

# **Liquidation or Restructuring**

## **German and International Experience**

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# Workouts and Insolvency Law

- Out-of-Court Workouts function in the Shadow of Insolvency; Insolvency Reorganization operates in the Shadow of Insolvency Liquidation
- Transition on this Scale should not be Subject to Moral Hazard, discourage Strategic Behaviour by any Players, and not create Windfalls
- In the Transition, Rights of Players should only be Modified to the Extent Necessary; Discontinuities reduced to Minimum

# Insolvency

- All Economies and Insolvency Systems need a Liquidation Path
- Most Elements of Liquidation are Classical and Time-Proven
- Rescue Systems Depart to a Greater or Lesser Degree From the Liquidation Structure in Procedure and Substance
- Will Address Liquidation First

# Who May be a Debtor

- Only Merchants or All Entities, incl. Individuals?
- Separate Regime Needed for Large Corporations/Public Companies? For banks and Insurance Companies?
- Partly or Wholly State Owned Commercial Entities?
- Other Public Entities (Municipalities, Agencies)?

D: A Unitary, Structurally Identical System for Commercial and Non-commercial Debtors, incl. Individuals, Partnerships, and Most Public Commercial Entities; Banks and Insurance Companies Included.

# The Trigger Criterion

- Illiquidity or Balance-Sheet-Test?
- Criteria for Illiquidity (Non-payment of Certain Amount of Debt for Certain Period v. Generalized Illiquidity)
- Valuation of Assets for Balance Sheet Test
- Differentiation of Creditors and Debtor Filings?
- Automatic Relief in Case of Debtor Filing?

**D:** Illiquidity as General Trigger; alternatively Balance Sheet Test for Corporations; Presumption of Illiquidity in Case of Debtor Filings; Prospective Illiquidity only for Debtor Filings

# Who May File

- The Debtor (in the Case of Organizations: Each Manager or Management Collectively? Shareholder Approval Needed?)
- Creditors (Every Creditor or a Creditor Quorum? Fully Secured Creditors? Creditors with Uncertain or Disputed Claims? Sanctions for Frivolous Filings?)
- Public Authorities?

**D:** The Debtor; Every Member of Management Individually, except in Case of Prospective Illiquidity; Every Creditor Individually (Unless it has no Legitimate Interest; Civil Sanctions for Frivolous Filings)

# Sanctions on Insolvent Trading

- Duty to file ? For all debtors? For Management of Corporations (with Limited Liability)?
- Deadlines? (Long Enough for Out-of-Court Workout?)
- Sanctions: Civil and/or Criminal?

**D:** Only Managers of Entities with Limited Liability Need File within Three Weeks after Discovery of Insolvency; Civil Liability (Reduced Dividend for Pre-Existing Creditors, Full Amount for Fresh Creditors; Criminal Sanctions in Case of Fraudulent Behaviour)

# Staying Creditor Action

- Bankruptcy = Collective Debt Collection for Pre-Bankruptcy Creditors
- Automatic Stay
- Scope: Enforcement of Judgments, Pending Lawsuits, Foreclosure of Security Interests, Perfection of Mortgages. Additionally: Demand of Payment, Creditor Harassment etc. (U.S.)? Set-Off (U.S.)?
- Interim Measures after Filing before Opening of Case Indispensable

D: Opening Decision of Unitary Proceedings Operates Automatic Stay with Standard Content [Debt Enforcement and Litigation, Includes Lienholders in Movables (but not Owners under Retention of Titel Clauses); Mortgagees in Land are Stayed upon Trustee Application by Separate Court Order); Set-Off not Stayed]; Enforcement of Administrative Claims not Contraced by Trustee is Stayed for Six months. Court Interim Measures upon Filing Generally Include Freezing of Assets and Stay of Creditor action



# Pending Contracts

- Contracts which have not been Performed Entirely by either Party may be Rejected or Assumed. Rationale: Creditor Equality, Relief for Estate from Burdensome Contracts
- In Case of Rejection, the Other Party has an Allowable Claim for Damages
- Court Involvement Necessary (U.S.) or not (D)?
- Contracts of Duration (Leases, Employment) May be Rejected for Future Only (D: with Minimum Legal Notice Periods)
- Separate Regime for Utilities: Duty to Contract Anew with Estate even When Contract was Rejected for the Past
- Certain Financial Transactions will be Terminated and Netted Automatically

