The Acquisition and Leveraged Finance Review

Fourth Edition

Editor
Christopher Kandel

The LawReviews

THE ACQUISITION AND LEVERAGED FINANCE REVIEW

The Acquisition and Leveraged Finance Review
Reproduced with permission from Law Business Research Ltd.

This article was first published in The Acquisition and Leveraged Finance Review, - Edition 4

(published in September 2017 – editor Christopher Kandel)

For further information please email
Nick.Barette@thelawreviews.co.uk

The Acquisition and Leveraged Finance Review

Fourth Edition

Editor
Christopher Kandel

The Law Reviews

PUBLISHER
Gideon Roberton

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

BUSINESS DEVELOPMENT MANAGERS
Thomas Lee, Joel Woods

ACCOUNT MANAGERS
Pere Aspinall, Sophie Emberson,
Laura Lynas, Jack Bagnall

PRODUCT MARKETING EXECUTIVE
Rebecca Mogridge

RESEARCHER
Arthur Hunter

EDITORIAL COORDINATOR
Gavin Jordan

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Claire Ancell

SUBEDITOR
Anne Borthwick

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN 978-1-910813-78-2

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

THE LAW REVIEWS

THE MERGERS AND ACQUISITIONS REVIEW

THE RESTRUCTURING REVIEW

THE PRIVATE COMPETITION ENFORCEMENT REVIEW

THE DISPUTE RESOLUTION REVIEW

THE EMPLOYMENT LAW REVIEW

THE PUBLIC COMPETITION ENFORCEMENT REVIEW

THE BANKING REGULATION REVIEW

THE INTERNATIONAL ARBITRATION REVIEW

THE MERGER CONTROL REVIEW

THE TECHNOLOGY, MEDIA AND
TELECOMMUNICATIONS REVIEW

THE INWARD INVESTMENT AND
INTERNATIONAL TAXATION REVIEW

THE CORPORATE GOVERNANCE REVIEW

THE CORPORATE IMMIGRATION REVIEW

THE INTERNATIONAL INVESTIGATIONS REVIEW

THE PROJECTS AND CONSTRUCTION REVIEW

THE INTERNATIONAL CAPITAL MARKETS REVIEW

THE REAL ESTATE LAW REVIEW

THE PRIVATE EQUITY REVIEW

THE ENERGY REGULATION AND MARKETS REVIEW

THE INTELLECTUAL PROPERTY REVIEW

THE ASSET MANAGEMENT REVIEW

THE PRIVATE WEALTH AND PRIVATE CLIENT REVIEW

THE MINING LAW REVIEW

THE EXECUTIVE REMUNERATION REVIEW

THE ANTI-BRIBERY AND ANTI-CORRUPTION REVIEW

THE CARTELS AND LENIENCY REVIEW

THE TAX DISPUTES AND LITIGATION REVIEW

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

BHARUCHA & PARTNERS

DLA PIPER WEISS-TESSBACH RECHTSANWÄLTE GMBH

ESTUDIO BECCAR VARELA

FALUDI WOLF THEISS ATTORNEYS AT LAW

GILBERT + TOBIN

HANNES SNELLMAN ATTORNEYS LTD

KOLCUOĞLU DEMIRKAN KOÇAKLI ATTORNEYS AT LAW

LATHAM & WATKINS

LINKLATERS LLP

MAGNUSSON DENMARK

PINHEIRO NETO ADVOGADOS

SOŁTYSIŃSKI KAWECKI & SZLĘZAK

STRELIA

VANDENBULKE

WALDER WYSS LTD

CONTENTS

PREFACE

Acquisition and leveraged finance is a fascinating area for lawyers, both inherently and because of its potential for complexity arising out of the requirements of the acquisition process, cross-border issues, regulation and the like. It can also cut across legal disciplines, at times requiring the specialised expertise of merger and acquisition lawyers, bank finance lawyers, securities lawyers, tax lawyers, property lawyers, pension lawyers, intellectual property lawyers and environmental lawyers, among others. An additional area of complexity and interest at the moment comes out of market forces that are driving convergence in the large cap leveraged financings between loan and high-yield bond products generally, as well as between different markets (particularly pressure on markets outside the United States to conform to terms available in the US market but sometimes also vice versa), and increasingly the market is debating whether to adjust for differences in bankruptcy, guarantee or security regimes, and frequently deciding not to.

The Acquisition and Leveraged Finance Review is intended to serve as a starting point in considering structuring and other issues in acquisition and leveraged finance, both generally but also particularly in cases where more than just an understanding of the reader's own jurisdiction is necessary. The philosophy behind the sub-topics it covers has been to try to answer those questions that come up most commonly at the start of a finance transaction and, having read the contributions, I can say that I wish that I had had this book available to me at many times during my practice in the past, and that I will turn to it regularly in the future.

