

THE ACQUISITION
AND LEVERAGED
FINANCE
REVIEW

SIXTH EDITION

Editor
Marc Hanrahan

THE LAWREVIEWS

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PREFACE

Leveraged finance, particularly with respect to acquisition financing, has been an expanding asset class for many years. As of the fourth to quarter of 2018, leveraged loans outstanding totalled US\$1,147 billion and high-yield bonds outstanding totalled US\$1,256 billion. The average annual growth rate for leveraged loans outstanding (2000–2018) equalled 15.8 per cent and for high-yield bonds (1997–2018) equalled 6.5 per cent.¹ In 2018, leveraged finance loan totals for acquisition finance surpassed the previous records set in 2007.²

The leveraged finance markets and these markets' participants grow deeper and more sophisticated year over year. The playing field for acquisition finance, particularly for private equity deals, remains in large part an issuer-controlled game with an increasing number of new financing sources clamouring to become involved. As has been noted by many, credit controls (covenants and collateral coverage) remain soft and continue to weaken in some cases. That said, default rates are at the low end of the historical range and new piles of capital continue to be accumulated to support acquisition financing. As discussed in the Introduction that follows, regulators are indicating concern about the leveraged loan market in the case of an economic downturn but, to date, that does not seem to have stifled the appetite for new deals and associated financings.

For lawyers, this is a great area of practice. There is lots of activity given the size of the asset class; everything from new issuance, to refinancings, to work outs and insolvency proceedings. But to be an effective practitioner in the area, more is required than occasionally dabbling in leveraged finance transactions. Most lawyers who successfully practice in leveraged finance do it full time. Knowing 'market terms' is considered to be very helpful, if not critical, to success in this area.

This volume is intended to introduce the newcomer to the legal basics involved in leveraged finance, particularly acquisition finance, so that he or she is grounded in the underpinnings of the practice area. It is also intended to be a helpful update for the more seasoned practitioner with respect to what is new and what is being talked about in leveraged finance deals.

1 Source: Financial Stability Report of the Board of Governors of the Federal Reserve System, May 2019.

2 2018: U.S. Primary Loan Market Review, LSTA 3 January 2018.

Thanks to my partners Casey Fleck and Doug Landy, and my associates Chris Hahm, James Kong and George Miller, for their help in editing the volume and preparing the Introduction that follows.

Marc Hanrahan

Milbank LLP

New York, NY

September 2019

GERMANY

*Thomas Ingenhoven and Odilo Wallner*¹

I OVERVIEW

Acquisition finance in Germany has traditionally been dominated by loan agreements with German or Germany-based international banks, often in club deals. The spectrum has broadened and by and large all kind of financings available in the London market can be accessed in the German market as well. A large part of the leveraged loans are still structured as club deals, especially in the small and mid-cap market segment, but unitranche and super senior financings are increasing in number and volume. At the higher volume end of the market, there are typically term loan Bs (TLBs) and high-yield bonds combined with bank revolvers.

The Loan Market Association (LMA) standard documents have established themselves as the dominant documentation standard in Germany for syndicated loan facilities. The LMA published two German law precedents for investment-grade borrowers and for real estate financing. At the lower volume end of transactions, LMA-based but shortened documentation prevails that, if only German banks and borrowers are involved, is often set out in the German language.

II REGULATORY AND TAX MATTERS

i Licensing requirements

In contrast to other jurisdictions (e.g., England), commercial lending in Germany generally requires a banking licence. Under the German Banking Act (KWG), the extension of loans is a regulated banking activity if it is performed on a commercial basis or to an extent that requires commercial business operations. The commercial basis-test is usually met if the lending undertaking is to be conducted for a certain period of time and with the intention to generate profits. Consequently, this requirement is usually met (long) before commercial business operations are required. In practice, the latter criterion is, therefore, of little relevance. It is noteworthy that, according to the administrative practice of the German Federal Supervisory Authority (BaFin), there is no *de minimis* exemption for lending activities, and the licence requirement under the KWG applies irrespective of whether or not loans are extended to consumers or corporate borrowers.

In principle, only banking activities conducted in Germany are subject to the licence requirement pursuant to the KWG. Commercial lending is generally considered to be conducted in Germany if the lender has its registered seat, or a permanent establishment, in

¹ Thomas Ingenhoven is a partner and Odilo Wallner is an associate at Milbank LLP.

Germany. However, the licence requirement may also be triggered if a lender does not have registered seat or a permanent establishment in Germany, but actively addresses the German market by repeatedly offering loans to individuals or legal entities situated in Germany. Where a lender does not actively address the German market, it may benefit from the 'reverse solicitation' exemption. Pursuant to this exemption, which is based on an established administrative practice of BaFin, no German banking licence is required for the extension of loans to borrowers situated in Germany if the extension of loans is permitted in the (foreign) jurisdiction in which the lender is situated, and the respective lending transaction has not been solicited by the lender but was provided solely upon the initiative and request of the borrower. The distinction between a reaction upon a request to provide a loan and the solicitation of a loan offer is highly fact-driven and requires an overall assessment of all circumstances of the individual case at hand.

