

Asset Sale in the Debtor-in-Possession Administration

A legal comparison

*Die übertragende Sanierung in der Eigenverwaltung
Eine rechtsvergleichende Untersuchung*

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Abstract

The subject of the dissertation is the asset sale of companies in the debtor-in-possession administration (*Eigenverwaltung*) in legal comparison with the U.S. 363 sale in Chapter 11. The dissertation is limited to corporations in bankruptcy.

In both *Eigenverwaltung* and Chapter 11 the debtor-in-possession continues to operate the business and both proceedings are generally associated with the restructuring of the legal entity. In the U.S., however, bankruptcy going concern sales by way of asset deals (so-called 363 sales) have revolutionized the restructuring practice in recent decades. Debtors carry out these sales, also known as fire sales, at an early stage of the proceedings without a plan of reorganization (that restructures the legal entity), which Chapter 11 actually provides for. As in the German *übertragende Sanierung*, the firm changes its owner; the legal entity remains in bankruptcy and is finally liquidated. Prominent cases in the U.S., such as those of Chrysler, General Motors and Lehman Brothers, are sales that were conducted in this way and in a very short time.

Chapter 1

The first chapter of the dissertation examines the historical and systematic foundations of bankruptcy law in Germany and the U.S. Based on these foundations and against the background of the differences between the two legal systems, a procedural comparison of the *übertragende Sanierung* and 363 sales is made. The chapter concludes with an analysis of the interests involved, which focuses on the incentives of the parties involved in the case of going concern sales in bankruptcy.

A.

Economic assumptions essentially form the basis of bankruptcy law in both legal systems. However, an examination of the historical genesis reveals significant differences. The goals and functions of U.S. and German bankruptcy law diverge. By the beginning of the 20th century, the idea of reorganization finally prevailed in the U.S., which has led to a strong position of the debtor.

The change in the German “bankruptcy culture” intended by the *Insolvenzordnung* has only been able to take place to a limited extent to date. This is due to the emphasized idea of debt collection, which is expressed in a historically grown, strong creditor position. The more recent influences of European Union law represent a clear transition, if not turning point and are difficult to align with the function of bankruptcy law as it is understood in Germany.

With regard to the shift towards bankruptcy governance, the same economic premises apply to both German and U.S. law. Differences arise from the varying degrees to which creditors play a role in the proceedings, which can be explained in part by differences in legal culture that are primarily historical. On the one hand, the focus in the U.S. is on protecting going concern value, while on the other hand, external stakeholder interests are also to be taken into account in bankruptcy. U.S. law places more stringent requirements on the management in the case of an asset sale in that it must take into account a large number of interests, whereas in Germany the creditor’s interest is generally the focal point.

B.

The differences between U.S. and German law are already apparent with regard to the procedure. The most striking difference between the two proceedings is that Chapter 11 does not require an insolvency test and thus facilitates access to the proceeding. The exclusivity period enables the debtor to prepare a reorganization without outside influence. Above all, however, the debtor-centric nature of U.S. bankruptcy law is expressed by the automatic stay, which provides protection against creditor collection actions and whose scope goes far beyond that of the *Schutzschirmverfahren* (section 270d InsO).

In Germany, a *Sachwalter* is appointed in every case. The U.S. counterpart, the examiner, on the other hand, is only appointed upon request and is relatively rare.

With regard to the *übertragende Sanierung* or 363 sales in particular, the possibility of an acquisition free and clear of claims, interests and other encumbrances under 11 U.S.C. § 363(f) expresses this debtor-centric nature of U.S. law particularly clearly. In the *Eigenverwaltung*, on the other hand, the debtor is required to work toward cooperative interaction with secured creditors, particularly in the case of claims secured by real estate.

C.

The interests of the parties involved differ greatly. With regard to the management, the dangers of the *Eigenverwaltung* in the case of a *übertragende Sanierung* result less from gambling for resurrection in the conventional sense, but consist in the management's conflict of interest. Empirical studies show that they see the opportunity to preserve their position and are thus practically no longer on the side of the company or its creditors, but on the side of the acquirer.

From the time of filing for bankruptcy at the latest, the shareholders typically have an incentive to work towards a reorganization of the entity, i.e. a restructuring plan, and to prevent a *übertragende Sanierung*.

