INSOL INTERNATIONAL

TREATMENT OF SECURED CLAIMS IN INSOLVENCY AND PRE-INSOLVENCY PROCEEDINGS II

INSOL INTERNATIONAL

International Association of Restructuring,
Insolvency & Bankruptcy Professionals

INSOL International, 6-7 Queen Street, London, EC4N 1SP
Tel: +44(0) 20 7248 3333 | Fax: +44(0) 20 7248 3384
www.insol.org

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PRESIDENT'S INTRODUCTION

Banks and other lending institutions will extend credit provided they can obtain effective security in the event of default. This results in the lender being assured that it has the right to recover its debt in a quick and efficient manner.

When a borrower defaults under a loan agreement, the lender is usually unaware of the extent of the debtor's financial difficulties. There is always a risk that the debtor may be unable to repay other creditors in addition to the lender and be forced into insolvent liquidation proceedings.

Unsecured creditors usually receive very little or nothing through the rateable distribution process employed in such proceedings. However, in most jurisdictions secured creditors stand outside the insolvency proceedings and the credit instruments would give the lender the ability to enforce its rights without utilizing the courts. A secured creditor also has the right to pursue recovery as an unsecured creditor for any balance of the debt which the security does not satisfy.

In June 2007 INSOL published the first edition of this book. The subject matter continues to be of interest and relevance to practitioners and, as a result, the INSOL Technical Research Committee decided that a second edition of this book should be published. INSOL International is delighted to present this new and updated 20 chapter book which includes seven new country chapters (namely, Brazil, BVI, Cayman Islands, Hong Kong, Mexico, Nigeria and Singapore) and 13 updated and revised chapters of previously included countries. The chapters cover a wide range of key issues that practitioners would find useful, including the types of security rights that are available, the enforcement of such rights, circumstances when the granting of secured rights may be challenged and declared void, and the impact of reorganisation of a company on secured creditors, to name but a few.

The project was led by Evan C Hollander of Orrick, Herrington & Sutcliffe LLP, New York. Evan was also involved in the publication of the 1st edition of this book and we are very grateful for his guidance, interest, and ongoing commitment to publish this book to a very high standard. Evan had a great team working on this project and we are indebted to all of them for committing their time to the editing and review process. We would also like to thank the contributors for taking the time to write / update these chapters, despite their busy schedules.

Julie Hertzberg
President
INSOL International

FOREWORD

Consistent with INSOL's mission statement to "facilitate the exchange of information and ideas", the Technical Research Committee first produced in 2007 a comparative study of the treatment of secured claims in pre-insolvency and insolvency proceedings. The template utilized in the prior edition of this guide, developed with the assistance of my predecessor Andrew DeNatale Of Counsel and Head of the Special Situations Lending Group at Stroock & Stroock & Lavan, provided a handy, accessible and well-organized reference tool outlining the issues impacting the enforcement of secured claims in the twelve jurisdictions covered in that edition. Thus, that template has been incorporated with slight modification into this new edition covering the laws in 20 jurisdictions.

The treatment of secured claims is a matter that insolvency practitioners address in virtually every case in every jurisdiction. This new volume clearly illustrates the advantages and limitations of secured status in in pre-insolvency and insolvency proceedings in each of the 20 jurisdictions covered. As more corporations have extended their presence across borders, it has become critical for practitioners and investors to understand the nuances of the treatment of secured claims in multiple locations. It is the Committee's hope that this study will enable practitioners to navigate the complexities that arise in multinational restructurings, and to provide investors with a handy guide for sound practical information regarding the risks and rewards of secured investments in different countries.

The project would not have been possible without the help and support of others. The initial acknowledgement must go to the Technical Research Committee for developing the concept and format of the project, and to my predecessor who oversaw the production of the prior edition of this volume. I also extend my thanks to the contributors, each of whom submitted excellent material for the jurisdictions covered by the project. Finally, I would like to extend my sincere gratitude to my colleagues, Scott Morrison, Vincent Yiu and Nicholas Sabatino for assisting in the editing of the chapters in this volume and Emmanuel Fua, Peter Amend and Monica Perrigino, who assisted in drafting the materials on the United States.