In order to qualify as 'lending' under the KWG, a person or entity must grant loans, or enter into contractual obligations to grant loans. Hence, the acquisition of a loan, which has already been disbursed in full prior to such acquisition and where the purchaser is under no obligation to extend any (further) credit, does not qualify as 'lending' pursuant to the KWG. The mere administration of the acquired loan by the purchaser in accordance with the loan agreement does not trigger a licence requirement under the KWG. Therefore, the acquisition of fully disbursed term loans does not generally require a banking licence in respect of the purchaser. There are two important exceptions to this rule. First, a novation, prolongation or other material amendment of an existing loan is treated by BaFin as an extension of credit. As a consequence, a purchaser of fully disbursed term loans, who does not have a banking licence for lending transactions, must not enter into the aforementioned amendments or transactions in respect of the acquired loans. This, of course, limits the available options should the acquired loans, for example, need to be restructured. Second, the acquisition must not be conducted on an ongoing or revolving basis. The ongoing acquisition of loans (or other receivables) on the basis of a master agreement would require a banking licence for factoring transactions under the KWG. Last, where the purchaser of loans also acquires the role as facility agent or security agent, the exercise of such role may require a licence pursuant to the German Payment Services Oversight Act (ZAG).

Since 2016, there is a further exemption from the general rule that the extension of loans on a commercial basis requires a banking licence. This statutory exemption in the KWG is available for certain alternative investment funds (AIFs) and their managers (AIFMs), and is widely used by credit funds that originate loans within and into Germany. The exemption applies to German AIFs and AIFMs, which in turn are regulated by the German Capital Investment Act (KAGB), EU-AIF and AIFM, which are subject to the rules and regulations implementing the Alternative Investment Fund Managers Directive (AIFMD). Among other prerequisites, the loan origination must form part of the collective portfolio management of the AIF and AIFM. Third-country AIFs and AIFMs may only benefit from this exemption if they have successfully completed the notification procedure for a marketing and distribution of the respective fund in Germany with BaFin. A notification procedure for the marketing and distribution of the fund only to professional investors does not suffice for the purposes of this exemption under the KWG.

ii Taxes and fees

Interest payments under loan agreements are subject to German corporation tax if the lender is tax-resident in Germany, which, together with the solidarity surcharge, amounts to 15.825 per cent. In addition, trade tax imposed and rate set by municipalities applies (roughly between 7 and 18 per cent).

While Germany charges a withholding tax on specific capital investments, interest on loan agreements is generally not subject to withholding tax. Certain exemptions apply, for example, for certain hybrid loans (i.e., loans with an interest rate linked to the borrower's profits or liquidity). Furthermore, in the case of non-German lenders, the German tax authorities could impose a withholding tax obligation on the borrower if the interest is subject to German limited tax liability (e.g., in the case of a non-German lender if the loan is secured by German real estate). Specific attention is, therefore, required in phrasing tax gross-up and indemnity clauses.

Interest expenses are generally tax deductible in Germany. Certain exemptions apply, such as the interest barrier rule,² which limits the tax deductibility of interest expenses in excess of the interest income to 30 per cent of the tax EBITDA of the relevant taxpayer (subject to certain exemptions), and the add-back provisions under the German Trade Tax Act. In order to achieve deductibility of interest expense of the acquiring entity taking out the financing against operating income of the target in a leveraged buyout, a tax group is usually implemented between both entities by way of a profit and loss transfer agreement. For the purposes of corporation and trade tax, the operating profit may then be set off with the interest expenses. The problem can be further mitigated by a debt pushdown, bringing part of the interest-incurring debt to the same level as the operating profit.

While loans are by default VAT exempt, lenders may opt to charge VAT on interest payments. As it might be unclear whether the borrower is entitled to a corresponding VAT credit (in the absence of which the VAT paid to the lender would be a definite cost item), such an option is typically excluded from VAT gross-up in loan agreements.

There are no stamp duties payable in Germany. There are notarisation and registration fees in connection with share pledges over limited liability companies and land charges. Notarisation of share pledges may trigger notarisation fees – the registration or assignment of land charges in the land register and the submission to immediate enforcement trigger registration and notarisation fees, respectively. Fees depend on the value of the collateral asset.

With respect to the US Foreign Account Tax Compliance Act (FATCA), it is not required for German lenders to enter into FATCA agreements. Instead they are obliged to make certain reports. Nevertheless, it is typical for LMA-based documentations to include FATCA wording, usually based on the LMA wording for allocating FATCA risks to lenders.

iii Sanctions

It is typical for facility agreements to contain representation and undertakings regarding compliance with domestic, EU, UN and US sanctions. As many German banks have US branches or subsidiaries, these provisions can also be found in facilities agreements governed by German law or made for German club deals. Compliance with these sanctions, specifically with US economic and trade sanctions that have extraterritorial reach and are administered

2 Note that the German Federal Fiscal Court considers the interest barrier rule unconstitutional and has referred the case to the German Federal Constitutional Court.

and enforced by the US Office of Foreign Assets Control (OFAC) is, however, problematic. German and EU blocking laws prohibit participation in foreign boycott measures (i.e., sanctions that are not UN, EU or German).

