implemented in § 13 InsO. The concentration of insolvency courts, arguably the proposal with the most structural and transformative potential, has not been included into the law. According to the model of Ayotte and Yun (2009; discussion in section 1.1) the reluctant use of the pre-reform in-court procedures can be linked to a perceived low-level of court expertise. In line with the model, the recent reform provided more clear guidelines, decreasing the power of the courts in in-court proceedings. As outlined however, judges and administrators

[90] RegE-Inso (*Regierungsentwurf Insolvenzordnung*) denotes preliminary reform drafts of the insolvency law
[91] RegE-GVG (*Regierungsentwurf Gerichtsverfassungsgesetz*) denotes preliminary reform drafts of the law on the constitution of the courts
[92] A concept referred to as *Bürgernahe Gerichte* in German
[93] This expertise is defined as: "Certified experience in insolvency, commercial and civil law and the required basic knowledge of the social and tax law as well as in accounting"

still have significant authority such that a more progressive approach to improving judicial expertise would have arguably benefitted the reform.

Structural regulations to increase court-expertise in the European insolvency landscape

France handles bankruptcies in the commercial courts (*tribunaux de commerces*), of which 135 exist across the country, having decreased from 191 in 2008 (Conseil national des greffiers des tribunaux de commerce, 2011). A similar concentration around the commercial centers, most prominently Paris, as in Germany (Appendix 1) can be found, and courts vary in terms of expertise. Corporate turnarounds are slightly more likely in Paris and more sophisticated procedures, such as pre-warning mechanisms are in place (Blazy, et al., 2011). Under both the *mandat ad hoc*, as well as the *conciliation* the debtor can recommend the mediator, allowing for the appointment of an expert who is already familiar with the situation (Fried Frank, 2005). In the case of Spain, the 2004 reforms attributed a specialized set of mercantile courts with authority over commercial issues, including insolvency. This allowed for some degree of specialization and centralization for matters that had previously been handled within the dispersed civil court system. Thirty mercantile courts were established originally[94], centered in the main commercial centers of Spain, and judges had to undergo a set of exams and classes to receive the title as mercantile specialists. Early observers argued that the specialized system helped to unify the bankruptcy code vis-à-vis a set of practical issues that have arisen after the reform (Alonso & Madrid, 2007) and the establishments of the mercantile courts was well received overall (Navarro & Gonzales, 2008). However recent critics have attributed mercantile courts and administrators processing Spanish insolvencies with similar deficiencies as the German bankruptcy landscape. These result from low expertise as a result from the lack of a bankruptcy tradition and a low filing rate, no provision for financial training for commercial judges, an excessive range of authority of commercial courts, ranging from transport to intellectual property inhibiting a more focused specialization, and the lack of an incentive system for administrators to encourage rehabilitation (Celentani, et al., 2012). Arguably however, the creation of a specialized judicial system has contributed to the exposure of these shortfalls such that these can further be addressed in subsequent reforms. For SMEs the UK, a similar principle as in Germany generally applies - in-court insolvency procedures are handled by the country court where the registered office is located. Larger insolvencies[95] are handled by the Chancery division of the High Court and are handled by a dedicated sub-division, the Bankruptcy court, allowing a concentration of expertise for more complex cases. Overall the expertise of the bankruptcy courts is well perceived (R3 Association of Business Recovery Professionals, 2010).

From a European perspective, the reform only partly mitigates a deficit in the German bankruptcy code. This is apparent especially in the comparison with the UK, which often source judges from a pool of lawyers with a more significant amount of professional experience (Hirte, 2011), and where judges are arguably provided with more guidance due to a large number of precedent cases. Given the different legal traditions the UK practices would be hard to emulate in Germany. Spain, on the other hand has shown how more centralized and expertized courts can catalyze reforms in a civil law context.