Many thanks go to the expert contributors who have given so much of their time and expertise to make this book a success: to Nick Barette, Gideon Roberton and Gavin Jordan at Law Business Research for their efficiency and good humour, and for making this book a reality; and to the partners, associates and staff at Latham & Watkins, present and past, with whom it is a privilege to work. I should also single out Sindhoo Vinod, Aymen Mahmoud, Angela Pierre and Oliver Browne for particular thanks – their reviews of my own draft chapters have been both merciless and useful.

Christopher Kandel
Latham & Watkins LLP
London
August 2017

Chapter 10

GERMANY

Andreas Diem and Christian Jahn[1]

I OVERVIEW

The recent developments in the European leverage loan market are reflected in the German local market. As there is considerable liquidity in the market, the number of primary leveraged buyouts (LBOs) is increasing. The total deal flow in 2016 was again higher than in the preceding year, and reached a 10-year-high by the end of the first quarter of 2017. However, a vast part of the recent market activity is attributable to refinancings rather than new money transactions. In the first quarter of 2017, as opposed to preceding quarters, the market returned to being dominated by refinancings, repricings, add-on financings and recapitalisations. There has been a number of large-cap acquisitions and mid-cap LBOs are stable at a relatively high level. Large-cap transactions are typically financed with high-yield bonds, mid-cap acquisitions with bank debt from domestic banks (the majority of which are currently club deals). However, debt funds providing unitranche financings, as well as senior debt financings, have significantly grown in the German market in recent years and competition between banks and debt funds (resulting in further pressure on pricing and documentation) is expected to continue to increase. With respect to large-cap deals, in particular cross-border financings provided by institutional investors, but increasingly also by banks, covenant-lite terms are widely accepted. In the mid-cap market, conditions are more traditional. Most lenders require a leverage covenant (covenant-loose) and often even the full set of covenants. On the other hand, terms of low-leveraged deals continue to become increasingly similar to corporate-style structures.

II REGULATORY AND TAX MATTERS

i Licensing requirements

The German Banking Act requires the authorisation of entities providing banking services (including lending activities). Authorisation (being licensed in Germany or 'EU passported') is generally required if an entity is conducting banking business in Germany commercially or on a scale that requires a commercially organised business undertaking.

When it comes to foreign lenders, the practice of the German banking supervision is that such authorisation is not only required if a foreign lender operates permanent establishments or branches in Germany, but also if it turns to the German market from abroad in a targeted manner in order to repeatedly and in a businesslike manner or on a commercial basis (i.e.,

1 Andreas Diem and Christian Jahn are partners at Latham & Watkins LLP.

with the intention of a certain degree of regularity, not necessarily an intention to realise profits) provide financial and bank business in Germany;[2] however, a special authorisation is generally not required in the following cases:

a Reverse solicitation: a person or company having its registered office or ordinary residence in the Federal Republic of Germany demands services on its own initiative from a foreign provider (non-solicitation exception). Note, however, that the distinction between reacting to an approach with a credit offer and taking executive action always requires an overall appraisal of all circumstances and must be analysed on a case-by-case basis.

b Acquisition of loans: the acquisition of loans is generally outside the scope of banking licence requirements. However, the restructuring of the loan after its acquisition may be deemed a regulated lending activity.

c Credit funds: pursuant to a legislative change that became effective on 18 March 2016, certain alternative investment funds (AIFs) and their managers (AIFMs) may originate loans within and into Germany if the loan origination forms part of their collective portfolio management (subject to certain requirements and restrictions).[3] AIFs not covered by this exemption have at least more flexibility with regard to the restructuring of loans. The exemption not only applies to German AIFs and AIFMs, but also to EU-AIFs and AIFMs and third-country AIFs and AIFMs (subject to a notification procedure that requires that the third country complies with the minimum standards of the AIFM Directive).

If none of the exceptions applies, the only way for the foreign lender to legitimise cross-border lending transactions in Germany is to obtain an exemption from the authorisation requirement.[4] The legal requirement for an exemption is that 'the entity does not require supervision, given the nature of the business it conducts'. In general, this only applies if the company is effectively supervised in its home country in accordance with internationally recognised standards and the competent home country authority cooperates satisfactorily with the German Financial Services Supervisory Authority (BaFin).

ii Taxes and fees

Generally, in Germany there are no withholding taxes (WHT) payable on (fixed) interest by persons who are not tax resident in Germany. As an exception to this rule, however, the granting of security interests in German real estate or certain German rights is subject to limited tax liability and may therefore trigger WHT on any interest payable for the secured loan (no matter where the lender, borrower or grantor of security is domiciled). In addition, real estate transfer tax may be levied on the purchase price of real estate when enforcing a mortgage or land charge. As a further exception, profit participating loans may trigger non-tax resident taxation and WHT on the respective interest payments.

