

# The bigger the choice, the harder it is to choose

## UNDER THE NEW PREVENTIVE RESTRUCTURING PROCEDURE, LANDLORDS HAVE TO FEAR THE SHORT-TERM TERMINATION OF LONG-TERM LEASES, EVEN OUTSIDE OF FORMAL INSOLVENCY PROCEDURES

### Executive Summary

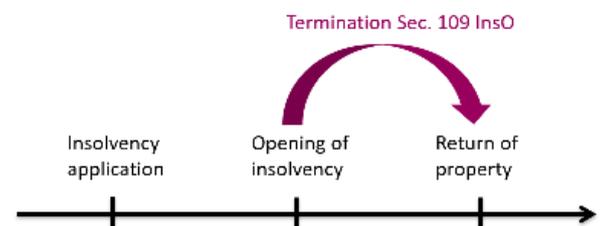
- With the preventive restructuring procedure, which is to become law on 1 January 2021, tenants are granted the option to terminate long-term lease agreements outside of insolvency proceedings with a three-month notice period if of benefit to their restructuring.
- This significant restriction regarding the validity of lease agreements is based on the new Business Stabilisation and Restructuring Act (*Unternehmensstabilisierungs- und -restrukturierungsgesetz –StaRUG*), which is aimed at implementing the EU Restructuring Directive (Directive 2019/1023) into domestic law to give companies distressed from the COVID-19 pandemic a ‘second chance’. The German federal government’s draft legislation was published on 14 October 2020; the first reading of the draft legislation in the German parliament (*Bundestag*) was subsequently held on 18 November.
- In our GSK Update, we analyse the economic and strategic implications from the landlord’s perspective.

### Further threat of insolvency

To mitigate the consequences of the COVID-19 pandemic, the obligation to file for insolvency was suspended at the beginning of the year and temporary protection against termination was introduced for tenants who were unable to meet their rental payment obligations during the lockdown due to loss of income. However, these payment obligations have neither been suspended nor automatically deferred, with the result that many tenants are postponing rental payments. To be able to survive at all in the still tense situation, many tenants expect landlords to make significant concessions to alleviate some of the pain. Some landlords are willing to make such concessions in the belief that their tenancies will remain stable in the long run.

### What are contracts worth today?

The old principle of law that ‘agreements must be kept’ applies today only to a limited extent. In the event of the tenant’s insolvency, the insolvency administrator may terminate lease agreements irrespective of fixed terms with a notice period of three months to month’s end (Section 109 German Insolvency Code (*Insolvenzordnung – InsO*)). Also, through restructuring by way of an insolvency plan, the tenant already has the option of closing locations and continuing business with a restructured company. ‘Self-administration’ and ‘protective shield proceedings’ – in principle two welcome ways of structuring insolvency proceedings – permit the tenant to stay in control of the insolvency proceedings.



### The new termination possibility

With the introduction of the ‘preventive restructuring framework’ (StaRUG), tenants outside of the insolvency proceedings with all its negative consequences have the opportunity to take remedial measures at an early stage and, **if necessary, enforce them against the will of individual creditors**. From the landlord’s point of view, the possibility of **terminating mutual contracts with a notice period of only three months, even with a long-running fixed-term lease** (Sections 51 ff. StaRUG-RegE), is significant, and thus coincides with the regulation under German insolvency law. The judge, who has to approve the termination of the contract, should only reject it if termination would **not be appropriate for the restructuring**.





### Rent arrears in the restructuring framework

Similar to the insolvency plan procedure, outstanding rent receivables can be reduced in a restructuring plan – in case of doubt even down to zero. In view of the extremely low satisfaction rates in insolvency proceedings, the legislator considers these serious interventions to be justified because they will restore future solvency. For the time being, however, the government's draft bill has averted the plan that ancillary provisions, such as replenishing security deposits and maintenance obligations, could be changed or waived by way of restructuring.

### Negotiating positions in insolvency proceedings

In the insolvency practice to date, it is less about the right of termination per se. If a company becomes insolvent and goes into liquidation, future rent is lost anyway. However, the right of termination gives the insolvency administrator a good negotiating position precisely when the aim is to restructure the company and rescue the business as a going concern. If there are several locations, the landlord is then often faced with the requirement that the location generates a certain minimum return in order to survive. This can go so far that different locations become the subject of a bidding contest.

### Economic effects

When (unused) security deposits are mentally 'booked' to the period of the provisional insolvency proceedings, the economic risk of tenant insolvency can in principle be quantified as the sum of the following three items:

- rent arrears before insolvency application;
- eviction and renovation costs; and
- loss of rent due to vacant periods after the return.

