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Trends and Developments in the German Restructuring Market

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The Current Macro Picture and the German Distressed Market

The current macro environment in Germany is characterised by high interest rates as a reaction to high inflationary pressure after the COVID-19 pandemic, constrained consumer sentiment and geopolitical tensions around the globe negatively impacting the export-driven German economy. Since Q2 2023, Germany's economy is in a technical recession, and the macro outlook does not suggest a rapid, strong turnaround.

In terms of sectors, real estate companies (especially developers) in particular continue to suffer from decreasing asset values against a backdrop of increasing costs of capital and building materials. Furthermore, highly levered companies with near term maturities are increasingly struggling to refinance as — if respective leverage is financeable at all — the current pricing of such debt often appears to be challenging from an interest coverage perspective.

Consequently, the distressed market has become increasingly active in Germany and will continue to be so. Whilst the market has already experienced a wave of real estate developer insolvencies and seen the first major German Schemes (StaRUG) involving German law-governed debt in 2023 (see **Notable Trends in German Restructuring 2023**, below), it remains to be seen how German courts will handle the most delicate aspects of StaRUG proceedings — namely, the potential requirement for shareholder consent to initiate a StaRUG and the requirements to be met to effect a (cross-class) cramdown (see **Key Inflection Points for the Use of StaRUG Proceedings Going Forward**, below).

Furthermore, 2023 brought landmark decisions on the correct forum for in-court restructuring within and outside the EU (Galapagos) and secured creditors' rights in a German insolvency. These decisions will shape future restructuring discussions for German assets (see **Galapagos and Other Landmark Decisions Shaping Future Restructurings**, below). Similar trends are expected to continue in 2024/2025, particularly real estate restructurings, while the German restructuring market will be waiting for the first StaRUG involving foreign law-governed financial debt (see **Final Remarks and Outlook**, below).

Notable Trends in German Restructuring 2023

Uptick in insolvency proceedings, especially project development companies

In 2023, Germany experienced a sizeable uptick in insolvency filings without notable restructuring efforts prior to filing. This is particularly true for real estate developers. The German market for real estate developments is fragmented, with approximately 9,000 players fighting for a share of the pie. Many market observers have long expected the market to consolidate, and the summer of 2023 may have marked the starting point for such structural change.

The lack of pre-insolvency restructuring efforts in the development sector is perhaps unsurprising. Germany's new pre-insolvency tool, StaRUG (see below), allows for tailor-made financial restructurings of multilayered financing structures on a single-entity basis and is therefore best suited where a large part of the company's indebtedness is pooled in one entity. In contrast, project developers typically have a decentralised financing structure. Typically, each project is ring-fenced in a separate SPV that incurs project-specific, mortgage-backed senior financing; in larger structures, this is topped up with mezzanine debt at the SPV level.

There are a few notable exceptions, such as large-cap developers like Signa, Aggregate or Consus (which also raised significant debt at holding level) and Euroboden (which filed for insolvency in September 2023 with approximately €90 million of unsecured notes issued at TopCo level).

Furthermore, at SPV level in small- and mid-cap structures, local banks remain the predominant source of financing. The mechanism to bind minority dissenting creditors under StaRUG can hardly offer any benefits, especially where project financing is provided by single local banks. In such situations, work-out bankers often see a situation in which their senior secured debt is value-covered and therefore incentives for an out-of-court compromise are limited. On the contrary, the option for such an

SPV or development company to reject onerous contracts in insolvency proceedings may be another reason why an ordinary insolvency process may appear more attractive than a financial restructuring out of court.

StaRUG proceedings

The “German Scheme” — StaRUG — experienced many “firsts” in 2023 and gained real traction as a tool for quasi-consensual restructuring.

Many of the recent cases concern publicly listed companies that were taken private by individual or small groups of shareholders in the context of a sizeable deleveraging, without the opportunity for minority shareholders to buy back into equity. As a result, associations of retail investors (in particular) have started to campaign against the StaRUG as a tool for “unfair” squeeze-outs in restructuring situations, in which retail investors are left behind without adequate compensation. However, a challenge of LEONI’s StaRUG before the German Constitution Court launched by one such association has failed, as the German Constitutional Court did not even accept the respective challenge. It remains to be seen whether the fight will continue on other battlegrounds, such as matters of valuation as recently seen in Adler, or whether the peak of resistance in that regard has already been seen.

