Submission for the 2023 III Prize in International Insolvency Studies

Third-party releases in the restructuring of an enterprise group member.

A comparison between the German StaRUG and the UK Scheme of Arrangement.

Lucas Reinert*

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A. Introduction

Modern companies are often part of a network of legal entities, so-called corporate groups.[1] These corporate groups are organized in the form of a dominant parent company with hundreds or thousands of sub-holdings, subsidiaries, and affiliated companies.[2] UNCITRAL (loosely) defines groups as 'two or more legal entities (group members) that are linked together […].'[3]

Spectacular insolvencies hitting whole groups are of fundamental relevance as they are capable of disrupting whole economies.[4] At the same time, we are witnessing a shift in the environment of insolvency law away from traditional liquidation to a more restructuring-focused approach.[5] This is reflected in the European Restructuring Directive[6] and the rise of restructuring proceedings in recent reforms in the Netherlands, the UK, France, Italy,[7] and Germany[8]. However, group restructurings[9] face severe hurdles due to interdependencies between group members. This holds particularly true for intra-group guarantees and cross-liability arrangements[10], which are an 'important and familiar aspect of the landscape in the financing of corporate groups'[11]. By commonly engaging into these arrangements, companies

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1 Paul L Davies, Sarah Worthington and Christopher Hare, *Gower's Principles of Modern Company Law* (11th edn, Sweet & Maxwell 2021) 7-022; Phillip I Blumberg, 'The Transformation of Modern Corporation Law: The Law of Corporate Groups' (2005) ConnLRev 605, 606; Eilís Ferran and Look Chan Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 21; Vanessa Finch and David Milman, *Corporate Insolvency Law* (3rd edn, CUP, 2017) 496–497; Danny Spahos, 'Lenders, Borrowing Groups of Companies and Corporate Guarantees: An Insolvency Perspective' (2001) 1 J Corp L Stud 333; UNCITRAL Legislative Guide on Insolvency Law – Part Three: Treatment of enterprise groups in insolvency (2010) 5.

2 Blumberg (n1) 606; Ferran and Ho (n1) 21; Finch and Milman (n1) 497.

3 UNCITRAL (n1) 5 para 2; to forms of groups Peter T. Muchlinski, *Multinational Enterprises and the Law* (3rd edn, OILL 2021) 53–62.

4 Cf Thomas Liebscher in Holger Fleischer and Wulf Goette (eds), *Münchener Kommentar zum GmbhG* (4th edn, C.H. Beck 2022) Annex sec 13 para 1319 with examples of the German market.

5 For the UK: Sarah Paterson, *Corporate Reorganization Law and Forces of Change* (OUP 2020) 33–45; for Germany: Stephan Madaus and David Ehmke, 'Germany: Still Waiting for the Revolution in Restructuring to come?', https://www.online-hero.nl/art/4351/special-issue-preventive-restructuring-4-germany-still-waiting-for-the-revolution-in-restructuring-to-come, accessed 2 August 2022.

6 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] OJ L172/26 [hereinafter 'Restructuring Directive'].

7 Cf Ilya Kokorin, 'Third-Party Releases in Insolvency of Multinational Enterprise Groups', (2021) 1 EFCR 107, 108.

8 *Unternehmesstabiliserungs- und restrukturierungsgesetz*, *StaRUG*.

9 Term covers restructurings of a group or a group company.

10 Terms used interchangeably and cover intra-group collateral.

11 Jennifer Hill, 'Corporate Groups, Creditor Protection and Cross Guarantees: Australian Perspectives' (1995) 24 CanBusLJ 321, 340.

affiliated with the borrowing companies collateralize the claims of creditors against the latter, typically through liens on company shares, real collateral on the assets of the main group members, guarantees or assumptions of debt.[12] Even though provisions specifically addressing groups are still marked by a shadowy existence, countries like Australia, Ireland, Singapore,[13] as well as Germany[14] and the UK[15] react to intra-group guarantees with the restructuring tool which is subject to this paper: third-party releases.

This tool extends the restructuring-related total or partial discharge of debt or its alteration concerning the principal debtor to affiliated companies, whose obligations are linked to the primary obligation, or release the principal debtor in proceedings with respect to the affiliated company.[16] Due to their significance for group restructurings, this paper solely deals with releases of affiliated group companies, referred to as 'affiliated-party releases', and focuses on the UK and Germany.

This paper argues that affiliated-party releases are necessary for group restructurings (B.I.), incentivize groups to early restructuring (B.II.) and address intra-group dependencies intensified through cross-liability arrangements (B.III.). Affiliated-party releases can overcome the single entity doctrine, which is outlined in Chapter B.IV. Creditors' expectations and the expected capital cost increase provide no reasons for the releases' prohibition either, as they can be protected by safeguards (B.V.) and limited by certainty (B.VI.), respectively. Subsequently, Chapter C of this article explains why the UK approach is one small step ahead of the effective German framework regarding affiliated-party releases, before drawing a conclusion (D.).

B. Pladoyer for Affiliated-Party Releases

I. Necessary Tool for Group Restructurings

Supporting affiliated-party releases traces back to the general argument of being a useful tool to facilitate group restructurings.[17] More specifically, reference is often

[12] Holger Altmeppen, 'Aufsteigende Sicherheiten im Konzern' (2017) ZIP 1977; Peter H Hoegen and Christopher Kranz, 'Neue Möglichkeiten der Konzernsanierung durch SanInsFoG und StaRUG' (2021) NZI 105, 107; Lars Westpfahl and Tom Dittmar, 'Die Behandlung gruppeninterner Sicherheiten im StaRUG' (2021) NZI-Beilage 46; Ilya Kokorin, 'Promotion of Group Restructuring and Cross-Entity Liability Arrangements' (2021) 2 JCLS 557, 561; Finch and Milman (n1) 64; David Milman, 'Group of Companies: The Path Towards Discrete Regulation' in David Milman (ed), *Regulating Enterprise: Law and Business Organisation in the UK* (Hart Publishing 1999) 219, 226.

[13] Ilya Kokorin, Stephan Madaus and Irit Mevorach, 'Global Competition in Cross-Border Restructuring and Recognition of Centralized Group Solutions' (2021) 56 TexIntlLJ 109, 140.

[14] Sec 2(4) StaRUG.

[15] *Re Noble Group Ltd.* [2019] BCC 349 at [25].

[16] Cf Kokorin EFCR (n6) 117.

[17] Cf explanatory memorandum of the German government regarding the StaRUG, BT-Drs. 19/24181, 111, 113; Hoegen and Kranz NZI (n10) 107; Richard L. Epling, 'Third-Party

made to the need of including intra-group guarantees in the restructuring plan to preserve the value of the group and prevent subsequent insolvencies of group companies.[18] This paper submits that affiliated-party releases are indeed a core instrument for every legal toolbox of restructuring-friendly jurisdictions. This argument has two aspects: First, the rationale behind intra-group guarantees and secondly, their consequences for group restructurings.