3.3.2.9 Reallocating power from the courts to the creditors and the debtors

As outlined in the previous section, the reform relocates control over the in-court process from the courts to the debtor and the creditors. To this end, the reform attributes creditors with more rights during the preliminary process most importantly by summoning the preliminary creditor meeting (§ 22a), which is consulted on the choice of the preliminary administrator[96] (§ 56a). The discretion of the court in appointing an administrator has consequently been significantly limited. This holds true

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[94] The onset of the financial crisis increased the number of courts to 45 (Andreev, 2010)

[95] Exceeding a share capital of GBP 0.12m

[96] This privilege to the creditors can be precluded if the court judges that the formation of such a committee would negatively impact the position of the debtor. As before, however, the creditor committee may overrule an unwanted preliminary administrator with a unanimous vote upon the convention of the first committee meeting (§ 57 *InsO*).

especially if the preliminary creditor committee unanimously votes in favour of a certain administrator, in which case the court may only reject the proposal if it judges the candidate unfit. Previous sections already elaborated on the counterbalance to this new aspect of the reform, most importantly simplification of the debtor's access to self-administration. Similarly, the law now allows the court to appoint a preliminary administrator who has already consulted the debtor prior to the insolvency filing, for instance with the drafting of the restructuring plan (§ 56). Practitioners have welcomed this as it allows for continuity of the process (Frind & Gärnter, 2010).

The power of the parties in the European insolvency landscape

All European jurisdictions have access to self-administration procedures, such that the rights of the debtor are on a fairly equal footing with respect to this (Section 3.3.2.6). Significant differences remain in the treatment of creditors, heralding from the previously described different traditions of the codes. In the UK, floating charge creditors, holding security over essentially all of the company's assets have the power to initiate an *Administration* procedure and appoint the administrator, providing financial creditors with a significant amount of control and heralding from the antiquated *Receivership* procedure which would place control over the insolvent debtor entirely in creditor's hands. In France, on the other hand, creditors do not have direct influence over the choice of the administrator, an illustration of the creditor-unfriendliness of the code. Similarly in Italy and Spain, creditors are able to initiate the procedure, given they can prove insolvency, but are not consulted on the administrator either. With respect to the appointment of the administrator, Germany and the UK have stripped the court of most of its discretion. This has overall been perceived as a beneficial regulation (Hirte, 2011; Frind & Gärtner, 2010). In fact, the role of the court as a neutral, reliable and fairly passive enforcer of the law is an often quoted ideal among European practitioners and stands in contrast to the rather active role US courts play in Chapter 11 proceedings (R3 Association of Business Recovery Professionals, 2010), suggesting that, in the wake of the European reform movement of the last year, an independent "European approach to bankruptcy" is emerging.

3.3.2.10 Increasing the threshold for the formation of the preliminary creditor committee

A controversial point relates to a new threshold for the formation of a preliminary creditor committee based on the size of the firm[97] (§ 22 a). It effectively excludes creditors of small enterprises from the opportunity to be consulted on the preliminary administrator in an insolvency scenario. This point has received attention especially due to the large number of SME's in Germany (see Appendix A). Hirte (2011) argues that this mechanism of better involving financial creditors should be available to all companies.

Abridged processes for SMEs in the European insolvency landscape

As shown by Lakhal (2012) 99 percent of insolvent firms are SMEs in France, similar to the German corporate landscape. This explains the existence of a threshold in the formation of creditor committees based on the size of the debtor can also be found in the *procédure de sauvegarde* under the French code[98]. Importantly however, the two committees of trade creditors and financial creditors can be formed for smaller firms if either the debtor or the administrator explicitly demands this. German SMEs are not provided with this option. A similar corporate demography exists in the UK (R3 Association of Business Recovery Professionals, 2010), and broad access to the restructuring procedures is provided. Contrary to the preclusion of certain aspects of the procedures, only SMEs[99] can profit from a stay on creditors in a *CVA*. Spain, together with

[97] The preliminary creditors committee is only convened for sufficiently large enterprises due to the procedural effort. Large enterprises are defined as exceeding two of the subsequent three factors: 1) EUR 4.84m balance sheet total 2) EUR 9.68m annual revenues 3) Minimum of 50 full-time employees on annual average (Art. L. 622-30 et seq., French Commercial Code)

[98] The thresholds under the *procédure de sauvegarde* are 150 employees and EUR 20m in annual revenues

[99] The firm needs to meet two of three criteria: a turnover less than GBP 5.6m, assets worth not more than GBP 3.26m and no more than 50 employees.

