Chapter 10

Leveraged Finance in Germany – Special Considerations

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10.1 Introduction to the local market

Generally, the German market had shown greatly increased activity prior to the onset of the credit crunch. High liquidity helped to maintain a high level of buyout activity and leveraged financings. Hedge fund participation in the German market remained more on the debt side providing financing to investors rather than moving into the traditional territory of private equity houses. Secondary buyouts had become an important factor and also stapled finance became a standard feature in the German debt market, even if not regularly taken up by buyers.[1] Between 2001 and 2006 the number of transactions in Germany increased annually by 30–40 per cent, and there was a slight decrease in 2007.[2] The changes in the credit market environment in the second half of 2007 were felt in the German market and this slowed activity considerably from late 2007.[3]

Leaving the economic environment aside, the German legal system is well adapted to document financings. While English law was still frequently chosen in earlier years to govern facilities agreements for syndication reasons, with syndicates comprising entities from a vast

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[1] For a pre-turmoil view on the German market *see* KPMG's Leveraged Finance Study 2006, Market Outlook for Leveraged Finance and Private Equity in Germany, 2007, page 4.
[2] *Deutsche Unquote*, March 2008, p1.
[3] *Deutsche Unquote*, July 2008, p1.

variety of jurisdictions, German law has now been widely accepted as governing law for finance documents[4] in recent years.

German tax law on thin capitalisation changed with effect from 1 January 2008 and as a consequence interest expenses are only tax deductible in an amount up to 30 per cent of the EBITDA of a borrower group, provided that none of the new escape clauses are applicable. There are exceptions to this rule under the following escape clauses:

(a) interest expenses fall short of €1 million;
(b) the relevant entity does not belong to a group for accounting purposes (*keine Konzernzugehörigkeit*); or
(c) the debt/equity ratio at the level of the German borrower claiming interest deduction is lower than or equal to the overall debt/equity ratio of the group of which it is a member.

However, the exception in point (c) is not available if interest payment is made to qualifying shareholders (those holding more than 25 per cent), related parties to such shareholders or persons having recourse against such qualifying shareholders (including related parties). "Such shareholders" means shareholders outside the consolidated group. As a consequence of these changes to the tax law, restrictions commonly used on certain security rights to avoid that those security rights are qualified as harmful recourse to the shareholder (or persons related to the shareholder) of the relevant debtor have fallen away and are not applied any longer. While harmful recourse to the shareholder or related persons is still a relevant feature, it is not usually an issue in ordinary financings where security is limited to security to be given by members of the group. Also, any carve-outs customarily made in relation to security over receivables and bank accounts and other restrictions concerning members of the obligor group seen in facilities agreements concerning German borrowers until the end of 2007 are no longer required in relation to security.

In addition, the German Act on the Modernisation of the Law pertaining to Limited Liability Companies and to Combat Abuses (*Gesetz zur*

[4] In terms of security documents, the applicable law is almost invariably the law of the jurisdiction where the relevant asset to be encumbered is located.

Modernisierung des GmbH-Rechts und zur Bekämpfung von Mißbräuchen ("MoMiG")) came into effect on 1 November 2008. This Act not only changed and reformed the provisions of the German Limited Liability Companies Act ("GmbHG"), it also affected other Acts, such as the German Stock Corporation Act ("AktG"), the German Commercial Code ("HGB") and the German Insolvency Code ("InsO"). The principal concern of the reform is to facilitate and accelerate the establishment of a business and to set up rules more in line with the regulations provided by a large number of Member States of the European Union, where the requirements applying to the formalities of establishment and to the raising of minimum nominal capital are less stringent. Policy-wise, the aim of the reform is, *inter alia*, to make the legal form of a German limited liability company ("GmbH") more attractive and to even out disadvantages experienced by the use of a German limited liability company in the competition between legal forms of entities. In addition, instances of abuse that have emerged in practice in connection with the use of German limited liability companies are to be combated through the application of various measures. The changes which came into effect as a consequence of this reform also impact, to a certain extent, financing structures and taking security in Germany and are referred to below.

