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MARKET CONFORMITY OF INSOLVENCY PROCEEDINGS: POLICY ISSUES OF THE GERMAN INSOLVENCY LAW

Manfred Balz*

I. INTRODUCTION

The topic of this conference suggests that a developed rescue culture is more civilized than a liquidation culture, and that we should all pray to be blessed with a Chapter 11.1 According to the City of London folklore, which has traditionally been sardonic about German business, Germany simply does not have acceptable rescue manners. In short, Germans have been depicted as rescue Neanderthals.

While this view may be valid under the existing Konkursordnung of 18772 and the Vergleichsordnung of 1935,3 with their very inefficient composition or arrangement

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3. Vergleichsordnung [Composition Act], v. 26.2.1935 (RGBl. I S.321), translated in BUTTERWORTHS INTERNATIONAL INSOLVENCY LAWS, supra note 2, at 216 [hereinafter Composition Act]. For a general discussion of the 1935 law, see
things may change (albeit not dramatically) under the bankruptcy law reform enacted in 1994. This law is considered so radical that it was thought wise to postpone its entry into force until January 1, 1999. I had the pleasure of some involvement in the layout and drafting of this law.

We in Germany think that the law should contain no bias or built-in normative preference for rescue over liquidation. Rescue should certainly not be prevented by inadequate rules wherever it is in the best interest of claimants, i.e., where rescue maximizes value. However, debtors should not be subsidized at the expense of unwilling claimants, in order to benefit rescues deemed to be in the public interest. We also think that "Rescue or Liquidation?" is not a properly framed question and does not reflect the range of options. Liquidation by way of a liquidating plan, or through a sale of all or substantially all of the assets of a debtor as a going concern, is probably the most economically sound solution in most instances. For Germans, sale of the going concern on the market, rather than sale to existing claimants—as reorganization has been characterized by critics of Chapter 11, such as Jackson and Baird—is generally preferable because it avoids delay, troublesome strategic misbehavior by claimants, and worrisome valuation issues. Thus, market sale of a going concern is the proper paradigm under German notions of absolute priority for insolvent debt-

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5. See Insolvenzordnung [Insolvency Act], v. 5.10.1994 (Bundesgesetzblatt [BGBI] I S.2866) (unofficial translation on file with the Brooklyn Journal of International Law) [hereinafter Insolvency Act]; Einführungsgesetz zur Insolvenzordnung [Introductory Act to the Insolvency Act], v. 5.10.1994 (BGBI. I S.2911).

6. "This long postponement is due to the fact that the Federal Lander (states), whose courts are to implement the new Insolvency Statute, have raised fears that they will not be able to satisfy the increased demand on staffing for several years." Wimmer, supra note 4, at A3.

7. The author of this paper was one of two draftsmen involved in framing the new bankruptcy statute at the German Federal Ministry of Justice.


ors, and it is only such debtors that come before the bankruptcy courts in Germany.

II. MEASURING THE EFFECTIVENESS OF INSOLVENCY PROCEEDINGS

How is one to measure the benefit derived from a neatly tailored bankruptcy system? The economic benefit of insolvency proceedings is not easily measured. Despite widely varying insolvency systems in countries with very similar economies, there is hardly reliable evidence that rates of growth, prosperity, employment, or monetary stability are related in a concrete way to the legal and institutional setup used for dealing with business insolvencies.

Obviously, the effectiveness of a bankruptcy regime cannot be measured by the number of proceedings, nor is the number of successful reorganizations as compared with the number of liquidations in bankruptcy an accurate indication of a successful regime. In fact, there is no way of discerning the optimal number of reorganizations. Contrary to popular belief, bankruptcy liquidation is not an economic ill or a “destroyer” of wealth. Rather, reallocating assets amidst the drama of bankruptcy may be beneficial to the economy because idle factors of production can be put to use more efficiently. Like the “creative destruction” wrought by technological innovation, liquidation may have similar useful long-term effects.10

Not even the viability of the reorganized entities that bankruptcy laws produce is a valid measure of the laws’ effectiveness. The continued existence of reorganized firms may be due to unfavorable conditions for structural change, to social inertia, or to the lack of mobility in the labor force. The survival of firms is not, economically speaking, an appropriate end in itself.