Italy, Portugal and Greece, has the highest proportion of SMEs in the EU[100]. Consequently, Spain used to be relatively accommodating to SMEs imposing only a low threshold. However the spike of insolvency filings in the wake of the financial crisis induced the legislator to significantly increase this threshold to ease the strain on the mercantile courts with the *ley 3/2009*. The 2012 Amendment has provided new guidelines [101]. Italy does not prescribe thresholds specific to creditor committees, but entirely excludes SMEs from the *concordato preventivo*, if they do not pass a threshold[102] (IFR, 2009). Notably however, this threshold is much lower than the German one.

In conclusion, the German threshold for SMEs appears to be at the high-end of its Continental European peers. It seems restrictive vis-à-vis the French procedure, where the threshold is optional and Italy, where it is much lower, but is less restrictive that the Spanish threshold. As has been explained however, the high Spanish threshold can be seen more as a temporary measure to cope with the adverse economic situation in the country, and may eventually be lowered again.

Conclusion - Germany as a bankruptcy location after the 2012 reform

The review of the 2012 reform of the German bankruptcy code has illustrated a set of changes with a clear turn-around-facilitating character. Most prominently, these have been found to be the introduction of a pre-insolvency umbrella procedure, the easier access to self-administration for the debtor and the extension of the restructuring plan to shareholder rights, including the explicit institution of a debt-for-equity swap. Overall these changes have provided the legal groundwork to mitigate significant deficits of the German code vis-à-vis its European peers, in the "competition of bankruptcy codes" (Hasenheit, 2012). At the same time, the review has shown a set of shortfalls of the reform, relating especially to claw-backs on out-of-court agreements, the cram-down mechanism, as well as the lack of structural change of the judicial authorities to increase the expertise of the courts.

Framing the reform within the insights of the review of the theoretical and empirical studies, especially the improved access to self-administration holds the potential to mitigate overinvestments in assets and encourage corporate risk taking (Celentani, et al., 2012) as well as stimulate innovation (Acharya & Subramanian, 2009). Importantly, the benefits of this debtor-friendly amendment hinges on a general acceptance of the procedure and thus a change in the insolvency culture, which can only gradually evolve from what long has been a liquidation-oriented culture of in-court processes (Djankov, et al., 2008). In the medium term, the provision of an attractive pre-insolvency umbrella procedure may help to mitigate the late filing rate, a key factor of the low success of in-court turnarounds in Germany (Frind & Gärtner, 2010). Anecdotal evidence shows that France, which suffered from the same delay in filing for insolvency (Blazy, et al., 2011), benefitted significantly from a similar reform in 2006 (Joubert, 2012). The effect on the cost of lending can not clearly be inferred from the studies. While a more turn-around oriented code may induce more risk-taking, which banks will seek to be compensated for in the form of higher lending rates (Rodano, et al., 2011), these have been shown to also hinge very much on country-specific aspects (Davydenko & Franks, 2008). Conversely, higher turnaorund rates imply higher recovery values which may reduce the collateral requirement, thus lowering the cost of lending (Davydenko & Franks, 2008). Additionally, the impact of the reform on bank's lending policy may be overshadowed by major structural changes in the banking landscape due to the impending Basel III regulation and the continued soveriegn debt crisis. On the negative side, the review has shown that the dispersed German court system (Appendix B) may result in misalignement with the role that Germany as a civil law country still attributes its

[100] Somoza (2011) reports the proportion of SMEs to total firms of 99.86% in Spain in 2009 and estimates similar levels for Italy, Greece and Portugal.

[101] The procedure may now be followed in cases not considered overly complex by the court based on 1) less than 50 creditors are presented on the list of creditors attached with the insolvency filing 2) the initial estimate of debt is now higher than EUR 5m and 3) the valuation of debtors assets and rights is lower than EUR 5m.

[102] To qualify for the *concordato preventivo* or the *fallimento*, companies need to exceed 1) EUR 0.3m in assets 2) EUR 0.2m in gross annual revenues over the last three fiscal years and /or 3) EUR 0.5m in indebtedness, due or not due (IFR, 2009).

courts. The intuitve link between court authority and court expertise has been underscored theoretically by Ayotte and Yun (2009).