In the typical group structure of centrally financed groups, the parent company takes on loans and distributes the capital throughout the group via cash-pooling or transfer of the loans.[19] Alternatively, banks lend to a company which was set up for the sole purpose of being the formal counterparty to the bank, a so-called Special Purpose Vehicle (SPV). This SPV then on-lend the funds received to the operating entities. This structure was used in *Re Oi Brasil Holdings Coöperatief U.A.*[20]. Legally, the companies within groups remain separate entities with separate asset pools, even in restructuring proceedings.[21] Even more important, each company within the group has its own creditors.[22] From the view of capital providers, this means a structural subordination risk.[23] Without intra-group guarantees, the lender could only assert claims against the formal borrower, which often only has minimal and/or changing[24] assets to satisfy the claim.[25] Moreover, SPVs do not conduct revenue-generating business activities on their own.[26] Neither do the holdings, as they typically solely managing the group's shareholding.[27] Therefore, intra-group guarantees became 'standard practice in private debt markets'[28]. A good example is *Cattles Plc. v. Welcome Financial Services Ltd.*[29], in which the parent raised £2.6 billion for the benefit of the whole group, mostly secured through upstream

Releases in Bankruptcy Cases: Should There Be Statutory Reform?' (2020) 75(2) Bus Lawyer Chicago 1747, 1158; Kokorin, Madaus and Mevorach (n11) 113; European Commission, Commission Staff Working Document Impact Assessment Accompanying the document Proposal for a Directive on preventive restructuring frameworks, SWD/2016/0357 final – 2016/0359 (COD), 22 November 2016, 71 para 5.5.1.

18 Explanatory memorandum StaRUG (n16) 199.

19 Altmeppen (n10) 1977; Peter H Hoegen and Christopher Kranz in Lucas Flöther (ed.), *Unternehmensstabilisierungs- und restrukturierungsgesetz (StaRUG)* (C.H. Beck 2021) Annex D para 49c; Jochen Humbeck, 'Plädoyer für ein materielles Konzerninsolvenzrecht' (2013) NZI 957, 958; Andreas Spahlinger and Helge Kortz, 'Germany' in Gregor Baer and Karen O'Flynn (eds), Financing Company Group Restructurings (OUP 2015) para 10.19–10.20; Christian Wenner and Michael Schuster, 'Insolvenzanfechtung im Konzern' (2008) ZIP 1512, 1513.

20 578 BR 169 (Bankr SDNY 2017).

21 Finch and Milman (n1) 497; Kokorin JCLS (n10) 557; Daoning Zhang, 'Preventive Restructuring Frameworks: A Possible Solution for Financially Distressed Multinational Corporate Groups in the EU' (2019) 20 EBOR 285, 287; for German law Spahlinger and Kortz (n18) para 10.05.

22 Finch and Milman (n1) 497; Kokorin JCLS (n10) 557; Milman (n10) 224.

23 Hoegen and Kranz in Flöther (n18) Annex D para 7; Wenner and Schuster (n18) 1513.

24 Through transfer amongst the group companies.

25 Christian Pleister, 'Behandlung von Drittsicherheiten in der finanziellen Restrukturierung von Konzernen' (2015) ZIP 1097; Spahos (n1) 334; Wenner and Schuster (n18) 1513.

26 Cf Kokorin EFCR (n6) 137; Pleister (n24) 1097.

27 Spahlinger and Kortz (n18) para 10.30; Wenner and Schuster (n18) 1512.

28 Spahos (n1) 334.

29 [2010] BCLC 712, CA.

guarantees. Downstream and cross-stream guarantees are also prevalent, especially in the SPV-variant.[30] Admittedly, finance structures in terms of equity, debt financing and retained earnings may vary significantly between companies.[31] However, intra-group guarantees are 'standard programme'[32] in group's financing and so have to be affiliated-party releases as essential restructuring tool. Whereas intra-group guarantees allow groups to obtain funding during their lifetime, they create insurmountable hurdles once a group experiences financial difficulties. This article will give three reasons for this.

First, as a result of intra-group dependencies, financial distress of one member is likely to result in financial distress of other, even previously solvent members, thereby threating the viability of the whole group.[33] Financial, operational and functional interdependence leads to one group member's insolvency being the starting of the 'domino effect' of insolvencies.[34] Consequently, the group restructuring would be torpedoed by the contagious insolvencies within the group.[35] The parent restructuring is a brilliant example. Parent companies are often pure holding companies.[36] It is the subsidiaries, divided into operational areas, which usually generate the positive cash flows necessary for the successful restructuring of the group. The subsidiaries survival is important to continue the group's operational activity and assist the reorganization.[37] Without solvent subsidiaries, the restructured legal entity might become an 'orphan', which makes a pure single-entity restructuring being economically inefficient.[38] Problematically, financial distress of the borrowing company is typically linked to financial distress of the operational entities which provided intra-group guarantees.[39] Thereby, the parent loses its operating entities and the control or power to govern throughout the group, respectively.[40] It is therefore essential to include intra-group guarantees in the restructuring plan and protect

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30 To this structure *Re Polly Peck International Plc (In Administration)* [1996] 2 All ER 433; to downstream Hoegen and Kranz NZI (n10) 107; to cross-stream Christoph G Paulus, Biner Bähr and Philipp Hackländer, 'Konzernweite Restrukturierungen – Hilft das StaRUG?' (2021) ZIP 1085, 1086.

31 Cf Artur Swierczok, *Das englische Scheme of Arrangement und seine Rezeption in Deutschland* (Nomos 2013) 32; Lars Westpfahl and Marvin Knapp, 'Die Sanierung deutscher Gesellschaften über ein englisches Scheme of Arrangement' (2011) ZIP 2033, 2034.

32 Pleister (n24) 1097 (translated).

33 Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) sec 1 para 28; Liebscher (n4) Annex sec 13 para 1321; Spahlinger and Kortz (n18) para 10.51.

34 Humbeck (n18) 959; Pleister (n24) 1098; Wenner and Schuster (n18) 1513.

35 See Humbeck (n18) 959; Pleister (n24) 1098; Spahlinger and Kortz (n18) para 10.51.

36 Spahlinger and Kortz (n18) para 10.30; Wenner and Schuster (n18) 1512.

37 See ABI Commission to Study the Reform of Chapter 11, Final Report and Recommendations (2014) 255.

38 Kokorin EFCR (n6) 117.

39 Cf Hoegen and Kranz NZI (n10) 105; Pleister (n24) 1097–1098; European Commission (n16) 72 para 5.5.2.

40 See Pleister (n24) 1101; Hoegen and Kranz in Flöther (n18) Annex D para 9.

the solvency of affiliates. Moreover, without the release, affiliates might be reluctant to contribute the funding, business commitments, collaboration, and services needed for the restructuring.[41]

Secondly, affiliated-party releases save costs and time necessary for the restructuring since they are capable of avoiding multiple restructuring procedures.[42] Otherwise, as illustrated by *Kokorin*, 'the 'race to the courthouse' […] transforms into multiple races to multiple court houses, which worsens the financial position of the group […].'[43] Similarly, the US court in *Re Purdue Pharma LP*[44] found that litigation against the third party results in distractions, costs, and ultimately the depletion of estate assets, even if the third party is no longer operating the business. Interestingly, the German legislator justified affiliated-party releases with this exact rationale of avoiding separate proceedings.[45]

Thirdly, if the creditor exercises its right against the affiliated guarantor, the latter has a right to be indemnified by the principal debtor, so-called 'ricochet claim'.[46] Indisputably, the ricochet claim 'would defeat'[47], 'annul'[48] or 'severely hinder'[49] the benefits of restructuring. Considering that the restructuring's success depends especially on liquidity during the restructuring,[50] recourse claims clearly run contrary to the aim of restructuring. So, cutting off recourse claims which adversely affect the plan company's estate facilitates group restructurings.[51] In other words, nothing has been won or 'little to be gained'[52] in releasing a claim if this claim comes back through the backdoor, 'disguised' as a ricochet claim.

Conclusively, affiliated-party releases provide a necessary tool for group restructurings.

