Avoiding the Abyss:
How to Buy Distressed Assets in Germany

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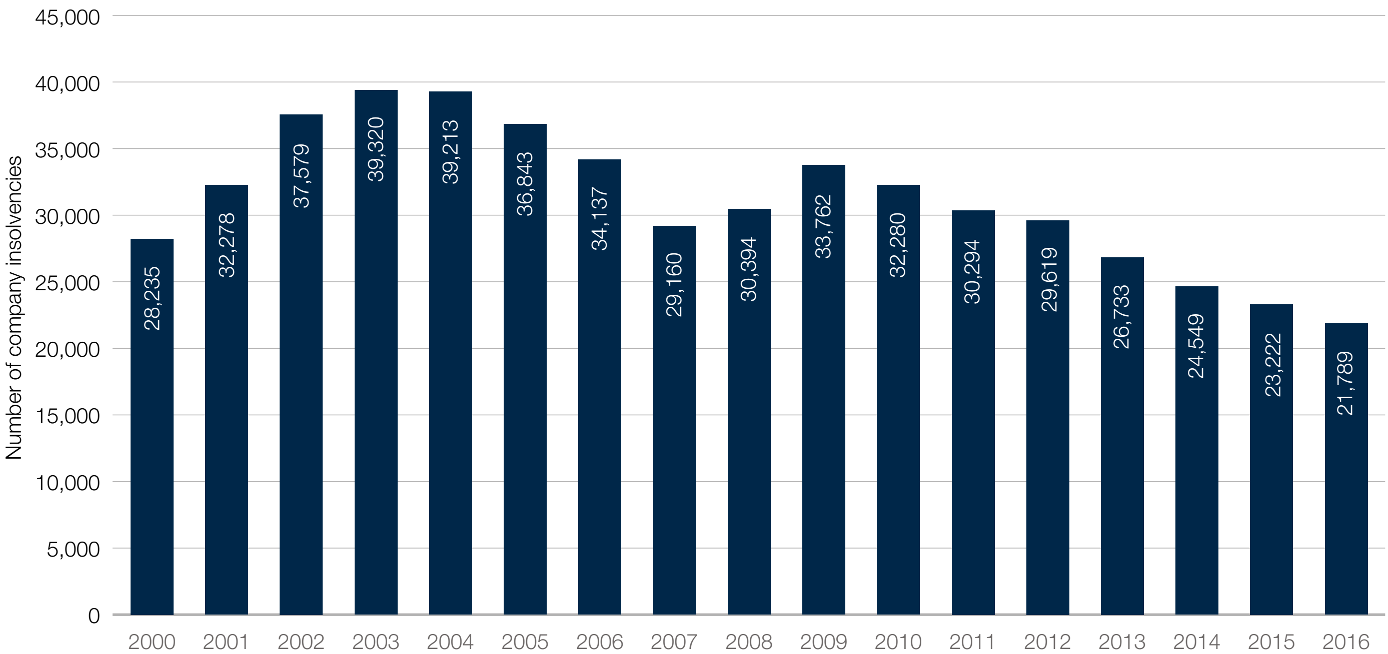
In today's world, the ability to move money around the globe with relative ease, combined with increasing competition among investors who require double-digit returns, has made Europe—and more specifically, Germany—an attractive venue for purchasing assets. Due to Germany's large industrial base, many buyers—in particular, private equity firms—often look in Germany for add-ons to their existing portfolio companies in the U.S. or simply for new investment opportunities.

Germany is Europe´s largest economy and for many years has been stable, both in economic and political terms. To that end, Germany offers interesting opportunities for corporates and financial investors to buy performing as well as underperforming/distressed assets. Notwithstanding obvious language and cultural differences, there are a few key points worth highlighting for buying distressed assets out of German insolvency proceedings.

As in all global economies, there are winners and losers among German companies. While the number of company insolvencies in Germany has been falling over time (Figure 1), there will always be some stagnant level of underperformance and extreme distress, forcing enterprises to file for insolvency as they become unable to meet their liabilities as they come. Due to the need for private equity firms to put money to work, purchasing a broken asset out of insolvency to turn it around is a viable investment strategy.