The case discussions have illustrated the important link between the bankruptcy code and the sources of financing. By providing a more debtor-friendly code, the restructurings of complex debt structures, including public debt, the presence of specialized distressed debt investors and mezzanine debt can better be coordinanted, following the model by Hege (2003). Given that ca. 95% of German distressed corporate debt is held by specialized investors (Paulus, 2008) and a significant amount of refinancings are due as early as 2013 (Joubert, 2012), the need for an effective, flexible and competitive code was imminent. As has been shown, wether the reform suffices to preclude further COMI shifts will hinge primarily on the practical proliferation of the debt-for-equity swap in in-court restructuring procedures, which played only a peripheral role under the pre-reform German code (Jostarndt & Sautner, 2010).

It is unlikely that the 2012 reform will result in the imminent broad perception of bankruptcy as an opportunity, as intentioned by the legislator. Rather, as its European peers, a change in the bankruptcy culture will likely take the form of a gradual evolutionary process. Additionally, the discussed structural shortfalls will stand in the way of a more pronounced effect of the reform. Lastly, given the resilience of the German economy, the new code will not immediately be tested by a spike in bankruptcies. This will result in a relatively small amount of new cases, driven primarily by isolated ailing industries, such as the solar energy industry. This may initially result in uncertainty where the legislator has not been sufficiently explicit (Baker & McKenzie LLP, 2009). Nonetheless, the reform constitutes a significant and vital step, especially with regards to the changed reality of European capital markets and the investor landscape. As illustrated by the case of Spain, the legislator must now be sensitive to implement amendments where further change is needed. The current discussion around a change in the entry-criteria for insolvency (Jahn, 2012) constitute a good starting point here. While this discussion sources from a survey of practitioners, policy descisions should also be grounded in empirical reseach from the financial and economic realm. To this extent, the continued facilitation of data accessibility in Germany and Europe is key to relevant and timely scientific insights. This is all the more important as the dynamic for reform across Germany's major economic peers will be further catalyzed, in part due to the persistent recessionary economic climate across most of Europe and especially in Spain and Italy. Notably, the UK has been surveying experts to assess the needs for further reforms (Financial Times, 2010). The continued reform movement in turn will drive further change in the German insolvency landscape.

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Appendix

A – European and German insolvency statistics

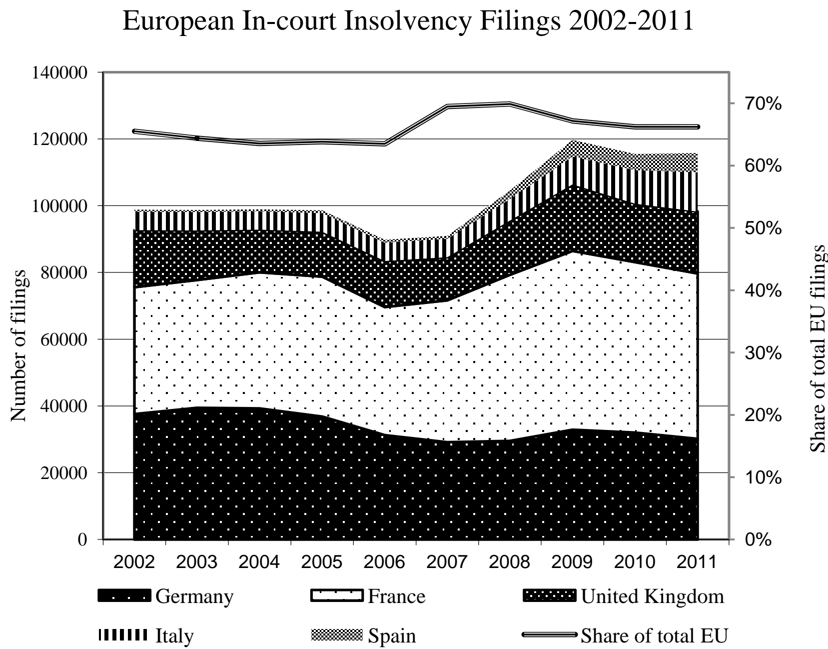

Figure I, Source: *Creditreform* (2012, 2006), Due to a statistical change, the pre-2006 data for Italy is non-comparable and has been frozen at 2006 level.