41 Kokorin EFCR (n6) 117.
42 Kokorin (2021) EFCR (n6) 135; Paulus, Bähr and Hackländer (n29) 1086; Peter H Hoegen and Franz B Herding in Flöther (n18) sec 90 para 17; Westpfahl and Dittmar (n17) 46; Benedikt de Bruyn and David Ehmke, 'StaRUG & InsO: Sanierungswerkzeuge des Restrukturierungs- und Insolvenzverfahrens' (2021) NZG 661, Fn 50.
43 Kokorin EFCR (n6) 111.
44 No 19-08289-rdd, Dkt No 2, 2-1, Bankr SDNY Sept 18, 2019.
45 Explanatory memorandum StaRUG (n16) 113.
46 For the UK *Re Butlers Wharf Ltd* [1995] BCC 717, 719; in Germany sec 774(1)(1) of the German Civil Code (*Bürgerliches Gesetzbuch*).
47 *Re ColourOz Investment 2 LLC* [2020] EWHC 1864 (Ch) at [72]; Jennifer Payne, *Schemes of Arrangement: Theory, Structure and Operation* (CUP 2014) 24.
48 European Commission (n16) 73 para 5.5.2.
49 Kokorin EFCR (n6) 115.
50 De Bruyn and Ehmke (n60) 665.
51 Also Epling (n17) 1747; Kokorin, Madaus and Mevorach (n11) 124.
52 Sarah Paterson, *Debt Restructuring* (forthcoming OUP 2022, on file with the author) para 3.01.

II. Incentive for Early Restructuring

To maximise the chances of successful restructurings, the law should provide incentives to reach restructuring-orientated solutions as early as possible.[53] An early restructuring attempt avoids the company going down further on the demise curve towards insolvency.[54] Only if the debtor's directors see a good chance for a turnaround of the company, they are incentivized to an early restructuring.[55] As an rescue-facilitating tool, affiliated-party releases have exactly this positive effect, which is also acknowledged by the European Commission[56]. This side effect is not to be underestimated: No group company would file for a restructuring, knowing that non-releasable intra-group liabilities lead to group-wide contagion and jeopardize the restructuring.[57] Additionally, affiliated-party releases create a 'trump card' for debtors in restructuring negotiations with creditors. Otherwise, holders of intra-group guarantees have leverage as their consent is needed for the release. By threatening to compromise creditors' guarantee claims, group companies are able to bring creditors on board and participate in the restructuring plan. This said, affiliated-party releases should be accompanied by a cram-down power. The requirement of consent of all creditors should be replaced by a majority requirement. Otherwise, creditors could pursue a hold-out strategy, as their position gets better the more other creditors waive or compromise their intra-group collateral.[58]

By preventing group-wide contagion and ricochet claims and providing a 'trump card' in negotiations, affiliated-party releases turn restructuring into a real alternative for directors of group companies and incentivize early filing.

III. Restructuring Instrument to Address Intra-Group Dependencies

This article argues that affiliated-party releases solve a manifestation of a broader problem, i.e. that restructuring law widely ignores the interdependencies between group members.[59] What makes group companies different from independent companies is their interconnection through *de jure* control[60], contracts[61], or ownership.[62]

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[53] Cf Reinhard Bork, *Rescuing Companies in England and Germany* (OUP 2012) para 2.06; Sarah Paterson, 'Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century' (2014) 27 LSE Working Papers 18, https://eprints.lse.ac.uk/60583/1/WPS2014-27_Paterson.pdf, accessed 2 August 2020.

[54] Restructuring Directive (n5), Recital 22.

[55] Madaus and Ehmke (n5).

[56] European Commission (n16) 72–73 para 5.5.2.

[57] Convincingly Kokorin JCLS (n10) 558.

[58] Pleister (n24) 1103; Paulus, Bähr and Hackländer (n29) 1086; Hoegen and Kranz NZI (n10) 105; Paterson, LSE Working Papers (n52) 7; Sarah Paterson, 'Reflections on English Law Schemes of Arrangement in Distress and Proposals for Reform' (2018) 15 EFCR 472, 486–488.

[59] Also argued by Kokorin EFCR (n6) 116–118, to this 'broader problem' Alexander Dahnert, 'The threat of corporate groups and the insolvency connection' (2009) 18 Int'l Insolv Rev 209, 218; Finch and Milman (n1) 497.

[60] Cf Daniel D Prentice, 'Some Aspects of the Law Relating to Corporate Groups in the United Kingdom' (1999) 13 ConnecticutJIntlL 305, 312–314.

[61] Dahnert (n58) 212; Muchlinski (n3) 49–53.

[62] Finch and Milman (n1) 497; Kokorin JCLS (n10) 557; Zhang (n20) 287.

Subsidiaries only fulfill their part in the whole group interest.[63] Similarly, decisions on the holding level are taken in the group's best interest, ignoring the impact on a single group member.[64] This article already explained[65] that groups are financed as one single economic unit. Nonetheless, they have to be restructured as a bunch of multiple single entities. The desire of matching the legal framework with the business reality of groups conducting their business activities through juridical entities, which are interrelated, intertwined and controlled by the parent company, is ubiquitous.[66] Affiliated-party releases are part of this overall desire since restructuring would be parallel to the economic and funding reality of groups. Providing finance and collateralizing this funding through intra-group guarantees can hardly be seen as separate economic processes, so why treating them separately in restructurings?

Generally, scholars proposed many ways to treat groups as one economic unit specifically for insolvency and restructuring purposes.[67] However, courts and legislators are reluctant to acknowledge this interdependencies.[68] This reluctance is to be overcome in relation to affiliated-party releases, as it is seen through a different lens. Usually, the discussion about treating groups as one economic unit focuses on liability within the group.[69] Broadly, by piercing the group veil, the parent shall be liable for its subsidiaries' conducts.[70] This runs contrary to the groups' interests, as shifting legal liabilities to protect the parent is one main reason to operate a business via a group.[71] Given this, the reluctance to introduce liability of a group company for the conduct of affiliated companies is understandable since it is hostile to groups and groups are fundamentally important for domestic investments.[72] However, courts are more inclined to treat groups as one single unit where this comes to the advantage of the group.[73] Affiliated-party releases are group-friendly, as they expand the restructuring toolbox for groups. Treating groups in a restructuring similarly to their economic functioning during their lifetime is the only way to keep

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63 Dahnert (n58) 216.
64 Wenner and Schuster (n18) 1513.
65 Chapter 1 above.
66 Blumberg (n1) 609; see also Dahnert (n58) 219–222; Jonathan M Landers, 'A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy (1975) 42 UChiLRev 589, 597; Hill (n9) 331–332; Irit Mevorach, *The Future of Cross-Border Insolvency: Overcoming Biases and Closing Gaps* (OUP 2018) 10.
67 Douglas G Baird and Anthony J Casey, 'No Exit? Withdrawal Rights and the Law of Corporate Reorganizations' (2013) ColumLRev 1, 48; Kannan Ramesh, 'Synthesising Synthetics: Lessons Learnt from *Collins & Aikman*' (2022) 1 JMJ 165; Harry Rajak, 'Corporate Groups and Cross-Border Bankruptcy' (2009) 44 TexIntlLJ 521.
68 Rajak (n67) 529–531; Davies, Worthington and Hare (n1) para 7-025.
69 Cf Hill (n9) 331–332; Milman (n10) 231–232; Davies, Worthington and Hare (n1) 7-013.
70 See eg John H. Matheson, 'The modern law of corporate groups: an empirical study of piercing the corporate veil in the parent-subsidiary context' (2009) 87 NCLRev 1091; Robert B Thompson, 'Percing the Veil Within Corporate Groups: Corporate Shareholders as Mere Investors' (1999) 13 ConnecticutJIntlL 379.
71 Dahnert (n58) 210; Finch and Milman (n1) 497; Hill (n9) 342.
72 Milman (n10) 236.
73 Ibid 239 with references to cases.

groups alive.[74] Affiliated-party releases are therefore in line with the legislators' and courts' approach to treat groups as one economic unit when it comes to their benefit. If restructuring law does not provide tools like affiliated-party releases to keep groups worth rescuing alive, the feared negative impact on the economy as a whole seems inevitable. Restructuring law must adopt affiliated-party releases as an essential part of recognizing economic reality in group restructurings to ultimately support national welfare.