Evan Hollander
Orrick, Herrington & Sutcliffe LLP
USA

CONTRIBUTORS

Australia	**Samantha Kinsey,** INSOL Fellow **Georgia Boyce** King & Wood Mallesons
Brazil	**Gilberto Deon Corrêa Jr.** **Luis Felipe Spinelli** **Gabriel Lucca Garibotti** Souto Correa Advogados
BVI	**Richard Evans** Conyers Dill & Pearman
Canada	**Brian Empey** **Andrew Harmes** Goodmans LLP
Cayman Islands	**Caroline Moran** **Justin Naidu** Maples Group
France	**Richard Jadot** **Valérie Claver** Ravet Associes
Germany	**Dr. Detlef Hass** **Christine Borries** **Dr. Martin Strauch** Hogan Lovells
Hong Kong	**Naomi Moore** **Jeremy Haywood** Akin Gump Strauss Hauer & Feld
India	**Sanjay Bhatt** Kesar Dass B & Associates
Italy	**Giorgio Cherubini** **Giancarlo Cherubini** EXP LEGAL – Italian & International Law and Tax Firm – Rome and Milan
Mexico	**Rodrigo Valverde** **Santiago Corcuera Cabezut** **Irene Cuellar** Curtis, Mallet-Prevost, Colt & Mosle, S.C.
Nigeria	**Ejemen Ofoman** **Wolemi Esan** Olaniwun Ajayi LP
Russia	**Pavel Boulatov** **Julia Zagonek** **Irina Maisak** **Julia Lymar** White & Case LLC
Singapore	**Debby Lim,** INSOL Fellow BlackOak LLC
South Africa	**Prof. Reghard Brits** University of Pretoria
Spain	**Juan José Berdullas Pomares** **Eduardo Fernández Goñi** Garrigues
The Netherlands	**Barbara van Gangelen** **Clark Warren** Houthoff
UAE	**Marcus Booth** **Claire Matheson Kirton** **Alexander Malahias** **William Watson** White & Case LLP
UK	**Richard Calnan** **Rebecca Oliver** Norton Rose Fulbright LLP
USA	**Evan Hollander** **Emmanuel Fua** **Peter Amend** **Monica Perrigino** Orrick, Herrington & Sutcliffe LLP

CONTENTS

GERMANY

1. Briefly summarise the types of security rights available and indicate, in each case:

- ***What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?***
- ***What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?***
- ***Is the security interest granted by law, contract or both?***

1.1 Movable or personal property

Security interests in respect of movable or personal property are principally granted through a security transfer of title (*Sicherungsübereignung*), a pledge (*Pfandrecht*), a security assignment (*Sicherungsabtretung*), or a retention of title (*Eigentumsvorbehalt*). In contrast to common law jurisdictions, there is no concept of a floating charge under German law, which means that each category of assets of a German company has to be separately identified and be made the subject matter of appropriate security arrangements. However, it is common that groups of assets, such as all goods contained in a warehouse or all the receivables of the company, are subject to an overall security transfer. Security rights are mostly regulated by the German Civil Code (*Bürgerliches Gesetzbuch*), which applies to every private legal instrument, including commercial transactions, as long as there are no other applicable specific rules.

A security transfer of title is usually used in relation to movable assets like an inventory. Such security interest requires a full transfer of title. It is created by agreement between the parties and the grantor retains possession of the relevant asset. The agreement is not required to be in a particular form, and registration of the security transfer of title is not required or possible.

A pledge is an accessory (*akzessorisch*) collateral, which means that there is a direct legal link between the collateral and the secured claim, i.e. if the secured claim ceases to exist, the collateral will cease to exist, and the collateral cannot be transferred without the secured claim. It is created by agreement between the parties. A pledge is created by pledging a chattel or claim as security for a debt. It is a right *in rem* to satisfy a claim. It requires that the debtor delivers up possession of the chattel. Registration of a pledge is not required or possible. Claims or rights may either be pledged or transferred for security purposes by way of an assignment. In the case of a pledge, the third-party debtor in principle must be notified of the pledge in order for the pledge to be effective.

An assignment (e.g. of receivables, intellectual property rights, or insurances) is, again, effected by agreement between the parties. There are no particular requirements as to the form of such an agreement, and registration is not required or possible. The debtor does not need to be notified of the assignment.

Under a retention of title agreement, the seller of personal property may retain title until the purchase price has been paid (condition precedent).

1.2 Real or immovable property

Security over real or immovable property is available either in the form of a land charge (*Grundschuld*) or a mortgage (*Hypothek*). A land charge is a non-accessory security right, i.e. a land charge is independent from the existence of the secured claims. The link between the land charge and the secured claim is created under a separate security agreement. In credit practice, the claim-secured

land charge (*Sicherungsgrundschuld*) as a special type of land charge is a common form of security. The owner of the property may raise objections stemming from the security agreement against the claim from a land charge, e.g. that certain payments are not yet due under the security agreement. It is thus not possible for a third party to acquire the land charge free of the aforementioned objections under the security agreement – i.e. even if a third party were to acquire the land charge not knowing the content of the security agreement, the owner of the property is still entitled to raise the objections under the security agreement against the new third-party owner of the land charge. In contrast to a land charge, a mortgage is an accessory right, depending on an underlying personal debt. Both are created by a private agreement between the parties, a notarised declaration of the chargor (*Eintragungsbewilligung*), and registration with the land register. Notarisation and registration of the land charge will result in fees, which will be calculated by reference to the amount secured by the security interest.

In practice, due to their more flexible non-accessory nature, land charges are considered the preferable real estate security interest and are used in almost all cases.

1.3 Granting security

In general, a security interest is created by contract, but there are a few exceptions. The most important statutory liens are the contractor's lien (*Unternehmerpfandrecht*) and the landlord's lien (*Vermieterpfandrecht*).

