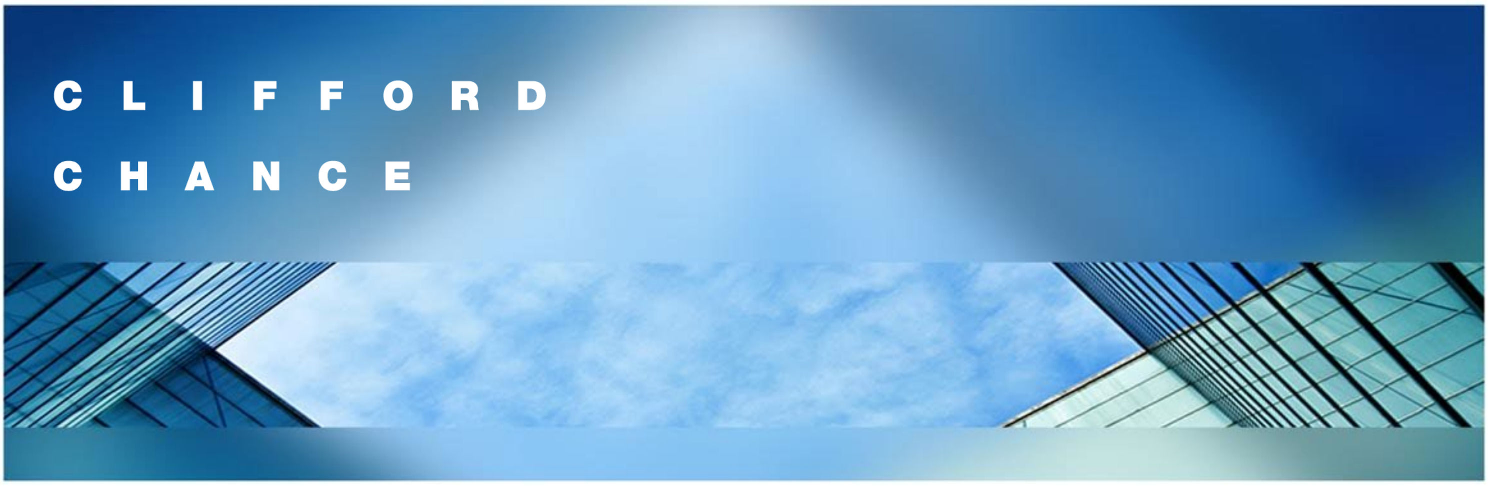

NEW GERMAN RESTRUCTURING SCHEME - A REVOLUTION OF GERMAN RESTRUCTURING LAW

The long-discussed bill for the "further development of the German restructuring and insolvency Law (*SanInsFoG*)" entered into force on 1 January 2021. Its core is dedicated to a newly introduced pre-insolvency restructuring procedure (*StaRUG* or "**German Scheme**"), which for the first time allows for the restructuring of debtors by means of a restructuring plan outside of German insolvency proceedings whilst enabling cross-group cram-down decisions. The German Scheme has elements of the well-known British Scheme of Arrangement as well as the new Dutch Scheme and is in its implementation, largely adapted from the German insolvency plan procedure.

Key issues

- Debtor-driven new pre-insolvency restructuring scheme including (cross-class) cram-down decisions
- Available for restructurings and reorganisations, rightsizing of debt and sales transactions
- Requires debtor in financial distress (impending illiquidity)
- Not available for insolvent businesses (no illiquidity and/or over-indebtedness)
- Includes a moratorium against enforcement
- Does not facilitate the termination of contracts (in contrast to the draft bill)