IV. Compatibility with Single Entity Doctrine

Unfortunately, the interdependent and/or control-based and/or ownership-related relationship between affiliated companies is commonly seen as not enough to overturn the separate legal personality of companies.[75] This doctrine is undoubted in the UK since *Salomon v. Salomon*[76], which also applies to companies within groups.[77] In the view expressed here, affiliated-party releases are compatible with the aforementioned doctrine, though. The argument has three aspects.

1. Weakened Through Parties' Arrangements

Firstly, the separate legal personality doctrine is particularly weakened in groups not only due to interdependence between members, but through cross-liability arrangements.[78] This is because group liability arrangements allow creditors to claim against an affiliate, thereby further intertwining the anyway correlated interests of the legally separate group members.[79] Another, more judicial way to look at this, is the argument, cross-liability arrangements 'soften' the veil of the group members' legal separateness,[80] as their assets are not completely separated anymore.

This is closely linked to another point: The parties themselves interfere with and deviate from the single entity principle. Intra-group cross-liability arrangements are characterized through creditors' access to assets of affiliates.[81] Access to asset pools of affiliated companies is exactly what defines a deviation from the single entity doctrine. This deviation is a result of arrangements by the parties themselves, including creditors. When the parties' arrangements purposefully lead to an intertwingling of single entity structures and thereby willingly deviate from the strict application of the single entity doctrine, restructuring law has to provide tools to disentangle these interconnections. As *Bork* puts it: 'Where […] restructuring has

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[74] Cf Dahnert (n58) 222.
[75] Landers (n66) 597.
[76] [1897] AC 22 HL.
[77] See *Adams v Cape Industries plc* [1990] Ch 433, 532; *Chandler v Cape plc* [2012] EWCA Civ 525 at [67].
[78] Kokorin JCLS (n10) 558; Richard Squire, 'Shareholder Opportunism in a World of Risky Debt' (2012) HarvLRev 1151, 1213.
[79] Kokorin JCLS (n10) 558.
[80] Cf Kokorin JCLS (n10) 558, Fn 4.
[81] Cf Pleister (n24) 1098.

a chance of success, the law must be in a position to support it with suitable rules.'[82] In this case, affiliated-party releases are the suitable disentanglement tool.

2. Inapplicability of Doctrine's Ratios

Secondly, the doctrine's ratios are not applicable in relation to affiliated-party releases. Treating groups either as one economic unit or as a bunch of single entities is not an 'all or nothing' decision. The qualification of structures in which business is conducted is not a matter of fact, but made by the law itself.[83] As a consequence, the way in which the law treats a business can vary depending on the context. In the UK Companies Act 2006[84], the law of corporate groups prevails the traditional entity concept in the areas of accounting and tax[85]. Whether the concept of group law or the single entity doctrine supersedes is a question of which best implements the objectives and policies of the particular area at hand.[86] We should not apply doctrines out of legal conservatism but on grounds of their policies.[87] The resulting questions are: what policies and objectives underlie the doctrine of separate legal personality and how do they apply in relation to affiliated-party releases?

As result of separate legal personality, the company is liable and not its members. Accompanied by limited liability, members are only liable to contribute the fixed amount they agreed to invest.[88] Moreover, the separate legal personality enables easier transfer of the business venture and eventually reduces costs of transfer.[89] Obviously, both doctrines were broadly speaking originally designed to stimulate capital investment in companies.[90] They do so by ensuring that the worst case scenario for investors is the loss of their investment.[91] Thus, separate corporate personality and limited liability were envisioned and designed as a protection for shareholders.[92] What is the shareholders' position towards affiliated-party releases? We have to differ between 'general' shareholders and the situation of cross-sharehold-

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82 Bork, *Rescuing Companies* (n52) para 1.01.

83 See Ross B Grantham, 'Commentary on "Goddard, Corporate Personality"' in *Corporate Responsibility* (n96) 69: 'the conception of the company as a distinct entity is a conclusion of law, […], and one relevant only in its particular context.'.

84 Hereinafter 'CA 2006'.

85 CA 2006, ss 399, 479–481.

86 Cf Blumberg (n1) 611; also Landers (n66) 597 who supports to determine the legal relations between affiliates in insolvency in accordance with both the policies underlying the legal rules and the business realities.

87 Ramesh (n67) para 19.

88 Davies, Worthington and Hare (n1) para 7-002–003; Ferran and Ho (n1) 16; Kokorin JCLS (n10) 557.

89 David Goddard, 'Corporate Personality – Limited Recourse and its Limits' in Charles EF Rickett and Ross B Grantham (eds), *Corporate Responsibility in the 20th Century* (Hart Publishing 1999) 11, 18.

90 Landers (n66) 617.

91 Davies, Worthington and Hare (n1) sec 8 para 1.

92 See Landers (n66) 618.

ings. The general shareholders of the plan company are generally in favour of restructuring, if and as long as it looks promising.[93] In insolvency proceedings, shareholders would be residual claimants and usually recover one-digit pence on the dollar. This bias towards restructuring can be extended to shareholders of other group companies. The melt-down and omission of one company in a group can have a domino effect which harms the investments of shareholders of affiliates, including those of the released affiliate. The latter itself is released from the guarantee claim and thus from the threat of financial distress, also beneficial to its shareholders. In relation to cross-shareholdings, limited liability is designed to protect the shareholding affiliates from claims of the principal debtor's creditors. However, it is the intra-group guarantees which open the door for exactly these claims, and the affiliated-party releases which protect the shareholding affiliates from these claims. By doing so, affiliated-party releases recreate the condition which applied under limited liability and which was only derived from through cross-guarantees. Hence, stimulating investment and protecting shareholders is not an argument against rescue-facilitating affiliated-party releases.

The rationale for separate corporate personality has to be extended to asset partitioning and entity shielding, though. Asset partitioning means for groups the segregation of collections of assets among group members.[94] Entity shielding ensures that assets of the company are shielded from the persons behind the company, especially from recourse claims of shareholders' creditors.[95] The group structure specifically aims at liability shielding and risk segmentation to prevent the 'domino effect' in case of financial distress of one group member.[96] Therefore, in relation to this rationale, separate legal personality benefits the companies or the group as a whole, respectively. However, contrary to the group's interest, the risk of group-wide contagion is exactly what is created through intra-group guarantees and has to be corrected through affiliated-party releases. To reach the goal of successful restructuring and prevent a domino effect, restructuring law has to 'correct' cross-liability arrangements in group restructurings and overcome separate legal personality. Unexceptionally sticking to this formal doctrine as a legal reason to prohibit affiliated-party releases would lead to results which are contrary to the doctrines' policies.

3. Cherry Picking and Potential for Abuse

Clearly, one could classify this as 'cherry picking', as groups secure finance through cross-liability arrangements in solvent times and getting rid of these claims in restructuring. This argumentation would miss the fact that restructuring does not

[93] Bork, *Rescuing Companies* (n52) para 3.03.

[94] Davies, Worthington and Hare (n1) para 7-006; Henry Hansmann and Reinier Kraakman, 'The Essential Role of Organizational Law' (2000) 110 Yale LJ 387.

[95] Dahnert (n58) 213; Ferran and Ho (n1) 12; Kokorin JCLS (n10) 557–558.