10.2 Financial assistance

While German law on limited liability companies does not specifically recognise any prohibition on financial assistance (it only provides for regulations in relation to capital maintenance in general[5]), German stock corporation law recognises explicit prohibitions under the AktG whereby a target company organised in the legal form of a German stock corporation (*Aktiengesellschaft*) is prohibited from giving financial assistance for the purpose of another entity acquiring its shares.[6] This prohibition would also extend to the subsidiaries of such stock corporation as such assistance would be assistance on behalf of their stock corporation parent. "Assistance" does not only comprise granting direct loans or other means to acquire the relevant shares, it also extends to granting (upstream)

[5] *See* 10.3 below.
[6] *See* Section 71a, AktG.

guarantees and other security for any indebtedness that the acquiror incurs to finance the acquisition of the stock corporation target, which is thus generally prohibited. This prohibition will generally also continue to apply to transactions after the acquisition itself, including the refinancing of acquisition debt.

Under the former law in force until recently, a German stock corporation was not allowed to provide any benefits to its shareholders other than dividends resolved upon in the ordinary proceedings. In order to overcome this obstacle in achieving upstream security, a conversion of the target company following the consummation of the acquisition into a different legal form, for example a GmbH or limited liability partnership ("KG") had been useful. As a further tool to overcome the relevant prohibition, the implementation of a profit-and-loss-pooling agreement or a domination agreement ("*Beherrschungsvertrag*") between the target and the acquiring entity has often been applied. However, conflicting views have been expressed so far in legal literature as to whether the financial assistance prohibition of Section 71a, Stock Corporation Act is to be disapplied if a stock corporation is subject to a domination agreement. This controversy seems to have come to an end with the insertion of a further sentence in Section 71a of the Act as a consequence of the MoMiG, stating that the prohibition shall not apply to legal transactions in case of a domination agreement. While the real impact of that provision needs to be seen in practice now that it has come into effect, the argument made in the context of the general prohibition of payments to the shareholders other than dividends might still continue to apply despite this amendment under the new law.

It has been argued in legal literature that the general prohibition on repayment of capital of any sort to the shareholders,[7] even if a domination agreement is in place, will not be inapplicable pursuant to Section 291, Stock Corporation Act (contrary to the explicit wording of the provision) but will continue to apply if it is evident that the dominating company will in fact not be in a position to indemnify the dominated company for any losses incurred.[8] It is argued that the

[7] *See* Section 57, AktG.

[8] For the obligation of the dominating company to indemnify the dominated company, *see* Section 302, AktG.

existence of a domination agreement only justifies the exemption from the general prohibitions by reason of the dominated company being entitled to compensation for losses incurred to be granted to the dominated company by the dominating company, with the creditors of that dominated entity economically not being deprived of the financial means of the company holding the compensation claim against the dominating company. However, if it is apparent from the outset that such indemnification obligation of the dominating company will economically not be meaningful as the dominating company might be a pure acquisition vehicle holding only the shares in the target and having no other assets from which compensation payments could be made, it is argued that the exemption shall not be available as this would contradict the rationale of the relevant provisions. Although the relevant prohibitions primarily apply in the relationship between the target company/stock corporation and its shareholders and, if applicable to a transaction, render the relevant transaction void, agreements with third parties falling within the ambit of these provisions may also be regarded as void if such third parties had knowledge of the violation of the prohibition or acted wilfully and *contra bonos mores* with the intent to procure damage (*sittenwidrige vorsätzliche Schädigung*).

10.3 Directors' duties and capital maintenance (including possible future changes)

While financial assistance prohibitions strictly apply only to German stock corporations,[9] capital maintenance requirements have to be observed both by German stock corporations ("AGs") and by GmbHs, while within KGs the applicable capital maintenance regulations are those which are applicable to the general partner of such partnership. As outlined above and generally speaking, the shareholders of a German stock corporation may not receive any benefit from the relevant stock corporation other than dividends resolved upon in accordance with the provisions of the AktG, and the repayment of capital to the shareholders is prohibited.[10] The provisions applicable to limited liability companies are somewhat less stringent

[9] *See* 10.2 above.
[10] *See* Section 57, AktG.

and the GmbHG only prohibits payments to the shareholders to the extent that such payment causes the net assets of the company to fall below its registered share capital (*Stammkapital*) 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.[11] It is acknowledged that the aforementioned prohibitions not only relate to direct cash payments to the shareholders, but also to any other benefits to the shareholders, including but not limited to the granting of security rights to any third parties which are lending to or have other payment claims against the relevant shareholders. The violation of these prohibitions generally gives the company a claim against the shareholders for repayment of the relevant benefit. Also, the members of the board (*Vorstand*) of a German stock corporation and the managing directors of a German limited liability company (*Geschäftsführer*) are bound by law to observe the relevant requirements. Acting in breach of those obligations (at least negligently) may lead to personal corporate law liability issues for the relevant directors and possibly also criminal liability in certain circumstances.

