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Company Group Insolvency in European Law: A German Experience

- Insolvencia de los Grupos en el Derecho Europeo: El Caso Aleman –

I. General Reflections

Before going in medias res I would like to make this distinguished audience familiar with some rather trivial, but important assumptions.

1. A difficult Approach

First: Derecho Europeo de Insolvencia (European Insolvency Law) does not exist as a workable set of insolvency law rules. There is, however, a European Regulation on insolvency proceedings, dealing with jurisdiction issues, forum questions, recognition etc. But the substantial law, relevant in insolvency, will be the law of the respective member state: English, French, German, Italian law etc. I will show you nevertheless, that the regulation will turn out to be relevant and instructive for our discussion.

Second: A young Belgian academic, Arie van Hoe[1], recently published an article on "Enterprise Groups and their Insolvency", claiming that enterprise group law does not exist either. What is at our disposal in just a method problem-solving. This appears eccentric at first, but shows a touch of wisdom, too. Insolvency Law and the law of corporate groups, although most interesting to all of us, is not a legal value in itself. It is just a methodological tool box, useful for coping with complex scenarios and intricate questions dictated by business reality. The law and its systematic ordering does not provide simple answers such as unity versus multiplicity.

[1] *Van Hoe*, ECFR 2014, 2000 et seqq.

Third: Since we have learned from US-Chapter Eleven that insolvency law does not only provide for collective executory proceedings but for multiple instruments for financial restructuring, everybody talks about this epochal achievement. We focus, when talking about insolvency law, more and more on restructuring models, and we have good reason to do so. We ought, however, never forget that turn around and reorganization is not in every case the adequate goal of corporate insolvency. There will be still a lot of cases left where creditor satisfaction and even winding up will turn out economically more sensible.

Fourth: Talking about corporate group insolvency seems to assume a well defined shape of both the group and its financial crisis. I am, however, not sure about this. Working on my paper for today, and pondering about the definition of corporate groups it just occurred to me what Supreme Court Justice Steward is quoted to have remarked in a 1964 opinion about the definition of pornography: “I know it when I see it.” The diversity and polymorphism of company groups makes the legal approach difficult. In civil law countries, such as Columbia, Spain, and Germany, we like to formulate a comprehensive definition covering the concerned field of law. Before doing so, we must, however, get closer to the facts and legal matters. The particular difficulty of defining corporate group insolvency is due to two reasons:

- The first one is the diversity of shapes in corporate group reality.
- And the second is the diversity of insolvency scenarios in corporate groups.

2. Outlining Goals and Challenges

Is the definition of the group somehow relevant or even crucial for revealing the mystery of corporate group insolvency law. Trying to start with a definition may appear very academic and very German. It is, however, helpful. For testing the approach for puzzling out the corporate group enigma.

Let us, for this purpose have a look at a set of simple PowerPoint organigrams. The *first* one is simple and helpful. Everybody will be d’accord, that these are standard group situations.

The *second* organigram, however, is closer to corporate law in action: a complicated network of affiliated legal bodies under mutual ownership and control. This leads to the question if corporate group rules should cope with these complicated groups either. And there will be still more distinction needed, the moment we talk about insolvency scenarios.

The *third* organigram shows a case of corporate distress throughout the entire group.

In the *fourth* and *fifth* organigram we realize an insolvency scenario which is, for the time being, limited to single companies. This is not (at least not yet) an insolvency of the group, but merely in the group, maybe the parent company’s distress (4) or single affiliates’ distress (5).

And for those who will ask me for transnational groups, I add, at last, a very simple chart showing the difference between a transborder affiliate and a mere transborder branch (slide no. 6).

Accordingly, the search for group insolvency rules may be limited to very rare standard scenarios of group-wide insolvency or extended to group-specific inter-corporate insolvency

problems in corporate group. The latter seems to be more appropriate, and this will be relevant for the understanding of our task and accordingly for the definition of corporate law insolvency.