The interests of the company are no longer taken into account. A possible conflict of interest exists if a managing director is also a shareholder.

On the creditor side, only secured creditors and DIP financiers or *Massekreditgeber* have an incentive to support a *übertragende Sanierung*. They will typically prefer a quick sale to a more protracted restructuring by means of a plan. This is due, on the one hand, to the generally higher expected value of the *übertragende Sanierung* for them. On the other hand, there is the possibility that secured creditors themselves act as potential acquirers in order to bring about some sort of a "cheap debt-equity swap". The possibility or risk of reclassification as a subordinated claim in the event of increased entrepreneurial influence due to covenants in loan agreements must be considered.

As a rule, all other creditors will be in favor of restructuring, as this is the only option that still promises an expected value of more than zero for them. Management is therefore exposed to various influences and is the fiduciary of different interests. The formation of creditor coalitions complicates this "distribution of interests".

Chapter 2

The second chapter examines the supervision of the debtor in *Eigenverwaltung* or Chapter 11. Against the background of the initial situation elaborated in the first chapter, it highlights the possibilities for creditors to exert influence on the debtor. The risks of abuse arising in connection with 363 sales in the U.S. are compared with the rules on creditor institutions in the case of a *übertragende Sanierung*.

A.

In a corporation's financial distress, a distinction must be made between *drohende Zahlungsunfähigkeit* and the occurrence of material insolvency. If material insolvency has not yet occurred, section 179a AktG and the Holzmüller-/Gelatine principles continue to apply in *Eigenverwaltung*. If there is material insolvency (*Überschuldung* and/or *Zahlungsunfähigkeit*), on the other hand, there is no teleological basis for the applicability of both the Holzmüller-/Gelatine principles and section 179a AktG.

From the point in time of the provisional *Eigenverwaltung* (*Eröffnungsverfahren*), the shareholders of a GmbH and AG are relieved to a large extent of their possibilities to exert influence. Due to clear legislative objectives, this also applies to indirect influence on the management, such as the right to convene, inspect and obtain information. In contrast, the right of the shareholders' assembly to elect the supervisory board in the case of an AG is not affected by section 276a (1) InsO. The legislative clarification that the provision also applies in the case of the *Eröffnungsverfahren* (section 276a (3) InsO) and that the supervisory bodies can thus only exert influence within this limited framework is to be welcomed. In factual terms, against the background of the objectives and function of bankruptcy law, no distinction should be made between direct and indirect measures, but only whether the measure in question has an impact on the estate (whose assets are allocated to the creditors).

In the U.S., the possibilities for control and influence by shareholders in Chapter 11 are considerably more extensive than in Germany. Neither the consent of the trustee/examiner nor that of the bankruptcy court is required for a change of management. The clear abuse test and the balancing test do not appear to be suitable for effectively preventing abuse of shareholder influence, as they only apply in exceptional cases.

The lack of a consent requirement can be explained by the strong position of state corporate governance law systems. This position is recognized and regularly deliberated by the federal bankruptcy courts. Conversely, the history of the U.S. Bankruptcy Code shows that – unlike in Germany – great importance continues to be attached to the interests of shareholders. This is also a particular manifestation of the different bankruptcy law culture, which contradicts the German understanding of creditor autonomy, at least in this context.

B.

In functional terms, the creditors' committee is similar to the German *Gläubigerausschuss*. In detail, however, there are major differences. Only unsecured creditors are represented on the creditors' committee; the interests of secured creditors, small claim creditors and employees are not represented in any institutionalized way. Unlike the members of the *Gläubigerausschuss*, those of the creditors' committee are only obliged to safeguard the interests of unsecured creditors.

In both legal systems, the creditor institutions have a great deal of influence on the appointment of a neutral third party (*Sachwalter* or examiner). In both Germany and the U.S., this means that the possibility of influencing the proceedings should not be underestimated. The constellation in which the debtor proposes to the court the members of the preliminary *Gläubigerausschuss* (section 22a (2), (4) InsO) and at the same time a *Sachwalter* in the

Schutzschirmverfahren (section 270d (2) sentence 2 InsO) and thereby decisively determines the further course of the proceedings must therefore be viewed critically. The experience with abusive behavior by the debtor in the U.S. suggests that these dangers should be taken into consideration for German law. *De lege ferenda*, therefore, it is to be

demanding that debtors can only exercise their right to propose the *Sachwalter* and the members of the *Gläubigerausschuss* alternatively. The resulting delay in proceedings is acceptable in view of the risks of abuse that otherwise exist.