2. How are security rights enforced? Is a court process or out-of-court procedure required or are both methods available? What are the practical difficulties experienced when security is enforced?

Since the assets of the debtor are effectively confiscated with the commencement of insolvency proceedings, and the power to manage and administer the assets of the debtor passes to the administrator, the following is related to enforcement outside of insolvency proceedings.

In order to enforce security rights under German law, the creditor must normally obtain a court judgment. For this to happen, court proceedings would have to be initiated, and the debtor would be ordered by the court to make the payments in question. The court judgment could then be used to enforce the security. In order to avoid lengthy proceedings, the mortgage or land charge documentation usually includes a submission of the debtor to immediate enforcement (*Unterwerfung unter die sofortige Zwangsvollstreckung*) against the property in relation to outstanding claims. Such submission to immediate enforcement requires a notarial deed which, for the purpose of enforcement of the mortgage or land charge, replaces a court judgment so that on the basis of the notarial deed enforcement can be initiated without having to obtain a court judgment.

Before a judgment can be executed with state assistance (bailiffs), three essential prerequisites must be fulfilled. First, the creditor must actually hold a court-certified copy of the complete (written) final judgment (*Titel*). Second, the judgment must contain an execution clause (*Klausel*). Third, the judgment with the execution clause must be served upon the debtor (*Zustellung*).

For enforcement against immovable property, the creditor can choose between three alternative steps: a mortgage to be entered in the land register (*Grundbuch*) on application of the creditor by way of execution (*Zwangshypothek*); a sale by court order (*Zwangsversteigerung*); or sequestration with an administrator appointed by the court in order to receive the rents and profits thereof (*Zwangsverwaltung*).

The proceeds from a judicial sale will firstly be used to cover the costs of the proceedings. The proceeds will then be distributed to all mortgagees / chargees according to their ranking, i.e. outstanding claims of the first-ranking mortgagee / chargee will be discharged first.

3. Are pre-insolvency proceedings available? If so, describe the types of pre-insolvency proceedings that are available, including:

- ***Who can initiate the proceeding?***
- ***What are the criteria used for opening the proceeding?***
- ***Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.?***
- ***Does the debtor's management remain in control of the business during the proceeding?***
- ***May contracts and secured and unsecured debts be adjusted in the proceeding without affected creditor consent?***
- ***What is the level of creditor consent that is required to effectuate a restructuring?***
- ***Is shareholder consent required in order to effectuate a restructuring?***

Following the example of United States (US) Chapter 11 proceedings and the French *procédure de sauvegarde*, the "protective shield proceedings" (*Schutzschirmverfahren*) were introduced to German insolvency law in 2012. Through those proceedings, companies can restructure their business under insolvency court protection by combining an early filing for insolvency with a motion for the ordering of self-administration. The objective is to give the debtor the chance to develop a so-called insolvency plan (see section 14 below) to be implemented in subsequent insolvency proceedings and to protect it from enforcement measures.

Besides the formal (pre-)insolvency proceedings, there are several out-of-court restructuring workouts available such as moratoriums, voluntary liquidations and business restructurings.

3.1 Who can initiate the proceeding?

An application for protective shield proceedings can only be filed by the debtor.

3.2 What are the criteria used for opening the proceeding?

The application must be based on either an impending inability to pay debts or an over-indebtedness of the debtor (for details regarding the criteria for the opening of insolvency proceedings, see section 4.2) and a reasonable expectation of a successful restructuring, which has to be confirmed by a certificate from an insolvency law expert.

3.3 The main actors in the pre-insolvency proceedings

The Insolvency court appoints a preliminary creditors' trustee (*vorläufiger Sachwalter*), which can be chosen by the company itself, and sets a deadline of at most three months for the debtor to submit a draft insolvency plan. Furthermore, the court is allowed to appoint a preliminary creditors' committee

(*vorläufiger Gläubigerausschuss*). In larger proceedings a preliminary creditors' committee is regularly appointed.

3.4 Does the debtor remain "in possession" of the business?

In these proceedings, the management of the company remains in control but needs the consent of the preliminary creditors' trustee for certain extraordinary transactions. The same applies to the preliminary creditors' committee for even more extraordinary and relevant transactions. Upon the debtor's further application, the court must order a stay on individual enforcement measures and grant the debtor the right to incur preferential debt for the period until the deadline expires.

3.5 May contracts and secured and unsecured debts be adjusted in the proceeding without affected creditor consent?

In insolvency shield proceedings, similar to regular insolvency plan proceedings (see below, section 14), each creditor has the right to approve or to oppose the adoption of the insolvency plan. However, its opposition can be irrelevant if, for example, the plan is approved by the majority of the creditors, namely, the established creditors' groups. For details see the answer to section 11.

3.6 What is the level of creditor consent that is required to effectuate a restructuring?

Creditors' consent is not needed for the initiation of these preliminary proceedings. The creditors can exercise their rights in the preliminary creditors' committee.

