Out-of-Court Restructuring
Alternatives in the EU, Germany and the US

Article By
Darren Azman
Uwe Goetker
Ravi Vohra
McDermott Will & Emery

European Union


A primary objective of the Directive is to ensure that viable enterprises and entrepreneurs with a “likelihood of insolvency” have access to effective national preventive restructuring frameworks that will enable them to continue operating.

The Directive contains mandatory minimum requirements and several optional
provisions that allow Member States to tailor the adoption to their existing national laws.

**Germany**

The German Federal Government has recently published a draft of the [Restructuring and Insolvency Law Further Development Act](https://www.gov.uk/government/consultations/restructuring-and-insolvency-law-further-development-act) (the draft law). The draft law is very ambitious in two respects: it aims to implement the Directive in its broadest sense and to provide a set of brand new out-of-court restructuring instruments, and Germany expects to make it effective as of 1 January 2021.

**Draft Law Overview and Characteristics**

The draft law provides for a flexible preventive restructuring toolbox that will help fill the gap between consensual out-of-court restructurings on one hand, and restructurings in the course of formal insolvency proceedings on the other. Although the toolbox is basically in the hands of the debtor, the protection of creditors’ interests remains one of the primary objectives of the draft law.

The preventive restructuring framework will be available to debtors that are facing imminent illiquidity, as defined under Section 18 of the German Insolvency Code, within the next 24 months. This imminent illiquidity also entitles the debtors to voluntarily file for the opening of insolvency proceedings, giving the debtor the choice between these two restructuring toolkits. Exempted from the preventive framework are debtors in the financial sector, which has its own separate, specific regulations, and natural persons who are not engaged in entrepreneurial activities.

Essentially, the debtor remains in charge of the restructuring and continues to run the business. The draft law proposes the involvement of a restructuring officer who would act as a moderator/supervisor. The officer can be appointed by the court either at the debtor’s request or *ex officio* in certain cases that require particular protection; for example, if the rights of consumers or small creditors are likely to be affected, if the debtor applies for a stabilisation order (stay) against substantially all creditors, or if the restructuring plan requires the monitoring of the fulfilment of creditors’ claims.

The restructuring court will also appoint a restructuring officer if it is foreseeable that the adoption of the restructuring plan requires a cross-class cram down (see below), unless only financial services companies—or their successors—will be affected by the plan.

The restructuring court may also appoint a restructuring officer as an expert, for example in the determination of an imminent illiquidity, or regarding the assessment of actual plan effects on dissenting minorities.

The informal starting point for a debtor’s restructuring under the draft law is a notification to the restructuring court. The court’s involvement is required in order to make use of the available restructuring instruments. These are

- Preliminary examination of the plan and voting rights
• Judicial approval of the plan
• Termination of executory contracts
• Stabilisation measures (stay of individual enforcements)
• Confirmation of the plan if not all affected parties have granted their consent.

Restructuring Plans

The restructuring plan is the heart of the preventive restructuring framework. It can include/affect certain, appropriately selected groups of creditors and the debtor’s shareholders. The restructuring framework is not limited to financial creditors and may cover all types of claims.

The only claims exempted from this framework are the claims of employees, including claims to occupational pension schemes, claims arising from intentional torts, and claims for state sanctions. Under the draft law, the plan can involve the shareholders as an affected group and thus also provide for debt-to-equity swaps. Subject to appropriate compensation, the restructuring plan can affect/define the security rights of creditors who hold intra-group third-party collateral.

Majority Vote and Cross-Class Cram Down

The parties affected by the plan are collated into groups of similar interests to vote on it. Creditors holding at least 75 per cent of the total amount (majority vote) must approve the plan in each group. If individual groups do not meet this majority requirement, approval is deemed to be granted (cross-class cram down) as long as the overall majority of the groups approved the plan and the members of the groups missing the majority requirement receive “an appropriate share in the plan value” and are not worse off in comparison to the expected situation without the plan.

Relaxed Absolute Priority Rule

The current absolute priority rule requires that lower priority creditors affected by the plan—the debtor, or a shareholder—must not receive any value that is not fully offset by monetary contributions to the debtor; and no creditor affected by the plan that would have to be satisfied on an equal basis in insolvency proceedings is placed in a better position than other, similarly situated, creditors.

However, under the draft law’s “relaxed absolute priority rule”, these absolute priority rules will not preclude distinctions between groups of creditors with equal rank in insolvency proceedings if such a distinction is appropriate in view of the nature of the economic difficulties to be cured and the circumstances. Creditors can still receive an appropriate share in the plan if the shareholders and/or the debtor commits to an essential cooperation required to implement the plan (sweat equity), or if the interventions in the rights of the affected creditors are minor, such as a mere deferral but not reduction, of payments for a period not exceeding 18 months.