Any payment to the shareholders of an AG in consequence of the existence of a profit-and-loss-pooling agreement or a domination agreement was, even under the old law, exempted from the above prohibition applying to a German stock corporation (AG).[12] But there had been debates in legal literature about whether the existence of such an agreement would also render inapplicable the relevant prohibition of payments to the shareholders of a GmbH to the extent that the registered share capital is violated, because the old regulations did not provide for an explicit exemption in that case, even if the interests were similar. Now that the MoMiG has come into effect, the situation has changed. As in consequence of this Act both relevant prohibitions in the German Stock Corporation Act and the German Limited Liability Companies Act have been amended to make it explicit that the relevant prohibition is disapplied where the payment to the shareholder is:

(a) between the parties to a profit-and-loss-pooling agreement or a domination agreement; or

[11] *See* Section 30, GmbHG.
[12] *See* Section 291, para. 3, AktG; *see* also 10.2 above.

(b) supported by an underlying claim for payment/delivery or a repayment claim which is fully recoverable (*vollwertiger Gegenleistungs- oder Rückgewähranspruch*).

Both exemptions should make it substantially easier to make upstream payments and/or grant upstream security. However, the primary intention of these amendments was to simplify cash-pooling between group companies, not to enable financing structures in leveraged financing transactions, and thus a number of issues remain open. As to the exemption referred to under (a) above, the argument continues to apply relating to the compensation claim of the dominated company against the dominating shareholder (being the main reason for the exemption from the prohibition) which claim is rendered meaningless where such dominating shareholder does not hold assets other than the shares in the dominated company. As stated at 10.2 above, the argument may well be made to again disapply the exception, with the result that the prohibition continues to apply in these circumstances. Also, the exception referred to under (b) above may be subject to doubts in the context of an acquisition context with a "naked" acquisition vehicle being the debtor of the repayment claim/compensation claim for any guarantee/security granted by the target. Accordingly, a number of uncertainties remain, and limits to the granting of upstream guarantees and upstream security in the context of acquisition financings will remain a topic on the agenda.

A violation of the capital maintenance provisions does not generally and *per se* render void a guarantee or other security interest granted to a third-party lender. However, it is good market practice for financing documentation to contain limitation language in relation to the liabilities of a German subsidiary having granted a guarantee and/or other asset security for its direct or indirect parent[13] taking account of the relevant prohibitions to the extent applicable. Usually the details of such limitation language are not very easy to agree upon.

[13] This commonly applies to GmbH, while for the reasons outlined above, AG generally do not provide any upstream guarantees and/or upstream security at all, unless a domination agreement is in place (and even in such case, counsel to the opposing parties do not necessarily share the same view on what is permissible under such domination agreement).

In addition to the usual capital maintenance requirements, court decisions and jurisprudence have also developed the concept of prohibited encroachment on the GmbH's vital financial means, prohibiting and invalidating a shareholder from extracting funds from a GmbH where such funds were required in order to maintain the GmbH's liquidity (*existenzvernichtender Eingriff*), the concept of which was much debated and now has developed into a kind of liability of the shareholder(s) vis-à-vis the company.[14] Thus, a GmbH may hold its shareholder(s) liable for causing the over-indebtedness (*Überschuldung*) or illiquidity (*Zahlungsunfähigkeit*) of such GmbH pursuant to Section 826 of the German Civil Code ("BGB"). It cannot be ruled out that a third-party creditor may also be held liable according to Section 830 of the BGB for aiding and abetting such prohibited encroachment, if the relevant shareholder acted with intent and also the relevant third-party creditor acted intentionally in aiding or abetting such intentional/willful acting of the shareholder(s).[15]

These principles apply *mutatis mutandis* to the prohibited encroachment on the vital financial means of entities in other legal forms. Therefore, German courts may determine that a chargor granting upstream guarantees and/or other asset security for its shareholders may have a valid defence or counterclaim against the claims of a third-party creditor in a case where that creditor was aiding or abetting a shareholder in such prohibited encroachment of that chargor's vital financial means.

10.4 The granting and perfection of security; equitable subordination

10.4.1 The granting and perfection of security

10.4.1.1 General considerations

German law does not provide for any security instrument coming close to a floating charge which would cover and provide security

[14] This is in contrast to the earlier discussions where a direct liability vis-à-vis third-party creditors was at stake.

