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DEBT-TO-EQUITY SWAP: OPPORTUNITIES AND RISKS

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I. WHY THIS TOPIC IS IMPORTANT

Debt-to-equity swaps are effective but also complex restructuring instruments: creditors convert their receivables against a company into equity and receive shares in the company in return.

A debt-to-equity swap enables companies to gain financial flexibility and time for further restructuring measures during periods of economic uncertainty or an ongoing crisis by reducing or eliminating balance sheet over-indebtedness as well as existing interest and principal payment obligations. For creditors, a debt-to-equity swap presents an opportunity to avoid the total loss of impaired receivables and to participate as shareholders in any (future) restructuring success. Specialized distressed-debt investors also frequently employ debt-to-equity swaps to acquire control of, or ownership interests in, a distressed company through a "loan-to-own" strategy.

The key risk factor is the valuation of the receivables to be converted: receivables against (nearly) insolvent companies are typically (nearly) worthless. However, if the receivables are worth less than the par value of the shares subscribed for in a capital increase, the full contribution must nevertheless be covered by the newly subscribed shares; otherwise, the new shareholder faces a liability for the difference, which must be settled. In insolvency plan proceedings, Section 254 para. 4 InsO (*Insolvenzordnung*, InsO) limits this liability risk, as no claims for over-valuation of the receivables can be asserted against the former creditors once the plan has been confirmed by the court. Valuation errors may, however, still affect potential new creditors who rely on the company having sufficient assets.

II. LEGAL BASIS

German law expressly provides for the debt-to-equity swap in insolvency plan proceedings (Section 225a para. 2 InsO) and in StaRUG restructuring proceedings (Section 7 para. 4 StaRUG) (*Unternehmensstabilisierungs- und -restrukturierungsgesetz*, StaRUG). It is also possible outside these proceedings, but then generally requires the resolutions and consents required under corporate law.

Typically, the debt-to-equity swap is carried out via a simplified (nominal) capital reduction to eliminate balance sheet over-indebtedness and to establish an appropriate relationship between existing and new shareholders, followed by a capital increase in exchange for a contribution in kind of the creditor's receivables in exchange for the issuance of new shares. The receivables contributed are typically extinguished as a result of the contribution, set-off, or waiver pursuant to the plan.

III. RECOMMENDATIONS FOR MINIMIZING RISKS

- **Assess the company's restructuring viability and integrate the measure into an overall concept**: A debt-to-equity swap is advisable only if the company is viable to be restructured and sustainable in the long term. The debt-to-equity swap should form part of a comprehensive restructuring concept that addresses the company's liquidity requirements and operational restructuring.
- **Assess receivables rigorously and carefully**: The valuation date, valuation method, and assumptions should be carefully documented. In cases of uncertainty, it is advisable to obtain an external expert opinion.
- **Clarify tax implications at an early stage:** The effects on loss carryforwards, restructuring gains, and, where applicable, real estate transfer tax (in relation to ownership thresholds) should be analyzed in advance. Where appropriate, obtaining a binding ruling may be advisable.
- **Negotiate corporate governance:** Board appointments, veto rights, approval and reporting obligations, anti-dilution provisions, exit rules (drag-along/tag-along), lock-ups, etc., should be clearly regulated in a shareholders' agreement.
- **Manage stakeholders:** Influences arising from co-determination, works agreements, key contracts, change-of-control clauses, financial covenants, etc., should be clarified early on, and communication with stakeholders—particularly customers, suppliers, and employees—should be well prepared.
- **Comply with capital markets regulations:** For listed companies or those closely tied to the capital markets, insider and ad hoc disclosure obligations, the attribution of voting rights, and potential mandatory tender offers must be examined; early consultation with BaFin may be advisable.
- **Select the appropriate procedure and timing:** Determine whether a pre-insolvency StaRUG proceeding, an insolvency plan, or a purely corporate-law-based implementation is appropriate or feasible. This depends in particular on approval requirements, liability limitations, safe-harbor provisions, and the role of existing shareholders.
- **Engage specialized legal counsel:** Debt-to-equity swaps involve corporate, insolvency, tax, labor, and, where applicable, securities law. Seeking early advice from specialized attorneys helps mitigate liability exposure and implementation risks.