Procedural and Substantive Rights of Equity Holders
Imminent *versus* Actual Insolvency

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1. Scope of Presentation

- Basic issues and some available solutions (not always conclusive answers) regarding treatment of equity/shareholders in collective proceedings

- Focus on corporations - with outlook on partnerships and sole proprietorships

- Comparative and functional perspective – based largely on personal research during the German reform discussion (1986-1994) and on field work with IMF, World Bank since the 90-ies

- Special emphasis on German Model - Reform of 1994 (InsO) and amendments of 2011 (ESUG)

- German Reform: Change of paradigm for financial restructuring of distressed firms. Transition from composition paradigm to reorganization paradigm
2. Composition *versus* Reorganization

- Most countries in the 90-ies had (and some still have) a COMPOSITION (arrangement, accord, accordo, convenio etc.) proceeding designed to
  - avoid bankruptcy liquidation of debtor entity
  - by majority vote(s) of general unsecured or all creditors,
  - thus securing survival of debtor entity generally with its existing shareholder/equity structure by „sacrifices“ of debt holders.

- Revival of composition paradigm (mere debt deleveraging of firms) in context of recent pre-insolvency schemes

- GER, in 1994 after long debate, followed REORGANIZATION of US. Ch. 11, by
  - involving entire corporate finance structure, including equity (and all, including secured and subordinate debt) in collective proceedings and insolvency specific decision-making mechanics
  - allocating going concern value of debtor enterprise according to majority consensus of classes – or absent class consensus - to „absolute priority“ (as applied in liquidation),
  - allowing to break veto of classes treated „fairly and quitably“ and receiving at least liquidation value, thereby frequently leading to „wiping-out“ of equity holders as the most junior class(es) of financiers
  - Protection of each individual dissenting claimant by guarantee of liquidation value („best-interest test“).
3. Insolvency *versus* Pre-Insolvency: Terminology (i)

- **U.S. Bankruptcy Code:** No showing of insolvency/illiquidity needed for debtor petition, immediate "automatic stay". GER InsO accepts debtor filings for documented imminent insolvency/illiquidity. Essentially no structural variance from proceedings for actual insolvency (illiquidity/overindebtedness). Eventual bankruptcy liquidation of debtor enterprise a possibility.

- Once case is commenced (opened), both U.S. and GER do not allow debtor to withdraw its petition at will but require a court ruling ("easy to get in, difficult to get out"). However: In GER, commencement of case requires judicial opening decision. In the *interim* period, petition may be withdrawn at will (subject to liability if duty to file in actual insolvency/illiquidity is hereby breached).

- During "Umbrella" stage of proceedings following GER 2011 reform (ESUG), *interim* period is extended for up to three months:
  - Only during mere imminent insolvency/illiquidity
  - Usually debtor management remains "in possession" monitored by a preliminary administrator
  - Judges routinely order stay of all creditor action
  - Feasible plans ("pre-packs") can be processed/voted upon/eventually confirmed only in subsequent standard formal proceedings
  - Otherwise, debtors may exit umbrella at will ("return to square zero").
4. Insolvency versus Pre-Insolvency: Terminology (ii)

- Numerous EU states have - formal or hybrid - pre-insolvency proceedings failure of which has no direct legal consequence for debtors (e.g., formal insolvency, possibility of mandatory liquidation, winding-up). EU COM proposes introduction of such proceedings in all member states.

- Terminology for our discussion:
  1. Insolvency proceedings: Those from which debtor cannot get out at its sole discretion, irrespective of whether a showing/proof of actual or imminent insolvency/illiquidity is required for commencement - Type A -.

  2. Pre-insolvency proceedings: Those commenced for imminent insolvency/illiquidity, financial difficulty, non-sustainable debt, etc., from which debtor may emerge at will if restructuring/reorganization is not achieved (irrespective of potential liability for damage to other parties) - Type B -.