[15] For the legal construction of aiding and abetting, the German Penal Code (StGB) is relevant *see*, for example, Cramer/Heine in Schönke/Schröder, *Strafgesetzbuch*, (27th edn, 2006), **26**(1/2); **27**(1–3).

over substantially all assets of an entity or person. Rather, the economic effect of an all-encompassing security instrument can be substantially achieved by taking security over the different asset classes that the relevant chargor holds by way of implementing different security instruments. The standard instruments are:

(a) security over shares (which may or may not be materialised in securities) and partnership interests;
(b) security over bank accounts (account pledges);
(c) security over receivables (trade receivables or receivables over intercompany loans or other monetary claims, by way of security assignment of receivables);
(d) security over fixed and current assets;
(e) security over IP rights; and
(f) security over real property.

Generally, the beneficiary would need to assess which assets the relevant chargor holds and/or would be of a value being proportionate to the effort of taking security over them and would then need to determine which kind of security should be taken. Basic security would comprise security over bank accounts and receivables, with further classes of security to be added depending on the assets that the chargor actually holds.

However, determining which assets are held by the relevant German chargor and whether such assets are pre-encumbered requires the cooperation of the chargor, as there are generally no public registers which would be available for lien searches or comparable searches. Thus, it is not possible to ascertain which kind of security was already granted by a potential chargor to any third party. The important exception to that principle is security over real property; but also in this case, no general search is possible (i.e., there is no means to verify by general search which real property a potential charger owns). Instead, it is a requirement to have the details of the relevant real property (where it is located, registered with which land register at which local court, registration/sheet (*Blatt*) number) to conduct any searches. Once the aforementioned details are known, it could be verified (if there is a recognised interest or a notary public makes the search) whether such specific real property is encumbered as per registration in that land register. (Security over ships and aircraft is

also subject to registration in the relevant registers and equivalent checks can be made in relation thereto.)

In addition, corporate documents relating to a German entity can be obtained by any third party (without the need to evidence any recognised interest therein) from the relevant registers, which would basically consist of excerpts from the commercial register in the case of German stock corporations, GmbHs and/or limited partnerships (*Kommanditgesellschaften*) and the articles of association/incorporation in the case of German stock corporations and GmbHs. Partnership agreements of limited partnerships are not filed with commercial registers. In any case, those publicly available corporate documents do not specify whether the relevant shares or partnership interests are encumbered.

Generally, German security rights are by their very nature either of accessory or non-accessory nature. Accessory security, which is directly linked to a claim, can only be vested in a person which is itself a creditor and only for the amount owed (presently or in future) to that creditor. In contrast, non-accessory security can be vested in any third party which holds such security for the relevant creditors. Accordingly, in syndicated facilities, non-accessory security rights are directly held by the Security Agent or Security Trustee (i.e., title to the relevant right is directly conferred upon it). Following the very nature of accessory security rights, title in the relevant right would generally have to be granted to the creditors of the syndicated facilities collectively (i.e., all lenders and all other finance parties). In order to facilitate the granting and the transfer of such security together with the transfer of commitments of the secured facilities (which might not necessarily be drawn on the date of such transfer), it has become widespread practice in Germany to establish a "parallel debt" in favour of the Security Agent (a feature which has already been used in other jurisdictions for a longer time period and which is also known as "covenant to pay"), which takes the form of an "abstract acknowledgment of debt" (*abstraktes Schuldversprechen*) under German law. This instrument is established either in the intercreditor agreement or the facilities agreement and creates an individual direct claim of the Security Agent which can be secured by the relevant accessory security rights. However, at the time of writing there were no clear German court decisions on such instrument. It is also common practice that

accessory security is not only vested in the Security Agent by virtue of that parallel debt, but that it is created both for the lenders (to secure their direct claims resulting from lending) and the Security Agent (to secure the claim it holds under the parallel debt).

In the case of repayment and/or other discharge of the secured obligations, non-accessory security rights will have to be explicitly released and the relevant rights will have to be re-transferred in order to effect a full release. In the case of accessory security rights like pledges, such rights will lapse by operation of law if the secured debt ceases to exist (and a release will only be provided as a matter of record). However, if the underlying debt (i.e., the secured payment obligation) is subject to transfers/disposal in consequence of new lenders acquiring participations in syndicated facilities, 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 are made by way of novation, accessory security rights will lapse by operation of law if the original secured claim legally ceases to 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 assigned and transferred to a new creditor.

