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NEW GERMAN RESTRUCTURING REGIME (STARUG) AN INTRODUCTORY GUIDE

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The new German stabilizing and out of court restructuring regime came into effect on 1 January 2021. The "Stabilization and Restructuring Framework of Companies Act", known as *StaRUG*[1], heralds a new phase in the German restructuring landscape, introducing a framework of tools including a new restructuring plan, which will enable debtors to restructure and cram down minority creditors outside of German insolvency proceedings for the first time.

Consequently, the new law is being considered a long awaited step towards bringing German restructuring tools closer to the English scheme of arrangement and Chapter 11 plan of reorganisation.

The *StaRUG* is a debtor driven pre-insolvency regime with the following key features, discussed further below:

1. A moratorium of 3 to 8 months to allow breathing space for the preparation of a restructuring plan.
2. A new flexible restructuring plan that can restructure all secured and unsecured liabilities of the debtor (except pension and payroll, and yet to be incurred liabilities under executory contracts), including through deferrals and debt haircuts, and can be confined to financial liabilities. It can also restructure affiliate guarantees and collateral, can implement debt for equity swaps and can alter shareholder rights. New financing can be granted, but there is no provision for super-priority.
3. The restructuring plan cannot, however, terminate or amend the terms of executory contracts such as leases, nor compromise pension or payroll liabilities. This is likely to limit its practical value for operational restructurings, such that its primary use may be financial restructurings.
4. Voting is conducted by reference to the affected classes of creditors and shareholders (if relevant). The voting threshold is 75% by value in each class, although this percentage is calculated by reference to the total value of the class, not just the value of those voting.
5. A dissenting class can be crammed down if, among other things, the class is not worse off as a result of the restructuring plan and it receives appropriate economic value in accordance with a modified absolute priority rule.
6. The restructuring plan can be conducted completely out of court, or with court guidance.
7. Further, the restructuring plan can be conducted either as a public or as a private proceeding. If the former, it will benefit from automatic recognition across the EU under the European Insolvency Regulation. If the latter, it can be enforced under the Brussels 1a Regulation or the private international law of the relevant jurisdiction.

Beginning of a New Culture?

For Germany, this may be the starting point for a viable out-of-court restructuring culture. Historically, Germany has been viewed less favourably than other jurisdictions such as the UK or the US as a forum for international restructurings due to its strict mandatory filing obligations, potential liability for managing directors, and the unanimous consent requirements for out-of-court restructurings. If a contemplated restructuring was not unanimously supported by the relevant creditors and/or shareholders, insolvency proceedings were required to effect any necessary cram-down.

Although German insolvency proceedings have been accepted more recently as a restructuring tool, the stigma of insolvency and the impediments faced by a debtor and its management in a German insolvency process continue to have a significant negative impact on a debtor's business. The new regime may therefore avoid significant business disruptions, liquidity issues and uncertainties for management and all stakeholders that, in light of past experience, can be caused by an insolvency filing.

Additionally, it will now be possible to restructure solely all or part of a debtor's capital structure, not previously possible in all-encompassing insolvency proceedings. It is this ability which means that the impact of *StaRUG* should not be

1 *StaRUG* transposes the European Directive (EU) 2019/1023 on preventive restructuring frameworks into German law. The German version of the Act is published in the German Federal Law Gazette 2020 I 3256.

underestimated: it has potential to become a true restructuring option for German debtors that require a debt restructuring and/or face minority creditors with a hold out value ("**Akkordstörer**").

Background to the new legislation

The legislative process was highly expedited in light of the COVID-19 pandemic, taking just over 3 months from the publication of the Ministry of Justice's initial draft until the final reading, an unusually short time frame given its broad effect and significance.

This expedited process led to various last minute changes including the removal of the ability to terminate executory contracts (such as leases), which is available in insolvency proceedings. This is an obvious limitation for restructuring businesses in retail and other sectors where the ability to deal with leases is key, and may therefore limit its practical application and attractiveness to financial restructurings. However, other helpful last minute changes were made:

- no earlier shift of directors duties to creditors. Management will continue to generally owe its duties to the company and its shareholders until either the occurrence of actual insolvency (i.e. illiquidity or over-indebtedness) requiring it to file for insolvency or the initiation of proceedings under StaRUG, which will trigger a shift in duty to protect the interests of the creditors as a whole;
- introducing the possibility of restructuring cross-stream and downstream guarantees and security of affiliates of the debtor, in addition to upstream guarantees and security; and
- the establishment of a creditors' committee as an additional body to supervise the debtor, in circumstances where the restructuring encompasses all the liabilities of the debtor and is akin to an insolvency proceeding.