EU regulation (EC) 2271/96³ and the German Foreign Trade Ordinance⁴ prohibit entities located in the EU or Germany, respectively, from complying with sanctions that are not recognised by Germany or the EU (these are most notably OFAC-administered sanctions). Compliance with UN, EU and German sanctions is unproblematic, and the relevant representations and undertakings in finance documents are phrased accordingly.

German borrowers and guarantors typically request carveouts from sanction covenants in the credit documentation so that they do not need to comply with sanctions going beyond those from the EU, UN and Germany. German banks also require that they be carved out so that the representations and undertakings are not given to them. An alternative to including carveouts is entering into a side letter providing for full sanction compliance (including OFAC) but which is only signed by non-German borrowers, guarantors and lenders. Awareness that these carveouts might be needed not only for German, but also for other European borrowers, guarantors or lenders is increasing in recent times, and occasionally carveouts extending to European members of a borrower group or non-German European banks, can be seen.

III SECURITY AND GUARANTEES

i Types of security and guarantees

In contrast to some common law jurisdictions like England,⁵ there is no ‘all-asset’ type of security instrument available in Germany. Rather, security has to be taken over each asset class individually by separate security documents. Generally speaking, security can be granted over almost all kinds of assets but some are more burdensome and costly than others. Due diligence is, therefore, required to establish what kind of assets are available and whether taking security over them is appropriate from a cost and benefit perspective.

Typical German security instruments for a financing comprise the following:

Asset type	Form of security instrument	Comments
Shares	Pledge	GmbH shares can only be pledged by notarial deed incurring notarial fees
Bank accounts	Pledge	Requires notice to account bank. Restrictions on payments or transfers can be imposed by lender

3 Article 5 of EU regulation (EC) 2271/96 of the European Council of 22 November 1996, protecting against the effects of the extraterritorial application of legislation adopted by a third country, and actions based thereon or resulting therefrom.

4 According to Section 7 of the German Foreign Trade Ordinance, German-based persons (e.g., borrowers, guarantors) may not give declarations to enter into or comply with a trade boycott unless the trade boycott is in accordance with sanctions imposed by the UN, the EU or Germany. It is further unlawful for anyone (Germany-based or not) to request a Germany-based person to adhere to trade boycotts that are in accordance with sanctions imposed by the UN, the EU or Germany. Violation may result in a fine of up to €500,000 or, under specific circumstances, criminal liability.

5 All asset security in England and Wales is typically taken by way of a floating charge.

Asset type	Form of security instrument	Comments
Receivables (including trade receivables, intercompany and insurance receivables)	Assignment by way of security	Usually (undisclosed) assignment; disclosure only in enforcement scenario
Moveable property (including machinery and inventory)	Transfer of title by way of security	The asset concerned must be clearly identified, either by transferring every item in a certain location or by revolving delivery of asset lists
Intellectual property	Pledge or assignment of title by way of security	Registration is not compulsory but recommended. Enforcement of the pledge takes place by public auction
Real estate	Land charges or mortgages	The land charge is preferred to a mortgage because it creates abstract security and can be reused. Both security interests are typically notarised and require registration in the land register incurring notarial and land register fees

There are no restrictions on granting security over real estate to foreign lenders; however, this might have adverse tax consequences.⁶ The grant of security over real estate and shares in a *Gesellschaft mit beschränkter Haftung* (GmbH), namely a German limited liability company, requires notarisation, which will involve the payment of notary's fees. In addition, security over real estate requires registration in the land register, which will involve registration fees. The notarisation and registration fees are determined by statute and can be substantial.

In addition to *in rem* security, it is common that the material members of the borrower group grant guarantees for all loans outstanding under the relevant facility agreement.⁷

ii Accessory or non-accessory nature of security

German law security interests are either accessory or non-accessory in nature. Accessory security interests are closely linked to, and share the fate of, the underlying secured claim. Accessory security interests do not come into existence without a valid secured claim and cease to exist, by operation of law, as soon as the relevant secured claim has been extinguished. A creditor cannot benefit from accessory security unless it is also the holder of the secured claims. As a consequence, accessory security interests will be automatically transferred together with the underlying secured claim and cannot be separately transferred. Non-accessory security interests, on the other hand, are independent of the underlying secured claim. They are more flexible from the perspective of the secured creditor. Non-accessory security interests need to be re-transferred or reassigned to the relevant security provider and do not automatically lapse upon extinguishment of the underlying secured claim. Mortgages and pledges are accessory security interests, whereas assignments and transfers for security purposes as well as land charges belong to the group of non-accessory security interests. Owing to their nature; there are different requirements for the creation, enforcement, release and transfer of accessory security versus non-accessory security that need to be observed.

iii Security agent and parallel debt

Non-accessory security is not linked to the holding of a claim and the security can, thus, be held by a person other than the creditors of the secured claims. Holding and administering of non-accessory security by security agents acting for the lenders is, therefore, straightforward. Accessory security on the other hand requires that the person holding the security is itself also the holder of the secured claim. A security agent is, however, not a creditor of the loans

⁶ See Section II.ii.