The general debtor-centric nature of U.S. bankruptcy law is particularly evident in the lack of authority granted to the creditors' committee in the case of 363 sales. It must proactively exercise the remaining information and hearing rights in order to effectively monitor the debtor.

In Germany, the decision on a *übertragende Sanierung* must generally be approved by the *Gläubigerausschuss*. In cases that are susceptible to abuse, such as insider sales, the meeting of creditors (*Gläubigerversammlung*) has the authority to give its consent. However, due in particular to the lack of liability risk for the members of the *Gläubigerversammlung*, this is not expected to provide greater protection against a sale made by a debtor in *Eigenverwaltung* contrary to the purposes of the bankruptcy proceeding.

In cases of sales to insiders, the case law of the U.S. bankruptcy courts sometimes imposes higher requirements than German law. The supervision of the planned sale by the *Gläubigerversammlung* should, based on the requirements occasionally imposed by U.S. bankruptcy courts, verify whether an accurate and meaningful valuation of the company is available and whether a marketing process has taken place. De lege ferenda, an amendment to Section 162 InsO could indirectly oblige the *Gläubigerversammlung* to exercise greater control.

Moreover, experiences in the U.S. have shown that in order to prevent undervalued sales, a regulation is needed that imposes clear requirements on the sale process. Section 163 InsO only insufficiently fulfills its purpose. The comply or explain rule (New York) could serve as a model de lege ferenda.

The principle of *Insolvenzzweckwidrigkeit* is only able to correct a *übertragende Sanierung* that has been carried out improperly in obvious exceptional cases.

The widespread use of gifting in the U.S., which allows deviations from the absolute priority rule, is unlikely to play any role in Germany (in the form of voting agreements) under current law. With restrictions, a constellation comparable to gifting would be possible in Germany by means of voting agreements, albeit significantly less attractive and associated with risks. If individual unsecured creditors are bypassed in this way, such an agreement would be void under Section 138 (1) BGB and the resolution of the *Gläubigerversammlung* could be challenged under Section 78 InsO. The "bypassing" of second lien creditors is only possible if the purchaser agrees to acquire the assets attached with the encumbrance. Since this will significantly reduce the purchase price, this is likely to be economically pointless.

The structure of competences of the InsO with regard to the approval requirements of the creditors' institutions should also include rules on the decision-making process, especially with respect to the *Gläubigerversammlung*. This includes clear voting and participation rules vis-à-vis insider sales.

Members of the *Gläubigerausschuss* who are on both sides of the *übertragende Sanierung* are subject to a voting prohibition with regard to all issues arising in connection with the sale. This

results from a *Gesamtanalogie* of the provisions of Section 34 BGB, Section 47 (4) GmbHG and Section 136 (1) AktG. The degree of conflict of interest in such a case, which is only partial, does not justify dismissal of the member. In the absence of statutory provisions relating to voting rights, *Gläubigerausschüsse* are advised to regulate these issues in their by-laws.

Furthermore, the fundamental legislative decision that secured creditors (*Absonderungsberechtigte*) are entitled to vote in the amount of the value of their security interest should be questioned. The danger of a hastily undertaken *übertragende Sanierung* for the quick pay-off of individual creditors to the detriment of the community of creditors, as is known in the U.S., exists in a similar way for Germany for the reasons mentioned of a lack of control of the debtor.

C.

With regard to the *Sachwalter* or examiner, the characteristic of *Unabhängigkeit* or disinterestedness is of particular importance in both the U.S. and Germany. A possible dependency of the neutral third party on debtors or creditors can represent a decisive weakness in the system of monitoring the debtor-in-possession in both procedural systems in order to prevent the risk of abuse.

Chapter 3

A.

The liability of the debtor company in connection with the *übertragende Sanierung* is only relevant in exceptional cases if the acquirer asserts contractual claims and if the purchase price payment has not yet been distributed to the creditors. Due to the insufficient assets, the liability of the debtor company to the creditors is not relevant. The same effect is seen in the U.S., where liability claims by the acquirer can practically only be enforced in the time window (typically small in bankruptcy) between signing and closing.