Finally, the dividend paid to creditors upon a bankruptcy liquidation is not a suitable indicator of success. The dividend will depend more on the credit system—especially the availability of secured credit, the equity ratio of a given industry, a certain economic order, and the burden of social protection imposed on firms and their creditors—than on bankruptcy law itself.

10. See Wimmer, supra note 4, at A8.
All of these considerations may appear trivial, but Germany has gone through a long and painful learning curve in reaching these conclusions. If the impact of bankruptcy cannot be measured, should we then recommend to our governments, especially those with economies in transition, that they make an arbitrary choice from the world's large menu of insolvency systems? I do not think so. In recent years, the economic analysis of law and the schools of institutional economics have yielded a number of reliable and precise precepts for the efficient structuring of the insolvency process. Among economists, it is undeniable that the goal of insolvency legislation is not to produce X percent reorganizations and Y percent liquidations, but rather to establish a structure that allows for efficient decision making in individual cases, and that minimizes losses to claimants and to the general economic environment.\(^{11}\)

III. MARKET CONFORMITY OF INSOLVENCY PROCEEDINGS: THE GERMAN REFORM

Until now, Germany has had one of the oldest bankruptcy statutes in force,\(^{12}\) accompanied by a statute on compositions.\(^{13}\) After an unusually long and intense reform discussion beginning in 1978,\(^{14}\) the German legislature completely overhauled the existing insolveney law and created an entirely new bankruptcy code (Insolvenzordnung).\(^{15}\) The legislature drew on an extensive comparative study of existing bankruptcy regimes, and, for the first time in German legislative history, the economic analysis of law and the precepts of institutional economics had a direct and explicit impact on legislative policy.\(^{16}\)

The new law reflects many elements of the most sophisticated pre-existing bankruptcy regime, namely, the Bankruptcy Code of the United States. However, the law expresses those elements in a continental legislative style that makes them

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11. See id.
attractive to Latin America and Eastern and Central Europe. Moreover, the German reform takes into account the criticism recently leveled by economic and legal scholars against the U.S. reorganization procedure, and avoids some of the rightly-criticized features of the U.S. Bankruptcy Code.

The explicit objective of the new statute is to establish a system that will provide market conformity of insolvency proceedings. The principle of the statute is that insolvency law should not supersede market processes or negotiations among the various classes of claimants, but rather should stimulate and, wherever necessary, simulate efficient market exchange processes.\textsuperscript{7}

The basic function of insolvency law is to correct, through collective action, market failure caused by the large number of unrelated claimants and their asymmetric information about the state of the debtor's affairs, their respective behavior, and the options for maximizing the value of the insolvent's estate. This type of market failure has been studied by the economic analysis of law as a "common pool" problem or a "prisoner's dilemma."\textsuperscript{8}

The role of insolvency law is to organize collective action in such a way that the value of the debtor's assets will be maximized and everyone involved will be better off than without such action; in other words, to collectivize and rationalize debt collection.\textsuperscript{9} It is not a legitimate function of bankruptcy law to maintain inefficient firms where such maintenance is not in the interest of creditors, to protect the debtor from its creditors, or to replace the rigor of general private and commercial law with vague judicial equity.

\textsuperscript{7} See id.


\textsuperscript{9} See Jackson, supra note 18, at 399.
A. Structural Elements

The legislature viewed twelve structural elements of the new German law as necessary prerequisites for the desired market conformity of bankruptcy.

1. Unitary Proceedings

The new law introduced a unitary insolvency proceeding.\(^{20}\) This proceeding differs from existing bankruptcy and composition proceedings (i.e., Chapters 7 and 11 of the U.S. Bankruptcy Code)\(^{21}\) in that it does not distinguish either the procedural rules or the influence and exit rights of claimants according to who files (i.e., the debtor or the creditor), or according to which outcome of the proceedings is expected or preferred by the petitioner (i.e., liquidation or reorganization).\(^{22}\) All possible ways of dealing with the debtor's estate (particularly piecemeal liquidation, the transfer of viable business units to another entity or the reorganization of the debtor entity, as well as all conceivable mixes of these solutions) may be negotiated within a unitary set of rules. The objective of unitary proceedings is to maximize the value of the estate for the benefit of claimants according to their respective priority (the so-called absolute priority rule).\(^{23}\) This is why the proceedings are entirely creditor-driven and why the debtor has no right to impose its will upon the creditor's interest or to "play with the money of creditors."\(^{24}\)

2. No Structural Bias or Normative Preference for Reorganization

This element implies that there is no normative hierarchy (as it exists, for example, in the French law) of outcomes in bankruptcy.\(^{25}\) Most of all, reorganization is not preferred over liquidation, and an orderly liquidation with a sale of entire


\(^{22}\) See Balz, supra note 16, at 491 n.23.