  3. GER „umbrella“ a hybrid between A and B Types. GER resists EU COM plans for Type B pre-insolvency proceedings.
5. Shareholder Involvement in Debtor Petition (i)

To be distinguished:

- Legal authority for valid debtor petition (1)
- Duty to file petition (2)
- Intra-organizational attribution of competence (management v. shareholders *viz.* shareholder controlled supervisory board) (3)
- Liability for misuse of authority (4)

**Type A**

- (1) Management Board (formal MB resolution? (USA?) Quorum of directors/members? Any member? (e.g., GER)
- (2) Many systems (e.g., GER, not, e.g., USA) impose duty to file on MB or any member (e.g., GER). Absent such duty, possibility of creditor filing motivates MB to „voluntary“ filing.
- (3) Directors‘ sanctioned duty to file generally overrides shareholder/sup. board opposition. Absent duty to file, intra-organizational competences remain intact. General rules apply to (4).
6. Shareholder Involvement in Debtor Petition (ii)

Type B

• No reasonable presumption that shareholder rights are worthless. Generally no statutory duty for MB to file petition, no right for creditors to do so.

• Intra-organizational allocation of competences intact in all respects – (1)-(4).

GER „Umbrella“ (ESUG)

• Only debtors may file in mere imminent illiquidity/insolvency.

• (1) Petition by quorum (1-n) of MB members needed under „statut social“/Satzung/bylaws for valid representation of company.

• (2) No duty to file.

• (3) Intra-organizational limitations on MB possible; shareholders (or sup. board) may cause withdrawal of valid petition – until standard insolvency proceedings are opened – by threat of „firing“ unruly directors. After opening of standard proceedings, shareholder/sub. board interference with course of proceedings no longer possible.

• (4) Personal liability to shareholders if provided by general law.
7. Corporate Governance during Proceedings (i)

TYPE A:

- In liquidation type proceedings (or in the liquidation stage of unitary proceedings such as the GER), appointment of a trustee is the rule, and corporate bodies are divested of their functions.

- In “voluntary” cases aiming at reorganization triggered by debtor, the latter frequently (in USA: as a rule) remains in possession (“DIP”) unless mismanagement, fraud etc. are discovered. DIP is considered to “stand in the shoes” of a hypothetical trustee. In some systems, such as GER, DIP is monitored by a professional (administrator) who alone may, e.g., bring avoidance actions and verify creditor claims.

- “DIP” may mean different things:
  
  - (i) existing management is kept in control while function of other corporate bodies (shareholders, sup. board) is suspended – except for revocation of appointment of directors which, however, require consent of the administrator (§276a InsO). Critique: moral hazard! Management may file to avoid accountability towards shareholders/sup. Board.
  
  - (ii) pre-insolvency governance remains intact (USA?) but directors owe fiduciary duty primarily to creditors.
8. Corporate Governance during Proceedings (ii)

**TYPE B:**

- Generally existing corporate governance remains intact. Notice periods, deadlines for corporate bodies may be shortened in some systems.

„Umbrella“ GER:

- Willing management that filed for imminent illiquidity/insolvency remains “in possession” unless reorganization is manifestly non-feasible and/or the preliminary creditors’ committee move for appointment of a trustee. **Critique:** Moral hazard (as in Type A) intensified because judge must appoint the (preliminary) administrator „picked“ by management; refusal for cause must be reasoned. Risk of „cronyism“!

**TYPE A:**

- **USA:** A committee of equity security holders (e.g., shareholders) may be appointed, the court may cause additional equity holders committees to be installed; s. 1102. Costs of appointed members enjoy administrative superpriority, thus burdening creditors, s. 503 (3)(F). Committee has access to file and shares information with non-members of the group. Rationale: Many ch. 11 are solvent (merely seeking to restructure contingent claims – cf. Manville case)- or to shed burdensome labor contracts (Airline cases).
- In some systems (ROM, to pour knowledge) a professional representative of shareholders is appointed at the expense of the estate.
- **GER** (proceedings with or without prior Umbrella): InsO does not address shareholder information rights, leaves those to rules law vis-a-vis a DIP (information usually only available in general meetings). Shareholders may organize themselves – at their expense.