⁷ See Section III.v.

under a facilities agreement made by the lenders. In order to allow the lenders to benefit from the accessory security, the security agent will commonly be granted a parallel debt obligation by the borrowers and guarantors in the amount of the debt under the finance documents. This artificially created obligation at the level of the security agent will then be secured by the accessory security. The parallel debt is in the same amount and payable at the same time as the obligations of the borrowers and the guarantors under the finance documents. Any payment of such underlying obligations will discharge the corresponding parallel debt and, vice versa, any payment in respect of the parallel debt will discharge the corresponding underlying obligations. The parallel debt is usually established in the intercreditor agreement or security agency agreement but can also be created in the facilities agreement or a separate document.

While the parallel debt concept is widely used as a standard to secure financings, the legal concept of creating parallel debt obligations in syndicated lending has not yet been tested before a German court. To mitigate such risks, it is not uncommon to secure, in addition to the security agent, the lenders directly.

iv Transfer of security and amendment of finance documents

Under German law, a transfer of secured claims will not automatically result in the transfer of all types of German security and, in some cases, can result in the automatic extinguishment of that security. Similarly, certain amendments to facility agreements may affect the validity of German guarantees and security.

Non-accessory security is usually granted to a security agent and remains unaffected in the event of a loan participation being transferred to a new lender, whether by way of assignment or novation. Accessory security rights share the fate of the underlying secured claim. If a lender has been directly secured by accessory security, the security interest will pass over to the new lender if the underlying loan claims are assigned to the new lender or the loan participation is transferred by way of assumption of contract. However, if the loan participation is transferred by way of novation (as is often the case under English law facility agreement), whereby the original loan claims are extinguished and then re-established with the transfer as new creditor, the accessory security interest will be extinguished.

To enable the transfer of loan participations without a risk of security ceasing to exist, two remedies are used in German lending practice. The most common one is to also secure the security agent via a parallel debt obligation as explained in Section III.iii. The other remedy is to include a 'future pledgee' concept whereby the security agent accepts the accessory security as representative for each future, yet unknown, secured party. The future secured party ratifies the granting of accessory security once it accedes to the finance documents at the time it acquires a loan participation. From a German perspective, it is also recommended not to use novations for loan transfers but only assignments or assumptions of contracts.

Further, amendments, term extensions or fee and interest increases must be structured in a way to ensure that guarantees and security are extended to the amended or increased obligations. There is certain doubt to which extent security grantors and guarantors are able to secure future unforeseeable debt. To mitigate this risk, it is market practice to confirm or redo German law security and expressly extend the security to the amended or increased secured obligations. Non-accessory security will be confirmed by confirmation agreements. For accessory security like pledges, new junior ranking security will be granted on top of the existing accessory security (known as 'supplemental pledges'). The latter might result in significant notarial fees in relation to share pledges over a GmbH.

v Enforcement of security interests

The enforcement of security interests depends on the type of security and the specific asset class over which security has been taken.

To enforce accessory security in the form of pledges, the underlying secured obligation has to become due and payable.⁸ This means an enforcement is not possible if only certain covenants or undertakings have been breached but the loans have not been accelerated or other payment claims have become due. Pledges over rights (such as bank accounts or IP) theoretically require that the secured party obtains an enforceable instrument.⁹ This requirement is, however, mostly waived in security agreements. The enforcement procedures are stipulated by law and typically require public auction¹⁰ unless the assets have a value determined at a stock exchange or other predetermined market price.¹¹ Pledges over receivables or bank accounts give the secured party a collection right of the claims against the third-party debtor or bank.¹²

German law does not contain requirements for the enforcement of non-accessory security (other than security over real estate). The parties are generally free to agree on enforcement triggers and procedures. The collateral is typically sold or auctioned subject to the enforcement procedures agreed upon in the security documents.

Enforcement of real estate security (i.e., land charges or mortgages) will be carried out by the lender in accordance with the German Foreclosure Act¹³ by way of a forced auction (compulsory sale) of the property. An application for foreclosure requires filing of an original enforceable instrument. To avoid court proceedings at the time of enforcement, the enforceable instrument is obtained when the real estate security is granted by way of a submission by the landowner to immediate foreclosure in the notarial land charge deed. In addition, a land charge or mortgage must be terminated before enforcement. The mandatory termination notice period is six months, causing significant delay in the enforcement procedures.¹⁴

Irrespective of the legal requirements, security agreements for financings usually contain preconditions before the security can be enforced, which are similar or identical across the different types of security. Typically, the borrower must be in payment default or declared default must have occurred. Generally, the lender must give notice of enforcement to the grantor of the security before starting enforcement procedures.

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

9 Section 1277 of the German Civil Code.

10 Section 1235 of the German Civil Code.

11 Section 1221 of the German Civil Code.

12 Section 1282 of the German Civil Code.

13 *Zwangsversteigerungsgesetz (ZVG)*.

