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**Short Statement on the occasion of the Panel Discussion  
"American College of Bankruptcy"**

**"Debtor-in-possession Proceedings in Germany"**

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## A. Introduction

Similar to the introduction of the insolvency plan, the introduction of the legal institution of debtor-in-possession proceedings is also part of the reform of the German insolvency law carried out in 1999.

The **insolvency plan** had been a central element of the insolvency law reform. However, at the beginning, this novelty often referred to as too cumbersome was mainly met with skepticism. Success stories like "Küppersbusch" or "Herlitz" now bring about a gradual change of attitude. The number of insolvency plans may still be very low; however, the introduction of the insolvency plan implies each debtor's chance – as reflected by Section 1 German Insolvency Code (*InsO*) – to use insolvency proceedings as a possibility of their own reorganization. This attitude has existed particularly in the United States so far, but now it also starts to pave the way in Germany. However, it has to assert itself against the "stigma" of bankruptcy and liquidation associated therewith which has literally existed for centuries and is therefore deeply embedded in peoples' heads. This naturally requires time. But it has to be interpreted as a quite promising signal that the attitude "insolvency as a chance of reorganization" increasingly spreads and is also adapted by the legal practice.

The legal institution of **debtor-in-possession proceedings** has developed in a similar way, although it has been accompanied by even more resentments. In this respect, the reservations against **debtor-in-possession proceedings**, which are widely spread in the United States, resulted in some kind of German variant on this legal institution - occasionally criticized as a **scandalous "setting the fox to keep the geese"** - which gradually becomes evident.

Instead of letting the present management continue to act unchanged, the principal party involved is dismissed and replaced by a qualified reorganization expert. The reorganization expert will then act as a member of the board of management and will, apart from the expertise it has at its disposal, inspire as the new, experienced "man at the head" confidence in both employees and bankers. It is known that this model has

been tried to use repeatedly, however it has seldom been finished off successfully. **Nevertheless, it involves a considerable development and success potential.**

Over the first few years following the entry into force of the German Insolvency Code, court rulings ordering debtor-in-possession proceedings were strange exceptional cases. For instance, it was reported that in the case of a court of Brandenburg expressly asking whether, if debtor-in-possession proceedings were ordered, the creditors' rights would be jeopardized, the expert refrained from giving an answer. The court then ordered debtor-in-possession proceedings, which is said to have led to an almost tumultuous course of proceedings. A similar case was reported from the jurisdiction of an insolvency court of Westphalia. Otherwise, the situation regarding the legal institution of the debtor-in-possession was relatively calm. In 1999, the Local Court of Darmstadt published a ruling by which the order of debtor-in-possession proceedings was rejected owing to its extraordinary character.

The wave of major insolvencies, which still has not died down in the fifth year following the entry into force of the German Insolvency Code (2003), has abruptly changed this image. The order of debtor-in-possession proceedings within the framework of the insolvency proceedings instituted over the assets of the media group of Leo Kirch even made this legal institution the focus of interest of the press. It was not until the controversy over the issue of the order of debtor-in-possession proceedings in the "Babcock-Borsig" proceedings that the Local Court of Duisburg issued a notable insolvency order in which it dealt with the prerequisites for the order of debtor-in-possession proceedings on more than four journal's print pages.

## **B. Debtor-in-possession**

What is the meaning of "debtor-in-possession" in Germany?

Debtor-in-possession proceedings entitle the debtor company to manage the insolvency estate itself, under the supervision of a creditors' trustee, and to dispose of the same autonomously. Debtor-in-possession proceedings presuppose the institution of

insolvency proceedings and may be ordered within the framework of either insolvency proceedings or an insolvency plan<sup>1</sup>.

Courts usually order debtor-in-possession proceedings within the framework of the insolvency order.

**The prerequisites are as follows:**

- **The debtor must file a corresponding petition; an ex officio order does not exist.**
- **If a creditor has filed a petition for the institution of insolvency proceedings, then it must approve of a debtor's petition for debtor-in-possession proceedings.**
- **Debtor-in-possession proceedings must not give reason to expect a delay of proceedings or any other disadvantage to creditors (Sec. 270 para. 2 German Insolvency Code).<sup>2</sup>**

## **C. Motives for the Order of Debtor-in-possession Proceedings**

In practice, debtor-in-possession proceedings have only been hesitantly used so far.

This should be justified in most cases, as the debtor is more or less appointed as its own insolvency administrator in this case, so that a best possible satisfaction of creditors' claims can be expected in exceptional cases only.

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<sup>1</sup> See Pape/Uhlenbruck, marginal number 828.

<sup>2</sup> More precisely: In the event that the insolvency court had initially rejected the petition of the debtor company whereas the creditors' meeting applies for debtor-in-possession proceedings, debtor-in-possession proceedings may also be ordered subsequently; the present insolvency administrator will then be appointed as creditors' trustee (Sec. 271 German Insolvency Code).

However, there are numerous constellations where the order of debtor-in-possession proceedings is useful and economically advantageous for all parties involved.

### **1. Incentive for Early Filing of a Petition**

Debtor-in-possession proceedings may only be ordered, inter alia, provided that no disadvantages for creditors are to be expected. It is particularly advantageous for creditors if a debtor company files a petition for the institution of insolvency proceedings for imminent inability to pay already at a very early stage, particularly if it submits a detailed insolvency plan at the same time that determines the reorganization of the company. If a petition is filed early an order of debtor-in-possession proceedings may be issued under certain circumstances as a reward.