Under German law, the typical issue of achieving deductibility of interest expense of the acquiring entity against operating income of the target can be solved by way of a

2 Section 32, paragraph 1, sentence 1 in conjunction with Section 1, paragraph 1, sentence 2, No. 2 of the German Banking Act.

3 Section 2, paragraph 1, No. 3b-d of the German Banking Act.

4 Section 2, paragraph 4 of the German Banking Act (and Section 2, paragraph 5, which will come into force as of 3 January 2018).

profit-and-loss-pooling agreement between the two entities creating, given certain circumstances, a fiscal unit or tax group between them. Such fiscal unit causes the revenues of the controlled entity to be allocated to the controlling entity when calculating corporate and trade taxes.[5] It should be noted, however, that the German law 'interest barrier' provides that deductibility of interest expenses exceeding interest revenues is generally limited to net interest expenses equal to 30 per cent of the relevant entity's earnings before interest, tax, depreciation and amortisation.[6]

Granting the loan is exempt from VAT; however, lenders may opt to subject interest payments under the facility agreement to VAT at a rate of 19 per cent. In this case, a liquidity advantage may arise for the lender due to an increased percentage of input tax deduction; however, for the borrower this corresponds with a negative temporary, or even definitive, liquidity effect. Hence, the exclusion of such option under the facility agreement is typically discussed between borrower and lender from a commercial perspective.

There are no stamp duties or documentary taxes in connection with the execution and performance of facilities or security agreements under German law. The registration of land charges and mortgages with the land register will trigger a registration fee the amount of which depends on the value of the relevant security interest. A pledge over shares or partnership interests, or both, as well as the granting of a security interest over real estate and a submission to foreclosure in connection with the latter, will require the involvement of a notary and therefore trigger notarial fees. Their amount will also depend on the value of the underlying transactions.

When it comes to pledges over shares in a German limited liability company, there have been discussions around the validity of a notarisation of such pledge by a Swiss notary (which for some time has become quite common in practice in order to save fees). The German Federal Supreme Court (BGH) ruled that notarisation of a share transfer by a foreign notary is generally valid and binding if the function of that notary is equivalent to the German notary's function.[7] Under German law, the requirements for notarisation of pledges over shares follow the requirements for notarisation of their transfer. The BGH unfortunately did not clearly state that a notarisation by a Swiss notary fulfils that criterion.

iii Sanctions

Many non-German law-governed facilities agreements contain provisions relating to compliance with non-German sanctions that have extraterritorial reach, such as economic and trade sanctions based on US foreign policy and national security goals administered and enforced by the US Office of Foreign Assets Control (OFAC). If German entities are party to such agreements, German blocking legislation against extraterritorial aspects of OFAC

5 Sections 14 et seq. of the German Corporate Income Tax Act and Section 2, paragraph 2, sentence 2 of the German Trade Tax Act in conjunction with Sections 14 et seq. of the German Corporate Income Tax Act. Fiscal units are also possible in relation to VAT and real estate transfer tax, but we have limited this overview to the most relevant forms of taxes.

6 Sections 4h German Income Tax Act in conjunction with Section 8a of the Corporate Income Tax Act.

7 BGH, resolution dated 17 December 2013, II ZB 6/13.

sanctions must be taken into consideration. The German Foreign Trade Regulation[8] prohibits a German resident from complying with any sanctions that are foreign to Germany or the EU.

As a result, German companies (as borrowers, guarantors, etc.) must not give any confirmation as to their compliance with any non-UN, EU or German sanctions (including OFAC), and German banks may not require compliance with such non-UN, EU or German sanctions (including OFAC) from any of its contractual counterparties (whether German or non-German). Appropriate carve-outs need to be included in the respective representations and undertakings. Alternatively, non-UN, EU or German sanctions-related clauses can be included in a side letter that is signed only by non-German parties to the transaction. Compliance with UN, EU and German sanctions regimes is permissible, so the relevant representations can be phrased accordingly.

III SECURITY AND GUARANTEES

i Types of security and guarantees

The German security regime does not provide for a global instrument granting collateral over substantially all assets of a person or entity (such as an English law floating charge). Substantially the same economic effect can be achieved by taking security over all the assets the relevant security grantor holds by way of implementing various security instruments, which generally are:

a pledges over shares and partnership interests;
b pledges over bank accounts, deposits and securities;
c security assignment of receivables (including trade receivables, intercompany and insurance receivables);
d security transfer agreements regarding moveable fixed assets and inventories;
e security over intellectual property rights (transfer, assignment or pledge); and
f security over real estate (mortgage, land charge).

