MAYER·BROWN

INSOLVENCY UPDATE

Distressed Enterprises in Germany – HR Restructuring Opportunities

6 March 2009

Investors often perceive the German employment law environment as a rather inflexible and strict framework. This perception can have a discouraging effect, which in the end might even prevent an investment, which otherwise had been promising. It is not our intention to discuss here whether or not this impression of possible investors is correct. However, in case insolvency proceedings are initiated, German employment law becomes more flexible and therefore – as a general rule – more employer-friendly.

As a basic principle, an enterprise's insolvency does not impact the applicability of general employment law rules. However, Sections 113, 120-128 of the German Insolvency Act (InsO) and certain case law concepts supplement the general employment law rules. A number of principles are amended in order to facilitate the enterprise's recovery from its economic difficulties. The rules provide for chances to restructure the workforce of a potential target more easily by setting a framework for an easier and faster restructuring with a capped maximum financial exposure.

Termination of Costly Employment Conditions

TERMINATIONS OF EMPLOYMENT RELATIONSHIPS

While employment contracts are not automatically terminated by the initiation of insolvency proceedings, the maximum applicable notice period is reduced to three months to the end of a month (compared to seven months to the end of a calendar month under general employment law rules).

Under general employment law principles applicable to companies with more than 10 employees, terminations are only valid if the employer can proof a justifying reason for the termination.

In an insolvency scenario, however, the insolvent employer and the works council can agree on a list of employees' names ("*Namensliste*") whose employment relationships shall be terminated for compelling business reasons. Terminations of employment relationships with the employees named on such list will generally be deemed justified.

TERMINATIONS OF WORKS COUNCIL AGREEMENTS AND SOCIAL PLANS

All collective agreements between the employer and the works council (so-called works council agreements) that have direct financial implications on the employer's operations can be terminated by the insolvency

administrator with a maximum notice period of three months. This rule applies even if the works council agreement stipulates a longer termination period. Works council agreements on subjects of mandatory co-determination (for example, begin or end of working time, overtime etc.) will remain in force even after the termination period has expired until a new agreement is concluded ("*Nachwirkung*").

The insolvency administrator may also revoke any social plan (including any severance payment obligations set forth therein) that has been entered into within the last three months preceding the employer's filing for insolvency.

Simplification of Restructuring Process

The outcome of insolvency proceedings can be (i) the liquidation, (ii) the continuation or (iii) the sale of the insolvent enterprise; each of these three scenarios usually accompany a restructuring of the employing company and a reduction of the workforce.

Under general employment law principles, the implementation of such restructuring measures tend to be time and cost intensive and subject to strictly formalized procedures. The flexibility of the restructuring employer is restricted to a large extent. For instance, the mandatory principle of social selection ("*Sozialauswahl*") strongly reduces the employer's possibilities to "cherry-pick" the employees who he wants to keep. In insolvency proceedings, however, these rather cumbersome phenomena of German employment law are overridden to a large extent if restructuring measures are implemented.

INTEREST RECONCILIATIONS AND SOCIAL PLANS

Implementing far-reaching restructuring measures usually constitutes a so-called change of business, which triggers the mandatory obligation for the employer to take all possible and available efforts to agree on interest reconciliation with the competent works council ("*Interessenausgleich*"). No restructuring measures, including terminations, may be implemented before such interest reconciliation has been agreed or negotiations have finally failed. Premature implementation of restructuring measures may result in considerable damage claims from the employees. Interest reconciliation negotiations are not subject to any statutory time limits and may therefore take a long time. In fact, it is a common tactic of works councils to prolong negotiations in order to increase the pressure on the employer.

Generally, the obligation to negotiate interest reconciliation also applies in cases of an insolvency of an enterprise. However, such negotiations can be considerably accelerated. Three weeks after the start of the negotiations with the works council, the appointed insolvency administrator may apply for approval from the competent labor court to implement the envisaged restructuring measures (usually delivery of notices of termination).

The labor court must grant approval if the economic situation of the enterprise requires the termination of employees. The labor court's decision includes the declaration that the intended terminations are justified and thus legally valid. This decision is also binding with regard to upcoming individual law suits and may, as an additional advantage, drastically minimize the risk of litigation.

Under German law, all restructuring situations accompanied by the termination of a significant number of employees require the completion of a so-called social plan ("Sozialplan"). A social plan is an agreement between the

employer and the works council that sets out measures to mitigate the economic disadvantages that employees suffer in connection with the restructuring measures. Usually, such agreement leads to the issue of severance payments. As there are no mandatory rules to calculate redundancy payments, it is usually impossible to calculate the restructuring costs and in particular the total amount of severance payments upfront.

In an insolvency scenario, the amount of severance payment is capped at two and a half (2.5) times a monthly salary per employee and the total amount of all severance payments shall not exceed one third (1/3) of the value of the insolvency estate. Thus, the maximum total severance exposure of the insolvent company may be calculated in advance.