Figure 1: Company insolvencies in Germany since 2016

Number of corporate bankruptcies in Germany from 2000 to 2016



German Insolvency Regulations

The U.S. Chapter 11 process continues to be the world´s most proven and favorable system for restructurings, offering various advantages that include debtor-in-possession standing, creditor protections, and other measures, including, for example, a cram-down mechanism that provides companies with a higher probability of preserving value for all stakeholders. Over the past 20 years, the majority of European jurisdictions have developed new approaches to insolvency, moving away from a creditor-driven process and more toward value-preservation by introducing various elements of Chapter 11 of the U.S. Bankruptcy Code into their legal frameworks.

Along with this transformation in thinking, Germany´s insolvency laws have also matured. The latest insolvency law, known as the Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen (ESUG), introduced a new facet called the "protective shield", or the Schutzschirmverfahren, which has greatly improved the ability of debtors to seek protection under insolvency.

This process allows a debtor to seek protection for a three-month window, during which it can attempt to execute via a debtor-in-possession mechanism a prepackaged restructuring with its main stakeholders.

The protective shield provides the enterprise with the potential to emerge from under this scheme with a court-sanctioned restructuring plan and, accordingly, avoid regular insolvency proceedings. Should rescue under the protective shield not be possible, the business will automatically file for regular insolvency proceedings that, in most cases, will result in an M&A process run by the insolvency trustee (übertragene Sanierung).

Based on their experience, the authors have identified certain key principles regarding how best to buy distressed assets out of German insolvency proceedings by using the M&A process to the investor´s advantage.

Key principles: M&A process

1: The German Process. When an enterprise files for insolvency in Germany, the court appoints a trustee to protect the interests of the stakeholders, both in the case of a debtor-in-possession (Schutzschirmverfahren) proceeding and in a regular insolvency proceeding. Under a debtor-in-possession framework, the trustee only serves as an oversight body with "light" enforcement rights. In comparison, the trustee has full control over the company during a regular insolvency filing and effectively acts as its CEO.

In both situations, it is imperative that investors build a strong relationship with the trustee, as he/she will make the majority of decisions in close coordination with the creditor committee regarding any potential M&A discussions.

2: Creditor Committee. The formation of a German creditor committee is similar to what has been established in Chapter 11. The court tasks the trustee with forming a creditor committee, which represents the largest creditors per creditor class and also always includes employees, represented by the works council, along with other relevant stakeholders. Early on, even before the filing, if possible, it is essential to work with the court and trustee to try to obtain a seat on the committee if the investor had previous financing in the company or is deemed a special interested party. A seat on the committee ensures more access to key information and carries certain influence during the restructuring process.

Developing or leveraging relationships with members of the creditors' committee or its advisors (in larger situations) is important for building trust and credibility early on and may be helpful to committee members, who are often inexperienced and under great pressure to find a way for the debtor to survive and/or achieve a higher recovery for its creditors. The creditor committee approves all major process steps from the trustee and also votes on any submitted M&A offers. In most situations, it is additionally helpful if the potential investor/buyer can lobby various other stakeholders involved in the M&A process to further enhance its chance of being successful.

3: Asset Sale. Assets are usually purchased out of insolvency via an asset sale, as it allows the buyer to take on the assets substantially free and clear of most liabilities. This is not as straightforward as what is contemplated in a Section 363 sale under Chapter 11, as employee-related issues usually are given significant attention in a transaction and such concerns typically, though not always, have stronger cultural support in Germany than they do in the U.S. Nevertheless, when taking over a workforce or transferring individual employees, it should be noted that personnel-related liabilities—e.g., vacation, overtime, etc.—follow employees into the new company.