Example: A sound firm with a capable management threatens to become insolvent as a result of the unexpected insolvency of its major customer and the bad debt losses related thereto; the creditors agree with the debtor to reorganize the firm within the framework of an insolvency plan, threatening with debtor-in-possession proceedings.

### **2. No Familiarization Period through Third-party Administrators**

Debtor-in-possession proceedings profit from the special firm- and industry-related know-how of the present management, which is particularly important in case of a planned reorganization of the company. This effect is even reinforced if, prior to filing a petition, the debtor company integrates reorganization experts or experienced insolvency administrators into its management.

### **3. Cost Saving**

Debtor-in-possession proceedings offer substantial cost advantages: first, the creditors' trustee only receives 60% of the remuneration determined for the insolvency administrator (Sec. 12 German Insolvency Fees Regulation (*InsVV*)); and, second, no costs of determination or realization are incurred with regard to items for which rights to separate satisfaction exist (Sec. 282 German Insolvency Code).

## D. Duties of a Creditors' Trustee

In the event that debtor-in-possession proceedings are ordered, a creditors' trustee is appointed with whom the claims of insolvency creditors are to be filed and who keeps the schedule of creditors (Sec. 270 para. 3 German Insolvency Code). The creditors' trustee has the same duties as the insolvency administrator in many respects; **however, the major difference between the two is that a creditors' trustee is not granted the power of management and disposal of the insolvency estate.**

However, a creditors' trustee has various duties of supervision, to cooperate and to provide information, for instance:

1. A creditors' trustee has to assess the debtor's economic situation and to supervise its business management; to this end, it may enter upon the debtor's premises like a preliminary insolvency administrator and inspect all business records (Sec. 274 para. 2 German Insolvency Code).
2. The debtor may only incur liabilities not belonging to the usual business activities with the approval of the creditors' trustee (Sec. 275 para. 1 sentence 1 German Insolvency Code); however, liabilities incurred without the approval of the creditors' trustee will remain effective externally. If the effectiveness of certain legal acts is to be imperatively made conditional upon the approval of the creditors' trustee also in external relationships, then the insolvency court can direct this upon the request of the creditors' meeting or individual creditors; the order is to be made public (Sec. 277 German Insolvency Code).
3. The creditors' trustee may assume the handling of money transfers and payments (Sec. 275 para. 2 German Insolvency Code).

4. Only the creditors' trustee may exercise the right of avoidance (Sec. 280 German Insolvency Code).
5. In the event that circumstances come to the knowledge of the creditors' trustee that give reason to expect that the continuation of debtor-in-possession proceedings would be detrimental for creditors, then it shall notify the creditors' meeting and the insolvency court thereof without undue delay; if no creditors' meeting is appointed the creditors' trustee has to inform the insolvency creditors and the creditors being entitled to separate satisfaction of such circumstances (Sec. 274 para. 3 German Insolvency Code).

## **E. Status of a Debtor Company**

If debtor-in-possession proceedings are ordered, the debtor company shall have all rights of an insolvency administrator, unless particular rights have expressly been assigned to the creditors' trustee; the debtor company must exclusively exercise these rights in the creditors' interest. Given the conflicts of interests that are often related thereto, debtor-in-possession proceedings are only useful if the debtor cooperates with the creditors' trustee on the basis of mutual trust, is prepared to devote its capacity to the service of the creditors without any restriction, and has their complete confidence. In the case of debtor-in-possession proceedings the debtor particularly has the following rights:

- the power of management and disposal of the insolvency estate, particularly the right to create liabilities and the right of action (Sec. 270 para. 1 German Insolvency Code);
- the exercise of the right to election in connection with mutual agreements (Sec. 279 German Insolvency Code);

- realization of items in which rights of segregation exist (Sec. 282 German Insolvency Code);
- drafting of a list of items of the insolvency estate and of creditors as well as an inventory of assets (Sec. 281 para. 1 German Insolvency Code);
- reporting at the reporting date (Sec. 282 para. 2 German Insolvency Code).

## **F. Termination of Debtor-in-possession Proceedings**

Debtor-in-possession proceedings are subject to the parties' autonomy. They are terminated by the insolvency court if such termination is applied for

- by the creditors' meeting or a debtor; or
- by an insolvency creditor or a creditor being entitled to separate satisfaction, either of whom substantiates by prima facie evidence that it is to be expected that debtor-in-possession proceedings will bring about a delay of insolvency proceedings or other disadvantages for creditors (Sec. 272 German Insolvency Code).

After the termination of debtor-in-possession proceedings the satisfaction of creditors' claims will be continued within the framework of the ordinary insolvency proceedings or insolvency plan. The present creditors' trustee may be appointed as insolvency administrator (Sec. 272 para. 3 German Insolvency Code).

## **G. Conclusion**

Summarizing it can be stated that debtor-in-possession proceedings have only been hesitantly used in German practice so far. However, this should be justified in most cases as the debtor is more or less appointed as its own insolvency administrator, so

that best possible satisfaction of creditors' claims can only be expected in exceptional cases.