14 Section 1193 of the German Civil Code.

vi Most relevant limitations on granting security interest

First-demand guarantees

German courts regard guarantees on first demand (i.e., on a mere assertion of a claim or production of a document) as potentially dangerous for the guarantor. Pursuant to case law,¹⁵ guarantees of first demand granted by individuals or companies inexperienced in international trade or finance are invalid. The same applies to guarantees of first demand, which are contained in general terms and conditions.

Over-collateralisation

German law security arrangements are deemed void if the total security taken is far in excess of the secured obligations at the time the security arrangements are entered into (initial over-collateralisation). Initial over-collateralisation is generally held to occur if at the time of entering into the security agreement it is certain that in the event of a foreclosure there will be an obvious imbalance between the realisable value of the collateral and the secured claims. There is no clear case law guidance on thresholds, but invalidity of the security is often assumed when the realisable value of the collateral exceeds the cover threshold (which is generally held to be 150 per cent of the nominal amount of the secured claims) by more than 200 per cent (i.e., the realisable value would be in excess of 300 per cent of the nominal value of the secured claims). Because of the relatively high thresholds, initial over-collateralisation is rarely an issue, but should always be considered when structuring security packages for loan financings.

While initial over-collateralisation always voids a security agreement, in a scenario where over-collateralisation only occurs during the term of a loan financing (e.g., by scheduled repayment of the loans), the security agreements are not deemed to become void. Pursuant to case law, for security interests which do not initially, but over the duration of the security arrangement, provide for security in a nominal value in excess of 150 per cent of the secured obligations and in a realisable value in excess of 110 per cent of the secured obligations, the security grantor obtains a right to request release of part of the collateral until the value of the collateral falls below the thresholds. As a result of the impracticalities of release and potential recreation of security, such a right to release is rarely exercised in practice.

Capital maintenance rules and financial assistance

Under German capital maintenance rules, a GmbH¹⁶ or a German stock corporation¹⁷ may secure or guarantee its own debt and that of its subsidiaries without limitation. Debt of a German limited liability company's direct or indirect shareholders and their affiliates can only be secured up to the amount of equity a shareholder is able to take out of the company granting the security.¹⁸ This means, in effect, that sufficient assets have to remain in the company so as to cover the debt of all other creditors. The commercial result of a limitation language reflecting these provisions is that all other creditors of the company become factually ranking prior to financial creditors benefitting from upstream security. A German stock corporation may, under capital maintenance rules, not grant any benefits to its shareholders

15 See, for instance, BGH, decision dated 23 January 1997, IX ZR 297/95.

16 This includes partnerships that include a GmbH as a general partner.

17 *Aktiengesellschaft* (AG).

18 Section 30 of the German Limited Liability Companies Act.

(or any affiliates of its shareholders) except for the payment of dividends from the annual profits of the stock corporation.¹⁹ These restrictions, however, do not apply if a domination or a profit-and-loss-transfer agreement has been entered into between the limited liability company or stock corporation as security grantor and its shareholder or if the security grantor has a fully valuable compensation claim against that shareholder.²⁰

A breach of capital maintenance rules would usually not render the security or guarantee invalid but the shareholder would have to compensate the company for any over-enforcement and the management of the company granting unlimited security or guarantees would become personally liable. To avoid these consequences, it is common market practice to include limitation language into security and guarantees granted by German entities with limited liability, which limits the enforcement to the legally permitted level subject to certain exceptions.²¹ The details of a limitation language are typically discussed in detail and at length. In addition, German stock corporations are subject to a strict financial assistance prohibition. This does not only comprise direct assistance to finance the acquisition of its own shares but also indirectly by way of upstream security and guarantees in respect of acquisition debt.²²

Debt pushdown

A debt push is often employed to overcome the restrictions of upstream guarantees and security (see above) and the resulting ‘structural subordination’ of creditors of acquisition debt. A debt pushdown is implemented by way of assumption of contract by the relevant target company. The extent to which a pushdown of acquisition debt can be implemented is also subject to corporate law requirements and needs to be analysed in detail in the light of the balance sheet situation and the tax affairs of the relevant group.

Destructive interference, bonos mores and inducement to breach of contracts

In addition to capital maintenance requirements, the German Federal Supreme Court has developed a concept of ‘destructive interference’²³ (i.e., a situation where a shareholder deprives an entity of the liquidity necessary for it to meet its own payment obligations).²⁴ This concept may be applied by courts with respect to the granting of guarantees or security by a German entity for securing debt of its shareholder.

Furthermore, the beneficiary of a transaction effecting a repayment of the stated share capital of a GmbH could become personally liable under exceptional circumstances. The German Federal Supreme Court ruled that this could be the case if, for example, the creditor taking security were to act with the intention of detrimentally influencing the position of the

19 Section 57 of the German Stock Corporations Act (AktG).

20 Section 57 of the German Stock Corporations Act (AktG), Section 30 of the German Limited Liability Companies Act (GmbHG). See Heidinger, *Kommentar zum Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbH-Gesetz)*, 3rd Edition, Section 30, No. 89, for further details.