3. Relevance for the Definition of Groups

When asked about the essential characteristics of a corporate group, most jurists will talk about ownership or (and) control[2]. This is, however, only relevant in the vertical view from above, stipulated e.g. in accounting group taxation or bank supervision, where we have to find out the extent of the entire group.

a) The recent EU directive on the annual financial statements, consolidated financial statements and related reports[3] e.g. the definition reads as follows (art. 2 Nr. 11):

"(11) 'group' means a parent undertaking and all its subsidiary undertakings.
(12) 'affiliated undertakings' means any two or more undertakings within a group.
(13) 'associated undertaking' means an undertaking in which another undertaking has a participating interest, and over whose operating and financial policies that other undertaking exercises significant influence. An undertaking is presumed to exercise a significant influence over another undertaking where it has 20% or more of the shareholders' or members' voting rights in that other undertaking."

b) In the German Banking Act (Kreditwesengesetz) we find a similar definition (sec. 1 par. 1 Nr. 20):

"A financial conglomerate within the meaning of this Act, subject to section 51a (2) is a group of enterprises which consists either of a parent enterprise, its subsidiaries and enterprises in which the parent enterprise or a subsidiary holds a participating interest, or of enterprises which are consolidated into a horizontal group …"

c) The recent group-oriented draft amendment of the German Insolvency Code, too, pretends to define the "group" in a new section 3e. This description, however, does not capture the entire group, but only the applicability of group rules between group members. This is the case if

- one company can exercise controlling influence over the other or
- two or more companies are put under the control of a third one.

The usefulness of this approach can be verified by a subsequent glance at our slide No. 5. Group insolvency rules can be applied without dealing with the group as a whole.

4. Legal Sources and Public Display

My presentation will be based on decades of experience and discussion in my country and on particular legal sources and international notifications. The first will be part three of the

[2] ■

[3] Directive 2013/34/EU of 26 June 2013, Official Journal of the EU L 182/19.

UNCITRAL Legislative Guide: "Treatment of Enterprise Groups"[4]. The second will be the German Insolvency Code of 1994 (Insolvenzordnung)[5], and the 2013 government draft amendment bill expicitly dealing with corporate group insolvency[6]. The third one will be the European Insolvency Law Regulation of 2000[7] and the 2013 (European Commission) proposal for an amendment of this regulation, again devoted to our today's subject. The rest will be common sense and my personal appraisal.

II. Group-wide Insolvency Cases

1. No Substantive Consolidation

Group-wide insolvency cases raise firstly the question if the law shall adopt the concept of substantive consolidation. Substantive consolidation would mean that a group of companies can be wound up or reorganized in insolvency proceedings as if it were a single legal body. The UNCITRAL "Legislative Guide on Insolvency Law" advises against this concept at least as a general idea and tends to permit it under "very limited circumstances" only. They are right. As a general rule, the separation of legal bodies in a corporate group has its justification or its significance, even in cases where the idea of piercing the corporate veil seems obvious. Substantive consolidation is more than partial veil piercing. It means pulling the veil down with utter consistency and neglecting even the least resort of partial stakeholder interest. This concept is obviously inappropriate.

2. No General Restriction of Avoidance Claims

Consequently, the idea of generally excluding or reducing avoidance claims in the corporate groups has to be rejected, too. This measure has been proposed in order to enhance the coordination of group members insolvency proceedings[8]. A Nottingham researcher, however, Arit Mevorach, pointed out in 2011, that upholding intercompany transactions and reducing avoidance claims would in the end mean treating group members as belonging to a single entity[9]. By contrast, applying avoidance provisions to tackle intra-group transactions may pose less threat to limited liability[10]. The UNCITRAL-guide, too, contents itself with the suggestion that the application of avoidance provisions should take the specific corporate group conditions into account. This is true. The subordination of claims between group members and the avoidance of harmful transactions are, both of them, playing a significant role in protecting the stakeholders of separate group members. This does not mean turning a blind eye on the group specifics. The courts will, e.g., have to make a difference between cash pool transactions within the group and intercompany loans.