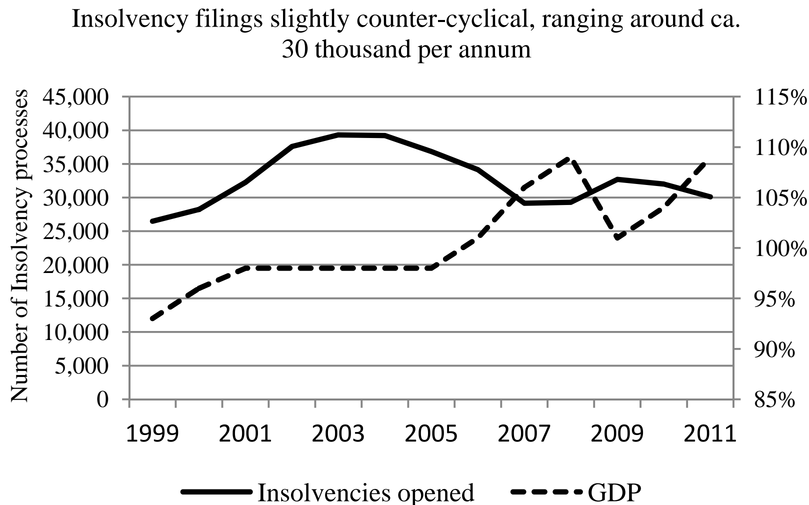

Figure II, Source: *Statitisches Bundesamt*, German Gross Domestic Product is indexed to 2005.

Figure I shows the development of insolvency fillings, based on the 2012 and 2006 *Creditreform* surveys. The major European economies provide the largest share of insolvency filings across Europe (ca. 65%). Spain and Italy have experienced significant increases of filings since 2007 but numbers are overall still low vis-à-vis Germany and, most importantly, France, the latter of which experienced a significant increase in insolvency filings as of 2006, coinciding with the implementation of the *loi de sauvegarde* (section 2.2.1.4).

A similar increase around the implementation of reforms has been noted for the case of Italy (Rodano, et al., 2011). Zooming in on Germany, figure II provides a historical overview of corporate insolvencies since 1999. As can be seen, the number of filings increased until 2004, which might in part have been driven by the burst of the Internet bubble, but which may also in part have been driven by the implementation of the *Insolvenzordnung*. To this extent, note that the development of corporate insolvency filings moves counter-cyclical for most of the time. Only the period just after

