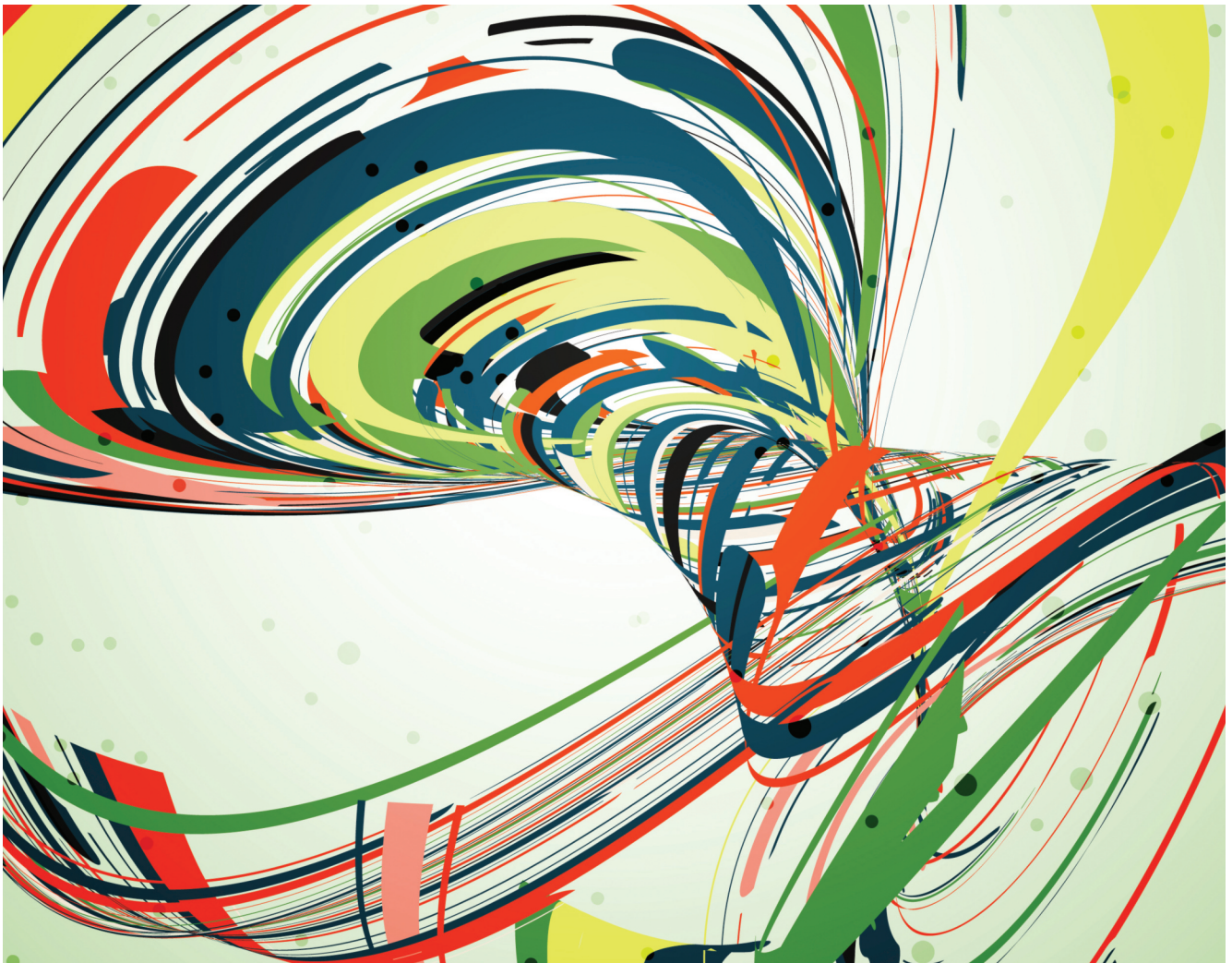


# CROSS-BORDER FINANCING REPORT

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### Germany

Thomas Weitkamp and Max von Cube, Latham & Watkins

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### SECTION 1: MARKET OVERVIEW

#### **1.1 Please provide an overview of the market and environment for cross-border financing in your jurisdiction.**

In the German market, market participants use cross-border financing for a variety of different purposes, including acquisitions, refinancings and leveraged buyouts (LBOs). LBOs are usually financed by way of senior debt provided by banks or institutional investors, and/or by way of (high yield) bonds. In particular, with respect to the mid-cap market, the market share of debt funds providing unitranche financings has increased significantly. Unitranches and high yield (HY) bonds are usually supported by revolving credit facilities provided by banks for general corporate purposes. Corporate financing is regularly structured as bank loans and, depending on the size, combined with bonds.