\(^{23}\) See id.


\(^{25}\) See Balz, supra note 16, at 491 n.23.
business units is not generally preferred over the piecemeal liquidation of the debtor's assets. It is primarily for creditors to decide which solution serves their interests best and to impose that solution upon the debtor and the equity holders.

3. Involvement of All Claimants in the Collective Process

The present German law suffers from the fact that action by secured creditors is not stayed automatically by the opening of bankruptcy proceedings; rather, secured creditors may continue individual actions against the debtor. The new law subjects all individual action, including action by secured creditors, to a stay. Moreover, subordinated debt (such as subordinated shareholder loans, claims for interest on pre-bankruptcy debt, etc.), which was excluded from insolvency proceedings under the old law, will be treated within insolvency proceedings, in order to allow a complete financial restructuring of the debtor enterprise and to enforce the absolute priority rule. Unless a plan makes other provisions, the debtor or equity holders will not receive value from the estate unless all creditor claims—including subordinated claims, such as claims for post-bankruptcy interest—have been met in full.

Unsecured creditors are to be adequately compensated for expenses incurred by the estate in identifying and selling collateral owned by secured creditors. Any creditor may, however, "oversecure" itself in such a fashion that these costs are covered by the value of the collateral; it therefore receives full payment of its claim.

26. See Jackson, supra note 8, at 211, 212.
27. See generally Manfred Balz, Sanierung von Unternehmen oder von Unternehmensträgern (1986); Jackson, supra note 8, at 211-12.
30. Insolvency Act, supra note 5, § 39, 1994 BGBl. I S.2871; see Kamlah, supra note 21, at 430-31 & n.131.
32. See id. § 171, 1994 BGBl. I S.2888.
33. This is a general principle of secured credit law in Germany and is not officially codified. During the debate over insolvency reform there was some discussion of amending the general law to cover this area; however, in the end, it was felt unnecessary to include any special provision in this regard.
4. No Interference with, but Full Recognition of, Pre-bankruptcy Entitlements

In order to minimize repercussions of bankruptcy on outside market processes (especially on the credit system), to avoid misuse of insolvency as a tool for cost reduction and a parameter of competition among enterprises in a given industry, and to forestall strategic uses of bankruptcy petitions, the opening of proceedings must not weaken or redistribute valuable pre-bankruptcy entitlements, such as title in movables sold under a reservation of title clause or the right to set off claims against counterclaims of the debtor. Interference with pre-bankruptcy contracts must be reduced to the minimum required for a workable collectivization of debt enforcement. In particular, the economic value of security interests must be fully protected in collective proceedings.

5. Abolition of Priorities for Pre-bankruptcy Classes of Claimants

The traditional privileges and priorities for certain classes of pre-bankruptcy creditors (typically the fiscal authorities or the workers) revalue or reinflate depreciated claims by the very fact of insolvency. Priorities in bankruptcy, as opposed to out-of-bankruptcy wealth allocation redistribute wealth under a presumed standard of equity. In line with the full recognition of pre-bankruptcy entitlements and the mandate against bankruptcy-specific revaluation of pre-bankruptcy entitlements, the new law abolishes all bankruptcy-specific priorities for pre-bankruptcy claimants.