21 German limitation languages usually contain certain carve outs and adjustments which deviate from the enforceable level stipulated by law but which shall ensure that the management of the company granting security complies with its obligations under the Finance Documents as it would otherwise become personally liable under capital maintenance laws.

22 Section 71a of the German Stock Corporations Act (AktG).

23 *Existenzvernichtender Eingriff*.

24 BGH, decision dated 16 July 2007, II ZR 3/04.

other creditors of the debtor in violation of the legal principle of *bonos mores*.²⁵ This intention can be deemed to be present if the beneficiary of the transaction was aware of circumstances indicating that the grantor of the guarantee or collateral was close to financial collapse.

According to a decision of the German Federal Supreme Court, a security agreement may be void because of tortious inducement of breach of contract if a creditor knows about the distressed financial situation of the debtor and anticipates that the debtor will only be able to grant collateral by disregarding the vital interests of its other business partners.

vii Claw-back rights in insolvency proceedings

Under the German Insolvency Code, the insolvency administrator (or in the case of debtor-in-possession proceedings, the custodian) may challenge transactions, performances or other acts that are deemed detrimental to insolvency creditors and that were effected prior to the opening of formal insolvency proceedings during applicable hardening periods. Generally, if transactions, performances or other acts are successfully challenged, any amounts or other benefits derived from the challenged transaction, performance or act will have to be returned to the insolvency estate.

An act or a legal transaction (which includes the granting of a guarantee, the provision of security and the payment of debt) detrimental to the creditors of an insolvent entity may be challenged in the following most relevant situations.

Congruent coverage (Section 130 Insolvency Code)

Transactions providing the creditor with security or satisfaction for its claims if:

- a* the relevant transaction was entered into within three months prior to the filing for insolvency, the debtor, at the time of the transaction, had already been illiquid and the creditor had positive knowledge thereof;²⁶ or
- b* the relevant transaction was entered into after the filing for insolvency and, at the time of the transaction, the creditor had positive knowledge of the debtor's illiquidity or of the fact that an application for the opening of insolvency proceedings had previously been filed.²⁷

Incongruent coverage (Section 131 Insolvency Code)

Transactions providing the creditor with security or satisfaction for its claims to which the creditor was not entitled at that time or not in that manner are subject to claw-back if:

- a* the relevant transaction was entered into during the last month preceding the filing for insolvency or thereafter;²⁸
- b* the relevant transaction was entered into during the second or third month prior to the filing for insolvency and the debtor, at the time of the transaction, was already illiquid;²⁹ or

25 BGH, decision dated 16 March 1995, IX ZR 72/94; BGH, decision dated 12 March 1998, IX ZR 74/95.

26 Section 130(1), No. 1 of the German Insolvency Code.

27 Section 130(1), No. 2 of the German Insolvency Code.

28 Section 131(1), No. 1 of the German Insolvency Code.

29 Section 131(1), No. 2 of the German Insolvency Code.

c the relevant transaction was entered into during the second or third month prior to the filing for insolvency and the creditor, at the time of the transaction, had positive knowledge that the transaction was detrimental to the insolvency creditors.³⁰

Transaction without consideration (Section 134 Insolvency Code)

Transactions without (adequate) consideration (e.g., where a debtor grants security for a third-party debt, which might be regarded as having been granted gratuitously), if granted within four years prior to the filing for insolvency

Wilful damage (Section 133 Insolvency Code)

Transactions providing the creditor with security or satisfaction for its claims within the four years prior to the filing for insolvency or thereafter if the debtor acted in bad faith with the intention to harm its creditors and the creditor receiving the security or satisfaction was aware of the debtor's intention (such knowledge being assumed or indicated under certain circumstances).³¹

An important option to avoid claw-back risks for security or guarantees in a financing transaction is to structure of security and guarantees as 'cash transactions'. A transaction is considered a cash transaction if the debtor receives a consideration of equal value in return for and concurrently with its own performance (e.g., the debtor grants security for a new loan within a short period of time after disbursement of the funds).

IV PRIORITY OF CLAIMS

i Ranking of claims and security

Under German law, all claims, whether secured or unsecured, have the same ranking unless subordinated by contract or law. The most common method of ranking is a contractual subordination by way of a subordination or intercreditor agreement between the various creditor classes and the respective borrowers. Structural subordination is also employed specifically in larger volume deals with multilayer financing structures. Contractual and structural subordination are often combined. Documentation is typically based on LMA standards with shorter versions for lower mid-cap deals.

Whether security can be created in first, second and further ranking form depends on the type of security. Accessory security like pledges can be created for different creditors in different rankings. Non-accessory security like receivables assignments can only be granted to one secured party as first ranking security. For layered financings, which would typically also have layered security packages (e.g., senior and mezzanine), pledges over shares, bank accounts and real estate can be granted separately for each creditor class. However, for non-accessory security such as receivables and inventory assignments, the security would need to be granted to one common security agent with ranking to be achieved via the intercreditor agreement. The common practice for most financings in Germany has evolved into pooling

30 Section 131(1), No. 3 of the German Insolvency Code.

31 The previous hardening period was 10 years, which has been reduced by the insolvency clawback reform, which became effective on 5 April 2017.

security at one security agent with one intercreditor agreement for all layers of creditors and debt. Parties rely on the contractual agreement in the intercreditor agreement on ranking and waterfall.

