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The New German Restructuring Regime

After the implementation of the European Restructuring Directive through the introduction of a new German Restructuring Code, Germany has a more attractive restructuring regime. Comparably to an English Scheme of Arrangement process, it will be possible to implement a restructuring plan which may foresee debt haircuts and other financial and corporate measures even against the vote of single obstructing "hold-out stakeholders", provided that a 75% majority of the stakeholders in each voting group approves the plan. Under certain conditions, it is even possible to "cram-down" a dissenting voting group entirely. This does not require the company to go through a formal insolvency process anymore. It is expected that these changes will fundamentally change the German restructuring landscape. For instance, insolvency forum shopping of German companies and classic debtor-in-possession/protective shield proceedings are expected to become much less frequent.

1. Introduction

Since 1st January 2021, Germany has a completely overhauled restructuring regime. Germany was obliged to change its existing rules in order to implement the European Restructuring Directive of 20 June 2019 (EUR 2017/1023, "Directive") into its national law. The Directive made it mandatory for EU member states to offer a "preventive restructuring framework" ("**Framework**") for companies in a financially distressed situation. In the midst of the German discussion on how to best implement the Directive, i.e. either with only small changes to the existing regime or with a big solution, came the Covid-19 pandemic ("**Pandemic**"). During the Pandemic e.g. mandatory insolvency filing obligations for directors had to be temporarily suspended and many German companies had to recur to loans (many of which are backed by the German state-owned development bank KfW) in nearly unprecedented levels to prevent their insolvency. Without these events, Germany might not have made the Framework effective half a year ahead of the transformation deadline prescribed by the Directive (June 2021), nor would it have opted for a such a bold change. In other words: the use-case for the Framework is evident from the start since it is commonly assumed that the amount of state aid granted to German corporations during the Pandemic created unsustainable debt levels and hence a risk for an excessive number of non-performing loans and "zombie" firms. The goal is to address this potentially problematic situation in the least value-destructive fashion.

The Framework is incorporated in a newly introduced Restructuring Code, which will not replace, but complement the existing Insolvency Code. It offers an alternative way of dealing with the problem of hold-out positions in a restructuring without going through a formal insolvency process. A majority of creditors will henceforward be

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able to force a dissenting minority to implement financial and corporate measures such as haircuts and deferrals of debt, debt-to-equity swaps, changes to the security package and even a sales process over the debtor company if the requirements set by the new restructuring law are met. Outside of an insolvency process, these measures had up to now only been possible on a fully-consensual basis, i.e. with the consent of each single creditor whose position was affected; from now on, the consent of the creditors' majority can be sufficient. As experience from other restructuring regimes (e.g. the English Scheme of Arrangement) shows, the mere existence of a non-consensual option as a fallback scenario will often be sufficient to promote reasonable consensual solutions.

The Framework provides opportunities for a distressed company to restructure its debt and for creditors to implement a necessary and reasonable restructuring even against a dissenting minority of creditors. Given that the rules are completely new and the changes to the existing restructuring and insolvency regime are fundamental, it is not yet clear how the new rules will be construed by German (and European) courts. For directors representing a distressed German company, many uncertainties remain or have been newly created. For better or worse, it is a dramatic shift that merits a closer look into the details.

2. Key Take-Aways

a. Before accessing the Framework, a company may try to reach a (fully consensual) restructuring settlement with its creditors through the process of a restructuring moderation ("**Moderation**"). Such settlement can be sanctioned by the court and will then be protected from insolvency claw back in a potential future insolvency. If this fails, the Moderation can be smoothly carried-over into the Framework where majority votes are possible. Because of this possible easy transmission from a consensual Moderation to a potentially non-consensual Framework, we assume that many cases will be resolved in the Moderation phase already.

b. The Framework facilitates the implementation of a restructuring plan ("**Plan**") which contains the necessary restructuring measures and is backed by the majority of creditors. However, such a Plan must exist in the first place and it must be convincing and sustainable. If that is the case, there continues to be a fair chance that the Plan may be adopted even without recurring to the Framework (e.g. in the context of a Moderation).

c. The Framework is a very flexible toolkit consisting of a menu of (court) measures out of which a company can chose. It includes moratoria, a potential pre-examination of the Plan by the court and a voluntary in-court voting of the Plan and the appointment of a so called "restructuring moderator", which can be ordered by the court upon demand of the company.

d. Only the distressed company, but not its creditors can commence a restructuring process under the new Restructuring Code. Access to the Framework is limited to companies which are in a state of threatening illiquidity, but not yet actually illiquid or (technically) over-indebted.

e. The centerpiece of the reform is the Plan whose content and adoption route is prescribed in detail in the Restructuring Code. The Plan can be implemented on the basis of majority votes and it may foresee haircuts, deferrals, debt-to-equity swaps, changes to the financial covenants and other financial and corporate measures. It can even affect collateral provided by other group companies or intercreditor arrangements.