To the extent that several different layers of debt and different classes of creditors are to be secured by identical assets, the distinction between non-accessory and accessory security also plays an important role. While rights under non-accessory security are usually conferred to one beneficiary only and there is no creating 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 etc.). The same holds true for the non-accessory right of land charges (*Grundschulden*) in German real property 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 of 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 separate first-ranking security rights are created for senior

secured lenders, with separate subsequent second-ranking security rights for a creditor group ranking behind this first-ranking lender group etc. However, in order to minimise documentation and effort, it is also not unusual for the creditor groups to agree to create only one accessory security right for themselves collectively within the same rank and then agree to the distribution waterfall in the relevant inter-creditor document which would be applicable to non-accessory security rights and for general purposes anyway.

If German substantive law is to apply to the relevant relationship, the concept of "over-collateralisation" is applicable.[16] Under relevant German case law, the value of collateral granted for security purposes must not be "excessive". The granting of a security right for the benefit of certain creditors violating this rule either in itself or in combination with other security rights will be deemed void if the violation exists at the time the collateral is granted (initial over-collateralisation – *anfängliche Übersicherung*). This would be 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 content and purpose) is a violation of the rules of acting in good faith and fair dealings and thus *contra bonos mores*. Although several court decisions deal with various percentages, there is no strict rule as to when exactly initial over-collateralisation has to be assumed.[17]

[16] If the lending relationship is governed by laws other than German law and such choice of law is recognised by German courts, it cannot, however, be completely ruled out that the concept of over-collateralisation might still be applied by German courts. It is unlikely that this will be achieved through Article 34 of the German Introductory Code to the German Civil Code (EGBGB), because a violation of *bonos mores* pursuant to Section 138, German Civil Code is not a violation of an internationally mandatory provision which has to be applied regardless of the applicable law (*see*, e.g., O Mülbert/S. Bruinier in WM 2005, *Die Anwendung inländischer Schutzbestimmungen am Beispiel ausländischer Kreditverträge*, pp105 and 109 for Section 138, German Civil Code not being applicable through Art. 34 EGBGB). However, Section 138 German Civil Code might be applied through operation of Article 6 of the German Introductory Code to the German Civil Code, if it is found that the result of the application of the non-German law grossly violates the most fundamental criteria of German perception of "*bonos mores*". Regard will presumably also be had to whether the domicile of the borrower is within Germany or in the jurisdiction whose laws are applied (*see* also the line of Argument in O Mülbert/S. Bruinier in WM 2005, pp105 and 113). To date no court decisions on that point have been published.

[17] *See* for example Ganter in Schimansky/Bunte/Lwowski, *Bankrechts-Handbuch*, (3rd edn), **2**(90), no. 352c.

Moreover, should any subsequent over-collateralisation (*nachträgliche Übersicherung*) occur as a result of progressing repayment of the secured indebtedness, the security grantor is entitled to a partial release of the collateral. However, such subsequent over-collateralisation would not affect the validity of the collateral. Jurisprudence is clearer on the applicable percentages in the case of subsequent over-collateralisation than in the case of initial over-collateralisation, and 110 per cent and 150 per cent are the thresholds commonly cited. Generally, there is subsequent over-collateralisation if the value of the realisable collateral exceeds 110 per cent of the amount secured. However, this threshold is replaced by a 150 per cent threshold if the valuation of the collateral is somewhat unclear. The relationship between the 110 per cent and the 150 per cent threshold also is debatable, but basically the 110 per cent threshold is applicable if the realisable value collateral may be determined without any difficulty (nominal value or similar), while the 150 per cent threshold shall be applicable if the realisable value cannot be clearly identified (market value or estimated value).[18] The burden of proof that application of the 150 per cent threshold is inadequate and the lower threshold should be applied instead is borne by the grantor of the collateral.

10.4.1.2 Types of security

Shares and partnership interests

The form of security over shares or partnership interest depends on the exact legal form of the company concerned, but in any event regularly by way of pledge as accessory security right, in favour of the actual creditors of the secured claim with such creditors being party to the pledge as beneficiary/beneficiaries. While it is theoretically possible that the shares or the partnership interests are also transferred rather than pledged to a security agent as a non-accessory security right, this form is quite unusual for this type of secured assets, e.g., for reason of liability as a shareholder or partner.