Corporate guarantees are another common form of (third-party) security in Germany.[9]

ii Accessory or non-accessory nature of security

German security rights are either of an accessory or non-accessory nature. Accessory security (e.g., a pledge) is directly linked to a claim and can only be vested in a person that is itself a creditor, and only for the amount owed (presently or in the future) to that particular creditor. In contrast, non-accessory security is not linked to a claim, and can therefore also be vested in any third party holding such security on trust for the relevant creditors.

8 Pursuant to Section 7 of the German Foreign Trade Regulation, it is unlawful for any German-based person (e.g., borrowers, guarantors) to make a declaration to enter into or adhere to a trade boycott unless such trade boycott is in accordance with German, EU or UN sanctions. In addition, it is also unlawful for any (Germany or non-Germany based) person to request a Germany-based person to comply with trade boycotts that are not in accordance with German, EU or UN sanctions. The consequence of non-compliance is a misdemeanour carrying a fine of up to €500,000 and (under very limited circumstances) criminal liability.

9 See Section III.v, *infra*.

In syndicated credit facilities, non-accessory security rights are held directly by the security agent (i.e., title to the relevant right is directly conferred upon it). With respect to the very nature of accessory security rights, title in the relevant right can only be granted to the creditors of the secured obligations (i.e., all lenders and all other secured parties). In order to facilitate the granting and the transfer of accessory security rights together with the transfer of commitments of the secured facilities, it has become widespread practice in Germany to establish a 'parallel debt' in favour of the security agent, which takes the form of an abstract acknowledgment of debt, if contained in German law-governed documents, and which is equivalent to a 'covenant to pay'. This instrument is established either in the facilities agreement or in the intercreditor or security agency agreement, or created by a separate document. In any case, it creates an individual claim of the security agent that can itself be secured by the relevant accessory security rights and will remain with the security agent in the case of an assignment or transfer of commitments; however, currently, there are no clear court decisions on such instrument, which leaves some uncertainty in the market on whether this concept is legally valid and enforceable. Therefore, accessory security is often not only vested in the security agent by virtue of that parallel debt, but also granted directly to the other creditors (to secure their direct claims against the obligors).

iii Transfer and release of accessory or non-accessory security

If the underlying debt (i.e., the secured payment obligation) is transferred to a new lender acquiring a participation in a syndicated facility, attention should be paid to the continued existence of the relevant German law security rights. While non-accessory security rights will continue to exist even if transfers of the underlying debt take place by way of novation, accessory security rights will lapse by operation of law once the original secured claim ceases to legally exist. However, accessory security rights will remain in place and will follow the transfer of the underlying debt (in whole or in part) by operation of law if such underlying debt is transferred to a new creditor by way of assumption of contract or respective claims are assigned to a new creditor.

In the case of repayment or other discharge of the secured obligations, or both, non-accessory security rights need to be explicitly released, and rights transferred or assigned need to be re-transferred or reassigned to effect a full release. In the case of accessory security rights such as pledges, security rights will lapse by operation of law once the secured debt ceases to exist (and a release may be declared as a matter of record only).

iv Enforcement of security interests

With respect to the enforcement of security interests, different rules apply to accessory security rights, non-accessory security rights and security interests over real estate.

To enforce accessory security rights in the form of a pledge, certain statutory requirements need to be met. A pledge generally may only be enforced if the secured (payment) obligation has become due and payable,[10] and pledges over rights (e.g., account pledges, share pledges) theoretically require the pledgee to obtain an enforceable instrument[11] before it may enforce the pledges. However, the requirement of an enforceable instrument can be waived and in practice it is inevitably waived in the relevant security agreement. Accordingly, enforcement

10 Section 1228, paragraph 2 of the German Civil Code.

11 Section 1277 of the German Civil Code.

cannot be triggered by a 'simple' event of default (unless the relevant facilities agreement has been terminated and thus the obligations have become due and payable); nonetheless, any payment default relating to a repayment or prepayment requirement or the payment of interest or fees would be sufficient to commence enforcement.

To enforce non-accessory security rights (other than security over real estate) such as security assignments of receivables or security transfers of fixed and current assets, there is no legal requirement to obtain enforceable instruments, as title to the relevant assets has been transferred in full together with a contractual arrangement that the rights in the relevant asset may only be used for specific purposes upon the occurrence of specific events. The parties are – at least in individually negotiated security agreements – generally free to agree upon events that trigger enforcement rights of the secured party. Termination and acceleration of the facilities is not a prerequisite for enforcement of non-accessory security rights, although in practice the enforcement triggers negotiated for accessory and non-accessory security will almost always be the same.