3. Background: Something had to be done

German restructuring experts from all professions used to look enviously to the legal restructuring regimes existing in other countries. It is not that a German insolvency process is – compared to those in other countries – particularly ineffective. But German law used to offer very limited alternatives. A company in financial difficulties would either have to find a consensual solution with its stakeholders in which everyone accepts a formal deterioration of its position in order to reflect the reality of the worsened situation of the company and to ensure its long term survival. Or, if that was impossible (or if dissenting creditors were not bailed out), it had to file for insolvency with all the effects that go along with such filing: an insolvency necessarily affects all creditors (also the small, non-financial ones); it still makes for a bad reputation; the legal entity will typically be dissolved; the shareholders will lose influence and their investment entirely and also the management will typically give away a large part of its decision-making power (and risks to be sued later-on by an insolvency administrator because of mismanagement or a belated insolvency filing). An insolvency filing was therefore not necessarily a credible threat against stakeholders playing on their holdout position.

Not so in other countries. US Chapter 11 rules, the English Scheme of Arrangement and the French *Procédure the Sauvegarde*, allow for majority votes without the wide implications that would be felt by all creditors in a German insolvency process. These features, combined with the confidence instilled by highly professional London courts applying a regime which has been tested for many years, the market-standing of English law firms and the accessibility of the English language prompted an insolvency forum shopping especially towards London to make use of the English Scheme of Arrangement. This was possible even for German companies since many loan agreements used to be (and still are) governed by English law, which was sufficient to confirm the international jurisdiction of the English courts in such cases.

This development had not gone unnoticed by the German legislator which in 2012 made a reform designed to enhance self-administration and insolvency plan proceedings. Successfully, since over the last years, larger corporate insolvencies were typically carried out as self-administration proceedings (during which the directors of the company remain in charge of the company) and they have often concluded in an insolvency plan, which can be described as a restructuring agreement between the company's creditors and other stakeholders made effective by the insolvency court, potentially applying majority rules.

But still, in the Directive, the European legislator asked for more: All European member states have to make a "preventive restructuring framework" available in their jurisdictions until June 2021 which must foresee a list of defined features including, most notably, the possibility of majority decisions outside of an insolvency process: national law must provide not only for a possibility to overrule a dissenting minority within a creditor voting group, but also, under certain conditions, a dissenting group in its entirety ("**Cross Class Cram-Down**").

With the new restructuring law, Germany has implemented the Directive and it has, in some respects, even gone beyond what was required by the Directive.

4. In more detail: What has been done?

a. Before accessing the Framework

Partially copied from foreign law (in this case, by the French *mandat ad hoc* and the *procedure de conciliation*) the measures of the Framework can be preceded by a Moderation which is a fully consensual process without the possibility of majority votes or the ordering of a moratorium. Although one might ask for the benefit of a formalized process if it is fully consensual anyway, we still expect, based on the experience in France, that the Moderation might have a surprising success. The possibility of making a restructuring settlement “insolvency-proof” (i.e. protection from insolvency claw back) through an order of the court, and, in particular, the possibility to continue the negotiations in the context of the Framework (which is facilitated by the law) might be attractive enough incentives for creditors to consent to a sound restructuring plan within a Moderation. However, a lot will depend on the experience and qualifications of the restructuring moderator who shall steer the process (whose maximum duration is limited to six months).

b. The possible content of a Restructuring Plan

The Plan can affect:

- Claims against the company;
- Collateral on assets belonging to the company;
- Ownership in the company (shareholding right and the shareholding itself);
- Intercreditor agreements;
- Guarantee claims against subsidiaries or collateral on assets of a subsidiary (“**Upstream Security**”)

This is very broad – most notably, it goes beyond what can be achieved in a fully-fledged German insolvency process in an insolvency plan. While it was clear that haircuts, deferrals, changes to financial covenants, debt-to-equity swaps and (partial or total) sales or carve-out processes had to be possible to allow for a meaningful restructuring (and the Directive did not leave much room in this respect), it was very surprising to see that the new German rules allow to make changes to intercreditor agreements and Upstream Security (even if it was set that the latter requires a fair compensation of the affected creditors).