1. WHO DOES IT APPLY TO?

The German Scheme can be used by entrepreneurs and companies (in all industries other than the financial sector) for financial restructurings and reorganisations, rightsizing of debt and sales transactions. It is designed as a debtor driven pre-insolvency restructuring process and can be used to restructure a wide variety of claims including group guarantees and intercreditor relationships. The German Scheme offers the debtor great flexibility with regard to its economic content and the stakeholder groups concerned (e.g. a plan involving only the financial creditors would also be possible). The corresponding restructuring plan, when accepted and confirmed, has a binding effect on all stakeholders involved. It is even possible to intervene in third-party collateral to the extent affiliated companies act as collateral providers. Employees cannot be included in the German Scheme. Like the English Scheme of Arrangement and the Dutch Scheme (WHOA), it has features designed to increase the efficiency of restructurings and introduces a procedure for cramming down dissenting creditors and shareholders in a way that combines the English Scheme of Arrangement with US Chapter 11 proceedings. It includes a mechanism for a pre-insolvency moratorium to facilitate negotiations for a restructuring plan and allows for compromises or special arrangements for financially distressed debtors which avoid the need for unanimity, prevent "hold outs", and allow for "cram-downs" of a dissenting class. It is available to German debtors and, where it is used as a public procedure, arguably also to non-German debtors, which means there are gaps in the law in relation to international jurisdiction and recognition.

2. MUST THE DEBTOR BE SOLVENT TO ACCESS THE PROCESS?

The debtor must be in a state of so-called "impending illiquidity" in order to be able to use the German Scheme, which corresponds to the concept of financial distress. This is considered a low bar as the planning period to assess impending illiquidity is up to 24 months. The initiation of the proceedings only requires (i) a notification of the debtor company to the restructuring court including (ii) a restructuring concept and (iii) a confirmation that the company is threatened with impending illiquidity (but not yet illiquidity and/or over-indebtedness which would constitute mandatory insolvency filing triggers). The scheme process may be suspended/brought to an end by the court if such level of illiquidity and/or over-indebtedness is reached at a later point in time in the scheme process, depending on the level of progress accomplished so far in the restructuring process.

3. IS THE COURT INVOLVED?

Yes. The tools are only available if the restructuring process is notified to the restructuring court. The court may order a moratorium of between 3 to 8 months which prevents creditors from enforcing their claims and security granted by the borrower and related group entities; this requires, *inter alia*, the submission of a complete and coherent restructuring plan, (ii) a liquidity plan for at least 6 months, and (iii) generally no significant outstanding payments to employees, the tax authorities, the social insurance or suppliers. The court is also involved in the formation of creditor groups and the content of the restructuring plan as well as the ancillary documentation which accompanies the plan (for example liquidity forecasts, fair value and restructuring opinions). The restructuring plan will need to be sanctioned by the court in order to cram down dissenting stakeholder groups.

4. DOES ANYONE SUPERVISE THE DEBTOR DURING THE PROCESS?

The process is mainly debtor driven with wide discretion as to the scope of the restructuring. A court-appointed restructuring expert will assist the debtors with the structure, negotiation and filing of the restructuring plan. The restructuring expert may also be granted supervisory duties and responsibility for monitoring cash management. The court shall hear the debtor, the shareholders and the creditors before appointing the restructuring expert. However, under certain conditions, the court must appoint the restructuring expert proposed by the debtor and only if this proposal is not binding the creditors themselves may propose an alternative candidate as restructuring expert. The court has also powers to put a supervisory body in place which would be comprised of creditors and employee representatives.

5. WHAT ARE ITS MAIN FEATURES?

One of the German Scheme's main features is the ability to cram down dissenting creditor groups, if a majority 75% in value is reached within a class and across a majority of the other creditor groups (in addition to satisfying a limited absolute priority rule). In order to avoid the dominance of large creditors within a group, the legislator has made the formation of small creditor groups mandatory, insofar as they are affected by the plan. Shareholders can be included in the plan (horizontal and vertical cram down). The restructuring plan may include amendments to financing agreements including waivers, increase of margins and interest, deferral of principal and changes to waterfall provisions in related intercreditor agreements. The cram down would principally follow the absolute priority rule with certain exceptions for the treatment of shareholders in cases where the contribution of the shareholder is considered essential for the restructuring or in cases where infringement of creditors' rights is considered to be minor - such as the extension of financings by up to 18 months. The new law offers certain protections for new money and related security. Features allowing for the termination of contracts and alteration of directors' fiduciary duties so that they are owed to creditors rather than shareholders, have been eliminated as part of a last-minute change to the law.