Security rights over real estate, such as a mortgage as an accessory security right or a land charge as a non-accessory security right, may only be enforced upon prior receipt of an original enforceable instrument, and no waiver is possible in relation thereto. This is why normally, upon the establishment of the relevant security over the real estate in question, a submission by the owner to immediate foreclosure in relation to the amounts owed under the mortgage or land charge either solely of the encumbered real property or of all of the owner's assets is obtained.

Enforcement of security over encumbered assets may generally be achieved by way of sale or, in the case of monetary rights, by way of collection. In the case of pledges, the relevant assets need to be sold by way of public auction,[12] unless the assets have a value determined at a stock exchange or other determined market price[13] or, under certain circumstances and if the parties so agree once the security interest has become enforceable, by way of a private sale.

v Most relevant limitations on granting security interest

First-demand guarantees

There are two types of guarantees under German law: an accessory surety, the amount and validity of which depends on the underlying claim's amount and validity; and a non-accessory guarantee, the validity of which is not dependent on the underlying claim's validity.

Pursuant to a decision of the BGH,[14] a guarantee on first demand contained in any agreement may be invalid and unenforceable if such guarantee on first demand is contained in general business conditions within the meaning of Sections 305 et seq. of the German Civil Code. Even if not contained in general business conditions, such guarantee may, pursuant to German case law, only be given by companies experienced in international trade.

Concept of 'over-collateralisation'

German law provides for the concept of 'over-collateralisation', according to which the value of collateral granted for security purposes must not be 'excessive'.

12 Section 1235 of the German Civil Code.

13 Section 1221 of the German Civil Code.

14 BGH, decision dated 23 January 1997, IX ZR 297/95.

If at the time of granting a security right either the value of the security right itself or its combination with other security rights is 'excessive', the relevant security will be deemed void (initial over-collateralisation). This is the case if there is a striking mismatch between the value of the security and the amount of the claims secured (taking into account not only the nominal value at stake but also the associated risk) so that the relevant arrangement taken as a whole (regarding its content and purpose) leads to a violation of the general rules of acting in good faith and fair dealings. Although several court decisions deal with various thresholds, there is no strict rule as to when exactly initial over-collateralisation has to be assumed. Generally, over-collateralisation will be assumed if the realisable value of the collateral exceeds 200 per cent of the secured obligations.

Should over-collateralisation subsequently occur as a result of progressing repayment of the secured indebtedness or an increase of the value of collateral that has been granted on a revolving basis (such as an assignment of receivables), the security does not become void, but the grantor is entitled to a partial release of the security interest. The precedents are clearer on the applicable thresholds in the case of subsequent over-collateralisation than in the case of initial over-collateralisation. Generally, subsequent over-collateralisation is assumed if the realisable value of the collateral exceeds 110 per cent of the amount secured. The realisable value should be calculated at the time when the security provider requests the release of the security assuming an enforcement of the security interest in the collateral at that time. Pursuant to a resolution of the Grand Senate of the BGH,[15] the threshold for subsequent over-collateralisation is generally reached where the then-current market value (if there is one) or the purchase price or production costs (if there is no market value) of the collateral exceeds the secured obligations by 50 per cent.

Capital maintenance rules and financial assistance

While capital maintenance rules in general may apply (see below), a security grantor organised in the legal form of a German stock corporation is prohibited from giving financial assistance to the purchaser of its stock.[16] 'Assistance' in this context not only comprises granting direct loans or other means to acquire the relevant shares, but also extends to granting (upstream) guarantees and other (upstream) security for any indebtedness incurred in connection with the acquisition of its stock. In addition, a German stock corporation may not grant any benefits to its shareholders (or any affiliates of its shareholders) except for the payment of dividends from the annual profits of the stock corporation on the basis of a resolution of the general annual meeting of the shareholders.[17]

These prohibitions, however, generally do not apply if a domination or a profit-and-loss-pooling agreement is in place between the stock corporation and its (new) shareholders whose obligations are secured. The granting of a benefit to a shareholder is permitted to the extent the stock corporation has a fully recoverable claim for true consideration or repayment against that shareholder.[18]

While financial assistance prohibitions strictly apply to German stock corporations only, capital maintenance requirements need to be observed by both stock corporations and limited liability companies, while within limited partnerships, the applicable capital

15 BGH, resolution dated 27 November 1997, GSZ 1 u. 2/9
16 Section 71a of the German Stock Corporation Act.
17 Section 57 of the German Stock Corporation Act.
18 Section 57 of the German Stock Corporations Act.