MORE FLEXIBILITY IN TRANSFERS OF BUSINESSES

The acquisition of an enterprise very often constitutes a transfer of the business within the meaning of Section 613a of the German Civil Code (*Bürgerliches Gesetzbuch* "**BGB**"). The general legal consequence of such a transfer of the business is the buyer's mandatory obligation to assume all employment relationships with all employees working in the affected business, including their current employment conditions and their rights under pension plans. Terminations due to such a transfer of the business are prohibited and the options to change employment conditions in connection with a transfer of a business are restricted.

This fundamental employment law rule is very often perceived as one of the key obstacles in an acquisition of German enterprises. Potential buyers often intend to acquire a target that fits with their own business strategy, without any or only with selected employees ("cherry picking"). However, under Section 613a BGB the buyer will assume all employees and in case of a workforce reduction for business reasons will have to respect the so-called social selection principle ("*Sozialauswahl*"). This principle focuses on age, seniority, disabilities and number of children, but not on performance or strategic aspects. As a consequence, buyers might either end up with a workforce that is too big to serve their business needs or will not be entitled to keep the young and good performing employees in case of workforce restructuring.

These strict rules of social selection may be altered if agreement on a list of employees' names can be reached with the works council (see above "*Terminations of Employment Relationships*"). If an employee's name is mentioned on such a list, labor courts may review the proper social selection only to a limited extent. Such a list of names is negotiated during the interest reconciliation negotiations that must be conducted prior to the implementation of restructuring measures.

Additionally, under the following legal principles, insolvency proceedings may also serve as a tool to circumvent the hurdles outlined above:

BUYER'S CONCEPT

Under case law principles, a restructuring concept based on the objectives of a buyer (so-called buyer's concept – "*Erwerberkonzept*") may justify terminations for compelling business reasons in an insolvency scenario. In practice, this means that the seller may implement the buyer's restructuring plan in the seller's business prior to the acquisition. Hence, the buyer may directly influence the implemented restructuring concept as well as the content of the list of names. The Federal Labor Court has ruled that such an approach is not in breach of the principles of Section 613a BGB (including its ban on terminations) if the target is insolvent.

This exception from the strict transfer of business framework avoids significant restrictions of German labor law. It offers a variety of restructuring options as a potential buyer may implement its own business and employment concept at the same time and prior to the acquisition.

USE OF A JOB CREATION AND TRAINING COMPANY

In order to avoid mass unemployment, employees affected by workforce restructuring measures are very often transferred to a so-called job creation and training company ("*Beschäftigungs- und Qualifizierungsgesellschaft*"). The purpose of such a company is merely to provide the terminated employees with an opportunity of continued employment and to prepare the employees for the employment market. The use of such a company is highly subsidized by the German state and very often part of the restructuring process of an insolvent enterprise.

In the context of employment law opportunities in insolvency proceedings, it is important to note that such job creation and training companies may be used to avoid the application of Section 613a BGB. If (i) all employees are employed by the job creation and training company (e.g. by way of tripartite transfer agreements which may even shorten the individual notice periods), (ii) the enterprise is insolvent and (iii) the buyer had not shown an interest in the target before the employees have been transferred to the job creation and training company, it is permissible to offer new employment contracts to selected employees with new employment conditions which may be less favorable than the previous employment conditions (optimized "cherry picking").

Hence, if such a job creation and training company is used an enterprise may be bought without employees and the restrictions of the social selection principle can be circumvented. It is important to note that these case law principles cannot be combined with the above outlined buyer's concept rules and that all general restructuring prerequisites, i.e. negotiation of interest reconciliation with works council prior to the transfer of the employees to a job creation and training company, must be met.

RELAXATIONS WITH REGARD TO EMPLOYEE-RELATED LIABILITY

Even if Section 613a BGB applies in the case at hand and the employment relationship is transferred by operation of law to the buyer of the business, the applicable case law provides certain relaxations for the buyer.

In case a business, or parts thereof, is bought out of the insolvency estate, the purchaser continuing the business of the insolvent enterprise may be entitled to some freedom with regard to certain liabilities vis-à-vis employees. For instance, the purchaser will not be liable for employee claims against the insolvent enterprise which already existed at the time of the opening of the insolvency proceedings. This limitation on the purchaser's liability in particular applies to possible claims for past service entitlements resulting from a company pension scheme.

Conclusion

The specific rules of insolvency employment law and the corresponding case law can considerably ease the restructuring of an insolvent enterprise, including dismissals. Besides the relaxation of formalities, insolvency proceedings ease the implementation of a new business concept – including a new HR structure – without facing the usual heavy restrictions of German employment law. Hence, they offer an enormous potential for prospective investors in the German marketplace.

If you have any questions or require specific advice on any matter discussed in this publication, please contact one of the lawyers listed below:

Dr. Marco Wilhelm
Partner, Frankfurt
T: +49 69 79 41 2731
mwilhelm@mayerbrown.com

Dr. Guido Zeppenfeld, LL.M.
Partner, Frankfurt
T: +49 69 79 41 1701
gzeppenfeld@mayerbrown.com

Dr. Malte Richter, LL.M.
Associate, Frankfurt
T: +49 69 79 41 2731
mrichter@mayerbrown.com