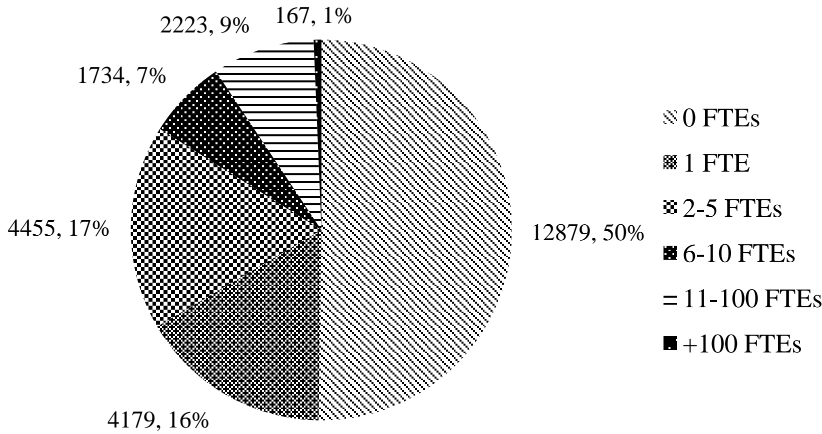

Figure III, Source: *Statitisches Bundesamt*, FTE = Full Time Equivalent

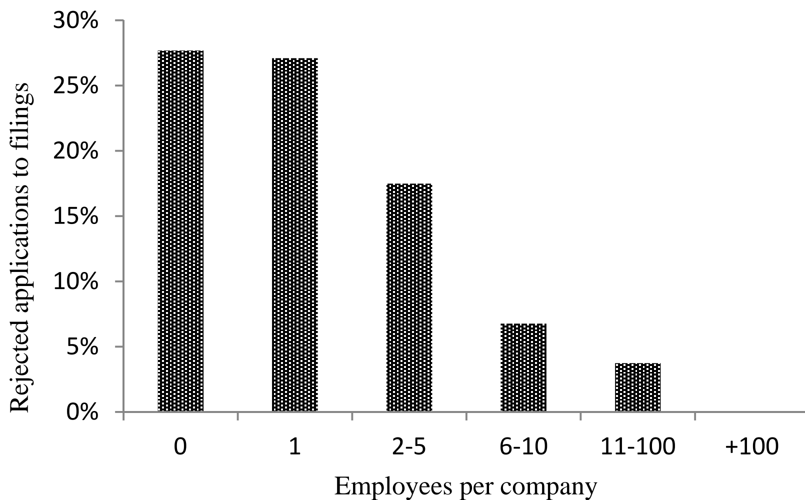

Figure IV, Source: *Statitisches Bundesamt*, based on February 2012 data

the implementation of the new insolvency law from 1999-2001 experiences a parallel move of German Gross Domestic Product and insolvency filings, which would underline the hypothesis that the new law to some extent impacted the number of filings.

As shown by figure III the majority of filings in 2011 was made up of SMEs, with less than 100 full-time employees. The ratio of SMEs is still slightly lower than the one found by Somoza (2011) for Spain (99.4% in Germany versus 99.86% is Spain). Overall, however the proportion of insolven SMEs is highly signficant.

Courts have the authority to reject filings if the applicant holds insufficient capital to cover the costs of the proceedings (§ 26). Based on the February 2012 data, 30 percent of corporate insolvency filings are rejected (Statistisches Bundesamt, 2012). As can be seen in figure IV the rejection of the filings are concentrated around the very small companies. The last two findings highlight the relevance that an economically efficient procedure for small companies can play.

B - German Insolvency courts and administrators statistics

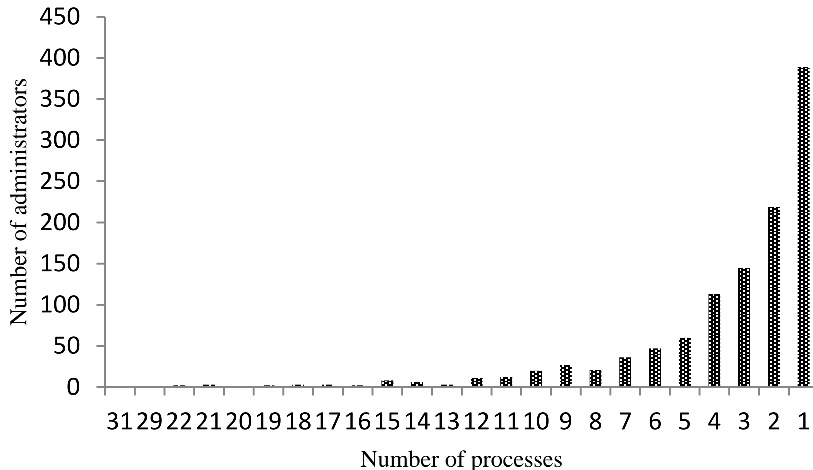

Figure V, data is from 01/01/2012-21/05/2012, based on the INDat Insolvenzbarometer available at www.indat.info/statistiken