As in many other European jurisdictions the total deal flow as well as the total deal volume in Germany was significantly higher in 2017 than in the preceding years, with Germany amongst the three most active European countries in terms of number of deals and volume of LBO transactions and senior loans in general. Covenant-lite terms have become widely accepted at least with respect to large-cap deals; however, they are less common in the mid-cap sector (although the market has successfully tried to structure covenant-lite transactions with debt volumes down to €200 million, or \$233.3 million approximately). The majority of transactions in 2017 (and so far in 2018) were refinancings and LBOs/acquisitions. However, we have also seen more HY bonds issued by German corporates including several first-time issuers. The availability of HY bonds as a financing instrument depends on the volume raised and the issuer's rating. Due to the flexibility provided, bonds have been valued by an increasing number of corporates. In addition, the issue of bonds pursuant to German law (SchVG) has become more common, which makes it easier for German midcap

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Thomas Weitkamp is a partner in the Munich office of Latham & Watkins.

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## SECTION 2: FINANCING STRUCTURES

### 2.1 What have been the key trends or developments in your jurisdiction over the past 12 months in terms of financing structures, deal drivers and the way borrowers and creditors are participating in the market?

An increasing number of transactions are being structured and organised by external debt advisors.

The erosion of documentary terms seen in the European market in general can also be seen in the German market. Covenant-lite terms, EBITDA adjustments and more flexibility with respect to the incurrence of additional debt are examples of such sponsor-friendly terms. Further to large-cap transactions, these are now also seen in mid-cap documents. Unitranche /super senior structures have been chosen in various leveraged finance transactions where sponsors balance higher leverage multiples in direct lending deals against lower pricing in bank financings.

### 2.2 Briefly outline some recent notable transactions involving your jurisdiction, highlighting any interesting aspects in their structures and what they might mean for the market.

We have seen various new debt funds pushing into the German market. The competition among debt funds and also among banks and debt funds, has significantly increased. Sponsors use the competition for very competitive selection processes, which increases the pressure on terms and documentation.

In 2017, one of the biggest ever German private equity transactions, the public takeover of Stada Arzneimittel by Bain Capital and Cinven was financed by €2.35 billion of bank loans and €1.1 billion of dual tranche bonds. The Stada acquisition was the first public takeover in Germany to use a financing package which included bonds.

In 2018, the first covenant-lite transaction with a volume below €250 million in the European market was arranged out of Germany.

corporates to get access to the market.

In recent years, the market has moved in favour of borrowers/issuers, resulting in a decrease in yield and an erosion of documentary terms. However, this development may have slowed down, as lender pushback and negotiations during syndication have led to an increased use of flex rights in the lenders' favour. In 2018, there have been some transactions with significant difficulties with syndication, resulting not only in changes to the pricing but also in changes to the structure (eg conversion of an all-senior structure into a senior/second lien structure).

### 1.2 Have there been interesting changes in the structure of the banking sector in your jurisdiction?

Although they have been in the market for a while, debt funds providing unitranche financings are currently gaining a bigger share of the market with respect to mid-cap financings, whilst also increasing the size of the tickets they are able to hold. Their competition with banks also leads to pressure on pricing and documentation. Due to the acceptance of debt funds as market participants, an increasing number of banks have started to focus on super senior financing by way of revolving credit facilities, as well as participating in term loans with a first-out/second-out structure.

## SECTION 3: LEGISLATION AND POLICY

### 3.1 Describe the key legislation and regulatory bodies that govern cross-border financing in your jurisdiction.

Financing activities such as lending or providing guarantees generally require a licence by the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) pursuant to the German Banking Act (*Kreditwesengesetz*). The licence requirement not only applies to entities located in Germany, but also to entities located outside of Germany, providing they actively target the German market with the intention of offering their services/products to German customers on a repeated basis. However, under certain circumstances, exemptions from the licence requirement apply, including for example in the following cases:

- The services/products are not actively offered by the foreign provider but requested by the client (reverse solicitation).
- The services/products are offered by an EEA-institution holding a corresponding licence in its home member state (passporting).
- BaFin granted an exemption from the licence requirement (requiring, inter alia, a respective application and effective home country supervision).
- The lender does not extend the loan but only acquires loan receivables.
- The lender is an alternative investment fund (AIF).