maintenance regulations are those applying to its general partner. As outlined above, the shareholders of a stock corporation may generally not receive any benefit from the relevant stock corporation other than dividends, and the repayment of capital to the shareholders is prohibited. The provisions applicable to limited liability companies are somewhat less stringent and only prohibit payments to the shareholders to the extent that such payments cause the net assets of the company to fall below its registered share capital or, if the amount of net assets is already below the amount of the registered share capital of the company, to cause such amount to be further reduced.[19] It is acknowledged that these prohibitions not only relate to direct cash payments, but also to any other benefits for the shareholders (or their affiliates), including the granting of security rights to any third parties that are lending to or have other payment claims against the relevant shareholders or affiliates.[20] As in the case of stock corporations, there are also exceptions for scenarios where a domination or a profit-and-loss-pooling agreement between the limited liability company and its shareholders is in place or the limited liability company has a fully recoverable claim for true consideration or repayment against its shareholders.[21]

While an entity that grants security interests or even payments in breach of these obligations is entitled to a repayment of the relevant benefit from its shareholders or affiliates, the directors of the disadvantaged entity themselves, in certain specific instances, may face personal – and in certain cases even criminal – liability.

A violation of the capital maintenance rules and limitations on financial assistance does not generally or *per se* render a guarantee or other security interest granted to a third-party lender void. However, even if one of the above-mentioned exceptions might apply, it is market practice to provide for appropriate limitation language in relation to the liabilities of a German subsidiary having granted a guarantee or asset security, or both, for its direct or indirect shareholders taking into account, to the extent applicable, the relevant prohibitions and the legal exceptions (e.g., for domination agreements), as well as recent case law relating to those prohibitions and exceptions by the BGH and several higher regional courts. The details of such limitation language are usually discussed in detail and at length.

Prohibited encroachment

In addition to capital maintenance requirements, court decisions and jurisprudence have also developed the concept of prohibited encroachment on the security grantor's vital financial means. According to this concept, a shareholder is prohibited from extracting funds from a debtor where such funds are required to maintain the debtor's liquidity. The concept has led to a threat of liability of the shareholders in relation to the company. Thus, a debtor may hold its shareholders liable for causing its over-indebtedness or illiquidity. It cannot be ruled out that a third-party creditor may also be held liable for aiding and abetting such prohibited encroachment if both the relevant shareholder and the relevant third-party creditor acted intentionally. Therefore, in special circumstances German courts may determine that a security grantor providing upstream guarantees or asset security for its shareholders may have a valid defence or counterclaim against the claims of a third-party creditor.

19 Section 30 of the German Limited Liability Companies Act.

20 See Diem, *Akquisitionsfinanzierungen*, 3rd edition, Section 43 No. 4, for further examples.

21 Section 30 of the German Limited Liability Companies Act.

vi Claw-back rights in insolvency proceedings

In insolvency proceedings, security interests may be impacted by claw-back rights of the insolvency administrator. The insolvency administrator may challenge the creation of security interests granted over the assets, if the creation was to the disadvantage of other creditors and the following requirements are met.

Congruent coverage (Section 130 Insolvency Code)

It is required that:

a the security was granted or effected within three months prior to or subsequent to the filing for insolvency;

b the debtor was illiquid at the time of the transaction; and

c the creditor had knowledge of such illiquidity or of the relevant facts that support a compelling conclusion with respect thereto.

Incongruent coverage (Section 131 Insolvency Code)

It is required that:

a the creditor was not entitled to the creation of the security either at all, in that manner or at that time; and

b the security was granted or effected:

- either within one month prior to, or subsequent to, the filing of opening insolvency proceedings; or
- within two or three months prior to the filing if (1) either the debtor was illiquid at the time of the transaction or (2) the beneficiary had knowledge of the fact that the creation of the security was to the disadvantage of other creditors.

Transaction without consideration (Section 134 Insolvency Code)

It is required that the security was created:

a within four years prior to the filing for the opening of insolvency proceedings; and

b without a consideration.

Intended damage claw-back right (Section 133 Insolvency Code)

It is required that:

a such security has been granted or effected during a four-year period prior to the filing of the opening of insolvency proceedings (please note that the claw-back period in relation to security interests was recently reduced from 10 to four years in the Insolvency Claw-back Reform, which became effective on 5 April 2017);

b the debtor had the intention to disadvantage its creditors on the date of the transaction (such intention being indicated by certain circumstances); and

c the beneficiary was aware of the debtor's intention to disadvantage its creditors (such knowledge being assumed or indicated under certain circumstances).

However, the risk of claw-back rights can be significantly reduced if structured in the form of a cash transaction (i.e., the debtor received 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 outlined under 'Intended damage claw-back right', above (which will be difficult because cash transactions are indications against these criteria).[22]

IV PRIORITY OF CLAIMS

i Contractual arrangements for ranking of security

In cases where several layers of debt and different classes of creditors are to be secured by identical assets, the distinction between non-accessory and accessory security plays an important role. While rights under non-accessory security are usually conferred to one beneficiary only and there is no creation of a second ranking right in the same asset (e.g., assignment of receivables to the security agent in order to secure various groups of creditors), accessory security rights can be conferred to different groups of creditors in subsequent ranking (e.g., first-ranking pledges, second-ranking pledges). The same holds true for the non-accessory right of land charges over German real estate, which can be granted in subsequent ranks.