It is just as important to understand what the Plan cannot affect and this is claims of employees (neither salaries nor pension claims). This limitation was contained in the Directive and it might define the remaining scope for debtor-in-possession insolvency processes: If a restructuring cannot be implemented without a considerable contribution from the employees’ side (e.g. workforce reductions or salary-freezes) and if a consensual solution cannot be reached, a company might be forced to recur to an insolvency process.

c. The adoption of the Restructuring Plan

The Plan is a type of agreement between the company's stakeholders which, under certain conditions, does not require the consent of all parties to the agreement if it is approved by the court. The voting takes place in groups and the Restructuring Code sets mandatory guidelines on how the groups need to be formed (classification of plan-affected persons). In principle, the Plan needs to be approved by each group whereby an approval of 75% of the represented claims in each group is sufficient (meaning that a 24,9% minority within each group can be overruled; "intra-group cram down"). However, provided that the creditors are treated fairly compared to their likely recovery and ranking in an alternative insolvency the court can also overrule an entire group which refuses the Plan (Cross Class Cram-Down). The new law permits exceptions to the so called "absolute priority rule" – which provides that the ranking of creditor classes in an alternative insolvency must be reflected in the Plan – insofar as it is possible to allocate value to the shareholder if the continuity of the shareholder is necessary for the company's survival, even though the shareholder would not receive anything in an insolvency.

The voting can but does not have to take place in court. In any event, the court must confirm the Plan if the measures provided therein shall come into binding effect.

d. Other potential measures offered by the Framework

In addition to the confirmation of the Plan (and a potential voting of it in court proceedings), the company may demand the court to order an enforcement stop (moratorium). Moreover, the court may appoint a restructuring representative whose competences are described by the new law. We assume that in cases where the representative is appointed upon request of the company, the company will give broad competences to the representative on the basis of a power of attorney. Furthermore, the law will restrict termination and retention clauses which cannot be based on the sole fact of the company entering the Framework. New financings will be largely protected against insolvency claw back and lender liability risks.

e. Changes to the Insolvency Code

In the context of the implementation of the new Restructuring Code, certain changes have been made to the Insolvency Code, too. Some of them were simply required to secure consistency between the two regimes. However, three changes seem notable:

i. Over-indebtedness and threatening illiquidity will become more distinguishable as the liquidity forecast period will be set to one year for over-indebtedness and two years for threatening illiquidity. Until the end of 2021, a shortened (and thus more favorable) four months forecast period will apply for "COVID-companies" for the purposes of the over-indebtedness test. The mandatory insolvency filing period in case of over-indebtedness (but not for illiquidity) was be prolonged from three to six weeks (please note that certain Covid related exceptions continue to apply).

ii. The scope of management liability because of a belated insolvency filing has been changed. The liability regime will mostly be less strict insofar as potential positive developments and cash-inflows during the relevant period (see above) need to be considered as well (which was not the case hitherto), but, on the other hand, certain privileges (e.g. with respect to social security and tax payment obligations) will fall away, too.

iii. The entrance-hurdles to self-administration proceedings have been raised. It can be thus assumed that self-administration insolvency will largely be replaced by restructurings under the Framework.

5. Outlook/Open questions

It appears a relatively safe bet that the regime will stop the insolvency forum shopping known from the past. But will the German legislation also serve as a model law for other European Member States? Will it contribute to a more business-friendly legal environment and help to deal with the excessive debt-levels which are a consequence of the generous state aid during the Pandemic? Will the exclusion of claims under employment agreements from the possible scope of the Plan limit its field of application and usefulness in an excessive degree? What room will be left for “classic” insolvencies? How will international/European recognition of court decisions work for non-public Framework proceedings? We are of course happy to keep you updated on any future developments.

For further questions don't hesitate to contact our specialists:

Joachim Ponseck, MBA, Lic en droit
joachim.ponseck@bakermckenzie.com

Prof. Dr. Artur M. Swierczok, LL.M., MSt.
artur.swierczok@bakermckenzie.com

Baker & McKenzie - Partnerschaft von Rechtsanwälten und Steuerberatern mbB

Berlin
Friedrichstrasse 88/Unter den Linden
10117 Berlin
Tel.: +49 30 2 20 02 81 0
Fax: +49 30 2 20 02 81 199

Frankfurt am Main
Bethmannstrasse 50-54
60311 Frankfurt / Main
Tel.: +49 69 2 99 08 0
Fax: +49 69 2 99 08 108

Dusseldorf
Neuer Zollhof 2
40221 Dusseldorf
Tel.: +49 211 3 11 16 0
Fax: +49 211 3 11 16 199

Munich
Theatinerstrasse 23
80333 Munich
Tel.: +49 89 5 52 38 0
Fax: +49 89 5 52 38 199

www.bakermckenzie.com