B.

The management of the debtor in *Eigenverwaltung*, which is liable pursuant to Sections 60, 61 InsO, is subject to a number of duties in connection with the *übertragende Sanierung*, which arise from the continued validity of its management function under corporate law (modified under bankruptcy law) and from the purpose of the proceedings under bankruptcy law. The analysis of U.S. law on 363 sales has identified a body of duties that can be functionally transferred to German law and integrated into the existing structure of duties of care and loyalty.

The duty of the management of the debtor in *Eigenverwaltung* is directed towards achieving the best possible satisfaction of creditors. Once the decision has been made in favor of a *übertragende Sanierung*, there are extensive duties with regard to the marketing of the company. This is illustrated by U.S. law, which has a specific body of duties for the management of the debtor-in-possession. The question of the permissibility of break-up fees, which is the subject of lively debate there, does not arise with such explosive force with regard to Section 1 InsO. Break-up fees are permissible if they do not reduce the assets of the estate. What is absolutely necessary is a comparative calculation which proves that a restructuring of the legal entity, for example by means of a plan, does not put the creditors in a better position than a *übertragende Sanierung*.

The Business Judgment Rule also does not apply to the management of the debtor in *Eigenverwaltung*. However, the management retains some discretion. The framework of specific factors for the analysis of going concern sales as well as the experience of the U.S. case law with regard to these sales can be used *cum grano salis* for the contouring of this discretion. The discretion is limited insofar as the maximization of the distribution mass is always the highest priority. This is particularly evident in cases where a reorganization of the corporate entity appears possible but is fraught with considerable uncertainty. If the debtor plans a quick *übertragende Sanierung* with the argument of a decline in the value of assets (melting ice cube), this must be substantiated. The mere assertion of the occurrence of a loss in value is not sufficient.

Members of the management of a GmbH or AG are obliged to disclose that they are to be rehired by the acquirer. In the case of a management buyout by way of a *übertragende Sanierung*, there are comprehensive duties of disclosure relating to the actual value of the company, which are attributable to the duty of loyalty. This can already be inferred from current corporate law and is, from a perspective of legal comparison, supported by the inherent fairness standard in Delaware.

U.S. bankruptcy courts generally apply the fiduciary duty of loyalty regarding 363 sales in a very debtor-friendly manner. The reasons for this could be the complicated mixture of different jurisdictions (corporate law of the individual states and federal bankruptcy law), but also the generally debtor-friendly bankruptcy law in the USA.

Members of the management are liable for their own culpable misconduct in accordance with the standard of Section 60 (1) sentence 2 InsO, which applies with the proviso that the management, unlike an insolvency administrator, does not require a training period. Limitations of liability under corporate law, i.e. under the articles of association or contractually agreed between the management and the corporation, no longer apply in *Eigenverwaltung* due to the management's authority to act as determined by bankruptcy law.

The principle of *Gesamtverantwortung* under corporate law continues to apply in *Eigenverwaltung*, so that members of the management are in principle jointly and severally liable.

C.

Members of the *Gläubigerausschuss* are also subject to a broad range of duties in monitoring the debtor in connection with a *übertragende Sanierung*. They must generally monitor the debtor's or its management's performance of its duties. In addition, there is a high level of monitoring with regard to the question of consent to a *übertragende Sanierung*. Members of the *Gläubigerausschuss* are also liable for damages if they use their internal influence for their own benefit and to the detriment of other creditors. This applies in particular to the case of distressed debt investors, for example if they purchase additional claims by exploiting insider information.

Both in the U.S. and in Germany, there is a tendency to limit the liability of members of creditor institutions so as not to jeopardize their willingness to accept membership. Members of the creditors' committee only have to fear liability in cases of gross abuse, as they enjoy the liability privilege of qualified immunity.

However, the result of the analysis shows that an analogous application of Section 93 (1) sentence 2 AktG to members of the *Gläubigerausschuss* is not possible. Dangers of abuse due to the practice of distressed debt investors in the U.S. show that this strict liability of members of the *Gläubigerausschuss* is justified.

D.

The *Sachwalter* is liable for breaches of duty in particular in the event of negligent supervision of the debtor or its management as well as failure to report disadvantages to creditors pursuant to section 274 (3) InsO.