# Avoidance of Preferences and Fraudulent Conveyances

- Approaching Bankruptcy often Produces Unfavorable Transactions and Fraud to Creditors. Avoidance and Preference Law Restores Assets of the Estate and Creditor Equality
- General Scope: Fraudulent Transfers, Gratuities, Transactions for Inadequate Consideration; Different Reach-Back Periods
- Preferences: e.g., Payment on Unmatured Claims, Grant of Security for Originally Unsecured Claims, Payment of Subordinate Claims (Shareholder Loans), in a „Critical Period“

## Avoidance (Cont'd)

- Generally Tougher Rules and Longer Reach-Back for Insider Transactions
- Reliance on Subjective Factors such as Knowledge of Insolvency or Intent to be Reduced to the Extent Possible
- Transactions in Ordinary Course of Business and Contemporaneous Exchanges to be Exempt
- Automatic Nullity, or Court Enforced Restitution?
- Competence of Bankruptcy Court or of General Courts?

# Priorities

## Standard System

- Secured Creditors (if at all Involved in Proceedings)
- Administrative Claims (Debt Contracted by Estate/Trustee, Post-Opening Payment for Labour, Leases etc. Unless Contracts are Rejected), Trustee Remuneration, Court Fees; Superpriority for Trustee and Court a Necessity to Allow Opening in Asset Deficient Cases)
- One or Several Classes of Pre-Bankruptcy Claims (Frequently: Labour for x Months, Back taxes)
- General Unsecured Creditors

# Priorities (Cont'd)

## **Additional Elements:**

- Subordinate Creditors (Contractual Subordination; Judicial (U.S.) or Legal (D) Subordination of Certain Shareholder Loans)
- [Certain Non-Allowable Claims: Commonly Gratuities, Penalties etc., in D treated as Subordinate Claims]

## **Policy:**

The Fewer Priorities for Pre-Bankruptcy Claims the Better. They Create Diverse Creditor Interests, and Complicate Creditor Governance; Inject Complexity in Rescues (e.g., Class Voting); Disinterest General Creditors in Course and Outcome of Proceedings.  
D and A Abolished all Such Priorities.

## B. Rescue Systems

- Workable Rescue Systems Presuppose the Existence of a Liquidation Path
- Classical Liquidation May, with Minor Adjustments, be Used as a Rescue Mechanism
- Rescue Systems May Depart from Most Elements of Liquidation (trigger; treatment of creditors, contracts, and avoidance; debtor influence rights; priorities etc.)

# Three Types of Business Rescue I (1)

## A. Liquidation Type (General):

Auction of the Firm; Sale of Going Concern on the Market

- (a) Avoids Judicial Valuation
- (b) Distribution of Cash Proceeds According to Priority
- (c ) Speedy Solution Possible
- (d) Sale to Insiders with Asymmetric Information an Issue (Market Price Formation May be Distorted)

# Three Types of Business Rescue I (2)

## Classical Liquidation Type : Asset Deals (Asset Auctions)

- Existing Entity is Dissolved, Inherent Intangibles and Tax Attributes May be Lost; Transfer of Client Relationships and Contracts Requires Third Party Approval in Most Systems
- D: By Far Most Widely Used Rescue Technique

## Recent Auction Discussion: Share Deals (Equity Auctions)

- Existing Entity Survives Free and Clear of Debt and Encumbrances
- Fresh Equity Issued, or Existing Equity Transferred to New Owners
- Disadvantages of Asset Deals Avoided



# Business Rescue II

- B. Composition Type

- Only Debtor May File (Debtor Protective System)
- Debtor Remains in Control, in Most Systems Supervised by Curator
- Bars Liquidation
- Secured and Priority Debt Not Affected (Paid in Full)
- Equity Cannot be Wiped out (Enterprise Rehabilitated in Hands of Previous Owners)
- Majority of Affected (Unsecured) Creditors Required
- Judicial Confirmation When Majority is Reached; in some Systems Additional Requirement that Creditors Plausibly Receive as Much as in Hypothetical Liquidation

D: Abolished as Ineffective; was Misused Strategically By Debtors; Squandering of Assets.