Supportive Instruments
The debtor can apply for a stay of individual enforcements for up to three months in order to facilitate a successful restructuring. Under certain conditions, the stay can be extended by one month in order to complete the voting, and by up to eight months in order to obtain confirmation of the pending restructuring plan by the court.

The draft law also provides for the termination of executory contracts by the restructuring court if

- A prior request by the debtor for adjustment or termination failed.
- The termination is combined with the adoption of a restructuring plan that also includes other restructuring measures.
- The termination is not manifestly inappropriate in light of this plan.

The damage claims resulting from such a termination must be classified as a separate group of creditors under the debtor’s plan and can—like other involved creditors—also be affected by the restructuring plan.

**Managing Directors’ Duties**

The draft law specifies the general crisis detection and restructuring obligations of managers of entities with limited liability. It also introduces the new concept of a shift of managing directors’ fiduciary duties from the shareholders’ to the creditors’ interests. The shift occurs when the company is facing imminent illiquidity, which is the same standard that would allow a debtor to avail itself of the preventive restructuring framework in the draft law, or to voluntarily file for insolvency proceedings. The interests of the shareholders and other parties involved may only be considered to the extent these do not conflict with the interests of the creditors.

Managers who violate these duties are liable to the company for the damage caused, unless they are not responsible for the violation. Once the restructuring court is notified of the debtor’s restructuring, the current draft law allows creditors to pursue these claims themselves.

**Next Steps**

The implementation of the Directive in the European Union and the draft law in Germany may set the stage for a new era in European restructurings. In Germany, for example, all stakeholders should prepare for the new rules now, as their roles and interests may change significantly.

- A debtor’s managers and their supervisory bodies have to prepare for preventive restructurings, and will have to consider the creditors’ interests earlier than previously. Shareholders have to support a restructuring, or may very well forfeit their position, even without formal insolvency proceedings.
- Banks and other creditors of German debtors have to assess their risks in light of the fact that a 75 per cent majority will be able to overrule minorities.
- Parties to contracts may want to think twice about refusing to engage a debtor
in restructuring negotiations, as the contract may be terminated without formal insolvency proceedings and their resulting damage claims will be treated as a separate group under the restructuring plan.

It is also worth noting that the draft law is likely to promote more distressed German investment opportunities

**United States**

There is no similar out-of-court restructuring regime in the United States, but there are several viable options for restructuring or liquidating a business outside a traditional chapter 7 or 11 bankruptcy filing.

A company and its creditors can always engage in a consensual restructuring under the terms of the relevant loan documents or relevant agreements, or consider an assignment for the benefit of creditors (an ABC), or dissolution under state law.

**Assignment for the Benefit of Creditors**

ABCs provide a state law statutory or common law alternative to filing a federal bankruptcy case. Under an ABC, the insolvent company's assets are assigned to a third-party assignee that is selected by the company and charged with liquidating the company's assets to satisfy creditors’ claims.

ABCs differ from state to state, particularly when it comes to the level of court oversight, or lack thereof. For example, in Delaware, the Court of Chancery plays an active role in the proceedings and will require the assignee to, among other things, file certain motions and post a bond to protect the interests of creditors against potential misconduct or negligence by the assignee. In contrast, other states such as Illinois and California, have little to no statutory ABC regime, which means that the entire process, including the administration and distribution of the estate’s assets to creditors, is completed without court intervention.

Putting aside these state-specific variations, most ABC proceedings are commenced in a similar manner. First, the company follows applicable state corporate law and the company's internal charter documents in obtaining approval of the ABC, which often requires board or shareholder approval. Second, the company executes an agreement with the assignee, under which the company assigns all of its right, title, and interest in the company’s assets. The assignee then steps into the role, thereby displacing the company’s officers and directors, and assumes fiduciary obligations to the company’s constituents, including shareholders and creditors. The assignment is subject to any and all existing liens, and the assignee must honour all valid, perfected, and enforceable liens.

After the assignment occurs, the assignee is tasked with several important responsibilities, including the following:

- Take inventory of and secure the company’s assets and review its books and records.
- Create a service list of all the company’s creditors.
• Run lien searches to determine if any creditors have security interests in the company’s assets.

• Close all bank accounts and transfer funds to new accounts in the assignee’s name.

• Provide notice to all creditors.

• Retain specialised professionals, as needed, such as legal counsel, financial advisors, investment bankers, accountants, appraisers, and auctioneers.

After creditors receive notice of the ABC, they must file a claim with the assignee in order to share in the distribution of proceeds generated from the liquidation of the company’s assets. Some states provide for a statutory time period within which a creditor must file a claim. For example, California has a 150 to 180-day period, whereas most other states’ are closer to 90 days. Regardless of whether or not a state statute provides a specific time period for filing claims, the assignee’s notice to creditors will include one for filing claims.