Financing activities involving financial instruments, eg (debt) securities and certain other forms of (debt) instruments (*Vermögensanlagen*), may also fall in scope of German financial regulatory law. The public offering of securities for example generally requires a prospectus under the Securities Prospectus Act (*Wertpapierprospektgesetz*) unless an exemption applies (eg offering to qualified investors, limited number of offers, limited amounts). Certain intermediary services relating to financial instruments such as brokerage, placement, and underwriting also generally require a licence by BaFin, and may be subject to the conduct rules set forth in the Securities Trading Act (*Wertpapierhandelsgesetz*).

### 3.2 Have there been any recent changes to legislation or regulations that may impact the cross-border financing market or availability of funding in your jurisdiction?

There have been no recent changes having significant impact specifically on cross-border lending activities.

### 3.3 Are there any rules, legislation or policy frameworks under discussion that may impact lenders or borrowers involved in cross-border financing in your jurisdiction? How can market participants prepare?

Upon the occurrence of Brexit, UK entities would be treated as non-EEA entities and thus would no longer be able to provide their services in Germany under a UK licence based on the EU passport privilege (unless agreed otherwise in the pending EU/UK Brexit-negotiations).

## SECTION 4: LOCAL MARKET NORMS

### 4.1 Are there frequently asked questions from new market entrants or often overlooked areas from parties involved in cross-border financings in your jurisdiction?

Under German law, in insolvency proceedings, shareholder loans become automatically subordinated to other creditors' claims. Repayments of any shareholder loans are subject to a one year claw-back period immediately preceding the filing for the opening of insolvency proceedings, regardless of whether the respective repayment occurred in a financial crisis or otherwise.

In a German court ruling, third parties were treated as quasi-shareholders (and therefore subordinated creditors in its debtor's insolvency) if they had a 'shareholder-like influence' on the borrower. Following this decision, it has become controversial whether financial institutions, which, for example, through tight undertakings and a comprehensive security package take certain control over the business of the borrower, could be treated as such quasi-shareholders. It

is, however, common market practice to use standard covenant and security packages.

A recent German court ruling declared fee arrangements as being general terms and conditions to the detriment of the borrower void, requiring the pricing of a loan to be fully included in the interest. The ruling has particularly raised uncertainty as to what extent arrangement fees in syndicated loans are still valid. Market participants should be prepared for discussions on alternative fee concepts.

### 4.2 Please describe any common mistakes or misconceptions that exist about the financing market in your jurisdiction.

German law provides for a number of security rights that are accessory to the existence of the secured claim. In particular, pledges can only be granted directly in favour of the creditor of the secured claim and are limited to the respective amount of such claim. In case of a transfer of a participation in a syndicated loan, the new lender needs to benefit from the existing security. A problem arises where the secured claim temporarily ceases to legally exist (eg by way of novation), as the pledges fall away in such situation. One way of addressing this is the pledges securing parallel debt (equal to outstanding debt amount) in favour of the security agent. The 'future pledgee' concept is another option by which the security agent acts as an attorney without the power of representation for future lenders who will then declare their consent by signing the respective transfer certificate. Both of these concepts are common practice, but have never been tested in court.

### 4.3 Are there any classes of assets over which security cannot be taken or regulations specific to your jurisdiction governing the taking of security over certain classes of assets that lenders should be aware of?

Essentially all classes of assets can be taken as security under German law with very few limitations (eg certain IP rights). However, there is no global instrument granting security over all assets (such as a floating charge). Furthermore, no lender may receive or hold security excessive in value in comparison to the amount of the secured obligations.

Pledges over shares in a German company with limited liability (GmbH) need to be created by way of a notarial deed. This creates further significant costs that need to be taken into account. The former approach, namely to have the notarisation take place in Switzerland has been abandoned by most market participants after a German court ruling put the validity of such pledges under doubt.

#### 4.4 What measures should be taken to best prepare for your local market norms?

Parties should seek advice from a local law firm and involve them in the process at an early stage to ensure that any issues with respect to timing or costs are addressed or avoided.