While it is usual practice that non-accessory security rights are conferred upon a security agent, with contractual provisions in intercreditor documentation regulating the waterfall for distribution of proceeds from enforcement of such security rights among the different creditor groups, practice varies in the case of accessory security rights. Quite often, first-ranking security rights are created for senior secured creditors, with separate second-ranking security rights for a creditor group ranking behind the first-ranking lender group, etc. In order to minimise documentation and effort for the security grantor, it is also not unusual for the creditor groups to agree to create only one accessory security right for all of them collectively within the same rank, and then agree to the distribution waterfall in the relevant intercreditor document, which would be applicable to non-accessory security rights and for general purposes anyway.

ii Impact of the German insolvency regime on secured creditors

After a filing for opening of insolvency proceedings, it may take several weeks for formal insolvency proceedings to be commenced and a final insolvency administrator to be appointed. In the meantime (i.e., during the preliminary insolvency proceedings), the court may – and usually will – grant a moratorium, which prohibits any disposal of assets by the debtor (including its creditors). Hence, such creditors, even if they hold title to assets subject to collateral, may not enforce their security interest themselves during that period, but will need to rely on the preliminary administrator to enforce the collateral.

Generally, the insolvency administrator will have to realise any assets that belong to the debtor's estate unless otherwise resolved by the creditors' meeting and provided that the insolvency administrator has a respective realisation right pursuant to the German Insolvency Code (see below). Realisation may not only be implemented by the sale of individual items of the company's property, but also through the sale of the company's business as a whole or in part.

22 Section 142 German Insolvency Code.

In selling the company's property, special treatment is required for items that are subject to rights of separation and recovery[23] or preferential rights.[24] Any right *in rem* or personal right under which the debtor may claim that the item in question does not belong to the estate involves the right to separate that item from the estate. The relevant creditor may require that items that are subject to a right of separation be surrendered out of the estate, and such items may not be realised by the insolvency administrator.

In contrast, any preferential rights such as real estate mortgages, pledges over moveable assets and rights, transfers by way of security and assignments by way of security do not involve a claim for surrender out of the estate but only a claim for preferential satisfaction of the respective creditor's claims when realising the asset to which the preferential right refers. In the course of preliminary and formal insolvency proceedings, the beneficiaries of security are entitled to receive the full amount of the proceeds from their enforcement without, generally, the need to share these proceeds with other creditors. However, the formal insolvency administrator will, where it has the right to enforce the security, deduct the costs of the realisation consisting of, generally, ascertainment costs (4 per cent) and realisation costs (5 per cent) plus taxes (VAT), if applicable, from the realisation proceeds. This does not apply, *inter alia*, to the enforcement of pledges over shares or partnership interests, as the formal insolvency administrator does not have a right to enforce the security. Any realisation surplus remaining after satisfaction of any party holding a preferential right will be allocated to the debtor's estate.

iii Equitable subordination of shareholder loans

Under German law, shareholder loans are subordinated in a debtor's insolvency.[25] The former prerequisite of a financial crisis during which the loan was granted or not recalled has fallen away since 2008, as have former repayment restrictions outside insolvency proceedings. Thus, prior to an insolvency, a shareholder loan may be repaid at any time, and generally no restrictions apply. However, once insolvency proceedings have been commenced, all shareholder loans become automatically subordinated to other creditors' claims, while repayments of any shareholder loans within a claw-back period of one year immediately preceding the filing for the opening of insolvency proceedings are subject to claw-back rights,[26] regardless of whether such repayment prior to insolvency occurred in a financial crisis or otherwise.

In a ruling by the BGH in 1992,[27] 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 company. The decision related to a savings institution that held pledges in its borrowers' shares, and in addition had massive contractual and factual influence over the management of the borrower group. Following this decision, it has become controversial whether financial institutions that, for example, through tight covenants deal with questions that are typically dealt with by shareholders, could be treated as quasi-shareholders by German courts and therefore become equitably subordinated in the borrower's insolvency. It is therefore important that covenants provide sufficient flexibility to the borrower to manage

23 Section 47 of the German Insolvency Code.

24 Sections 49–51 of the German Insolvency Code.

25 Section 135 of the German Insolvency Code.

26 Section 135 of the German Insolvency Code.

27 BGH, decision dated 13 July 1992, II ZR 251/91.

its day-to-day business without the requirement of prior approvals by the lenders. It is also often provided that certain covenants are not directly applicable to German obligors, but only indirectly by way of information undertakings relating to actions otherwise prohibited by the respective covenants and a determination right for lenders whether such actions would have material adverse consequences for the lenders' risk or security position. There are, however, no court decisions relating to such 'restrictive covenants', and a court will likely make its decision based on an overall view of not only the documentation, but also the factual influence of lenders.