Rents in current insolvency proceedings, on the other hand, are privileged liabilities and as such are generally fully recoverable.

### Duration until repossession of the property

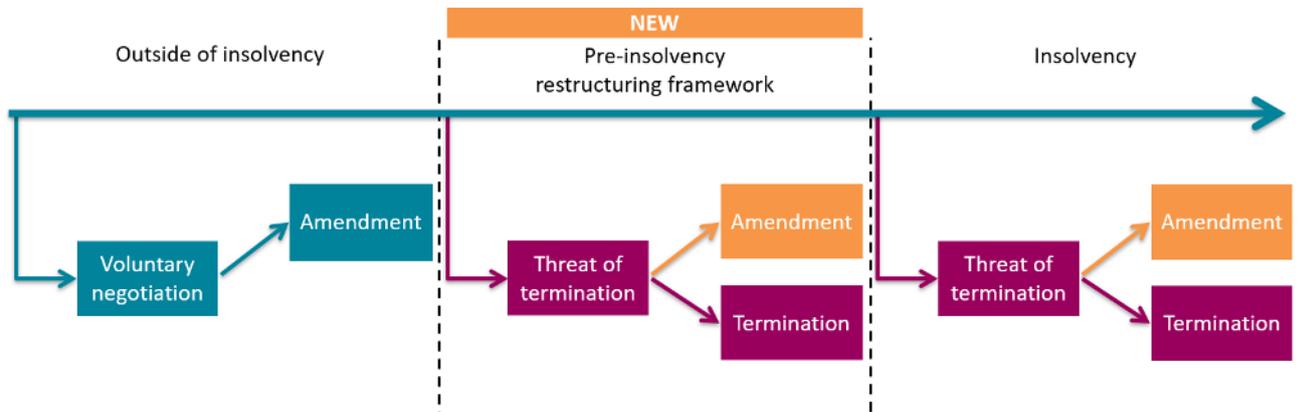
The time horizon from filing for insolvency to the return of the rental property is usually around seven months. However, the insolvency administrator can also exercise his right to terminate the lease at a later date (resulting in further rentals of value) or terminate the lease earlier by amicable termination of the contract.

### Negotiation position in the restructuring framework

This now also applies to restructuring proceedings prior to insolvency. Even if concessions in terms of content cannot be directly enforced, these regulations may still be on the negotiating table. The tenant may force the landlord to choose between **voluntary amendments to the lease or enforced termination of the contract by the court with three months' notice**.

The restructuring framework will thus considerably increase the landlord's contract risk, a fact that has already been criticised in the discussion. This applies in particular to constellations in which – for various reasons – a rent above the market level has been agreed. However, start-up incentives, such as rent-free periods and expansion grants, which have to be amortised over a long period, should be examined more carefully in the future.





### Legislative procedure

The new ‘restructuring frameworks’ will not be the big relief for companies if the exemption from the obligation to file for insolvency ends on 1 January 2020, including for the case of over-indebtedness. After all, the restructuring framework will only be available to those companies that are not yet obliged to file for insolvency. Moreover, due to its complex design – very close to the current insolvency plan procedure – the preventive restructuring framework will above all facilitate the restructuring of financial liabilities in larger companies. In the first reading in the German Bundestag, this was exactly the topic of discussion, that is, the restructuring framework is not the right solution for rescuing the smaller retailers, restaurants and service providers affected by the coronavirus crisis.

The controversial discussions in the German Bundestag on central aspects of the reform law and the critical response of the trade associations therefore also cast doubt on whether the implementation will actually take place at the turn of the year. It would be desirable that the legislator takes the time to plan the most sweeping reform to insolvency proceedings for 20 years with the necessary attention to detail and not leave specific issues up to subsequent judicial clarification. The expert hearing scheduled for next week will certainly provide further insights.

### GSK team outlook

Until now, breaking the fundamental principle that agreements must be kept (*pacta sunt servanda*) was only permissible in the context of formal insolvency proceedings. However, in yesterday's reading in the German Bundestag, Minister of Justice Lambrecht expressly emphasised yet again that companies are entitled to terminate contracts that are too expensive if a majority of creditors agree to a restructuring by way of an insolvency plan. If a tenant has several rental properties and it emerges, for example, that his expectation regarding a location is affected and the contract is not lucrative for him, the tenant will in future be able to free himself from an unpleasant cross-subsidisation. Going forward, landlords thinking about their lease strategies may need to consider another factor: the ‘restructuring risk’ of the tenant.

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