As opposed to shareholder new money deals, a further notable observation is that, to date, there has been no public StaRUG in which the proceedings have been used for full-blown lender-led take-control transactions. Whilst there are several instances in which upside-sharing mechanisms have been agreed for creditors, this is typically achieved through debt instruments without any governance rights, rather than a straight equity participation. It remains to be seen if such outcomes are a mere function of the preferences of the specific lenders who happened to be affected by the first test cases, or whether this is also reflective of the strong leverage of shareholders in the StaRUG context. Where the debtor company is organised as a limited liability company (GmbH), a controversial line of jurisprudence requires shareholder approval to initiate StaRUG proceedings; this gives shareholders leverage in any commercial discussions before entering into any form of restructuring transaction (see below for more detail).

One of the headline cases was LEONI.

LEONI is an automotive supplier with approximately 95,000 employees across 24 countries and revenues of approximately €5 billion. Prior to its restructuring, LEONI’s shares were listed and widely distributed, with the largest shareholder holding 16.5%.

LEONI's primary financial debt consisted of €1.105 billion of revolving credit facilities (RCFs) (plus approximately €280 million equivalent undrawn RCF commitments at subsidiary level) and €343 million of Schuldschein loans.

A first restructuring attempt failed at the end of 2022, after the buyer of one of LEONI's business segments refused to close the sale. The company subsequently initiated StaRUG proceedings at TopCo level in parallel with a consensual deal at TopCo and subsidiary level. As a consequence of the StaRUG plan and the consensual deal, the anchor shareholder received 100% of the shares in TopCo for €150 million new money, the debt was re-tranched in a sustainable and unsustainable portion and only the sustainable portion was left in place as such and extended.

Key Inflection Points for the Use of StaRUG Proceedings Going Forward

Potential shareholder consent requirement for a StaRUG filing

The basic requirement for initiating StaRUG proceedings is the filing of a notice with the restructuring court, alongside a restructuring proposal and a confirmation that the company is in a state of imminent insolvency.

In contrast to the Netherlands, for example, German law is silent on whether such filing by the board requires shareholder consent. There have been several court decisions in recent months painting a mixed, and not particularly helpful, picture of how German courts think about this question.

In June 2023, the District Court of Nuremberg ruled on LEONI that a StaRUG filing by the board of a stock corporation does not require the approval of an annual general meeting (AGM). The court mainly relied on the unlimited and unrestricted power of the board of a stock corporation to represent the company, including in court, which would also extend to a filing for StaRUG proceedings. Furthermore, the StaRUG law itself would suggest that AGM approval cannot be required for a StaRUG filing, given the option to cram down the equity in a StaRUG. Such option would have hardly any practical relevance if shareholders could protect themselves by blocking the StaRUG filing in the first place. Therefore, the District Court of Nuremberg held that the directors of a stock corporation do not require AGM approval for a StaRUG filing, at least if a StaRUG is the only option to implement a restructuring solution and maintain a going concern outside a formal insolvency process.

To the contrary, other district courts held in particular for the German limited liability company that shareholder consent is actually required to file for a StaRUG and, surprisingly, a filing without such consent is to be considered invalid.

Decisions of the local district courts are not necessarily binding for the other 22 restructuring courts in Germany (there are 24 courts in total), but they will be taken into account for future restructurings. The current trend seems to indicate that the board of a stock corporation does not require AGM approval for a StaRUG filing and that the board of a limited liability company may file. This question is one of the main drivers for the future success of German restructuring plans and the future of the German restructuring landscape in a competitive pan-European environment for preventative restructuring tools. There is expected to be significant ongoing debate on this.

Lessons learned from German cramdowns to date

Under the StaRUG, Sections 26 and 27 stipulate the requirements for a (cross-class) cramdown, in particular the "no-worse-off" test for dissenting creditors in the relevant alternative scenario, requiring the court confirming the plan to find that dissenting creditors are not worse off under the plan compared to the relevant alternative (Section 26, para. 1 No. 1 StaRUG).

Early rulings indicate that German restructuring courts do not yet examine respective requirements themselves — at least in their written judgments — in a great amount of detail.

In LEONI, the District Court of Nuremberg found the explanations in the proposed plan (and particularly the expert opinions of the court-appointed experts) sufficient to fulfil the above requirements and approved the plan, including the cramdown of the "old" equity.

Other district courts have either ruled merely based on evidence presented by the debtor or appointed court experts without examining respective requirements in more detail themselves.