3. Group Administrator or Single-Company Administrator? No general Preference!

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5 BGBl. ■

6 BT-Dr. 18/407.
7 Official Journal Nr. L 160/1 of 30.6.2000.

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9 *Mevorach*, ECFR 2011, 235, 250.
10 Ibid., p. 251.

There is, for the same reason, no general answer to the widely discussed question if the same administrator shall manage a bundle of insolvency proceedings within a group or if each group member should have an administrator (or receiver) of its own. In many cases the first will be advantageous, in others – particularly in avoidance scenarios – the second. The law should permit both ways and leave the distinction to the courts.

4. Intermediate Conclusion

My preliminary conclusion is after this: Even in the field of consolidated groups and group-wide insolvency there is no silver-bullet response to the questions of company group insolvency. It goes without saying that the diverse cases of intra-group distress will be still more complicated.

III. Intra-Group Insolvency

1. The Domino Cascade Phenomenon
As long as the intra group-conflagration can be limited to the assets of only one group member we are able to content ourselves with general insolvency law rules, complemented by substantive law: corporate group liability, comfort letters etc. Things get much more difficult if the distress is extended within the group. Responsible for this is in many cases the so-called domino effect, which may become virulent in different variations.

a) A domino effect can cascade the top down, if e.g. a parent company is no longer able to maintain the affiliates survival or in many cases, where the going concern of affiliate companies depends on the continuity of the parent company's business model. This holds particularly true in cases where the affiliates, despite of being separate legal bodies, operate like mere branches of the group, e.g. as a DIY (Do it Yourself) market chain.

b) A domino effect bottom to top may have different reasons, too. In lots of cases it is the daughter's need for liquidity, which affects the parent company, particularly if there is an ongoing, legally binding letter of comfort. In Germany we must, in addition, take into account the financial effects of so called intercompany agreements. These intercompany agreements – mostly control agreements, combined with profit and loss transfer agreements – are both instruments for legitimate intercompany control and tax models for compensating earnings and losses in order to save on corporation taxes. Mandatory company law, however, decrees, that in this case the parent company has to pay for the annual losses of the affiliate, which, in turn, can lead to a breakneck scenario, if the intercompany agreement has not been terminated in good time. And, last but not least, an affiliate which has been financed by loans granted by the parent company may drag the letter in the abyss, because the parent claims will be subordinated in the affiliate's bankruptcy proceedings[11] and consequently written off in the parent's balance sheet.

c) In a third group of cases we experience the domino effect both bottom up and top down. The famous Media Group Kirch, established about 50 years ago, was, after a period of tremendous growth, insolvent in 2002 due to overindebtedness of the holding company. This sounds like a mere top bottom scenario. However, it was both: upwards and downwards. The holding company had no longer been able to maintain its costly daughters. In 2002 two major affiliates – "Kirch Media" and Pay-TV – had gone insolvent, and this, in return, had affected

[11] See sec. 135 Insolvency Code.

the holding companies. In the end the group as a whole was threatened by insolvency. Parts of the group members had to be wound up, others sold to international competitors, whilst the famous TV company "Premiere" succeeded in producing a turnaround. The group as such has been torn into pieces. The group members suffered very different fates. And what is left? Some former affiliates surviving, and lots of pending civil proceedings, e.g. against Deutsche Bank and the former chairman of its executive board, charged with the allegation that they had doomed the group by public indiscretion.

2. The Domino Effect: a Challenge to Insolvency Law

a) Insolvency law must not give one uniform answer to the domino question. It will have to cope with both

- the challenge produced by the domino effect and
- the challenge to prevent the domino phenomenon.

