DeutscherAnwaltVerein

2nd Position Paper

of the German Bar Association (DAV) by the Legislative Committee "Insolvency Law" and the European Affairs Working Group of the Section of "Insolvency and Restructuring Law"

on the Proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) No. 1346/2000 on Insolvency proceedings COM(2012) 744 final

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Introduction

The German Bar Association (Deutscher Anwaltverein – DAV) is a professional body comprising more than 67,000 German lawyers. Being politically independent, the DAV represents and promotes the professional and economic interests of the German legal profession.

I. Summary

As already set out in its Position Paper 14/2013 the German Bar Association welcomes the proposed amendments of the European Insolvency Regulation as set out in the "Proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) No. 1346/2000 on Insolvency Proceedings" (hereinafter "EIR"), in particular the new draft Article 18 EIR. The German Bar Association agrees with the general concept of this new article and has assessed its functioning. However, for the purpose of further discussions the German Bar Association recommends certain amendments of the draft in order to enhance the amended Regulation´s efficiency.

II. Discussion of Art. 18 EIR (Powers of the liquidator)

In the Proposal for a Regulation of the European Parliament and the Council amending the Insolvency Regulation several modifications are proposed, inter alia, with the aim of improving the efficient administration of the debtor's estate in situations where the debtor has an establishment in another Member State.

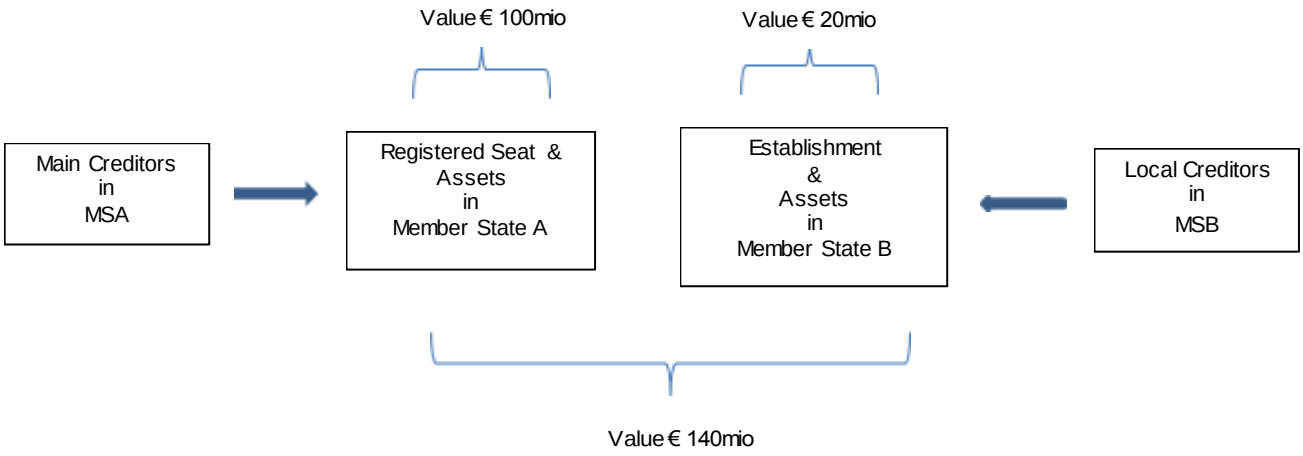
The opening of secondary proceedings should for example not be necessary, if the liquidator of the main proceedings (the LMP) promises to the local creditors (the LC) that they would be treated in the main proceedings (the MP) as if secondary proceedings (the SP) had been opened and that the rights they would have had in such a case with respect to the determination and ranking of their claims would be respected in the distribution of the assets (so called "Synthetic Secondary Proceedings"). Since such a practice is currently not possible under the law of some or probably most Member States, the Proposal introduces a new rule of substantive law enabling the LMP to give such undertakings to LC with binding effect on the estate (cf. Proposal, Explanatory Memorandum, no. 3.1.3).