We expect that *StaRUG* will be utilized by larger corporations, given the level of documentation and legal advice that will be required, but the German government has indicated its desire to make the procedures attractive for midsized entities with practical handling guidance and sample documentation.

Key Elements of StaRUG

Prerequisites

StaRUG is available to debtors (excluding financial institutions) with their centre of main interest ("**COMI**") in Germany, and who are imminently illiquid, i.e. on a more likely than not basis are not fully funded for 24 months.

It is a debtor driven pre-insolvency process: a company cannot implement the StaRUG process if it is insolvent (i.e. illiquid and/or over indebted). However, if insolvency occurs after a StaRUG proceeding has been initiated, the otherwise mandatory filing obligation is suspended and the managing director must inform the restructuring court of the insolvency occurrence. The court must then decide to either: (i) terminate the *StaRUG* proceedings, in which case insolvency proceedings will be opened; or (ii) continue, if this is in the interests of the creditors as a whole, or, if insolvency was caused by the acceleration of a claim to be restructured in the restructuring plan, the achievement of the restructuring objective is predominantly likely and would eliminate insolvency grounds. This is likely to be the case if the restructuring process is sufficiently progressed.

An independent restructuring officer may be appointed, and although not mandatory in a financial restructuring, will be generally mandatory where the debtor has applied for a moratorium affecting substantially all creditors, or a cross-class cram down of non-financial creditors is required.

Moratorium

The court may order a moratorium of between 3 and 8 months to allow breathing space for the debtor to finalise its restructuring plan, during which creditors are prevented from enforcing their claims and security (granted by both the debtor and its affiliates). The moratorium is however, subject to certain requirements: the provision of (i) a restructuring plan and (ii) a liquidity plan for at least 6 months, and there being no significant outstanding payments to employees, the tax authorities, social insurance or suppliers.

Restructuring Plan

The main feature of *StaRUG*, the restructuring plan, offers great flexibility and provides for the restructuring of:

- all secured and unsecured liabilities of the debtor (other than those relating to pension and payroll), but may be confined to certain financial liabilities of the debtor;
- collateral granted to secure such liabilities by the company and its affiliates (except financial collateral and collateral provided for certain financial securities) as well as guarantees;

- contractual provisions (including financial covenants) and intercreditor arrangements, rearranging the ranking and enforcement rights of the various creditor classes and allows for customary restructuring measures such as the use of standstills, deferrals, debt haircuts, debt for equity swaps (with the creditors consent) and the provision of new collateral; and
- shareholder rights, allowing for equity measures such as debt to equity swaps, share transfers, capital reductions and capital increases to the exclusion of subscription rights of existing shareholders. Shareholders can be diluted or squeezed out entirely.

New financing may be granted under *StaRUG* (but no super-priority can be established), and on sanction of the restructuring plan the restructuring measures taken are ring-fenced from potential lenders' liability or certain claw-back risks in a subsequent insolvency.

Restructuring Plan: General Consent Requirements and Cram-Down

The restructuring plan must be voted on by the affected classes of creditors and shareholders (if shareholders' rights are impaired). Creditors with different rights must form a separate class: at the least secured creditors and unsecured creditors must form a separate class, as must small creditor groups (a measure designed to mitigate minority oppression), subordinated creditors and shareholders.

In principle, subject to cross-class cram down, the approval of 75 % in value in each class is required (based on the value of all voting rights in a respective class, rather than just the value of those participating in the vote). Unsecured creditors votes are determined in accordance with their nominal amount. Secured and guaranteed creditors' votes are determined on the value of the respective security and guarantees; shareholders' voting rights shall be determined by their respective participation in the equity.