3.7 Is shareholder consent required in order to effectuate a restructuring?

Shareholder consent is not necessary to initiate these proceedings. Shareholders also exercise their rights via the preliminary creditors' committee.

4. Are insolvency proceedings available? If so, describe the types of insolvency proceedings that are available, including:

- ***Who can initiate the proceeding?***
- ***What are the criteria used for opening the proceeding?***
- ***Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.?***
- ***Does the debtor's management remain in control of the business during the proceeding?***
- ***May contracts and secured and unsecured debts be adjusted in the proceeding without affected creditor consent?***
- ***What is the level of creditor consent that is required to effectuate a restructuring?***
- ***Is shareholder consent required in order to effectuate a restructuring?***

4.1 Who can initiate the insolvency proceeding

The commencement of insolvency proceedings requires a petition to the competent insolvency court

by either the debtor or one of its creditors. If a company is insolvent, the management of the company must apply for the commencement of insolvency proceedings without culpable delay and no later than three weeks after the occurrence of a ground for insolvency. The three-week period may only be used for restructuring or negotiations with an investor if it is reasonable and likely that such measures will be successful. The obligation to file for insolvency arises irrespective of the executives' knowledge of insolvency. As a result, the executives are under an ongoing obligation to monitor the standing of the company to exclude the risk of personal civil and criminal liability.

4.2 Criteria used for opening the proceeding

Under the German Insolvency Act (*Insolvenzordnung* or InsO) insolvency proceedings require a reason for being opened. Such reasons can be:

- the debtor's liabilities are greater than its assets (over-indebtedness or *Überschuldung*), or
- the debtor is unable to meet its debts as they fall due (inability to pay debts or *Zahlungsunfähigkeit*).

An event of "impending inability to pay debts" (*Drohende Zahlungsunfähigkeit*) does not give rise to the obligation to file for insolvency proceedings but entitles the debtor (but not the creditors) to do so.

The insolvency court will refuse a request to open insolvency proceedings if the debtor's assets are insufficient to cover the costs of the proceedings. Otherwise, it will open the insolvency proceedings.

4.3 The main actors in insolvency proceedings

Apart from the debtor, the main parties involved in the insolvency proceedings are the insolvency court (*Insolvenzgericht*), the administrator (*Insolvenzverwalter*) and the creditors' representation, i.e. the creditors' meeting (*Gläubigerversammlung*) and the creditors' committee (*Gläubigerausschuss*).

4.3.1 Insolvency court

The main functions of the insolvency court are to create the procedural framework for the realisation of the debtor's assets and to appoint and supervise the administrator. The realisation of the debtor's assets is part of the administrator's job. The insolvency court has exclusive power to terminate insolvency proceedings. It is also able to order or approve special proceedings, e.g. an insolvency plan, self-administration (debtor-in-possession) and the discharge of residual debt.

4.3.2 Administrator

The administrator is a professional person (i.e. always a natural person), usually a lawyer, who derives his or her powers through the appointment by the court. In legal terms, the administrator is not a representative of the creditors or of the debtor – he or she is independent. Upon the opening of the insolvency proceedings the debtor's right to manage and transfer the assets involved in the insolvency proceedings is transferred to the administrator. The administrator can choose to liquidate the company, continue the business and restructure the debt through an insolvency plan, or sell the business as a going concern. The administrator is personally liable for damages occurring because of a disregard of his or her legal duty of care. The administrator owes a duty of care to the debtor and the creditors, as well as to third parties who claim ownership of goods possessed by the estate due to retention of title.

4.3.3 Creditors' representation

The creditors' meeting, in its capacity as a supervisory and controlling body, is an institution peculiar to insolvency proceedings. The creditors' meeting is convened by the insolvency court. All secured and unsecured creditors, the administrator and the members of the creditors' committee are entitled to attend the creditors' meeting. If there is no creditors' committee the creditors' meeting votes upon resolutions concerning particular matters of importance and decides whether to cease or continue the debtor's business.

Unlike the creditors' meeting, the creditors' committee is optional. In larger insolvencies, however, a creditors' committee is regularly appointed. Its function, both in liquidation and administration proceedings, is to assist and supervise the administrator's "management". In liquidation proceedings, the creditors' committee is vested with substantial decision-making powers. The prior approval of the committee is required for particularly important transactions to be undertaken by the administrator.

4.4 Does the debtor remain "in possession" of the business?

The position of the debtor is not as strong as it is under US law. Prior to the court's order for the commencement of insolvency proceedings, there are no automatic restrictions on the debtor's power of disposal. However, after filing for insolvency, the insolvency court has the power to make all provisional arrangements that it considers necessary to protect the estate against changes which would be detrimental to the creditors. In particular, the court may impose restrictions on the debtor's power to manage and administer assets. The court regularly appoints a preliminary insolvency administrator (*vorläufiger Insolvenzverwalter*). With the opening of insolvency proceedings, the assets of the debtor are effectively confiscated. Although the debtor retains title to property, the power to manage and administer the assets of the debtor passes to the administrator.