ABCs are generally used in two scenarios:

1. The company is insolvent, can no longer operate, and cannot find a buyer. Utilising an ABC process allows the company to liquidate its assets, collect accounts receivable, and distribute the proceeds to creditors. Importantly, the process allows existing directors and officers to essentially walk away from the company, leaving the assignee to handle the wind-up.

2. The distressed company has identified a buyer to acquire its assets but does not have enough cash or time to justify a chapter 11 bankruptcy filing. Venture capital-backed technology companies often meet this criteria as they tend to have very little, if anything, to monetise in a liquidation. They are therefore frequent users of the ABC process. Failing technology companies often require a faster, less public, and more cost-efficient process than bankruptcy (which can take months, if not years, and is subject to significant court and fiduciary scrutiny) in order to sell their assets and pay off as much of their debt as possible. This is why California became the capital of ABCs in the late 1990s when the dot-com bubble burst.

The benefits of an ABC are not, of course, confined to venture-backed entities. ABCs can be used by a range of small businesses that want to avoid the complexities of a court-supervised bankruptcy process.

**ABC Shortcomings**

Notwithstanding the efficiencies that can be realised through an ABC process, there are several shortcomings.

There is no “automatic stay” that prevents creditors from exercising remedies against the company. This is in contrast to a chapter 11 proceeding, in which the automatic stay comes into effect immediately on commencement of the bankruptcy case.
The commencement of an ABC often constitutes a default under most contracts. As a result, counterparties to those contracts may exercise their termination rights. This again stands in contrast to a chapter 11 case, in which the automatic stay prohibits contract counterparties from exercising termination rights.

The Bankruptcy Code permits companies in chapter 11 to assign contracts to a third party, notwithstanding the existence of anti-assignment provisions in such contracts. This is a critical issue if the company intends to sell its assets as a going concern, which often requires the assignment of key contracts to the buyer.

There are significant risks to a buyer of assets in an ABC, as compared to a chapter 11 proceedings. For example, the Bankruptcy Code permits companies in chapter 11 to sell its assets “free and clear” of creditors’ liens and claims, including successor liability claims that may later be asserted against the buyer. No such right exists in an ABC process. In addition, creditors can later collaterally attack the sale of assets in an ABC as a fraudulent transfer. This risk is more present in ABC processes that are not supervised by a court. In contrast, a chapter 11 sale order insulates the purchaser from future collateral attacks. These issues can have a significant negative impact on the sale proceeds ultimately realized from a buyer.

**State Law Dissolution**

Unlike ABCs, dissolution under state law is generally governed by statute. Dissolution, at a high level, involves the company

1. Properly approving dissolution (much like it would approve commencing an ABC)
2. Filing a certificate of dissolution with the state in which the company was formed
3. Paying certain outstanding taxes
4. Winding-up its affairs.

Dissolution can also be voluntary or involuntary. Involuntary dissolutions occur when there are disputes among the company’s board members or equity holders that cannot be resolved consensually, thereby leading to a “business divorce.” For purposes of this article, only voluntary dissolutions are discussed below.

The first three dissolution steps are largely uniform from state to state. The fourth step, winding-up, is where an insolvent company may have a few choices. For example, in New York and Delaware, insolvent companies have two methods by which they may wind-up. These methods are commonly referred to as the “safe harbor method” and the “non-safe harbor method.”

**Safe Harbor Method**

This method generally requires public notices in newspapers and, in some states such as Delaware, a petition to the appropriate court to determine the amount and form of security that will be reserved for certain future or contingent claims.
If an insolvent company has many known or unknown future or contingent claims, the safe-harbor method adds a layer of protection for shareholders, officers, and directors. For example, in Delaware, under both safe harbor and non-safe harbor methods, if a company properly distributes its assets, shareholders’ potential liability for claims against the corporation is limited to the lesser of either their pro rata share of the claim amount based on ownership interest, and the amount of distributions received by the shareholder in connection with the dissolution.

If, however, a company elects the safe-harbor method of winding-up, shareholders have no liability for any claim against the company if no action is brought on account of the claim during the three-year wind-up period after dissolution. Officers and directors are also protected by the Delaware Court of Chancery’s determination of a reasonable reserve for unliquidated, contingent, and unmatured claims.

**Non-Safe Harbor Method**

The non-safe harbor method generally does not require any notice to creditors or a court petition. A company may simply dissolve, adopt a plan of distribution, pay the claims of any of its known creditors, and set aside what it thinks are appropriate reserves for unliquidated, contingent, or unmatured claims. In Delaware, for example, a company must set aside reserves for claims that are likely to arise or become known within 10 years after the date of dissolution.

Again, if this is done properly, shareholder liability is limited as in the safe harbor method.

**Next Steps**

Although federal restructuring options in the United States are limited to bankruptcy filings, distressed and insolvent companies do have several out-of-court tools available, depending on the relevant US jurisdiction. Of course, a company’s specific circumstances must always be weighed in determining the best path toward a successful restructuring or liquidation.