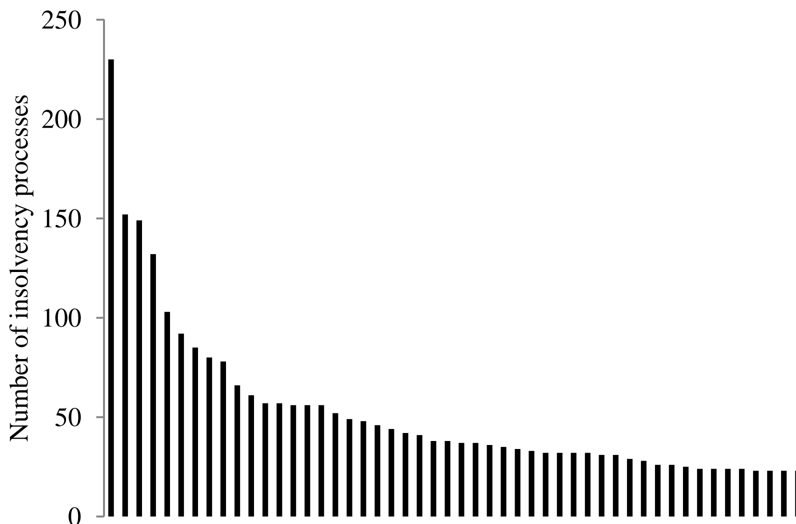

Figure VI, data is from 01/01/2012-21/05/2012, based on the INDat Insolvenzbarometer available at www.indat.info/statistiken

Section 3.3.2.8 addressed the initial proposal of a concentration of German insolvency courts included in the draft of the 2012 reform. The goal of this was to counter a court system that was perceived as too numerous, counting as many as 182 insolvency courts (Hallberg, 2009), providing judges and administrators with few cases to gain practical experience. Figure V and VI provide insights into both groups, administrators and courts officials respectively. Figure V illustrates the concentration of administrators who have handled 1 and 2 cases (53% of all administrators). Less than one percent of administrators have handled more than 20 cases, less than seven percent have handled more than 10. For the case of the 50 leading German insolvency courts (Figure VI), the median lies around only 40 processes. Naturally a strong correlation exists between urban centers and insolvency filings with the largest German cities all represented in the first 10 courts, led clearly by the Berlin court with 230 processes. Firms in rural areas, which tend to be smaller on the other hand will have to file insolvency with significantly less experienced courts and administrators. This adds to the significant difficulties that financially distressed SMEs are facing in comparison to larger firms. Given the economic relevance that these companies[103] have traditionally played in the German economy the economic implications are very relevant. Arguably, the analysis is limited by the timeframe of the statistics capture a time period of only ca. 6 months. On the other hand, given the relative lengthiness of insolvency procedures in Germany, they can likely be further extrapolated.

[103] This goup of firms is referred to as *Mittelstand* in German and often described as an essential part of the German economy.

C - Review of Bankruptcy Codes and Recent Reforms

Country	Germany	UK	Italy	France	Spain
LLSV (1998) Rating	3	4	2	0	2
Banking System	Banking finance key. Banks frequently form bank pools. Distressed companies not handled centrally. Banks accommodating to debt forgiveness (Jostarndt & Sautner, 2010; Davydenko & Franks, 2008; Brunner & Krahnen, 2008)	Highly concentrated industry, bankrupt companies handled centrally, banks typically hold floating and fixed charges giving them full control over process. Banks unforgiving in debt renegotiations to avoid strategic default. (Franks & Sussman, 2005)	Banking finance 80% of funding sources, multi-bank lending pervavsive (5 banks per borrower on average). (Rodano, et al., 2011)	Banking finance important	Banking finance key, banks tend to require securities to agree to lend. (Alonso & Madrid, 2007)
Number of bankruptcy courts	182 (Hallberg, 2009)	High Court with 42 district registries	NA	135 (Conseil national des greffiers des tribunaux de commerce, 2011)	45 (Andreev, 2010)
Legal Basis	Forced Settlement Act, 1935 and Bankruptcy Act, 1877; 1999 *Reform der Insolvenzordnung*	Insolvency Act 1986, amended 2000	1942: *Legge fallimentare* 1979: *Legge Prodi*	1985: *Loi 85 relative au redressement et à la liquidation judiciaires des entreprises*	Procedures dating back to 19th century law
Structural Reform	2012 *Gesetz zur weiteren Erleichterung der Sanierung von Unternehemen*	Enterprise Act 2002, Companies Act 2006	2005 Decree 35 (Restructuring) 2006 Law 5, Liquidation	2005 *loi de sauvegarde*, refined in 2008	2004, reform in 2009, amendment in 2012
Insolvency test BS= Balance Sheet test CS = Cash-Flow Test	Assets< Liabilities Iliquidity or impending iliquidity (CF)	Assets<Liabilities (BS) Iliquidity (CF)	Iliquidity (CF)	Iliquidity (CF) (cessation des paiements)	Iliquidity/Insolvency (CF)
Distinction between insolvent and solvent firm?	Yes	No for *CVA* and *Scheme of Arrangement*	Yes	No for *Procédure de sauvegarde*	Yes
Grace period post affirmative insolvency test	3 weeks	NA	Until losses occur	45 days	2 months, can be extended by 3 months
Creditor majority needed to pass plan (cram-down mechanism)	51% by value and number within each creditor class, agreement of all creditor classes but possibility to overrule dissident creditor classes (§ 244, § 245)	*CVA:*75% by value and 51% by number of unsecured creditors voting in one class *Scheme of Arrangement:* 75% by value and 51% by number *Administration* 50% of unsecured creditors	182*bis:* 60% of creditors *Concordato preventivo*: 51% of creditor classes, Creditors representing 51% of claims within class *Concordato fallimentare:* 51% of creditors in number representing 66.67% of the claims in value within in each class and among all creditors	*Procédure de sauvegarde* Financial creditor committee, trade creditor committee and potentially bondholder committee need to assent. 66.67% by size of claim needed within committes.	*Formal refinancing agreements* 75% by value of financial creditors,
Secured creditors can be bound?	Yes	*CVA* –No *SoA* – Yes *Administration* -Yes	Yes	Yes	No