**TYPE B:** General corporate governance applies.
10. Sale of Major Assets outside a Plan

Frequently, major assets, e.g., plant or subsidiaries must be sold immediately („fire sales“) to preserve their going concern value, or to raise cash/working capital. General law (GER: the so-called Holzmueller doctrine), or company bylaws, often require approval by shareholders and/or sup. Boards for such sales.

**Type A:**
Only insolvency decision making mechanics apply (e.g., approval of creditors committee(s); court approval; consent of a trustee, if any).

**Type B:**
General company law requirements (should) apply.

**Umbrella GER:**
Supervisory functions of shareholders/sup. boards are suspended. „DIP“ management must seek consent of preliminary administrator. On motion of creditors’ assembly, court may tie validity of transactions to prior consent of administrator.
11. Right of Shareholders to Liquidate Debtor Entity

Some jurisdictions (e.g., Spain) appear to allow shareholders during reorganization proceedings to frustrate rescue by resolving winding-up („corporate suicide“).

**Type A:** Out-of-court winding-up not possible for insolvent companies (USA: Federal preemption of bankruptcy over state corporate law; most other systems for other policy reasons).

**Type B:** Management and shareholders may have divergent interests regarding restructuring v. liquidations (social considerations, cash preference etc.). Shareholders may liquidate non-insolvent debtor, frustrate restructuring.

**Umbrella GER:** Shareholders have no influence on (dis-/continuation of debtor’s business.

**Adequate solution:** Require shareholder decision on filing for (mere) imminent illiquidity/insolvency.
12. Right of Shareholders to Propose Plan

**Type A:** USA –“DIP“ has exclusive right to propose/file a plan for 120 days following commencement, another 60 days for exclusive processing (s. 1121 (b)(c)). Thereafter any party-in-interest, e.g., any shareholder, or a shareholders’ committee, if set-up, may propose. GER: Only debtor (management) and administrator, § 218. Government had proposed plan initiative also for holders of 20% of equity; not accepted by Parliament.

**TYPE B:** Generally, only debtor may file within frame of general company law.

**Umbrella GER:** Only debtor may propose during umbrella (max. 3 months), after transition to full insolvency proceedings additionally the administrator.

**Adequate approach:** (1) In Type A proceedings, costs of shareholder plan should not burden the estate/creditors. (2) Delay by shareholder plan should be avoided or (second best) priced and imposed on shareholders (one imperfect solution cf. § 169(2): regular contractual interest payments on secured portion of creditor claims after 3 months, burdening junior creditors and shareholders). Debtor/shareholders should not „play with the money of creditors“ (Th. Jackson)
13. Shareholder Decision-Making on Plan, Classification

**TYPE A:** In proceedings following composition paradigm: No formal involvement of equity holders in insolvency forum for negotiations and decision making. Efficiency losses, risk of delay. Creditors must rely on conditionality; equity has veto power, may thereby extort value from creditors.

Jurisdictions following reorganization paradigm (e.g. USA, GER as reformed 2011) (1) involve equity holders in insolvency decision mechanics, (2) suspending general corporate governance rules, (3) break obstruction by classes, including shareholders, under principle of „absolute priority“ („cram-down“). GER follows USA ch. 11, with much simplification and de-sophistication suited for a Civil Law system.

**GER (full proceedings with or without prior umbrella stage):** Like senior claimants, equity holders, if impaired by the plan, are grouped in classes following liquidation rank (i.a., liquidation preference v. common stock). Substantially similar interest of shareholder subsets may justify sub-classes (e.g., small financial investors, *azioni di risparmio* etc. versus strategic holdings (e.g., of controlling stakes). Members of a class shall be treated alike.

**GER (full proceedings with or without prior umbrella stage):**

- Voting is by classes separately.
- Shareholder classes are deemed to have accepted the plan if they are not impaired, likewise if no member of the class takes part in the voting.
- Unlike for creditors where majorities (50+%) by amount and per capita are required, shareholder votes are counted only by the relative amount of their stake within a given class, §244.
- Company law voting right allocation, such as voting restrictions, e.g. for certain preferential shares, or multiple votes are not taken into account for the vote count, §238a, expression of insolvency focus on debtor’s enterprise finance – not on governance rights.