6. Adequate Protection of Secured Creditors Against Delay

Delay of bankruptcy proceedings affects various classes of claimants differently by withholding the eventual payment of their claims. Junior classes, equity holders, individual credi-

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34. See Wimmer, supra note 24, at 17. Workers are protected for arrears up to three months by a special social security system financed by the non-insolvent firms in Germany (Konkursausfallgeld). See id. The reform does not touch the administrative priority of post-bankruptcy claims (trustee loans, for example), a policy which is fully in harmony with the ideal of market conformity and which is one of the most significant advantages of formal insolvency proceedings over out-of-court winding-up procedures or work-outs.
tors, and—above all—unsecured creditors, whose claims and interests are, normally, fully or largely depreciated by insolvency, have an incentive "to play with the money" of senior classes, especially secured creditors, by delaying proceedings.\textsuperscript{35} Market conformity requires that those interested in delay pay those who are interested in avoiding it.\textsuperscript{36} The new German law, therefore, affords protection to secured creditors through regular payments of the agreed interest on their secured claims despite the automatic stay.\textsuperscript{37} Thus, the incentive for junior classes and for the trustee to prolong proceedings is strongly reduced.

7. Allocating Influence and Voting Rights to Determine the Course of Proceedings According to the Real (Not Nominal) Value of Claims

Another precept derived from market conformity is that influence and voting rights of claimants in creditor meetings should be apportioned according to the real (i.e., insolvency) value of entitlements, and not from the nominal amount. Thus, secured creditors would have more say than unsecured creditors in a real world situation where, as is the case in Germany, some seventy-five percent of debtor assets are encumbered with security interests.\textsuperscript{38} In this respect, the new law falls short of previous drafts by allocating voting rights in the creditors' meetings, for simplicity's sake, according to the amount of claims of all non-subordinated creditors, irrespective of the secured or unsecured character of these claims.\textsuperscript{39}

However, the law gives creditors the right to determine whether the debtor should remain in possession, and to deter-

\begin{footnotesize}
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\item See Jackson, supra note 18, at 411-12. He notes: In a world in which delay is inevitable, but the quantity of delay is not, there is no reason not to impose the possible costs of delay on the group that might benefit from it. Only by doing so can one try to ensure that there is no incentive to delay simply for the sake of playing with someone else's money.
\textit{Id.} at 414; see Balz, \textit{Logik und Grenzen}, supra note 18, at 1438, 1441.
\item See Jackson, supra note 18, at 411-12.
\item Insolvency Act, supra note 5, § 169, 1994 BGBl. I S.2888.
\item This is a cautious estimate. According to one source published in 1978, on average, 87% of the value of bankrupts' estates were paid out to secured creditors. \textit{See GESSNER ET AL., DIE PRAXIS DER KONKURSABWICKLUNG IN DEUTSCHLAND} 43, 171 (1978). More recent data, however, are not available.
\item Insolvency Act, supra note 5, §§ 235-238, 1994 BGBl. I S.2896-97.
\end{enumerate}
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mine which person should serve as a trustee entirely to the creditors.\textsuperscript{40} The appointment of a trustee will be final, even if the debtor will be rehabilitated. The debtor cannot hope to remain in possession when it files voluntarily for a reorganization proceeding. The debtor has, from the beginning of the unitary proceedings, no exclusive right to propose a plan, and a debtor plan will in no way be preferred over a plan proposed by other parties.\textsuperscript{41}

8. Providing Cash and Non-cash Solutions for Both Liquidations and Rehabilitations of the Debtor Business

Both liquidations and rehabilitations may be effectuated for cash or non-cash compensation of claimants, as each creditor may determine. A piecemeal liquidation or sale of the going concern out of the estate will normally be for cash compensation, paid from the proceeds received from purchasers under the distribution rules governing liquidations.

Not only may reorganizations of the debtor be carried out under a plan, but piecemeal or orderly liquidations may be carried out under a liquidating plan whereby parties-in-interest may provide for non-cash compensation of some or all classes, and may depart from the liquidation scheme of distribution.

The new law addresses, in an internationally unique way, the problem of insider dealing in insolvencies, both with respect to liquidation sales and to reorganization or liquidating plans.\textsuperscript{42} Insider dealing is a special problem in transition economies where debtors, managers or groups of owners may be interested in using bankruptcy to cancel previous debt and purchase the assets from the estate for a low price.\textsuperscript{43}

9. Flexible Classification of Claims and Interests in a Plan

The "insolvency plan" allows claimants at any stage of a proceeding to negotiate for a solution which departs from the mechanics of a liquidation and approximates the ideal of

\textsuperscript{40} See Kamlah, supra note 20, at 432.
\textsuperscript{41} See id.
\textsuperscript{42} For a detailed discussion, see Manfred Balz, Some Capital Market Aspects of Bankruptcy—Asymmetric Information, Multiple Rank Ownership, External Effects and Voting Leverage, in EUROPEAN INSIDER DEALING: LAW AND PRACTICE 287, 287-308 (Klaus J. Hopt & Eddy Wymeersch eds., 1991).
\textsuperscript{43} See id.
Pareto optimality (wherein no party is worse off than in any alternative solution, and where one or more parties fare better). This ideal of negotiations is reached by a potential consensus.