Only in cases of self-administration (*Eigenverwaltung*) will the debtor continue to run and manage the business. However, this takes place under the supervision of a creditors' trustee (*Sachwalter*). The German Insolvency Act of 1999 introduced self-administration into corporate insolvency. The purpose of self-administration does not deviate substantially from the purpose of regular German insolvency proceedings. The management in self-administration may liquidate the company, turnaround and continue the business, or sell the business as a going concern. The self-administration procedure is a useful option where maintaining the specialist skills of the current or established management is likely to benefit the creditors. Self-administration is also useful in international insolvency proceedings of group companies.

4.5 May contracts and secured and unsecured debts be adjusted in the proceeding without affected creditor consent?

In regular insolvency proceedings, the administrator can decide whether to continue or discontinue an ongoing contract, often referred to as executory contract (*Wahlrecht*). For example, the administrator can choose not to fulfil an ongoing supply contract after the commencement of the insolvency proceedings. As a consequence, the respective supplier does not have to fulfil its contract any further. Any damages for non-performance or outstanding payments can only be claimed as an unsecured insolvency creditor.

Other than that, the insolvency dividend is determined without creditor consent. In insolvency plan proceedings, each creditor has the right to approve or to oppose the adoption of the insolvency plan. However, its opposition can be irrelevant if the plan is approved by the majority of the creditors, namely, the established creditors' groups. For details see the section 11.

4.6 What is the level of creditor consent that is required to effectuate a restructuring?

In regular insolvency proceedings, it is generally the administrator who makes the decisions. In insolvency plan proceedings, a majority of creditors in each class, and a majority of the value of the claims in each class, must approve the insolvency plan, which is a requirement for a successful restructuring. Even if the necessary majorities have not been achieved, a voting group shall be deemed to have consented if the requirements of so-called prohibition of obstruction (*Obstruktionsverbot*) are fulfilled. According to the prohibition of obstruction, the rejection of the plan by a voting group is irrelevant if:

- the creditors forming such a group are presumed to suffer no loss under the insolvency plan compared to their situation without such a plan;
- these creditors participate adequately in terms of the economic value the parties will receive under the plan; and
- the majority of the voting groups have given their consent to the plan with the necessary majorities in each of them (in terms of the number of creditors and the amounts of their claims).

4.7 Is shareholder consent required in order to effectuate a restructuring?

In regular insolvency proceedings, the shareholders have a very subordinated role. They have no say in any decision of the administrator unless any shareholder subordinated claims are relevant for a quota. In this case, they are treated as creditors, which is obviously rare as it requires full prior satisfaction of all creditor claims. In insolvency plan proceedings, shareholder consent is required in order to effectuate a restructuring in so far as the insolvency plan has to provide a voting group for them. They take part in the voting and can eventually be overruled like any other creditors' group (see section 11 for details).

5. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

Certain transactions can be challenged by an administrator during insolvency proceedings in order to increase the assets in the estate. Transactions particularly at risk are gifts and certain transactions undertaken during or shortly before the financial difficulties of the debtor. A basic requirement of all challenges under the German Insolvency Act is that the transaction has a disadvantageous effect on the creditors as a body in that it impairs their chances of recovery. Typically, this is the case where the transaction has diminished the assets or increased the liabilities of the future estate. In detail, however, the particular grounds of challenge are rather subtle and are explained only in general terms here.

In particular, the following transactions may be challenged by the administrator:

- transactions undertaken by the debtor during the previous 10 years prior to filing for insolvency, or after such filing, with the intention of disadvantaging creditors where the other party to the transactions was aware of the debtor's intention at the time of the transaction;
- transactions undertaken by the debtor for no consideration within four years prior to the application for insolvency proceedings;

- transactions that, in consideration of a shareholders' claim for repayment of his loan replacing equity, or in consideration of an equivalent claim granted security or satisfaction, if: such transaction was made during the previous ten years in case of security or during the previous year in case of satisfactions, in each case prior to filing for insolvency proceedings or subsequent to such filing;

- transactions made in the three-month period prior to the filing for insolvency and the period between filing for and opening of insolvency proceedings can be set aside even more easily. The law distinguishes between satisfaction of claims or security which the creditor is entitled to (fair consideration) and satisfaction of claims or security which the creditor is not entitled to (unfair consideration).

However, a transaction in principle cannot be set aside if the debtor receives immediate adequate consideration.

If a creditor receives security, collateral, or payment in breach of these rules, the creditor must waive all rights under a security, repay all monies, or retransfer all assets received if the transaction is challenged by the administrator. If the security includes rights in movable goods or rights, the creditor would also be liable for all further damage to the relevant asset.

6. Is enforcement of security rights treated differently in each type of proceeding?

Generally speaking, the German Insolvency Act imposes an automatic stay on the enforcement of rights as soon as the insolvency proceeding commences but does not place any restrictions on enforcement at the pre-insolvency stage.

However, there are several exceptions to the principle of automatic stay (see section 11 for details).

7. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Before the opening of insolvency proceedings there are no priorities in distributions among creditors except for those that have been contractually agreed upon, e.g. in an intercreditor agreement. After the opening of insolvency proceedings there is a strict ranking. The German Insolvency Act recognises four types of creditors:

- secured creditors;

- estate creditors (*Massegläubiger* – the creditors of the estate whose claims arise after the commencement of insolvency proceedings, mainly through dealings with the administrator);

- insolvency creditors (the creditors of the debtor who, at the commencement of the insolvency proceedings, have a claim against the debtor); and

- subordinated creditors.

Thereafter, shareholders receive any residual quota against their share capital.

Secured creditors who have security rights in assets that belong to the bankruptcy estate and that are in the possession of the insolvency administrator are not entitled to realise the assets. Instead, the

administrator will realise the collateral and pay the proceeds to the secured creditors after discharge of the administrator's fees.

The estate creditors' claims must also be satisfied before the proceeds of the liquidation can be distributed among the insolvency creditors. Claims against the debtor which arise after the commencement of the insolvency proceedings upon agreement with or action by the administrator are not treated as insolvency claims. This would apply to a new loan which is provided to the administrator. The estate creditors play a separate role because they have not extended credit to the debtor voluntarily and, thus, have not assumed the risk of the debtor's insolvency. Moreover, they have enhanced the estate by delivering goods or rendering services, so it would not be justified to treat them on an equal level with the insolvency creditors.

In principal, all other insolvency creditors are treated equally and their claims rank *pari passu*. This means that all claims listed in the list of creditors' claims are satisfied proportionally, except claims of subordinated insolvency creditors. The latter rank junior to the other claims of insolvency creditors. Some examples of claims of subordinated creditors include: interest accruing from the claims of insolvency creditors since the opening of the insolvency proceedings, shareholders' claims for repayment of loans replacing equity etc.

Shareholders are paid only after all creditors have been paid in full.

8. How can secured creditors protect their interests in collateral during a pre-insolvency or insolvency proceeding?

Generally, in order for a claim of a creditor to be considered, the creditor has to apply for registration of its claim in a list of creditors' claims (*Insolvenztabelle*) within a certain time limit. This list is set up by the insolvency administrator. However, in general, creditors do not suffer any severe disadvantages if they register late. In the event the insolvency administrator has sold assets that originally secured the creditor's rights, for example, the creditor may claim the proceeds out of the sale. Nevertheless, it is strongly advisable to indicate the securities, especially any form of retention of title, at an early stage since it puts the creditor in a position to exert influence on the liquidation of the securing assets. Moreover, secured creditors may improve the chances of securing their claims and collateral by entering into so-called "pool-agreements" with other creditors. The administrator communicates with one of the members of the pool rather than each of them. This can reduce the complexity of the proceedings, facilitate the enforcement of the creditors' rights, and improve their leverage in negotiations with the administrator.

As outlined above, once proceedings have been commenced, the assets of the debtor are effectively confiscated by the administrator, so the creditor is stayed from taking action against its collateral. Possible enforcement actions of creditors are discussed in more detail in section 11 below.

9. Can the rights of a creditor against a non-debtor guarantor be affected in a proceeding of the primary obligor?

First, one has to differentiate between an on-demand guarantee (*Garantie*) and a surety (*Bürgschaft*). An on-demand guarantee under German law is a personal security that is non-accessory. An on-demand guarantee is a contractual relationship which is not explicitly governed by statutory law but is developed and shaped by legal practice, in particular by court judgments. A surety under German law is a personal security which is accessory. A surety is a contractual relationship which is governed by particular rules of the German Civil Code. English terms used to describe these concepts vary.

A German law *Garantie* is often translated as "guarantee" and sometimes as "indemnity", and a German law *Bürgschaft* is sometimes called "surety" and sometimes "guarantee".

The commencement of insolvency proceedings does not result in a stay of either a surety or an on-demand guarantee. Therefore, the creditor could take action against the obligor / guarantor to satisfy his or her claims.

10. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights?

If the acquisition (including registration where required) of a security right of a creditor has not been completed prior to the opening of the insolvency proceedings, the creditor remains unsecured. It is a general principle of German law that, after the opening of insolvency proceedings, rights in objects – be it a land charge, a pledge or even the title itself – forming part of the estate can usually no longer be acquired with legal effect. In case of security assignments of future claims, for example, claims of the estate generated after the opening of proceedings do not secure the creditor's interest.

With respect to real estate, the Insolvency Act provides for the exception of acquisition in good faith under certain circumstances. However, even after the acquisition in good faith there remains the risk that the acquisition will be challenged by the insolvency administrator.

11. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged? If so, how?

With respect to secured creditors, whether the creditor is entitled to take enforcement actions depends on the type of security. Creditors who are secured by retention of title, for example, are still entitled to enforce their right even if the insolvency administrator has chosen not to continue the underlying purchase agreement. Creditors secured by land charges may also enforce their rights irrespective of the pending insolvency proceeding. However, in practice, these creditors might face resistance in trying to enforce their security since their measures might overlap with enforcement actions of the insolvency administrator. Creditors secured by fiduciary transfer of assets / receivables or pledges are generally not entitled to take enforcement action themselves. Instead, the insolvency administrator enforces their rights on their behalf. Generally, the administrator sells the secured assets – charging a liquidation fee of approximately 9% of the proceeds for that action – and pays out the remaining proceeds to the creditors.