GER (full proceedings with or without prior umbrella stage): Absent plan acceptance by an impaired shareholder class, the plan may be confirmed if

- the majority of all classes have accepted, or are deemed to have accepted, the plan,
- the class is treated „fairly and equitably“, meaning for holders of equity that
  - no creditor receives more value than the full amount if its (allowed) claim (absolute priority),
  - no shareholder who would have equal (financial) rights as other members of the class without a plan receives more value under the plan than such other (non-discrimination among class members).
- no class member receives less value than she would receive without the plan, usually in a liquidation („best-interest-test), § 245.

Thus, in GER insolvency reorganization proceedings, equity may be „wiped out“ by a plan, if (1) all creditors take a loss or receive no more than 100% by amount, and if liquidation value of equity is nil = capital reduction to zero.
16. Modification of shareholder rights, company structure

GER (full proceedings with or without prior umbrella stage):
A plan may provide for all measures that would be permissible under general company/commercial law, § 225a, e.g.,
• change of corporate form (cf. Suhrkamp matter: change from partnership by shares to stock company, depriving minority shareholder of his governance rights)
• merger (fusion), split, transfer of shares to a another entity,
• reduction of capital to zero and issuance of fresh capital, e.g., in context of a debt-for-equity swap.
For such measures „change of control“ and similar clauses are invalid.
A shareholder exiting the company „for cause“ due to the plan is entitled only to liquidation value (realized either in or outside bankruptcy depending on existence of actual of insolvency).
Judicial confirmation substitutes otherwise necessary notarization; court will cause entry into commercial registers.
17. Debt-for-Equity Swaps (DES)

**GER (full proceedings with or without prior umbrella stage):**

- § 225a authorizes DES. They can aim at a 100% or lesser measure of ownership change by a capital increase from 0-n by issue of new shares exclusively to creditors for contributing their claims in kind.
- Under constitutional right of non-association membership in an entity cannot be imposed on unwilling creditors.
- Valuation of contributions needed? Or allocation according to amount of debt, or their liquidation -- or going-concern -- value ? Occasionally fixed proportions have been proposed between nominal dollars of secured, unsecured, and subordinated claims (SLO?)
- DES not a panacea (although the purest expression of absolute priority):
  - Banks not best suited investors in stocks; inefficient corporate governance.
  - Stock market „overhang“ depresses stock price even when lock-up is agreed
  - Misuse of DES by „vultures“ acquiring bad debt as takeover tool bypassing takeover law is a possibility (U.S. case law) and requires checks.
18. Closely held corporations, partnerships, sole proprietors

TYPE A:

- Both USA and GER apply absolute priority not only to corporations and large enterprises, but in principle to all business debtors (USA: except for family farmers/fishermen, ch. 12, and individuals amenable to ch.13).
- In USA lower courts law introduced a „new value exception“ to absolute priority (e.g., when owners contributed managerial or technical skills). U.S. Sup Ct. rejected: „Ahlers“, 485 U.S. 197; „North Lassalle“, 526 U.S. 434.
- USA, GER: creditors will not bona fide wipe out equity of owners who are needed for continuation of debtor business. Misuse potential must be checked: e.g., for „driving debtor out of business“ or „taking over its business“.
- GER: Cram-down against debtor, § 247. Objection against plan irrelevant if (1) debtor receives liquidation treatment/value and (2) no creditor receives more than full amount of its claim. For „honest“ individuals, liquidation treatment includes availability of discharge after liquidation, §§286-303.
19. Evaluation of Reorganization v. Composition Paradigms

I. „Reorganization“: Including equity in restructuring mechanics of TYPE A has advantages:
- Efficient (near Pareto optimal) negotiations in one forum, relative speed
- Rational choice between reorganization and liquidation.
- Proper insolvency representation of pre-insolvency contractual rank of entitlements („absolute priority“) – „market conformity“.