In the event of debt increases and term extensions, it is common practice in Germany to confirm non-accessory security and grant junior ranking accessory security (supplemental pledges, see Section III.iv) to ensure that the increased or extended debt is covered by the security agreements.

ii Impact of the German insolvency regime on secured creditors

All creditors, whether secured or unsecured, need to participate in the insolvency proceedings. Secured creditors are generally not entitled to enforce any security interest outside the insolvency proceedings. In the insolvency proceedings, secured creditors have certain preferential rights. Depending on the legal nature of the security interest, entitlement to enforce such security is either vested with the secured creditor or the insolvency administrator. If the secured creditor has a preferential right to enforcement or has a separation right, it may enforce its security by itself. Regarding preferential rights, the insolvency administrator generally has the right to realise any movable assets in the debtor's possession that are subject to security, as well as to collect any claims that are subject to security assignment agreements. If the enforcement right is vested with the insolvency administrator, the enforcement proceeds, less certain contributory charges (usually up to 9 per cent of the gross enforcement proceeds), are disbursed to the party secured by the security interests. With the remaining enforcement proceeds and any unencumbered assets of the debtor, the insolvency administrator satisfies all creditors (whether secured or unsecured) rateably.

iii Equitable subordination of shareholder loans

Claims for repayment of shareholder loans are subordinated in a German company's insolvency and treated, in effect, as if the loan amount was contributed as equity.³² Prior to an insolvency, a shareholder loan can be repaid at any time with basically no restriction. However, repayments made under a shareholder loan, whether due or not, within the year before the application to open insolvency proceedings can be challenged by the insolvency administrator and would need to be paid back to the insolvency estate.³³ Exceptions apply for loans granted by shareholders who (1) do not participate in the management of the company and who hold not more than 10 per cent of the capital of the company or (2) have acquired the shares in order to rescue the company in a financial crisis.³⁴

As the rules on equitable subordination only apply in an insolvency of a borrower, a borrower may make payments on a shareholder loan prior to its insolvency (subject to hardening periods of one year). Thus, in financing structures it is common for shareholders to agree with the lenders that shareholder loans are contractually subordinated and that (except for interest in certain cases) no payments will be made on the shareholder loans as long as the debt financing remains outstanding.

32 Section 39(1), No. 5 of the German Insolvency Code.

33 Section 135(1), No. 2 of the German Insolvency Code.

34 Section 39(4)–(5) of the German Insolvency Code.

Pursuant to case law,³⁵ even third-party lenders may be treated as shareholders in exceptional circumstances and thereby become subordinated. This is the case when lenders would have an influence over the borrower to an extent that they take over its day-to-day management. It is disputed whether by tight covenants as contained in template LMA documentation, lenders limit the corporate and commercial flexibility of borrowers to such an extent triggering the case law subordination. Representations and undertakings should, therefore, provide borrowers with sufficient flexibility to manage their day-to-day business. Sometimes, German obligors are carved out from specific covenants, but those apply indirectly to them via information undertakings to the lenders, which then have an option to consider cancellation for good cause.

V JURISDICTION

i Choice of governing law

Generally, courts in Germany will uphold the choice of law of foreign law governing loan agreements. The application of foreign law to agreements is governed by the Rome I Regulation.³⁶ A choice of foreign law will only then not be upheld if in the event of a conflict with public policy or overriding mandatory provisions of German or foreign law.³⁷ A choice of law regarding non-contractual obligations is subject to the provisions of the Rome II Regulation³⁸ and similar restrictions as under the Rome I Regulation. Under the conflict of law rules of Germany and the European Union, the *lex rei sitae* principle applies to all rights *in rem*, and German law may under those provisions also be applied to security interests over non-physical assets such as receivables governed by German law. Security over German collateral is, therefore, generally subject to German law.

ii Choice of venue

A choice of venue is possible under German and European law subject to certain limitations. An agreement on a place of venue could be blocked by provisions of German law and the Brussels I Regulation,³⁹ determining exclusive venues for certain matters (e.g., disputes concerning the ownership of immovable property, employment contracts, the existence of a company or the validity of registrations in public registers).

iii Enforcement of foreign judgments

The requirements for enforcement of foreign judgments depend on the country of the ruling court. Enforcement of judgments of courts of member states of the European Union of the European Economic Area are subject to the provisions of the Brussels I Regulation

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

36 Article 3 of Regulation (EC) No. 593/2008 of the European Parliament and of the Council on the law applicable to contractual obligations.

37 Article 9 of Regulation (EC) No. 593/2008.

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

39 Regulation (EU) No. 1215/2012 of the European Parliament and of the Council on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

or the Lugano Convention,⁴⁰ respectively, which are largely the same. Judgments of such countries will be recognised and are enforceable in Germany without separate declaration of enforceability by a German court. Judgments from other countries require a declaration of enforceability by a German court, and their recognition is subject to the provisions of the German Code of Civil Procedure,⁴¹ which require, inter alia, that the country of origin of the judgment would recognise and enforce German judgments on generally equivalent conditions (reciprocity).