# Business Rescue III

- **C. Reorganization via Plan (Design)**
  - Sale“ of Entity to Claimants (Debt and possibly Equity Holders)
  - Triggered by Debtor and Creditors (U.S., D)
  - Debtor Management Remains Generally in Control (U.S.) or is Generally Replaced by Trustee (D)
  - Plan Initiative for Debtor, Claimants and/or Trustee (D: only Debtor and Trustee)
  - Involves and May Impair all Claimants (incl. Secured and Priority Creditors); Equity often Wiped Out (U.S., D)
  - Distribution of Value Open to Negotiation
  - Involvement of All Claimants Requires Negotiation and Voting by Classes (Based on Separate Liquidation Priority; Different Classification and Different Treatment for Claimants of Same Priority but with Different Economic Interests a Possibility, U.S., D)

# Business Rescue IV

- **Operative Part of Reorganization Plan, i..a.:**
  - Classification of Claims and Interests; Insider Treatment
  - Reduction/Extension/Subordination of Claims
  - Substitution of New Debt for Old
  - Substitution of Collateral
  - Debt /Equity Swaps (U.S. yes, D: no, cf. infra)
  - Change Corporate Structure (U.S.: yes, D: no)
  - Sale of Part of the Business, Cash Distributions
- **Descriptive Part (outside Competence of Bankruptcy Court), i.a.:**
  - Adjustment of Labour Force, Change of Product Mix, Investments by Third Parties, Government Funds
  - Corporate Adjustments, Issue of Equity (D, cf. supra)

# Business Rescue V

- **Reorganization via Plan (cont'd)**  
(Judicial Confirmation)

- Acceptance by at Least One Impaired Class (U.S.) (D: a Majority of Classes) Required; „Cram-Down“ against other Classes
- Treatment of Dissenting Claimants [Policy Options: a) No Minimum Standard; b) Dissenters receive at Least Liquidation Value („Best Interest Test“: U.S., D); c) Dissenting Classes Receive Additional „Fair and Equitable“ Portion of Reorganization Bonus Under Absolute Priority Rule: U.S., D)
- Valuation Needed if Plan is not Accepted by All Individuals (Hypothetical Liquidation Value) resp. by All Classes (Reorganization Bonus). Possible Delay, Litigation.

## C. Sustaining Operations I

### Preserving the Going Concern

A Need in All Potential Rescue Situations (both of the Liquidation and Rehabilitation Types)

Requires:

- Energetic Case Management, Clear Governance
- Stay on all Creditor, including Secured Creditor Action
- Obtaining Fresh Money

# Sustaining Operations II

## Governance Options

- Trustee versus Debtor-in-Possession
- Classical Rescue Systems: Trustee in Liquidation / Debtor-in-Possession in Rehabilitation Proceedings (U.S. with Exceptions)
- Unitary Systems: A Trustee Appointed Unless Creditors/the Court Choose to Leave Debtor in Possession (Independent of Liquidation or Rehabilitation Path) Allowing for Maximum Flexibility (D)
- Power Sharing in case of Debtor Filings (before full insolvency)

# Sustaining Operations III

## Staying Secured Creditor Action

- Prevent Dismemberment of Estate, Automatic Disruption of Operations
- Stay Must Include Secured Creditors
- Right of Estate to Use and (Where Necessary) Sell Collateral
- Lifting of Stay When Collateral is Inconsequential

# Sustaining Operations IV

## Protection of Secured Creditors

### Who should Bear Cost of Delay?

- Adequate Protection of Secured Creditors: Regular Payments for Depreciation, Wear & Tear (U.S.)
- Alternatively: Determination of Secured Portion of Claim Early in Proceedings, Regular Payments of Contractual Interest on Secured Portion of Claim (D)
  - Positive Side Effects: Junior Claimants Bear Cost of Delay, Speeds up Decision Taking, Incentive to Lift Stay