[96] Cf Robert P Austin, 'Corporate Groups' in *Corporate Responsibility* (n96) 74 Liebscher (n4) Annex sec 13 para 1322; Spahlinger and Kortz (n18) para 10.51; see Chapter 1.

only serve the group, but pursues broader goals, like keeping the business within the community, saving jobs, know-how and skills[97]. This might not hold true for the holding, but it does so for the operating subsidiaries, which are prevented from group-wide contagion through affiliated-party releases. In both UK and Germany there is a shift of fiduciary duties towards considering the interests of the *whole group* of creditors in case of financial distress, including the unsecured ones.[98] Cross-liability arrangements transfer wealth away from the unsecured creditors, thereby diluting their returns in insolvency.[99] Moreover, these arrangements are hidden from non-involved creditors and may lead to opportunistic value-destroying behavior of the debtor's management.[100] A release of these claims effectively tackles this dilution and increases the return for unsecured creditors. Policy-wise importantly, unsecured creditors are usually non- or weakly adjusting,[101] whereas the creditors of intra-group guarantees are typically strongly adjusting and can protect themselves against the increased risk by charging higher interest rates[102]. What is the catch of affiliated-party releases, then?

Albeit affiliated-party releases are essential, an inherent risk of abuse to wash of liabilities cannot be denied. The reciprocal dependencies created through intra-group guarantees also have a protective function. For example, parent guarantees discourage the parent from putting its subsidiary in liquidation if the operations are not going well and the subsidiary struggles financially.[103] To maintain this function, affiliated-party releases must be conditional on certain safeguards. One way to do so is to make company's access to restructuring procedures conditional upon financial distress since in this case affiliated-party releases are essential to avoid ricochet claims and group-wide contagion.[104] Moreover, restructuring laws may ensure that those affected by the releases, i.e. the creditors of intra-group guarantees, have a say in the restructuring plan and in any case are not worse-off in a restructuring against their will. If this is ensured, there can be no question of washing off liabilities.

V. Creditors' *Legitimate* Expectations

Fairness and creditor rights often drive the discussion about third-party releases.[105] The protection of creditors' interests in relation to cross-guarantees is an obvious

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97 Restructuring Directive (n5), Recital 2.

98 Germany: sec 43(1)(1) StaRUG (specifically for restructuring); UK: *BTI v Sequana* [2019] EWCA Civ 112 at [216], [222].

99 Kokorin EFCR (n6) 112; Squire (n78), 1213.

100 Kokorin EFCR (n6) 112; Jay L Westbrook, 'Transparency in Corporate Groups' (2018) 13 Brook J Corp Fin & Com L 33, 50.

101 See Davies, Worthington and Hare (n1) para 7-007.

102 Chapter VI below.

103 Norman Mugarura, 'Different types of guarantee schemes and their usage in safeguarding against default risks in international commercial practice' (2016) 58(5) Int J Law Manag 507, 514.

104 Chapter I above.

105 See *Purdue Pharma* (n45); *Re Vitro SAB de CV*, 701 F3d 1031 (1052) (5th Cir2012).

concern.[106] This is because through the affected creditors' lens, the compromise of their guarantee claim appears somehow odd. One could say, without a *quid pro quo*, the creditors are deprived of their protection in the exact case the guarantee was asked for in the first place. Thereby affiliated-party releases may frustrate legitimate expectations of these creditors.[107]. One argument goes that banks often do not care about their formal counterparty within groups and thus economically lend to the group as a whole.[108] The opposite pole is that sophisticated lenders are fully aware of the legal entity principle and deliberately choose which counterparty's insolvency risk to bear.[109] This paper argues that both statements seem to be part of the lending reality and the correlation between lending practice and expectations imply two consequences: Creditors' expectations require safeguards (2.), but cannot hinder the allowance of affiliated-party releases (1.).

1. No Obstacle for Affiliated-Party Releases

Given the prevalence of cross-liability arrangements, it is fair to say that creditors in some way economically lend to the group as a whole. If the borrowing company is an SPV without any notable assets, the lending bank may only examine the creditworthiness of the group.[110] This is evident where the lender insists on guarantees of all affiliates.[111] However, even if not, the frequent concern relating to treating groups as one entity in restructuring, i.e. that creditors would carry risks of group members they did not contract with,[112] does not apply. Affiliated-party releases only modify rights of creditors against group members they contracted with. Creditors cannot be surprised if the group is treated as one entity to the extent of intra-group guarantees, if there is a clear legal framework on this. This to say, as long as there is no statutory rule or caselaw, creditors can legitimately expect their guarantee claims against affiliates to be enforceable. However, if there is a clear system of affiliated-party releases, stating both its legality and its requirements, creditors cannot *legitimately* expect their intra-group guarantee claims to be enforceable in a group restructuring. In other words, if interference with creditors' rights against affiliated companies becomes a common feature in restructuring plans, the argument of frustrated legitimate expectations appears invalid.[113] Assuming that affiliated-party releases are allowed and since creditors somehow lend to the group as a whole, the first consequence is a lack of basis of trust to prohibit affiliated-party releases.

[106] See Hill (n9) 324.
[107] Kokorin EFCR (n6) 137–139; also Reinhard Bork, *Principles of Cross-Border Insolvency Law*, (Intersentia 2017) 143.
[108] Cf Humbeck (n18) 958; Ramesh (n67) para 21.
[109] Dahnert (n58) 224; Daniel Ereira and Paul Sidle, 'England and Wales' in Baer and O'Flynn (n18) para 8.16.
[110] Cf Kokorin EFCR (n6) 137–138 with reference to *Oi Brasil* (n21) where the offering memoranda of bond debt was based on the group as a one entity.
[111] To this practice Spahos (n1) 334.
[112] See Dahnert (n58) 224.
[113] Similarly Ramesh (n67) para 21.

2. Safeguards to Prevent Expropriation of Rights

Concerning the second aspect of the lending practice, there is a good argument to be made that lenders deliberately choose their guarantors. To state it differently, the parties interfere with the single entity principle, but at the same time assume its application.[114] Even further, lenders adapt their lending practice to its application. In case of lending to an SPV, the bank may well examine the guarantors' creditworthiness. Given this, the law has to provide safeguards to respect the commercial decision of having specific intra-group guarantors and protect the rights stemming therefrom. From the creditors view point, there is no basis of trust that guarantee claims are not included and compromised in the restructuring of the principal debtor, but there is a basis of trust that these rights are not expropriated without having a say and any *quid quo pro* for the loss of rights. The latter basis of trust applies even if the lender insists on guarantees of all affiliates.[115] This gets even more important if their released guarantor would be solvent enough to satisfy their claims. Otherwise, intra-group guarantees would become worthless and superfluous, if they can be compromised without any consequences in the exact case for which they were are granted.

VI. Legal Certainty to Limit Capital Cost Increases

The reciprocal correlation between creditor-friendly restructuring law or collateralization, respectively, and cost of capital is widely recognized.[116] Cross-guarantees are seen as an important factor to negotiate larger amounts and lower interest rates on loans as the guarantors assume the insolvency risk of the lending company.[117] Logically, if banks must assess the *ex-ante* risk of their guarantors being released in restructuring, they are likely to incur higher interest rates for the guaranteed loan in the first place.[118] Eventually, finance for group members and groups may be subject to significantly higher costs and collateral requirements. This reasonable forecast is underlined by the objections of financial institutions to any rule on third-party releases, either unionwide[119] or domestically[120]. The argument to support these releases, though, has two elements. Firstly, for a group the trade-off between higher capital costs and the possibility of saving the group in the event of restructuring may be in favour of the latter. One could say groups purchase the opportunity

[114] Hill (n9) 339.

[115] See n111.

[116] Finch and Milman (n1) 77; confirmed by John Amour, Antonia Menezes et al, 'How do creditor rights matter for debt finance? A review of empirical evidence' (2015), in Frederique Dahan (ed), *Secured Financing in Commercial Transactions* (Elgar 2015) 3, 25; for a critical discussion see Paterson, EFCR (n57) 494–498.