As we have seen, the coordination of insolvency proceedings does not necessarily entail a coordinated winding up or coordinated turn around. The separation of the respective insolvency estates permits us to give the separate insolvency proceedings completely different results. And the eventually subsequent domino effect can mean that a group insolvency proceedings cannot in every case be planned in advance, but must sometimes be put together in the course of the proceedings.

b) In 2010 the ATEC-Industries Corporation (AG) in Vienna, Austria, went insolvent due to sudden refinancing difficulties[12]. The company and its management were not prepared for a turn around strategy and not for an organized liquidation either. ATEC was the headquarter of a worldwide corporate group consisting of 150 affiliates, which, all at once, were threatened by an imminent domino effect. These companies, despite remaining solvent for the time being, were threatened by the loss of their ATEC-oriented business model. At least two German affiliates, however, were able to go on doing business outside the ATEC group. The shares of these companies were sold, the companies integrated in a new business environment. This meant avoiding the domino effect by an exit strategy and was useful for both sides: the affiliates were able to survive, and the purchase price filled up the ATEC insolvency estate in favour of ATEC's creditors.

3. The Magic Word: Coordination

a) The result of these consideration comes as no surprise: The catchword of legal policy regarding distressed company groups arising in the mentioned document and draft legislation concepts is "coordination", not "consolidation": Obligation to coordinate the separate insolvency proceedings will be imposed on

- the courts,
- the receivers, and
- the creditors' committees.

[12] *Siemon*, NZI 2014, 55.

It is not difficult to agree to this concept. Its Achilles heel is, however, that the envisaged rules provide rather soft law. There is no guarantee that the acting persons will obey these rules.

b) The recent draft amendment of the German Insolvency Code at least tries to offer a bit more.

aa) If insolvency proceedings regarding the assets of group members are carried out at different courts, these courts shall be legally bound to cooperate in questions of
- arranging safeguard measures,
- appointing administrators,
- preparing insolvency plans, and
- other group-relevant procedural measures[13]

bb) Administrators in group member insolvency proceedings have to provide mutual report and cooperation[14]. In debtor in possession cases this task has to be fulfilled by the companies' organs[15]. And the separate creditor's committees may, each of them, apply for the appointment of a group creditor's committee, in order to support and assist the separate committees and administrators in fulfilling their duties of cooperation and co-ordination. This seems sensible to me.

cc) Following the concept of the draft Insolvency Code amendment these involved individuals will, however, be arched over by a particular, group-wide coordination organization[16]. This supra group organization shall be headed by a neutral group coordination administrator, who will be paid out of the respective insolvency estates. In the explanatory memorandum this administrator is described as the eye of the hurricane, producing a coordination plan as an un-binding guideline. Here I see a touch of costly bureaucracy. Practitioners did already warn the department of justice against the implementation of costly parasite expert. One expert used the polemical expression: "A heap of money wasted for useless ointment."[17]

IV. The Forum Issue

1. Group-wide Insolvency Cases

The safest way to coordination is carrying on insolvency proceedings of group members at the same court. Despite the warnings of Professor *Lo Pucki* from UC Los Angeles School of Law, who published verdicts against "Courting Failure" produced by "case placers". *Lo Pucki* observes a detrimental competition of courts and lawyers for attracting insolvency proceedings in the USA. I cannot assess the relevance of these warnings. Generally, however, the concentration of the competent courts is regarded to be the most promising way to bring the threads of affiliated companines' insolvency together. In most jurisdictions insolvency proceedings have to be opened at the registered seat of a company. In group wide insolvency the parent's forum appears much more favourable, though. This, however, is not yet granted

[13] See sec. 269 b; see also sec. 56b regarding the appointment of company group receivers.
[14] Sec. 269a
[15] Sec. 270d.
[16] Sec. 269 d et seqq.
[17] See *Weiland*, INDat-Report 3/2014, p. ■

in my country. In some big cases the acting lawyers nevertheless found a short cut to the parent forum[18].

a) The collapse of the German telephone provider group "PIN" with a Luxemburg parent corporation led to a bundle of insolvency proceedings in Cologne, Germany, although the registered seat was scattered all over Germany. Prior to filing for insolvency proceedings the group members had shifted the centre of their main interest to Cologne, which was the residence of their restructuring consultant. After that insolvency proceeding were opened at the Cologne court throughout the entire group.