In summary, there appears to be a tendency in restructuring case law to leave the assessment of crucial requirements for any cramdown to court-appointed experts. This in turn requires debtors and their advisers to present comprehensive expert evidence themselves and to suggest the right experts to be appointed by the court early on in proceedings.

Galapagos — Battle of COMIs and the First Filing Wins

Potentially one of the most significant decisions in the last 10 years in connection with the Recast European Insolvency Regulation (EIR) is the decision by the Court of Justice of the European Union (ECJ) in Galapagos BidCo (24 March 2022). This relates to the restructuring of Galapagos group, a German-headquartered heat exchanger business, which was subject to multinational litigation over the last couple of years.

At the heart of the legal dispute is an earlier judgment of the ECJ in the matter of Staubitz-Schreiber — C-1/04 dated 17 January 2006 (incidentally the ECJ's first decision in respect of the EIR). The ECJ had held that an earlier application for process within the scope of the EIR essentially blocks any later filing until the first filing has been heard and decided on, even if the debtor subsequently moved its centre of main interests (COMI) elsewhere. The question the ECJ had to decide in Galapagos was whether this also had the effect of blocking a subsequent application elsewhere or whether the principle of the automatic recognition of opened insolvency proceedings would take precedence over any earlier applications.

The ECJ decided in favour of the former — i.e., the continuing international jurisdiction of the court of the member state first seized excludes the jurisdiction of courts of another member state, effectively giving the first application a blocking effect vis-à-vis subsequent applications until the first court has delivered its decision and declined jurisdiction. In summary, the ECJ based its reasoning on existing case law and long-standing principles to prevent fraudulent or abusive forum shopping and to avoid incentives to transfer assets to obtain a more favourable position, the requirement for courts to verify their jurisdiction *ex officio* and the provisions for automatic recognition based on the principle of mutual trust among member states.

In its decision following the ECJ ruling, the German Federal Court of Justice (*Bundesgerichtshof*) did not construe German private international insolvency law — as the now applicable law between Germany and UK post-Brexit — as conferring the European blocking effect on the court first seized, as this was a European construction based on the principle of mutual trust not applicable between Germany and third countries.

The converging views of the ECJ and the *Bundesgerichtshof* on the priority of competing insolvency applications under the EIR and German private international insolvency law are likely to impact cross-border restructurings going forward and can be seen as having introduced an imperative to "race to the courts."

Galapagos — no claw-back if there is no other bid for the asset at the time of the auction sale

In parallel with the ECJ proceedings, the German administrator of Galapagos Holding had instigated a claw-back action with the Düsseldorf insolvency court, which sought to unwind the restructuring of the Galapagos group implemented through the enforcement of a Luxembourg share pledge in October 2019.

The Düsseldorf court dismissed the claw-back action in June 2023. While the Luxembourg share pledge was, in principle, protected under Article 8 of the EIR, the manner of enforcement was subject to review under the applicable German *lex fori concursus*. For the claw-back action to succeed, the administrator bore the burden of proof to substantiate and evidence that the enforcement had caused a detriment to creditors as a whole. This test would only have been satisfied if there was a causal link between the alleged flawed sales process and the non-receipt of a (higher) bid, such that, upon receipt of such offer, the proceeds of the sale would have resulted in an excess to the value of the senior debt secured by the pledge.

The decision arguably set a high bar to administrators challenging share pledge enforcements in an insolvency, particularly where there is plausible evidence that value breaks in the senior secured debt.

Final Remarks and Outlook

2023 brought significant developments and gains in terms of deal certainty for transactions involving a German scheme (for German law-governed debt) and also for potential enforcement transactions. Those will certainly come into play in the coming months and years.

Whilst 2023 saw parallel restructuring processes between the UK and an EU member state (Vroon, involving a parallel Dutch WHOA and an English scheme; Cimolai, involving a parallel Italian *concordato preventivo* and an English restructuring plan), the first test case for a parallel StaRUG and a UK process is yet to come. This will be the next important milestone to define the art of the possible for the restructuring landscape in Germany.

In terms of sector trends, real estate and retail companies in particular are expected to be in the focus of the restructuring market in the near-term, given continuously high interest rates and lower discretionary spending against the backdrop of an uncertain macro-economic outlook.

The leisure and travel industry may also come under (additional) pressure in the mid-term as many state-backed loans provided during the COVID-19 pandemic mature in 2024/2025. Those loans have incredibly cheap pricing and will most certainly not be refinanceable at a comparable level (if at all). Consequently, increasing restructuring activity is also expected in those sectors.

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