In Article 18 EIR paragraph 1 the following new wording is inserted:

"He may also give the undertaking that the distribution and priority rights which local creditors would have had if secondary proceedings had been opened will be respected in the main proceedings. Such an undertaking shall be subject to the form requirements, if any, of the State of the opening of the main proceedings and shall be enforceable and binding on the estate"

In addition a new Recital 19a is inserted:
"(19a) Secondary proceedings may also hamper the efficient administration of the estate. Therefore, the court opening secondary proceedings should be able, on request of the liquidator, to postpone or refuse the opening if these proceedings are not necessary to protect the interests of local creditors. This should notably be the case if the liquidator, by an undertaking binding on the estate, agrees to treat local creditors as if secondary proceedings had been opened and to apply the rules of ranking of the Member State where the opening of secondary proceedings has been requested when distributing the assets located in that Member State. This Regulation should confer on the liquidator the possibility to give such undertakings."

For illustration purposes we are looking at the following example:
Company A has its registered seat in Member State A (MSA) and maintains an establishment in Member State B (MSB). Insolvency Proceedings have been commenced with regards to Company A in MSA and liquidator A has been appointed by the insolvency court in MSA. No secondary proceedings have been opened in MSB yet. Liquidator A has assessed the value of the assets located in MSA and MSB of € 100mio and € 20mio. He is optimistic that he is able to sell Company A with all of its assets in MSA and MSB for a total purchase price of € 140mio (due to a synergy effect). In case a secondary proceeding would be commenced in MSB (i) certain creditors of the establishment in MSB would have priority rights which they would not have in the main proceedings in MSA; and (ii) a sale of Company A with all of its assets would be not achievable for the "synergy" purchase price of € 140mio.
Liquidator A wants therefore to avoid a secondary proceeding in MSB and is considering an undertaking pursuant to which priority rights of the LC in MSB will be respected in the distribution of the assets and/or the purchase price.



If no secondary proceedings are commenced in MSB the liquidator A has unlimited access to all of Company's A assets. However, in order to avoid secondary proceedings the liquidator considers to enter into an undertaking with the LC in MSB.

As such an undertaking must not expose the liquidator to personal liability the following subjects are to be reviewed and should be considered by the Proposal:

1. Any acknowledgement of priority rights of the local creditors (LC) in MSB must be permitted under the insolvency law of the main proceedings (MP) in MSA (as we understand it was the case under English insolvency law in the Collins & Aikman case). The Proposal must without any doubt override the lex fori concursus with immediate and binding effect in Art 18, if such preferential treatment of LC in MSB in order to achieve a better economic result for all creditors is not permitted or just not foreseen or even prohibited
2. Reading the new Article 18 and the new Recital 19a) leads to some uncertainty. The new Article 18 states, “that the distribution and priority rights which local creditors would have had if secondary proceedings had been opened will be respected in the main proceedings”. This can be understood in a way, that a priority right that a LC would have in an insolvency proceeding governed by the jurisdiction of MSB but that is not foreseen in the lex fori concursus of MSA would be included in the ranking system of the main proceeding in MSA giving the LC the same ranking with regard to the distribution of all assets gathered and liquidated in the main proceeding in MSA (“unifying approach”). To the contrary recital 19a gives a somewhat different understanding as it defines the undertaking as “to

apply the rules of ranking of the Member State where the opening of secondary proceedings has been requested when distributing the assets located in that Member State." This gives the impression that (i) the liquidator of the main proceedings (LMP) has to set aside a certain part of the funds deriving from the liquidation of the assets in MSB and (ii) the LCs benefiting from such undertaking shall be only participating with a priority ranking with respect to the distribution equaling to assets located in MSB ("separating approach").