II. Is a TYPE B proceeding (without involvement of equity) desirable?
U.S. system copes with financial crises and a very large number of cases. GER: has decreasing case numbers since 2009; existing law fully adequate. Consulting industry, however, lobbies for TYPE B in the name of „rescue culture“: It allows practitioners to continue their restructuring advice business for management into the more formal stages of the restructuring process without disruption and change of professionals.

III. TYPE B may be useful as temporary emergency legislation to delever large number of systemically overindebted/illiquid firms post financial crisis (e.g., in Greece). Caveat: „Hard cases make bad Law“ (Justice O.W. Holmes)!
20. Share/Equity Sales in a Liquidation Type Proceeding?

- Successful Reorganization realizes not only value of debtor’s assets, but of its organization (the latter is an asset for insolvency proceedings)
- Full exchange of ownership is possible, via DES, issue of new shares to non-parties, etc.
- Why should value of debtor’s organization not be available for a straight market “share deal” (as against an “asset deal”) in a liquidation type proceeding?

I cannot go into detail here but have argued this option in a paper:

published in print as:

21. Restraints from EU company law directives (2nd, 3rd)?

**TYPE A**

- In an intelligent reading of the directives (called „teleological reduction“ in legal methodology), their rules on corporate governance of joint-stock-companies (società per azioni etc.) regarding shareholder decisions on capital measures or mergers (fusion“), and rules on protection of shareholders against dilution of their holdings, etc. do not apply in insolvency proceedings, including the *interim phase* post-petition, and may be substituted by insolvency-appropriate decision-making of the USA or GER types. In a situation where insolvency liquidation looms as only alternative to restructuring, the directive provisions would not serve their rationale.

- EU COM has – to our knowledge - not objected to GER insolvency law as amended in 2011.

- Nor have Human Rights or constitutional objections been raised validly.

**TYPE B**

General law with its governance rules continues to apply.
The End

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ANNEX:
An Insider view on German Insolvency Reform
Selected writings of Manfred Balz

1. SANIERUNG VON UNTERNEHMEN ODER VON UNTERNEHMENSTRÄGERN? VOL. 1, SCHRIFTEN ZUM INSOLVENZRECHT (RWS, COLOGNE), 1986

2. INSOLVENZVERFAHREN FÜR VERBRAUCHER?, ZRP 1/1986, S. 12 FF

3. AUFGABEN UND STRUKTUR DES KÜNFTIGEN EINHEITLICHEN INSOLVENZVERFAHRENS, ZIP 1988, 273 FF.

4. LOGIK UND GRENZEN DES INSOLVENZRECHTS, ZIP 1988, 1429 FF.

5. SOME CAPITAL MARKET ASPECTS OF BANKRUPTCY – ASYMMETRIC INFORMATION, MULTIPLE RANK OWNERSHIP, EXTERNAL EFFECTS, AND VOTING LEVERAGE, IN: HOPT/WYMEERSCH, EUROPEAN INSIDER DEALING (LONDON, 1991), S. 287 FF.

6. BALZ/LANDFERMANN, DIE NEUEN INSOLVENZGESETZE (IDW VERLAG, DÜSSELDORF, 1. AUFL. 1995, 2. AUFL. 1999)

7. BALZ/SCHIFFMAN, INSOLVENCY LAW REFORM FOR ECONOMIES IN TRANSITION - A COMPARATIVE LAW PERSPECTIVE, BUTTERWORTHS J. OF INTERN’L BANKING AND FINANCIAL LAW, 1/2 (1996)


10. DIE ZIELE DER INSOLVENZORDNUNG, IN: KÖLNER SCHRIFT ZUR INSOLVENZORDNUNG (1ST ED., COLOGNE, 1997, 2. AUFL. 2000), S. 3 FF.


12. RESTRUKTURIERUNG IN PERSPEKTIVE, IN: EBKE/SEAGON/BLATZ, INSOLVENZRECHT 2.020 (BADEN-BADEN, 2014)