4: Financing. As a result of the debtor's poor credit history and the fact that it is restructuring or is, in fact, insolvent, any potential investor will obviously be required to provide equity and debt to finance working capital and capital investments. Credit insurers tend to be gun-shy of a new debtor with respect to opening credit lines for suppliers. Due to the company's "new start" circumstances, the amount of fresh money required will be higher than would be typical in any going concern situation. The investor will have to present a solid business plan that shows ample liquidity to reassure the trustee and creditor committee before they make any key decisions on the new owners, as these stakeholders need to manage public perception and show that the proposed transaction will preserve a high number of jobs.

5: Works Council and Trade Unions. Other key constituents during the M&A process are the works council and trade unions, whose obvious objective is to preserve as many jobs as possible. Typically, German insolvency law offers greater flexibility to reduce headcount at lower severance costs versus an out-of-court restructuring (usually six to 12 months of costs and benefits for terminated employees). For a potential investor to take advantage of this, any proposed reduction in workforce must be done at the seller's expense, and any headcount and/or salary reductions for future employees need to be fully negotiated via a labour agreement prior to signing a sales agreement and be a condition precedent for closing.

While a negotiation is never easy, it is imperative that such an initiative be executed before taking on the new assets to ensure that all benefits flow through P&L and cash flow from the first day post-restructuring. A potential buyer must take this into account when submitting a bid, as the trustee will look to extract as much money as possible in the sale to ensure employees who do not transfer to the new business are provided for.

It is also important to remember that in a full-blown insolvency, the trustee will take advantage of a provision under which the German government provides funds for employee wages for the first three months and, accordingly, will try to consummate a feasible transaction as quickly as possible to minimise cash outflows from the insolvent estate.

Equally important is the implementation of a communication plan around a sound story to explain to employees why such an offer or way forward is the best available alternative compared to a liquidation of the business or its purchase by another buyer. It is always pragmatic and value-enhancing to start early to build a credible story and begin to develop trusting relationships as a foundation for working together in the future.

6: Day One Readiness. Preparation for the first day is critical. Typically operations will have a new management team, which will need to regenerate a positive culture with employees from the outset. Even though the buyer may have new management in place, key middle management or junior personnel may have left the business because it typically is easier for people in these positions to find other jobs.

Therefore, it is imperative to have a long list of possible management replacement candidates at hand to be able to react quickly in case of underperformance while also taking into account that the German workforce normally has long notice periods. Recruiting key individuals typically takes three to six months. In certain situations, interim candidates may be required until permanent replacements can be hired.

7: Augment the Management Team. New management will have its plate full in the first weeks because it must communicate with all key stakeholders to stabilise operations and provide assurances to customers regarding a continuous flow of products and services. At the same time, management must actively engage with suppliers, reassure its employees, and ensure positive public relations. In many cases, it makes sense to bring a CRO on board to drive key restructuring initiatives and free up critical management time for the CEO and CFO to run the day-to-day business.

8: Cash Management and Finance. A critical area for any business is cash management, and that is obviously even more important for an enterprise emerging from insolvency. During the insolvency period, suppliers are often paid in advance or on delivery, as the trustee has guaranteed such payment to ensure the delivery of goods and/or services.

This arrangement changes immediately on the first day post-insolvency when suppliers are informed about the new ownership and are asked to continue to supply the company, despite the fact that their trust in the previously failed business has likely been severely damaged. In many cases, these same suppliers may have lost money due to the insolvency filing.

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The new company must demonstrate to its suppliers that it is on stable ground and engage in discussions with credit insurers to help convey a positive story to the market. If factoring or other financing facilities need to be put in place, it may take a few weeks until the new companies are fully operational and have properly set up all required administrative items, such as VAT numbers, bank accounts, etc. That can hinder or delay the availability of the necessary financing and therefore appropriate planning and effective negotiations may be required to avoid any cash shortfalls post-emergence.

Buyer Beware

Buying assets out of a German insolvency process must be approached with caution. This article outlines eight key principles to help an investor navigate through the process to purchase an asset and create substantial future value.

Although the implementation of the proposed new EU directive to allow preventative restructuring will only officially be launched in the next couple of years across various European member states, its future effect is not fully known or entirely clear. In the meantime, the opportunity to purchase assets out of a current German insolvency process remains a viable option, at least in the short term, for non-German investors.

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