Another advantage is the "safe harbour" effect: The provisions of a restructuring plan which has become legally effective and the corresponding legal acts for the implementation of this plan cannot be subject to claw-back in potential subsequent insolvency proceedings until a "sustainable restructuring"; this also applies under certain conditions to any financing provided for in the plan, including its collateralisation. Here, a relevant fact is that a repayment of a new financing does not constitute a legal act in the implementation of the restructuring plan and thus does not benefit from the safe harbour effect.

6. HOW LONG IS THE PROCESS LIKELY TO TAKE?

The new law does not limit the time for the restructuring but, from our experience with other in-court debtor in possession restructuring proceedings, we believe it would typically take approx. 3 to 6 months, or up to 9 months for large restructuring cases.

7. IS IT LIKELY TO BE MORE COST-EFFECTIVE THAN THE EXISTING REGIME?

The aim of the new law is certainly to be more cost efficient than existing insolvency proceedings, but the extent to which it achieves this remains to be seen. Rather surprisingly, it provides for (rather low) fixed hourly rates of up to EUR 350 for the restructuring expert which indicates that additional arrangements might become necessary to encourage the right experts to take on this role.

8. CAN THE COURT'S APPROVAL OF THE PLAN BE CHALLENGED?

Only in cases where the absolute priority rule is not complied with, the stakeholder provides prima facie evidence that it is materially worse off than it would have been without the plan, and the plan does not provide for compensation for those stakeholders who demonstrate that they are worse under the plan. If funds are provided by the debtor to compensate for a disadvantage claimed by a creditor, the proceedings to clarify the factual situation are conducted later and outside the actual restructuring proceedings. In this way, the restructuring plan can be implemented independently of individual interests that have been raised. In order to cram down its shareholders, the debtor would need to show that the business is not able to continue as a going concern (or, even if it could technically continue as a going concern, it would not be expected to generate shareholder returns), and that an attempt to generate proceeds for the shareholders through a sale of the business is expected to be "apparently unsuccessful". This would typically be demonstrated by a comparison of the plan scenario with the alternative liquidation scenario (showing that the shareholders would not receive anything in the liquidation scenario either).

9. WILL THE PLAN BE AUTOMATICALLY RECOGNISED ACROSS THE EU?

The debtor has the choice between a public or private scheme. The public scheme will be registered as a proceeding in Annex A to the European Insolvency Regulation and thus benefit from automatic recognition. In the absence of a specific recognition regime, the private scheme will be reliant upon private international law for recognition.

10. IMPACT ON THE RESTRUCTURING MARKET IN GERMANY AND BEYOND?

In Germany, we discussed for many years the need to implement more efficient out-of-court and pre-insolvency restructuring proceedings. The German Scheme provides a tool to preserve value and to continue the business as a going concern which is generally good news for all stakeholders involved. Having said that, we cannot exclude the possibility that the German Scheme will mainly be used to right-size the debt owed to the unsecured creditors and will mainly affect the position of those with limited recovery prospects in the capital structure.

The adoption of the German Scheme will definitively increase the options for business rescue in Germany and provide more flexibility and efficiency of restructuring proceedings. The new law represents fundamental changes to the existing restructuring landscape which is why banks and investors currently have a positive, but in certain instances also sceptical, view of the new Scheme. These players will need to be convinced that the German Scheme can be used in a measured and balanced manner to stabilise business operations with the support of major creditors while avoiding the negative impact of insolvency proceedings. Thorough preparation for and structured alignment with the secured creditors and majorities in the creditor groups will therefore be key for the success of the new German Scheme.

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