## SECTION 5: PRACTICAL LEGAL CONSIDERATIONS

### 5.1 Briefly explain (i) the typical security package available at closing and (ii) any downstream, upstream and cross-stream guarantees available in your jurisdiction, in each case, with reference to any specific restrictions or limitations.

Typically, for LBOs only security over shares in the initial borrower (BidCo), as well as security over HoldCo's and BidCo's assets, are available at closing. A security package from the operating companies (e.g. land charges (real estate), security transfer (movable assets), pledges (shares, bank accounts, global assignment (receivables)) can only be obtained following closing, ie after the target company has been acquired.

Up- and cross-stream guarantees/security are subject to capital maintenance rules applicable to stock corporations (*Aktiengesellschaft*), limited liability companies (*Gesellschaft mit beschränkter Haftung*) and limited partnerships (*Kommanditgesellschaft*) with a limited liability company as general partner. A violation of such capital maintenance provisions may lead to a personal liability of its directors. The common approach addressing this is a so-called limitation language, which ensures (subject to certain exceptions and adjustments) the preservation of the stated capital (*Stammkapital*). This may lead to a substantial

decrease in value of the guarantee/security but is widely accepted by market participants. Following recent court rulings leading to uncertainty as to whether the test for the preservation of the stated capital should apply at the time of granting or of enforcing the security, the leverage market has reverted to applying the test on enforcement.

For stock corporations the rules applicable to up- and cross-stream payments are even stricter and prohibit (subject to certain exceptions) the making of payments to stockholders except for distributions of balance sheet profit. This applies to upstream guarantees or security accordingly. In addition, a stock corporation is prohibited from giving financial assistance by supporting a third party on the acquisition of shares in the stock corporation, including by way of (up-stream) guarantees/security for any acquisition debt.

### 5.2 Are there any specific issues or challenges creditors should be mindful of regarding an insolvency or restructuring situation? Have there been any major judicial changes to the insolvency system (or related judicial decisions) in your jurisdiction recently? How long does an enforcement process typically take?

In insolvency proceedings, in certain circumstances the insolvency administrator may challenge the creation of security interest granted over the assets if the creation was to the disadvantage of other creditors. The risk of such claw-back rights can be significantly reduced if the relevant security is structured in the form of a cash transaction (i.e., the debtor receives an arm's-length benefit in connection with and within a short period of time following the creation of the security). In such case, the security can only be challenged based on the criteria of an intended damage claw-back right, which means that (a) the debtor had the intention to disadvantage its creditors and (b) the beneficiary was aware of such intention. This will prove difficult because cash transactions are indications against these criteria. Claw-back rights can no longer be exercised once the applicable hardening periods (from three months up to 10 years) have expired.

Further recent changes in law provide for insolvency proceedings for a group of

companies, eg by insolvency proceedings of all group companies being dealt with by one court, and of a restructuring procedure before an actual insolvency takes place. The overall intention is to strengthen the position of both debtors and creditors in order to prevent a loss of value.

The duration of an enforcement process depends on the individual security right. Different rules apply to accessory security rights, non-accessory security rights and security interests over real estate. While a share pledge enforcement, for example, can be realised within a few months, the enforcement of security over real estate can take significantly longer depending on the circumstances. Enforcement may generally be achieved by way of a sale or, in the case of monetary rights, by way of collection. In case of pledges, the relevant assets need to be sold (with certain limited exceptions) by way of a public auction.

## SECTION 6: OUTLOOK

### What are your market outlook predictions for the next 12 months in cross-border financing in your jurisdiction?

We expect a further increase of unitranche/super senior financings provided by debt funds and banks. Banks seek larger commitments in such transactions subject to limitations set by debt funds which are keen to maintain control over the main terms of the financing documentation.

We further expect that underwritten transactions will be structured more carefully in order to avoid further failures in syndication and sponsors ending up with less favourable terms than initially achievable. The trends in the US and the UK markets will continue to have a significant influence on the German market.

The bond market is difficult to predict. On LBO transactions we believe that sponsors will try to use the loan market for more certainty of funding. Issuers will try to find the right window for the offering of the bonds.

Overall, the enormous liquidity pressure in the market will, in our view, see a very busy year-end in 2018, in which sellers will use relatively low pricing for acquisition debt to compete in auctions involving high purchase prices.



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