Country	Germany	UK	Italy	France	Spain
Stay on secured creditors?	Only upon request of administrator	Only under *Administration*	Yes (for major procedures)	Yes (not automatic for *mandat ad hoc* and *conciliation*)	No, only upon court decision in rare cases
DIP financing allowed?		Only under *Administration*		Only under *Conciliation* and if exit is public	Yes (after 2012 reform)
Continuation of business	16% (Jostarndt & Sautner, 2010)	65% (Franks & Sussman, 2005)	NA	11% (Blazy, et al., 2011; Kaiser, 1996)	10% (Alonso & Madrid, 2007)
Priority in Liquidation, based on Nomura (2010)	1. Secured Creditors 2. Cost of proceedings, post-order claims from prelim. Administrator; Claims from pre-order contracts if performance was chosen 3. Unsecured creditors	1. Fixed charge holders 2. General expenses, costs of liquidation 3. Preferential creditors 4. Floating charge holders 5. Unsecured creditors	1. Super senior claims (insolvency costs and post-ins. Financing) 2. Privileged claims of government for judicial expenses 3. Secured creditors 4. Unsecured claims	1. Unpaid amounts due to employees 2. Judicial cots 3. New post-insoilvency financing 4. Perfected mortgages and pledges with retention rights 5. Post-judgement claims of ins. Process 6. Pledges without retention rights 7. General privileges (tax, social claims) 8. Unsecured debts	1. Privileged claims including secured creditors to the extent of the sale price of the security, salaries, taxes 50% of the claim of the creditor who was the first to file for insolvency where applicable. 2. Ordinary claims. 3. Subordinated claims.

E- Table of abbreviations

APR	Absolute Priority Rule
Art	Article
CC	*Code de Commerce* (French Commercial Code)
COMI	Center of main interest
CVA	Company Voluntary Agreement
DIP	Debtor-in-possession
EBITDA	Earnings before interests, taxes, depreciation and amortization
EU	European Union
FTE	Full-time equivalent
GmbHG	*Gesetz betreffend die Gesellschaften mit beschränkter Haftung* - company law for companies of limited liability (GmbH)
HGB	*Handelsgesetzbuch* – German trade law
InsO	*Insolvenzordnung* (German Insolvency Code)
LBO	Leveraged Buy-Out
LSB	*La Seda de Barcelona*
PIK	Payment-in-kind
RegE-InsO	*Regierungsentwurf Insolvenzordnung* - Legislative draft of Insolvency Code
SGB	*Sozialgesetzbuch* – German Social Insurance Code
SIA	Spanish Insolvency Act
SME	Small and medium enterprise
UK	United Kingdom
U.S.C	United States Code (US Bankruptcy Code)