3. In case of the aforementioned separating approach with a synergy effect as assumed in our example, i.e. a total purchase price of € 140mio for all assets of Company A, it has to be decided if and to which extent the LC will participate in the step-up in value, i.e. the € 20mio. (the Step-up-Value):
   (a) Option A, the LC will be treated as if the secondary proceedings have been opened, i.e. their priorty rights will only extend to the original asset base of the establishment of Company A, i.e. the value of € 20mio; or
   (b) Option B, the local creditors will participate in the Step-up-Value pro-rata, i.e. with € 20mio x (€ 20mio / € 100mio) = € 4mio.
   (c) Option C, as Option A but with a share of the LC in the Step-up-Value in case of their shortfall by filing the relevant shortfall claim in the insolvency proceedings in the MSA.
4. Finally, we understood that the undertaking was criticised as potentially harming the interests of local creditors. Therefore, it may be sensible to include a legal remedy for local creditors to apply for a court review of the undertaking in their local jurisdiction.

This leads us to the following **recommendations**:

A) In our view the separating approach would lead to a more favourable solution as the unifying approach may cause an LC to end up with a better outcome than in the case of a secondary proceeding being opened in MSB. Therefore, we recommend aligning the wording of the new Article 18 with Recital 19a).

B) With regard to the Step-up-Value we believe that Option C seems to be the preferable alternative. This Option would as well work best in the case that the expected values could not be achieved in MSA and MSB. E.g. in a case where the

LMP is contrary to his former expectations only able to sell the assets in MSA for € 90mio. and in MSB for € 15mio.

C) With respect of an equal treatment of all creditors, any distribution of assets taking different ranking and priority rights into account requires as a pre-condition a reliable and professional valuation report which assesses the value of:

(a) the shares or total assets of the Company A;
(b) all assets located in MSA; and
(c) all assets located in MSB.

D) For this purpose the valuation method has to be considered, in particular it should be made clear on which basis or pursuant to which method such a valuation has to be furnished, i.e. based on :

(a) the enterprise and/or the liquidation value or on both;
(b) the enterprise value, equity value or discounted cash flow method, or market price for single assets.

E) To enhance the acceptance of the undertaking in the Member States we recommend considering the introduction of a special legal remedy against the undertaking: If the LMP is making such undertaking for the benefit of the LC in MSB the LC in MSB should be able to apply before the insolvency court which would have jurisdiction for a potential SP in MSB in order to have the undertaking reviewed by this court. This court should assess whether the undertaking is indeed not harming the position of the LC in MSB. Of course, the time period for this appeal should be limited to a very short period, e.g. seven days after receipt of the undertaking by the LC.

F) In addition, we recommend that the Proposal should set up some guidelines to satisfy the subjects set out in lit. II. A) to E) above.

G) As much as we agree with the concept set out in the draft Article 18 we must observe that the current draft version of the EIR reform proposal is not in line with the idea set out in Recital 19a), which foresees an undertaking of the LMP “binding on the estate … to treat local creditors as if secondary proceedings had been

opened”. One of the mayor effects of the opening of a secondary proceeding in MSB would be, that secured rights in MSB would be treated in accordance with the lex fori concursus and the liquidator in this proceeding could deal with secured assets to the benefit of the general body of LCs and secured creditors could no longer take such assets away from the estate according to Article 5 EIR, if the jurisdiction in the state of the secondary proceedings has a restructuring friendly legal framework holding all assets together for the purpose of achieving the best outcome for all creditors as a whole. As long as Article 5 EIR would not be changed or the LMP would be able to agree with the relevant secured creditor a similar treatment of their security on a voluntarily basis, the LMP would effectively not be in a position “to treat local creditors as if secondary proceedings had been opened”.

This is from our point of view just one example that the highly disputed current version of Article 5 EIR needs to be included in the current reform project as well. We refer to the Decision of the German Bundesrat (Federal Council, 2. Legislative chamber of the Federal Republic of Germany, see Bundesrat, Drucks. 777/12 from 22.03.13) asking for a new version of Article 5. Like the Bundesrat we recommend that the protection of secured creditors should be in line with the protection already granted under the lex rei sitae. The protection of such rights must however not exceed the protection granted under local laws. This would not be fair with respect to the unsecured creditors. A new wording of Article 5 EIR subjecting such rights to the lex fori concursus of the member state where the secured asset is located would not harm the financing institutions and the financing system in Europe as the value of the collateral is generally calculated by the financing institutions on the basis of the lex rei sitae already.