# Sustaining Operations V

## Obtaining Fresh Money

- Minimum Solution:
  - Administrative Priority for Estate Contracted Debt (U.S, D).
  - Grant of Liens on Unencumbered Assets (U.S., D)
  - Junior Liens on Encumbered Assets (U.S., D)
- Advanced Extra Solutions (s. 364 U.S. Code)
  - Superpriority for Fresh Credit Over Other Administrative Claims
  - Grant of Senior Liens on Encumbered Assets (with Adequate Protection for Existing Lien Holders)

## D. Links Between Rehabilitation and Liquidation (Policy Choices) I

- Procedural:
  - Procedural Bias for Rescue (U.S.) versus Open Search Process (D)
  - Unitary (D) versus Different Legal Framework (U.S. and most other systems)
  - Parallel Options throughout Proceedings(D) versus Sequential Stages (U.S. with Conversion as a Possibility)
  - Plans Available both for Rescue and Liquidation (D and U.S.: Liquidating Plans)

# Links between Rehabilitation and Liquidation (Policy Choices) II

- **Substantive:**

- Minimum Claimant Expectation: Hypothetical Liquidation Value (Minority Protection) (D and U.S.)
- Maximum Claimant Expectation: Distribution of Going Concern Value According to Absolute Priority/Liquidation Rank ( in Case of „Cram-down“) (D and U.S.)
- No Link (Rehabilitation Preferred Even if Claimants Fare Worse than in Liquidation)  
(F and some recent systems)

## E. Links Between Out-of-Court and Court Proceedings

- Out-of-Court Negotiations Structured by a) Liquidation Priorities and b) Real Life Diversity of Creditor Interests, *i.a.*,:
  - Bank Credit, Trade Credit, Tort Claims; Cash Preference, Risk Taking, Non-Monetary Interests (Longstanding Business Relationship, Future Employment, Macro-Economic Goals, etc.), Insider Interests, Multiple Ownership Rights (Debt plus Equity, Secured plus Unsecured Debt etc.)
- In-Court-Negotiation Should Accept (and not Level Artificially) Diversity:
  - Classification and Separate Class Voting
  - Achieves In-Court Viability of Pre-Negotiated („Pre-Packaged“) Rescue Schemes

## F. Unitary Proceedings I (Germany)

- Unitary Trigger and Access
- Unitary Procedural Framework. Unitary Creditor Rule (Autonomy)
- No Normative Preference
  - for Rescue over Liquidation,
  - or for Rescue via Plan over Rescue via Liquidation
- Appointment of Trustee the Rule, Debtor-in-Possession Possible under Creditor Control
- Unitary Creditor Body Governance (espec. Control on Continuation of Operations)
- Minimum Court Involvement in Economic Decisions

# Unitary Proceedings II (Germany)

- Regular Contractual Interest Payments on Secured Claims,
  - Cost of Delay Borne by Junior Claimants
- Parallel Pursuit of Alternative Schemes (Liquidation and one or Several Plans) Possible; Court will Stay Liquidation when a Promising Plan is under Consideration
- All Conceivable Solutions Can be the Object of a Plan
  - Rehabilitation/Liquidating Plans, any Type of Mix
- Minimum Protection of Dissenting Individual Parties Best Case Liquidation Value of Claimants' Entitlements
  - including Liquidation Discharge for Personally Liable Owners
- All Classes Share in Going Concern Value under Priority Rule that Would Apply in Liquidation ( „Cram-Down“ )

## G. Efficiency of Insolvency Proceedings

- Clear-cut trigger, Predictability for Debtors and Creditors
- Value Preservation/Maximization, Prevent Automatic Disruption of Operations
- Flexibility, Stimulating Creative Search, Negotiated Solutions
- Enforce Pre-bankruptcy Rights as Fully as Possible, Discourage Strategic Behavior, Market Conformity
- Translation of Out-of-Court Interest Patterns, Allowing Pre-Packaging of Rescues
- Disincentives for Delay
- Energetic Liquidation, Enforcement of Market Exit Always an Option
- Creditor Governance, Sparing Use of Judicial Resources

*Thank you!*

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