By allowing a flexible classification of rights and interests which follow not only legal criteria, but also differing economic interests, a bankruptcy plan will serve the interests of all better than will the schematic regime of statutory liquidation. All members of a class must be treated alike, but various classes of claimants who would have equal rank in a liquidation may be classified and treated differently by a plan. Thus, for instance, a plan may give different treatment to liquidated and unliquidated or contingent claims (e.g., the claims arising from asbestos risks in the famous Manville case). Likewise, trade and bank credits, or general claims and insider claims (for example, of shareholders or relatives of the debtor), may be differentiated.

10. Adequate Minority Protection for Each Claimant

Voting procedures in insolvency serve the exclusive purpose of overcoming the common pool problem that stems from the plurality of unrelated actors. Voting procedures do not serve a political purpose, as in the political majority rule. In the world of economics, there is no reason to believe that a majority is better able to determine what is good for dissenting individuals. Freedom of investment, essential to a market system, requires that no individual be forced to invest or reinvest the liquidation value of its entitlement (i.e., the liquidation value) into a reorganization or other solution which a majority may desire. Therefore, under the new law, a plan may be confirmed by the court only when each dissenting individual claimant receives the full cash equivalent of its claim as that claim would be realized in a best-case liquidation.

44. See Wimmer, supra note 24, at A6.
45. See Insolvency Act, supra note 5, § 226(2), 1994 BGBI. I S.2895; see also Kamlah, supra note 21, at 431.
47. See supra text accompanying note 19.
11. Overcoming Obstruction by Groups Through “Cram-down”

A plan may be confirmed against the will of an impaired dissenting class of claimants or against the will of the debtor, when the class or debtor receives the full liquidation value of its claims or interests, and when it is treated fairly and adequately as against all other classes. This rule is derived, in essence, from section 1129 of the U.S. Bankruptcy Code, but is greatly simplified for the use in a civil law system.

A class is considered to be treated adequately and fairly when: (1) no other claimant or class receives more than the full amount of its claims; (2) neither the debtor nor any junior claimant or class receives any value; and (3) no claimant or class with equal liquidation rank receives better treatment than the dissenting class.

12. Introducing a Discharge (Fresh Start) for Honest Individual Debtors

Following Anglo-Saxon models, the new statute grants honest debtors a discharge from their pre-bankruptcy debt under certain conditions. The law blends elements of both Chapter 7 and Chapter 13 discharge of the U.S. law and avoids the potential for misuse that is inherent in the two American models. In order to be relieved from her debts, the debtor must not only leave her existing assets to the trustee for the payment of creditor claims, but, for a duration of seven years, she must also assign any garnishable future income from work to a trustee who will ratably distribute the income to insolvency creditors.

While such a rule is not necessarily implicit in the logic of insolvency law as a response to the common pool problem, it can be expected to enhance creditors’ chances to be paid, and it is not contrary to market principles. Surprisingly for some, it has been hailed by a large segment of the consumer credit industry.
The seven-year period may be too long for transition economies, but there is a strong argument in favor of introducing the concept of discharge in bankruptcy into the systems of transition economies. Entrepreneurial talent and personal initiative will no doubt be an especially scarce resource there, and an insolvent individual should not be blocked for life from making a fresh start in the private sector.

IV. CONCLUSION

The German bankruptcy system has considerable appeal to transition economies. For example, the Parliament of Bulgaria recently enacted a very modern insolvency law which contains the essential elements of market conformity as in the new German Insolvenzordnung.54

54. The Bulgarian legislature received legislative advice by a mission of the International Monetary Fund, in which Henry Schiffman of the International Monetary Fund and the author of this paper participated.