StaRUG provides for the possibility of a cram-down of a dissenting class if: (i) a majority of 75% is reached within a class and across a majority of the other creditor classes; (ii) the crammed down class is not worse off as a result of the restructuring plan; and (iii) the crammed down class receives appropriate economic value in accordance with a modified absolute priority rule. Deviation from the absolute priority rule is possible for the treatment of shareholders where their contribution is considered essential for the restructuring, and, in respect of creditors, where their claims are not affected materially (for example where the nominal amount is not compromised or the maturity of claims is extended by 18 months).

Individual creditors have the right to appeal the plan should the requirements not be met.

Involvement of Restructuring Court

Whilst the negotiation of the restructuring is a complete out-of-court process, the company may opt to (and may be required to) involve the newly established restructuring court to assist with the following:

- to supervise the plan approval process, including class formation, and approve it;
- to issue preliminary legal guidance on individual questions (for example, whether the company is imminently illiquid);
- to appoint an independent restructuring officer to assist the debtors with the structure, negotiation and filing of the restructuring plan (which is only necessary in limited cases, but may be proposed by the debtor, or by creditors representing 25% of the voting rights in each class); and
- to issue certain stabilization measures (for example, the moratorium).

In terms of process and documentation, *StaRUG* is otherwise similar to the established German insolvency plan regime and many provisions contain references to the insolvency plan proceedings. Such similarities and references to insolvency plan proceedings will hopefully facilitate its implementation in practice.

Recognition across the EU

The debtor may decide whether the *StaRUG* restructuring be a public or private proceeding. A public restructuring plan will be registered as a proceeding in Annex A to the European Insolvency Regulation and will benefit from automatic recognition in participating member states. If the plan is private, it has potential to be recognized and enforced under the Brussels 1a Regulation, or in accordance with the private international law of the relevant jurisdiction.

Conclusion

Although as yet untested, *StaRUG* has the potential to become an efficient and viable option for debtors that require a restructuring of their capital structure and/or face minority creditors with a hold out value ("**Akkordstörer**"). The potential to take advantage of one proceeding

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to restructure a multi-jurisdictional group outside of an insolvency process will no doubt increase the attractiveness of restructuring in Germany, which is to be welcomed. However, the various limitations of *StaRUG*, including the 75 % majority voting threshold, its inability to address redundancy and pension liabilities and to terminate executory contracts, significantly limit its practical value for operational restructurings. We expect insolvency proceedings to remain of substantial importance for such restructurings, with *StaRUG* likely to be the focus for large over-leveraged debtors requiring a financial restructuring with minimal disruption to their business operations.

Further changes to existing insolvency legislation

In conjunction with *StaRUG*, the German legislator has implemented changes to existing German legislation relating to the grounds for the insolvency as well as to the COVID-19 exemptions.

Changes to Over-Indebtedness Test

The German mandatory insolvency ground of over-indebtedness is subject to a going concern test, i.e. whether the company is more likely than not fully funded for a certain going concern period, which had previously been defined as the current and next business year. The respective forecast period for over-indebtedness has now been shortened to twelve (12) months only (subject to the COVID-19 exemption during 2021 where (for relevant companies), the forecast considers a four (4) month period).

No abolition of the over-indebtedness concept/ Partial extension of the COVID exemptions to be extended until 30 April 2021

The strict insolvency filing obligations (for both illiquidity and over-indebtedness insolvency grounds) were suspended for companies affected by the COVID-19 pandemic from 1 March 2020 until 30 September 2020, from which date the mandatory filing obligation for over-indebtedness was suspended until 31 December 2020. Although some legislators and market participants lobbied for the removal of the mandatory filing obligation for over-indebtedness in the recent reforms, and others supported an extension of the suspension (particularly in light of the November and December lockdowns, and problems with the processing and payment of the state aid programs), Germany did not take the greater step of abolishing its historic over-indebtedness concept.

Rather, it suspended any filing obligation until 30 April 2021 for companies which: (i) had applied for state aid between November and December 2020; or (ii) could not apply for legal or factual reasons but would be eligible; however, in each case, it is required that the applied state aid will eliminate the insolvency ground. As the state aid programs aim to partially cover revenue losses of November and December 2020 only, the suspension is in effect limited to companies with smaller funding needs.

If you would like more information about the topics raised in this briefing, please speak to your regular contact at Weil or to any of the authors listed below.

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