[117] Kokorin EFCR (n6) 111; Hill (n9) 340; Pleister (n24) 1098.

[118] European Commission (n16) 72–73 para 5.5.2.; see Pleister (n24) 1098.

[119] European Commission (n16) 74 para 5.5.2.

[120] Statement on the draft bill for the further development of restructuring and insolvency law by the German Association of the credit industry (*Verband der Kreditwirtschaft*), from 10 October 2020, 5.

of rescue-facilitating affiliated-party releases for the amount by which the cost of capital increases. Beside the restructuring benefit of continuing the business, affiliated-party releases avoid multiple restructuring proceedings, which ultimately saves costs elsewhere.[121]

Secondly, legal certainty about affiliated-party releases is capable of keeping the increase in capital costs at a minimum, as 'lenders will charge rates that reflect uncertainties.'[122] If the legal framework for affiliated-party releases is clear, lenders can adjust interest rates to reflect average levels of affiliated-party releases and their consequences. This allows lenders to gain experience regarding affiliated-party releases over time and assess the risk for a release and its adverse consequences. Eventually, this would result in lenders only charging for a greater risk, but not for uncertainties.

Nevertheless, affiliated-party releases may create an obstacle for group financing, if they are not subject to certain safeguards. This is because lenders may make intra-group guarantees a precondition for providing finance.[123] A worthless intra-group guarantee might turn out to be a deal-breaker. For this reason, the aim is to allow affiliated-party releases in group restructurings without making intra-group guarantees worthless. This seems to be walking a tightrope: By tipping the balance slightly into one of these directions, legislators and courts face the risk of either making it almost impossible for groups to obtain financing, or failing to provide instruments for effective group restructurings. A *quid pro quo* for the affected creditors seems to be an effective remedy, as then lenders obtain something for their loss of rights, even in case of a release. This limits the lenders' risk, maintains the value of intra-group guarantees, and eventually enables groups to obtain (affordable) funding.

C. Affiliated-Party Releases in the UK Part 26A Restructuring Plan and the German StaRUG

The UK Part 26A restructuring plan is based on the Part 26 scheme of arrangement[124], which is known for its efficiency in group restructurings.[125] It became a go-to procedure for foreign groups,[126] first and foremost for German groups[127]. The German legislator just recently introduced its first ever preventive Restructuring

[121] See Chapter 1.
[122] Finch and Milman (n1) 506; see also Hill (n9) 346–347.
[123] Spahos (n1) 334: 'the lender will normally insist on the execution of intra-group guarantees […] before committing himself to any financing arrangement.'; see also Hill (n9) 340; Pleister (n24) 1098.
[124] Hereinafter 'SoA'.
[125] Reinhard Bork, 'The Scheme of Arrangement' (2012) IILR 477, 478 and 489; Finch and Milman (n1) 412; Paulus, Bähr and Hackländer (n29) 1085.
[126] Finch and Milman (n1) 412 (Fn 18), 418; Westpfahl and Knapp (n30) 2036–2037.
[127] See the examples of *APCOA Parking (UK) Limited & Ors* [2014] EWHC 991 (Ch); *Primacom Holding GmbH v Credit Agricole* [2012] EWHC 164; *Re Rodenstock GmbH* [2011] Bus LR 1245.

framework (*StaRUG*), entered into force 1 January 2021. The safeguards and objectives examined in Chapter B provide the roadmap for the following analysis of the UK and German approach in relation to affiliated-party releases.

I. Effectiveness for Group Restructurings vs Abuse Prevention

1. Entry Barriers and Scope of Application

The lower the entry barriers, the higher the risk that debtors use the process to wash off liabilities. The German StaRUG requires financial distress of the debtor in form of 'imminent insolvency'[128]. Whereas the UK SoA can be used by solvent debtors,[129] Part 26A requires the company to face financial difficulties, similarly to the German StaRUG. Additionally, the purpose of the arrangement or compromise must be to eliminate, reduce or prevent, or mitigate the effect of these difficulties.[130] Recent caselaw shows that these entry requirements are to be interpreted very extensive,[131] which makes this approach still more flexible and earlier accessible than the German system of 'imminent insolvency'. Despite being a low hurdle, it is expected to prevent obviously solvent debtors from using the procedure, though. At the same time, it seems to be flexible enough to begin restructuring when it is promising and not too late for a turnaround.

Regarding the nature of cross-liability arrangements, the German StaRUG allows the release of cross-, down- and upstream guarantees and collateral, respectively. Sec. 2(4) StaRUG refers to sec. 15 of the Act on public Companies (*AktG*), which shows that all types of group members are eligible for a release. Sec. 15 AktG also covers foreign affiliates,[132] which must also apply to sec. 2(4) StaRUG.[133] Coming to third-party releases in the UK, 'it is well-established in English jurisprudence that a scheme can affect the rights of creditors against third parties,'[134] which proved to be true for restructuring plans.[135] Intra-group guarantees are eligible for a release in order to prevent intra-group ricochet claims and give effect to the plan.[136] However, relating to the parties and the nature of the claim the UK approach is broader in three aspects. First, in contrast to Germany, the UK also allows for the release of

[128] Sec 29(1) StaRUG.
[129] *Scottish Lion Insurance Co Ltd v Goodrich Corp* [2010] CSIH 6.
[130] Sec 901A CA 2006.
[131] *Re Virgin Atlantic Airways Ltd.* (convening hearing) [2020] EWHC 2191 (Ch) at [39]; *Re National Car Parks Ltd.* [2021] EWHC 1653 (Ch) at [49].
[132] Volker Emmerich in Volker Emmerich and Mathias Habersack (eds), *Aktien- und GmbH-Konzernrecht* (10th edn, C.H. Beck 2022) sec 15 AktG para 5.
[133] Westpfahl and Dittmar (n17) 46.
[134] Kokorin, Madaus and Mevorach (n11) 124.
[135] *Re Pizza Express Financing 2 Plc* [2020] EWHC 2873 (Ch) at [52]; *Re Gategroup Guarantee Limited* [2021] EWHC 304 (Ch) at [163]; *Re Virgin Active Holdings Ltd* [2021] EWHC 1246 (Ch) at [72]; *Car Parks* (n132) at [52]; *Re ED&F Man Holdings Ltd.*[2022] EWHC 433 (Ch) at [56].
[136] SoA cases *Re La Seda de Barcelona SA* [2010] EWHC 1364 (Ch) at [19]; *Re Lecta Paper UK Ltd* [2020] EWHC 382 (Ch) at [20]–[21]; Part 26A cases *Pizza Express* (n136) at [52]; *Gategroup* (n136) at [163]–[165]; *Virgin Active* (n136) at [72].

non-affiliated parties (insurers, auditors, advisors).[137] Whereas it is not entirely clear whether these non-affiliated-party releases require some form of ricochet claim,[138] both Germany and the UK seem to qualify a ricochet claim as prerequisite for third-party releases in intra-group constellations. Sec. 2(4) StaRUG is clear on this, stating that a collateral or guarantee claim against the affiliate is necessary for a release. It hereby presumes firstly, that a ricochet claim would always arise if the claim against the affiliated company were exercised and secondly, that the affiliate cannot be the plan company itself. The statement of *Snowden J* in *ColourOz Investment* stresses the decisive role of ricochet claims in relation to affiliated-party releases in the UK: 'This 'ricochet claim' would defeat the purpose of the scheme, since [the debtor] would ultimately remain liable for the very amount that was purportedly compromised by the scheme'[139]. Consequently, the existence of a ricochet claim is a prerequisite but at the same time sufficient for a release.