VI ACQUISITIONS OF PUBLIC COMPANIES

Public companies are usually organised as stock corporations, a partnership limited by shares or a European company.⁴² These entities are subject to the Stock Corporation Act or the Regulation on European Companies.⁴³ Transactions in the capital markets are regulated by the Securities Trading Act.⁴⁴

The takeover of listed public companies in Germany is regulated by the Takeover Act.⁴⁵ The Act and supplemental guidelines set out the rules for the consideration, the content of the offer and the offer procedure.

According to German law, a person obtaining the direct or indirect control over a listed company has to submit a mandatory offer for the acquisition of all shares in the target company. Control is assumed if 30 per cent or more of the voting rights are acquired by a person. Voting shares of subsidiaries and persons acting in concert are attributed to the acquiring person under certain conditions. An enforcement of security over shares in a listed public company may also trigger a mandatory offer for the acquirer that needs to be taken into account when structuring security packages. There is no obligation to make a mandatory offer if the control over the target company was reached by way of a voluntary takeover offer. Exemptions from a mandatory offer may be granted by BaFin. The takeover offer must stipulate a consideration at a certain minimum price as regulated in an ordinance (higher of the average share trading price of the past three months and the highest price paid by the bidder during the past six months).⁴⁶

Voluntary offers generally follow the same rules as mandatory public offers. The bidder may freely set the purchase price unless the offer may lead to acquiring control in the target.

A mandatory or voluntary offer may not be made subject to financing. The bidder has to have financing agreements in place ensuring payment assuming that all shares are tendered.⁴⁷ The bidder has to specify in the offer how its financing is ensured. The financing arrangements must provide the bidder with certain funds that are definitely available if and

40 Convention on jurisdiction and recognition and enforcement of judgments in civil and commercial matters dated 30 October 2007.

41 Section 328 of the German Code of Civil Procedure.

42 Stock company, Partnership limited by shares and *societas Europaea*.

43 Aktiengesetz (AktG) and Regulation (EC) No. 2157/2001 of the European Parliament and of the Council on the statute for a European company (SE).

44 *Wertpapierhandelsgesetz* (WpHG).

45 *Wertpapiererwerbs- und Übernahmegesetz* (WpÜG).

46 Takeover Act Offer Ordinance (*WpÜG-AngebotsVO*).

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

when the offer closes.⁴⁸ For considerations in cash, a written confirmation has to be provided by an independent securities services provider (a ‘financing confirmation’) that the bidder has taken all necessary measures in order to ensure that the funds required are available for the complete fulfilment of the offer at the time the consideration becomes due.

All shareholders have to be treated equally in an offer. The offer may be made conditional in certain respects. For example, essential antitrust conditions are accepted by the authorities. The conditions have to be objective, and the offeree has to be able to make an informed decision on the basis of the information provided. A valid condition may be that shares in excess of a minimum threshold are acquired. In practice, takeovers are often conditional on the acquisition of at least 75 per cent of the voting shares, enabling the bidder to reorganise the target group. Once the bidder has announced its decision to make a takeover offer it is obligated to execute the further offering procedure. The offer may only expire if conditions relating to it are not fulfilled.

VII THE YEAR IN REVIEW

The high volumes and strong deal count of 2017 for leveraged finance transactions in Europe and Germany continued at a high level in 2018, albeit not reaching new heights. Structures suffered again in 2018, with ongoing dilution of lender protections. Conversion from maintenance to incurrence covenants accelerated, and the percentage of covenant lite loans rose still further. This is especially true for larger mid-cap, large cap and leverage/investment grade crossover financings. For mid-cap and smaller deals, covenants have also become looser but continue to apply with maintenance testing. A leverage covenant remains the norm, but a second or third financial covenant has become rare. On the other end of the spectrum, crossover deals are moving to look increasingly like corporate financings. This environment continues, driving a large number of refinancings, which is responsible for a large share of the issuance volume. Availability of funding in Germany is not only driven by the strong domestic bank market, but also by an increasing push of debt funds into Germany. Since their appearance in the market in 2013, debt funds have reached parity in unitranche deal count in 2018.

VIII OUTLOOK

Despite economic growing uncertainty, it seems that the favourable and borrower-friendly conditions in the German lending market will continue for the time being. A number of developments in recent documentation addressed flaws in standard finance documentation that were simply too tight for borrower groups to prosper and develop. We would expect those to stay. On the other hand, increasing numbers of restructuring situations and concerns for the general economic outlook might result in more robust covenant protection for lenders in new finance documentation. Debt funds will continue to provide a large and even increasing part of the financings in the small and mid-cap space while the predominance of banks as arrangers and underwriters in the upper mid-cap and large cap segment will continue.

⁴⁸ Conditions are only permitted to a very limited extent. For more detail, see Baums, Thoma, *WpÜG – Kommentar zum Wertpapiererwerbs- und Übernahmegesetz*, 8th delivery, Section 13, No. 191.

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