At the pre-insolvency stage, claims may generally still be enforced. However, between the filing for insolvency and the opening of the insolvency proceedings (such period usually lasts up to three months in Germany), the insolvency court (respectively the competent court for enforcements with respect to the estate's real property) is entitled to prohibit or suspend enforcement measures by creditors except with respect to immovable assets. This is also the case in protective shield proceedings (*Schutzschirmverfahren* – for details of which see section 3 above).

In general, creditors cannot challenge a stay of enforcement at the pre-insolvency stage or after the commencement of proceedings.

12. Can collateral in which a secured party has an interest be used by the debtor or sold during a case without the consent of the secured party? If collateral may be sold without the secured party's consent, may it be sold "free and clear" of the liens of the secured party?

Are there specific rules regarding the debtor's use of "cash collateral" as opposed to other types of collateral?

After the opening of insolvency proceedings, the right to manage and transfer the debtor's assets passes to the insolvency administrator. Thus, the administrator is generally entitled to use and dispose of the debtor's movable and immovable assets. However, with respect to assets that effectively do not belong to the estate – due to a right of segregation of the creditor holding title in the property – the administrator is obliged to release these assets. Movable assets subject to security rights which are in the possession of the insolvency administrator may be used by the administrator for the period until their realisation. However, the secured creditor is entitled to compensation for the loss in value of the asset in which such a creditor has security rights.

Under German law there is no specific treatment for "cash collateral".

In practice, the continuation of the debtor's business often depends on the willingness of creditors to inject fresh capital. In the event an insolvency administrator incurs such loans, the creditor's claim will be satisfied ahead of other insolvency creditors. Nevertheless, usually creditors insist on security rights for these loans. The administrator may grant such right if there are still sufficient "free" assets in the estate to secure the loans. In any case, the administrator may secure the loans by the goods and receivables generated during the continuation of the business.

13. During the course of a pre-insolvency and insolvency proceeding, can additional liens on a secured creditor's collateral be granted to a third party in violation of the contractual arrangements between the debtor and the secured creditor?

In general, the administrator has to respect the secured creditors' rights in its collateral. Insofar as the secured creditor is or has become over-collateralised (subsequent over-collateralisation – see section 16 for further details), the administrator can ask to release parts of the collateral from the lien and grant additional subordinated liens to a third party. By asking for the release, the administrator would, however, not violate any contractual arrangements with the secured creditor.

If the contractual arrangement regarding a lien also extends to future or further assets or collateral created or acquired after the commencement of insolvency proceedings, the administrator can choose not to perform the future part of the contractual arrangement and grant additional liens to a third party regarding these assets or collateral. The creditor can then claim damages for non-performance only as an insolvency creditor, i.e. the creditor would only receive the insolvency dividend.

14. What distribution will a secured creditor receive if a company is reorganised?

Part of the insolvency reforms in Germany included the introduction of a procedure that bears a strong resemblance to the reorganisation procedure of the Chapter 11 US Bankruptcy Code.

The core element of this procedure is the insolvency plan, which is part of the German Insolvency Act and which provides for reorganisation.

If a company is reorganised by an insolvency plan, a secured creditor will generally receive a distribution according to the provisions of the insolvency plan. If the insolvency plan does not contain any provisions regarding the secured creditors, the plan does not affect their rights.

The plan may be proposed by the debtor or by the administrator. In addition, the creditors' meeting is entitled to request that the administrator propose such a plan. The insolvency plan may provide for

changes in the legal relationships of the debtor and creditors. There are three types of creditor to be dealt with in this situation: secured creditors, unsecured creditors and subordinated creditors. A group of creditors must be formed for each of these categories of creditors. Subgroups may be formed where certain creditors have homogeneous economic interests. Employees should, and creditors with small claims may, form separate groups. To conclude the plan, the insolvency court determines a date for discussion of and a decision about the plan. A majority of creditors in each class and a majority of the value of the claims in each class must approve the insolvency plan. Even if the necessary majorities have not been achieved, a voting group shall be deemed to have consented if the requirements of so-called prohibition of obstruction (*Obstruktionsverbot*) are fulfilled. According to the prohibition of obstruction, the rejection of the plan by a voting group is irrelevant if:

- the creditors forming such a group are presumed to suffer no loss under the insolvency plan compared to their situation without such a plan;
- these creditors participate adequately in terms of the economic value the parties will receive under the plan; and
- the majority of the voting groups have given their consent to the plan with the necessary majorities in each of them (in terms of the number of creditors and the amounts of their claims).

The prohibition of obstruction resembles the "cram-down rule" in Chapter 11 of the US Bankruptcy Code.

Finally, the plan has to be approved by the insolvency court.