This leads to the second point: In the UK, this claim can even be artificially created through deed contribution,[140] which shows the traditionally high flexibility in English restructuring law. Therefore, the Part 26A plan company can be the principal debtor[141] or one of the debtors[142] or the guarantor itself through deed contribution. It is not clear whether German courts would accept this artificiality. With regards to abuse, this artificiality can be doubted, but it is still to embrace where group restructurings are deemed to fail without deed contribution since the lack of a ricochet claim would hinder affiliated-party releases. Accordingly, in the *ED&F case*[143], *Green J* expressly confirmed that deed contributions for affiliated-party releases are entirely appropriate. Thirdly, in the UK the compromised third-party claims can be contractual or tortious in nature,[144] whereas sec. 2(4) of the German StaRUG only covers intra-group collateral and guarantees.

As interim result, the scope of application for third-party releases in the UK restructuring plan is significantly wider than in the German StaRUG.

2. Broader UK Framework Matched by Safeguards

Albeit desirable from a rescue-oriented view, the English release approach increases the necessity for safeguards to prevent abuse and protect creditors against expropriation of their rights. Under English law, a release is only possible if the

137 *Re T&N Ltd (No 4)* [2007] Bus LR 1411 at [65]; *Lecta Paper* (n137) at [22].
138 Paterson, *Debt Restructuring* (n51) para 3.05.
139 Cf n48 at [72].
140 *Re Swissport Fuelling Ltd.* [2020] EWHC 1499 (Ch) at [10]; *Re Port Finance Investment Limited* [2021] EWHC 378 (Ch) at [62]; to Part 26A *Gategroup* (n136) at [174].
141 *Noble Group* (n15) at [21]–[24].
142 *Re NN2 Newco Ltd* [2019] EWHC 1917 (Ch) at [7], [29].
143 Cf n136 at [56].
144 *T&N* (n138).

claims against the plan company and the third party are sufficiently closely connected.[145] This requirement seems to be weakened by the English courts,[146] but is clearly fulfilled in relation to intra-group cross-liability arrangements. This was confirmed in *La Seda de Barcelona*[147]. Moreover, the release must be necessary to give effect to the arrangement[148]. This is most clearly satisfied if intra-group guaranteed debt is compromised, as the ricochet claim would hinder the arrangement.[149] As *Trower J* stated in *Swissport Fuelling*, claims against affiliates can be compromised 'in order to give complete finality to a compromise […]. This will be necessary where third parties have ricochet claims against the scheme company if the scheme creditors' claims against them are not compromised.'[150] Thus, both qualifications serve as a correction for the broad release of non-affiliated parties and are always fulfilled regarding intra-group guarantees. Since the German StaRUG limits the scope of releases to the intra-group context, such restrictions are obsolete in the StaRUG.

3. Results on Effectiveness and Abuse Prevention

In both jurisdictions, the debtor must be in financial difficulties to enter the restructuring plan. The UK courts handle this very extensive. In relation to affiliated-party releases, both frameworks appear very effective, as they are eligible for a release under both Part 26A as well as sec. 2(4) of the German StaRUG. The stricter requirements in the English regime regarding the connection between the parties and the claims as well as the case-by-case decision on the necessity of releases for the plan's success are based on the UK's broad approach, especially the release of non-affiliates, and may be considered redundant in the intra-group context. So far, the UK approach appears more pragmatic and rescue promoting, as (i) very early restructurings are possible, (ii) deed contribution is clearly permissible, and (iii) tortious claims against third parties are eligible for a release. This pragmatic approach comes with stricter examination of the creditors' protection under II., also considering the intercorrelation with capital costs.

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[145] *T&N* (n138) at [51]; *Re Lehman Brothers International (Europe) (No 2)* [2010] Bus LR 489 at [63]; *Seda Barcelona* (n137) at [22].
[146] Kokorin EFCR (n6) 124; *Noble Group* (n15) at [25].
[147] Cf n137 at [21]–[22].
[148] *Lehman* (n146) at [65]; *Noble Group* at [25].
[149] Chapter B above; also *ColourOz* (n48) at [72].
[150] Cf n141 at [56].

II. Measures to Protect Creditors and Maintain Value of Intra-Group Guarantees

1. Creditors' Benefits for the Release

Starting with the similarity in creditor rights, Plan 26A as well as StaRUG restructuring plans have to benefit those creditors whose rights against affiliates are released. However, the approach is different. German law provides a mandatory appropriate compensation for the release.[151] Even though this appears as an inflexible but precise requirement, there are uncertainties which may adversely affect the value and risk mitigating function of intra-group guarantees and ultimately the costs of capital. These include *inter alia* valuation issues regarding the subsidiary,[152] the question of the right reference for the compensation – the actual value of the collateral, its value in the alternative scenario,[153] or the financial status of the affiliate[154] – and the question who owes the compensation[155]. Moreover, there is also a mandatory compensation in case of cross-class cram-downs[156] and the relationship between these two compensation rules is everything but clear.[157] Lastly, the scope of the obligation is narrowed to situations in which there is no compromise of the principal claim, but a swap of securities or a change of the distributional order.[158] This is because accessory collateral depends in its existence and amount on the principal claim. By compensating the principal claim, the accessory collateral is *automatically* reduced, without an obligation to compensate.

Comparably, in the UK, the plan should make commercially sense and benefit plan creditors.[159] This qualification is met when the alternative of exercising the guarantee claims would negatively affect what the creditors would recover under the plan.[160] Given the rescue-facilitating function of affiliated-party releases which preserve the business' value, this condition is usually satisfied if liquidation or administration is the alternative. For example, in *La Seda de Barcelona* the release prevented the trigger of escalating group insolvencies and thereby benefitted the creditors.[161] This qualification protects creditors and at the same time appears more flexible than the German approach by acknowledging that there can be other benefits than monetary compensation. The same applies to the 'give and take' element in

[151] Sec 2(4)(1) StaRUG.
[152] Westpfahl and Dittmar, (n17) 47.
[153] Paulus, Bähr and Hackländer (n29) 1088.
[154] Hoegen and Kranz NZI (n10) 107–108.
[155] Ibid 108.
[156] Sec 26(2) StaRUG.
[157] Christoph Thole, 'Der Entwurf des Unternehmensstabilisierungs- und restrukturierungsgesetzes (StaRUG-RefE)' (2020) ZIP 1985, 1988; Westpfahl and Dittmar, (n10) 47.
[158] Westpfahl and Dittmar (n10) 47.
[159] To SoA Payne (n46) 24.
[160] Ibid.
[161] Cf n137 at [12].

English law.[162] In context of third-party releases, this element must be established between the third party and the creditor.[163] It must not entail monetary compensation, but can include indirect short- or long-term benefits like the group's financial stability.[164] Noteworthy, it seems that courts sometimes refer to affiliated-party releases being well-established rather than strictly examining this requirement, e.g. in *Noble Group*[165], *Re All Scheme Ltd*.[166] (both SoA) and *Pizza Express*[167] (Part 26A). Creditors are still protected through the commercial reasonableness test of the plan, though.

2. Creditors' Voting Rights

With regard to creditors 'having a say' in the restructuring, the StaRUG and Part 26A forgo a majority in number within the classes and just require 75% majority in value,[168] which supports restructuring and is to embrace. A further part of creditor protection is class constitution.[169] In Germany, creating one class with creditors whose rights from intra-group guarantees are affected by the plan is mandatory.[170] As a result, these creditors vote within the class of creditors with released intra-group guarantees and within the class of 'general' creditors affected by the restructuring plan.[171] In the UK, there is also a statutory rule on class composition in Part 26A[172], but broader and less clear than the German rule. Traditionally, class composition in the UK includes practical considerations on a case-by-case basis.[173] In principle, the considerations for class composition in Part 26 schemes apply,[174] modified through the differences between the procedures. Broadly, the decisive point is that the persons within the class have *rights* which 'are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.'[175] The following overview consisting of three conclusions shows that English courts reach both flexibility and protection of creditors when sanctioning the class composition regarding third-party releases.