b) In the "Arcandor" group running the famous "Karstadt" department stores insolvency proceedings, too, were opened at the forum general of the parent company throughout the "Karstadt"-Group. These proceedings even included the big mail order company "Quelle" which in the past had been acquired by the "Karstadt" Holding "Arcandor". Prior to filing for bankruptcy proceedings several members of the group had moved with their registered office to the parent's domicile, enabling coordinated insolvency proceedings at the court of the "Arcandor" seat in Essen, Germany.

2. Consistent Solutions
However, this appears inadvisable.

a) After this experience there were loud voices proclaiming that every insolvency case regarding a group member should be carried out at the parent's forum. If you remember, however, that the distress may start in a minor affiliate company and will not in every case affect the whole group, this solution appears much too inflexible.

b) The draft amendment in Germany is now aiming at trying out a more flexible solution.

- There is no mandatory corporate group forum.
- Any corporate group member applying for the opening of insolvency proceedings may, however, simultaneously apply for the acknowledgment of the respective court's competence for eventual follow up insolvency proceedings concerning other group members[19]. There is only one exception to this general rule: The applicant will have to furnish prima facie (glaubhaft machen) that the company is a relevant group member, representing more than 10 % of the group's balance sheet total and more than 10 % of the staff[20]. The group forum acknowledged by this court decision will continue to exist even if the court terminates the applicant's insolvency proceedings, but not the proceedings related to other group members[21].
- If in a follow-up case insolvency proceedings will be opened by another court this subsequent insolvency case can be referred to the group forum. This referral decision is mandatory if so requested by the debtor without undue delay[22]. The court of the group forum may in this case even dismiss the insolvency receiver and appoint a domestic person[23].

[18] See *Karsten Schmidt*, KTS 2010, 1, 21 et seq.
[19] Sec. 3c.
[20] Sec. 3a.
[21] Sec. 3b, perpetuation fori.
[22] Sec. 3d.
[23] Sec. 3d par. 3.

At first glance this flexible conept is a useful approach: a particular group forum which will be fixed by the court in accordance with the case at hand.

V. Trans-Border Scenarios

1. The 2000 European Regulation to be amended in Favour of Company Groups
a) Trans-border group insolvency questions will be covered by the presentation of my learned colleague Professor Sotomonto. For this reason I will only add some remarks about the European regulation of 2000 mentioned above. The insolvency regulation is part of a comprehensive European framework of private international law[24]. It does, however, only deal with procedural law and does not provide harmonization of substantive law. It has therefore been recently criticized by Professor emeritus *Bob Wessels* from Leiden, Netherlands, for lacking contribution to the European or even worldwide market.

b) The recent proposal for a regulation amending this regulation[25] "introduces an obligation to coordinate insolvency proceedings relating to different members of the same group of companies by obliging the liquidators and the courts involved to cooperate with each other in a similar way as this is proposed in the context of main and secondary proceedings. Such cooperation could take different forms depending on the circumstances of the case. Liquidators should notably exchange relevant information and cooperate in the elaboration of a rescue or reorganisation plan where this is appropriate. The possibility to cooperate by way of protocols is explicitly mentioned in order to acknowledge the practical importance of these instruments and further promote their use. Courts should cooperate, in particular, by exchanging information, coordinating, where appropriate, the appointment of liquidators which can cooperate with each other, and approving protocols put before them by the liquidators".

In addition, the proposal gives each administrator formal procedural rights in the proceedings concerning another member of the same group. In particular, the administrator has a right to be heard in these other proceedings, to request a stay of the other proceedings and to propose a reorganisation plan in a way which would enable the respective creditors' committee or court to take a decision on it. The administrator also has the right to attend the meeting of creditors. These procedural tools may enable the administrator of the group member which has the biggest interest in the successful restructuring of all companies concerned to officially submit his reorganisation plan in the proceedings concerning a group member, even if the administrators in these respective proceedings are unwilling to cooperate or oppose to the plan.