15. Will the rights of a secured creditor over assets of a debtor remain intact subsequent to the reorganisation of the company?

The confirmation of the plan by the competent court will effect the arrangements provided for in the plan. The general legal concept with respect to insolvency plans provides for discharge of the claims of unsecured creditors to the extent that they do not receive the quota according to the plan. In contrast, the rights of secured creditors remain unaffected if not provided for otherwise in the insolvency plan.

However, as the parties are free to arrange the plan according to their own interest, the plan may deviate from this general rule. The plan may make determinations with respect to the distribution of the debtor's assets between the secured and unsecured creditors. It may also provide for a waiving of the secured rights. As soon as the order confirming the insolvency plan becomes legally binding, it becomes binding upon all the parties involved. If the plan is to create, modify, transfer or waive rights in objects or if shares in a company with limited liability are to be transferred, the declarations of intent on the part of the parties involved which are included in the plan are at the same time deemed to have been given in the form required by law. The same applies to the undertakings included in the plan on which the creation, modification, transfer or waiving of rights in objects or transfer of shares are based. In contrast, the plan does not affect the rights of the creditors of the insolvency proceedings against the debtor's co-obligors and guarantors. Moreover, the rights of such creditors to objects not forming part of the assets involved in the insolvency proceedings or deriving from a priority notice covering such objects remain unaffected by the plan.

16. What rights does a secured creditor have if its secured claim is over-secured? What happens if a secured claim is under-secured?

There are two types of over-collateralisation, the initially over-secured (*anfänglich übersichert*) and the

subsequently over-secured creditor (*nachträglich übersichert*).

According to the case law of the German Federal Supreme Court (the BGH), a security interest, and the agreements granting such interest, can be void if an initial over-collateralisation is so excessive that it must be considered as being against *bonos mores* (*gegen die guten Sitten*). Although no specific case law exists, a decision by the BGH indicates that the loan-to-security ratio would be well beyond the threshold applied to subsequently excessive collateralisation if the realisable value of the security is more than 150% of the amount of the secured obligations. In addition, in order for the over-collateralisation to be regarded as initially excessive, it must be based on a creditor's reprobate attitude (*verwerfliche Gesinnung*), which is assumed if a creditor, out of self-interest, displays an ethically unbearable recklessness against a borrower.

If the realisable value of the security at any date after being granted permanently exceeds the amount of the secured obligations by more than 10%, the subsequently excessively secured creditor is, according to the case law of the BGH, regularly obliged to release security back to the debtor insofar as the estimated market value of security, which depends on the risks of realisation of the security and on the market situation, exceeds the secured amount by more than such 10%.

A fully secured creditor is entitled to receive payment of the full principal, including pre- and post-interest and expenses in the event the security purpose agreement includes such costs. If this is not the case, claims regarding post-interest and expenses are subordinated.

If secured claims are under-secured, the creditor bears the risk of not recovering all of his or her claims in the event of enforcement. In any case, the secured creditors retain an unsecured claim as an insolvency creditor for the shortfall.

17. Will a court give full force and effect to a foreign restructuring of contractual arrangements that are governed by local law? If so, what requirements will need to be met for the court to do so?

As a general rule, a distinction must be made between whether or not insolvency proceedings have been opened in a member state of the European Union.

If insolvency proceedings are opened in a member state of the European Union, the European Insolvency Law Regulation takes precedence. The opening of insolvency proceedings by a court of a member state that has jurisdiction under the European Insolvency Law Regulation is recognised in all other member states as soon as the decision is effective in the state in which the proceedings are opened, cf. Article 19(1) of the European Insolvency Law Regulation. Besides this rule, the European Insolvency Law Regulation (Article 34ff) provides for the possibility of opening secondary proceedings in a member state with (significant) assets of the debtor. The European regulator has, however, tried to limit the amount of so-called "synthetic" secondary proceedings. The administrator can now give confirmation to creditors in a different member state that they will be treated according to their local law in secondary proceedings.

The autonomous law of sections 343ff of the German Insolvency Code comes into effect if the insolvency proceedings are opened in a third state or if the decision to open insolvency proceedings concerns an insolvent person who is not covered by the personal scope of the European Insolvency Law Regulation.

The opening of foreign insolvency proceedings is generally recognised pursuant to section 343(1) of the German Insolvency Code. This does not apply if the courts of the state do not have jurisdiction under German law or if recognition leads to a result that is obviously incompatible with the

fundamental principles of German law, in particular if it is incompatible with fundamental rights (*ordre public*). Security interests taken after the request to open insolvency proceedings, as well as decisions taken to implement or terminate the recognised insolvency proceedings, are also accepted.

* The temporary adjustments to German insolvency law due to the Covid-19 crisis are not covered in these answers as they are only of a temporary nature.

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INSOL INTERNATIONAL

INSOL International, 6-7 Queen Street, London, EC4N 1SP
Tel: +44(0) 20 7248 3333 | Fax: +44(0) 20 7248 3384
www.insol.org