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162 To SoA ibid at [16]; *Swissport* (n141) at [46]; *Lehman* (n146) at [28]; to Part 26A *Virgin Atlantic* (convening, n132) at [38]; *Pizza Express* (n136) at [27]; *Re Smile Telecoms Holdings Ltd* [2022] EWCH 740 (Ch) at [27]; *Car Parks* (n132) at [56].
163 See Payne (n46) 24.
164 Kokorin EFCR (n6) 123.
165 Cf n15 [24].
166 [2022] EWCH 549 (Ch) at [49].
167 Cf n136 at [52].
168 Sec 25(1) StaRUG and sec 901G CA 2006.
169 See Bork, IILR (n126) 482.
170 Sec 9(1)(3) StaRUG.
171 Westpfahl and Dittmar (n10) 47.
172 Sec 901C(3) and (4) CA 2006.
173 *Port Finance* (n141) at [78].
174 *Virgin Atlantic* (convening, n132) at [41]–[42].
175 *Sovereign Life Assurance Co (In Liquidation) v Dodd* [1892] 2 QB 573, 583; *NN2* (n143) at [43]; *Swissport* (n141) at [61]; *Port Finance* (n141) at [76]; *Car Parks* (n132) at [58]; *ED&F* (n136) at [59]–[61].

Creditors of different kinds of third-party claims can, but not have to be separated into different classes. In *Noble Group*, *Snowden J* stated in relation to class composition and third-party releases: '[I]t seems to me that the releases of any claims 'arising out of, relating to or in respect of the Scheme Claims […]' must fall into the same category.'[176] However, a statement in *NN2 Newco* suggests that different kinds of rights against affiliates can result in another class composition, as *Norris J* commented in relation to the noteholder class: 'Rights against guarantors are likewise identical.'[177] This suggests that, if rights were different, separate classes may become necessary.

If it facilitates restructuring and does not adversely affect these creditors, creditors with third-party claims and sole creditors of the plan company can vote in one group. In *All Scheme*, those creditors with possible redress claims against an affiliate had to vote in one group with the Financial Ombudsman Service, which was entitled to a fixed fee.[178] The reasoning was that '[a]ll such creditors have claims that would be unsecured in an administration'[179]. However, the court admitted that this can be different if the vote of the creditors without claims against affiliates could be determinative for reaching the majority threshold.[180]

3. The Sanction Hearing

Lastly, this paper shortly discusses the protection at the sanction stage. The German courts solely examine the legality of the plan, not its expediency.[181] The court does not sanction the plan if the applicant is worse off under the plan than in the alternative scenario.[182] However, considering the aforementioned obligation to adequately compensate creditors whose claims against affiliates are compromised, these creditors would never be worse off under the plan.[183] In the UK, the courts only sanction the plan if it is fair and reasonable, i.e. whether an intelligent and honest member of the class could reasonably approve the scheme[184]. So, the courts even examine the expediency of the plan, although they are very reluctant to interfere with creditor-approved plans.[185] This is different in a cross-class cram down, when creditor protection becomes even more important.[186] In general, the requirements for a

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[176] Cf n15 at [24].
[177] Cf n143 at [45].
[178] Cf n168 at [5], [54]–[56].
[179] Ibid at [54].
[180] Ibid at [57].
[181] Thole (n158) 1997.
[182] Sec 64 StaRUG.
[183] Westpfahl and Dittmar, (n10) 48.
[184] To SoA *Re Anglo-Continental Supply Co. Ltd* [1922] 2 Ch 723; *Lecta Paper* (n137) at [15]; to Part 26A *Virgin Atlantic* at [21], [68].
[185] Cf Sarah Paterson, 'Judicial Discretion in Part 26A Restructuring Plan Procedures' (2021) 10–11, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4016519 10, accessed 2 August 2022.
[186] *Re DeepOcean I UK Ltd* [2021] EWHC 138 (Ch) at [21] and [41]–[47]; how exactly is not entirely clear hitherto, cf Inga West, 'Reflection on a year of restructuring plans' (2021) 34(3) Insol

cross-class cram down differ. In Germany, the majority of classes have to vote in favour of the plan,[187] which is more difficult to achieve than the approval of one affected class, like in the UK[188].

III. Summarised analysis of the UK and German approach

Conclusively, in the German framework, creditors whose guarantee claims are compromised clearly vote in a separate class and are entitled to adequate compensation. Furthermore, the German StaRUG only provides for a legal assessment at the sanctioning stage. This is consequent given the clearly defined scope of application, which yet effectively covers all claims against affiliates. Creditor protection seems to be equally ensured in the UK through the flexible requirements of commercial reasonableness, elements of 'give and take' and discretionary class composition, but accompanied by a more rescuing-friendly pragmatism. The same is true for affiliated-party releases in combination with cross-class cram downs, where both jurisdictions basically apply a 'no worse off' test, but the UK having a lower threshold to cram down a class of dissenting voters. The more creditor rights are on the line, the stricter the UK courts' examination, especially the 'no worse off' test.[189] As a result, flexibility to effectively restructure businesses, especially groups, is complemented by appropriate protection devices. This is reflected in the refusal to sanction the plan in *Re Hurricane Energy Plc*[190].

D. Conclusion

Affiliated-party releases are necessary for every restructuring-friendly legal framework. They prevent rescue-hostile intra-group ricochet claims and group-wide contagion, incentivize early filing and address economic reality. Moreover, the instrument is expected to change the environment in negotiations by giving the debtor a 'trump card' of threating those releases. The doctrine of separate legal personality cannot hinder affiliated-party releases. The same applies for the argument of frustrated creditors' expectations. However, the law has to provide safeguards to ensure that creditors' rights are not expropriated and affiliated-party releases are not abused to wash off liabilities. Through this measures, cross-liability arrangements would still be valuable for lenders and make capital affordable for groups.

The German approach on affiliated-party releases is effective and fits well into the preventive restructuring framework of the StaRUG. Compared to the UK, however, the German StaRUG is more cautious with regard to affiliated-party releases and

Int 62, 63; Paterson, Judicial Discretion (n185) 17 et seqq proposed a new structured discretion framework.

[187] Sec 26(1) No 3 StaRUG.

[188] Sec 901G CA 2006.

[189] *Virgin Atlantic* at [25]–[26]; *Virgin Active* (n136) at [106]; *Smile Telecoms* (n163) at [28]–[30].

[190] [2021] EWHC 1759 (Ch).

provides clear rules on creditor protection, e.g. on class composition and compensation obligations. The latter is subject to open questions which are to be solved through German courts and until then may adversely affect interest rates due to uncertainty for lenders.

Comparably, the UK is more flexible and pragmatic in relation to third-party releases, as protection is primarily ensured through discretion, while reaching the same level of protection. Differences in the English system relating to the parties' relationships and the claims relate to the fact that English third-party releases go beyond intra-group guarantees. Elements like flexible class composition, deed contribution, extensive interpretation of 'financial difficulties' to enter the plan and a broad understanding of *quid pro quo* for the creditors form an overall picture of a pragmatic but protective affiliated-party regime. Which is to embrace is that both systems allow for cross-class cram downs and protect creditors through the 'no worse off' test, even though the German framework is more cautious regarding the prerequisites to bind dissenting classes.

All in all, the German affiliated-party release approach is suitably tailored to group restructurings. It recognizes economic reality and is as a huge step towards becoming restructuring-friendly. However, Part 26A can be said to be one small step ahead in relation to affiliated-party releases. It is more flexible and practical in terms of creditors' benefits and participation while ensuring creditor protection at the same time.