2. The COMI Concept and its Limits
a) The basic idea of the EU regulation on insolvency proceedings is that within the European Union insolvency proceedings will be opened in the member state where the centre of the debtor's main interest is located (the so called COMI)[26]. In the case of a company the place of the registered office shall be presumed to be the centre of its main interests, but only in the absence of an alternative business COMI. In addition, so called secondary insolvency proceedings within the limits of the domestic assets can be opened in another member state where the debtor possesses a branch (an "establishment")[27].

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[24] *Wessels*, ITLR 2014, 310, 313.
[25] See the wording of the explanatory memorandum.
[26] Sec. 3.
[27] Sec. 3 II, 27.

b) The insolvency regulation can be useful in very different scenarios. I would like to categorize them by the words “put cases” or “call cases”.

- Regarding “put cases”, there were at least two German cases where German companies – a lens manufacturer and a cable network operator – were reorganized under the umbrella of the English scheme of arrangment[28], although these companies did not have a COMI in England. The English courts accepted this application. However, the recognition of English schemes of arrangement by German courts is still a book sealed with seven seals.
- In other cases, “call cases” in my terminology, British courts and lawyers grasped for the assets trans-border branches and even of affiliate companies abroad, e.g. in Germany. German courts, however, only accept this in the case of a domestic branch of an English company, not in regard to separate legal bodies with registered seats in my country.

c) This leads me to the limited impact of the regulation. The regulation deals with the opening of transborder insolvency proceedings. This entails the application of domestic insolvency law in the respective country. It does not, however, touch the relevance of the companies domestic company law. This, in turn, leads to lots of legal questions, some of them handled in so called protocols, binding for the participating parties[29]. The application of company law rules in transnational insolvency cases, however, remains difficult. It may be for this reason that a growing number of legal rules which had been regarded as part of substantial company law are now characterized as part of insolvency law. In Germany, for example, the unlawful reimbursement of shareholder loans was regarded during a long period of jurisdiction as an offence against company law[30] producing reclamation suits (claw-back-claims???) under company law. The moment, however, you qualify these claims as insolvency law avoidance actions, the conflict of laws would allow to apply the legal rules of the country, where toe proceedings take place. This change of the so called qualification in the conflict of laws is a contribution to transnational insolvency law, because the relevant rules will be attracted by the jurisdiction of the insolvency court. So, in the end, insolvency proceedings in transborder corporate groups may even have a lasting impact on substantive company law in the years to come. But that is another story.

FRAGMENT:
A recent article of a young Antwerpen academic, Arie van Hue[31], points out that enterprise group law does not exist as a defined set of legal rules, but just as a method[32]. The author does not complain about this. His view is just realistic, criticizing the dichotomy of mere separate entity approach and simple enterprise[33], neglecting the “dynamic and permanent interplay between Unity and Plurality. Any legal strategy that aims to integrate enterprise groups into a legal order, needs to take that interplay into account”[34]: Enterprise groups are neither mere

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[28] *Hübler*, NZI 2012, 311.
[29] See *Zumbro*, Business Law International, 2010, 157 ff.
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[31] *Van Hue*, ECFR 2014, p. 200 et seqq.

[32] Ibid.
[33] Ibid., p. 204.
[34] Ibid., p. 204 et. seq.

collection of separate legal bodies nor a consolidated enterprise. In order to achieve the goal of insolvency law in the context of enterprise groups, the burden of entity centered insolvency law needs to be overcome[35], but not by “voodoo corporate law”[36], not by a commitment on a single enterprise approach[37]. There is only a method[38], inspired by the impact of common interest[39].

[35] Ibid., p. 213.
[36] Ibid.
[37] Ibid., p. 204.
[38] Ibid., p. 213
[39] Ibid., p. 211.