V JURISDICTION

A foreign choice of law clause in loan and security agreements is generally recognised and applied by German courts. Inside the EU, the recognition and effect of a choice of foreign law relating to contractual obligations is subject to the provisions of Rome I[28] and to German public policy.

The recognition and effect of a choice of law provision relating to non-contractual obligations will be subject to Article 14 of Rome II[29] and to German public policy.

German private international law mandatorily provides for the lex rei sitae principle to apply to all rights *in rem*.

VI ACQUISITIONS OF PUBLIC COMPANIES

German stock corporations are governed by the German Stock Corporation Act, and transactions on the German capital market are governed by the German Securities Trading Act and the German Securities Acquisition and Takeover Act. Compliance with provisions contained in these laws is supervised by BaFin.

When someone directly or indirectly acquires control over (i.e., at least 30 per cent of the voting rights in) a publicly listed company, a tender offer for all outstanding shares in that company is mandatory.[30] The 30 per cent threshold is calculated including shares held by subsidiaries and persons acting in concert. The offer needs to include a fair consideration (usually at least the average stock exchange trading price during the three months before gaining control). The tender offer needs to be filed with and approved by BaFin. In financing scenarios, this requirement is of particular relevance when it comes to an enforcement of pledged shares in a public company. An acquisition of stock in that context triggers the mandatory offer requirement in the same way as any other acquisition. The pledge of shares itself does not, however, trigger a respective duty.

Regarding public offers (whether mandatory or voluntary), German law[31] requires a bidder to ensure, prior to publishing the offer document, that it has the means necessary for fully performing the offer at its disposal at the time that the claim for consideration becomes due and payable. Where the offer provides for a consideration in cash, an independent

28 Regulation (EC) No. 593/2008 of the European Parliament and of the Council on the law applicable to contractual obligations.

29 Regulation (EC) No. 864/2007 of the European Parliament and of the Council on the law applicable to non-contractual obligations.

30 Section 35 of the German Securities Acquisition and Takeover Act.

31 Section 13 of the German Securities Acquisition and Takeover Act.

investment services enterprise shall confirm in writing that the offeror has taken the steps necessary to ensure that the means required to perform the offer in full are available at the time at which the claim for cash payment becomes due and payable ('financing confirmation').

If the bidder has not taken the steps necessary for these purposes, and if for that reason it does not have the necessary means at its disposal at the relevant time, the person who has accepted the offer may claim from the investment services enterprise compensation for any damage incurred as a result of the incomplete performance. The investment services enterprise is, however, only liable for gross negligence and wilful misconduct.

It is controversial whether the term 'necessary means' includes means for the refinancing of the target company's existing liabilities. The requirement to take 'necessary steps' is generally fulfilled with the signing of the loan agreement. It is, however, controversial whether and to what extent termination rights and conditions precedent to utilisation of the loans may be included in the loan agreement. Most legal authors only require a waiver of ordinary termination rights. Conditions precedent and extraordinary termination rights (e.g., after the filing of a petition for insolvency) are permitted according to those legal authors. Material adverse change clauses are also controversial.[32]

According to certain legal authors and to the practice of BaFin, the financing confirmation must not contain any conditions. According to other authors, conditions that are permitted in voluntary public offers[33] may also be included in a financing confirmation. Mandatory public offers must not contain any conditions, except for outstanding permits by authorities such as merger clearance.

VII OUTLOOK

Recently, there have been a number of court rulings by both the BGH and higher regional courts relating to the limitation of upstream loans, guarantees and security owing to capital maintenance rules applying to stock corporations and limited liability companies[34] in the past few months. Extensive discussions on how to draft respective limitation language are expected to take place in upcoming loan transactions, and it even remains to be seen if such language will still be necessary in the future.

A new Law for the Facilitation and Management of the Insolvencies of Groups of Companies was published in the Federal Law Gazette in April, and will come into force on 21 April 2018. The law intends to facilitate the coordination of insolvency proceedings of group companies, for example, by using one single competent court for all insolvency proceedings within the group, and nominating a coordinating administrator to be nominated for all insolvency proceedings within the group. It does not, however, provide for a consolidation of the insolvency estates of certain group companies, but will uphold the principle of multiple individual insolvency proceedings.

32 For more detail, see Diem, *Akquisitionsfinanzierungen*, 3rd edition, Section 11 No. 26.

33 Section 18 of the German Securities Acquisition and Takeover Act.

34 See Section V, *supra*.