A pledge of shares in a GmbH is considered a pledge of rights, as shares in a GmbH are never materialised and no share certificates or instruments related to such have to be transferred. The pledge of the shares does not necessarily also extend to the rights to dividends

[18] *See* Ganter in Schimansky/Bunte/Lwowski, *Bankrechts-Handbuch,* (3rd edn), **2**(90), no. 360 with further references to a number of court decisions.

which have to be included explicitly in the pledge agreement in order to be covered. Contrary to some other legal systems, voting rights remain with the chargor who will at all times remain entitled to vote, but of course can agree to vote in a specific way or, alternatively, may also grant a power of attorney to the pledgee(s) to vote in the name and on behalf of the chargor. The latter will hardly ever be agreed between the parties to a pledge in shares as the pledgee(s) will not want to act like a shareholder and to be treated as a shareholder or quasi-shareholder with the result that their (secured) claims are in certain specific cases equitably subordinated. The pledge of shares in a German limited liability company/GmbH requires notarial form pursuant to Section 15 of the GmbHG. If the required form is not complied with, the relevant agreement is void. For cost reasons the parties to such pledge agreement may sometimes want to agree on notarisation outside Germany, often notarisation in Switzerland is chosen. The German courts and specifically the German Federal Supreme Court (*Bundesgerichtshof*/BGH) determined that notarisation outside Germany is permissible for certain acts requiring notarisation provided that there is equivalence in function between the German and the non-German procedure. Such equivalence had been assumed if:

(a) the non-German notarising person is performing a function which is equivalent to the function of a German notary in the German legal system and which is requiring a comparable knowledge; and
(b) that person has to observe the relevant notarisation rules of procedure which conform to the underlying principles of the German law of notarisation.[19]

There have been decisions which have confirmed equivalency for notarisation in Basle Stadt, Switzerland[20] for the sale of shares,[21] but there is no decision of the German Federal Supreme Court (BGH)

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[19] *See* for example BGHZ 80, pp76 and 86.

[20] It is important to note that notarisation in other places in Switzerland is not equivalent to notarisation in Basle Stadt and thus cannot be used to replace German notarisation – compliance with the German notarial form would not be recognised and the relevant agreements might be void for lack of notarial form within the meaning of the relevant German law provisions.

[21] *See* the decision referred to at footnote 19.

specifically concerning GmbH share pledges. In addition, it has been disputed in legal literature whether notarisation outside Germany is sufficient in any case for the German law notarisation requirement and even more so as, for example, the Swiss law relating to obligations was changed with effect from 1 January 2008, abolishing the notarisation requirement for the transfer of shares under Swiss law itself.[22] However, in practice, notarisation in Basle Stadt is still an alternative chosen by practitioners for transfers of GmbH shares as well as for pledges of GmbH shares, but it is necessary to accept a qualification in the legal opinion on validity and enforceability of such agreement relating to the notarial form. The company whose shares are pledged, has to be notified of the pledge.[23]

In a German KG, the limited partnership interests may be pledged to the relevant creditors of the chargor, with the pledge being an accessory security right (as per the above at 10.4.1.1). Also partnership interests in a limited partnership are rights which are not materialised and no share or other certificates are issued evidencing the rights in the partnership. While the pledge of limited partnership interests generally does not require any specific form and as a general principle private written agreement should be sufficient, there is legal argument if the general partner of such limited partnership is a German limited liability company and the shares in such general partner are also pledged by way of notarial deed. This argument basically expresses the view that none of the pledges would have been perfected without the other and the relevant transactions are linked; accordingly parts of the relevant legal literature concludes that the pledge in the limited partnership interests which could otherwise be made by simple written agreement also needs to be notarised.[24] Although there are no decisive court decisions on that

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22 *See* the various articles about German notarisation and the changes in Swiss law: e.g., Weller, M. (2008) *Die Übertragung von GmbH-Geschäftsanteilen im Ausland: Auswirkungen von MoMiG und Schweizer GmbH-Reform, Der Konzern* , p253 et subs; Saenger, I. and Scheuch, A. (2008) *Auslandsbeurkundung bei der GmbH – Konsequenzen aus MoMiG und Reform des Schweizer Obligationenrechts*, BB 2008, p65 et subs. and others.

23 The corporate law requirement of notification pursuant to Section 16, German Act on Limited Liability Companies (GmbHG) is no longer in force in consequence of the changes implemented through MoMiG. However, to the extent dividend claims are also pledged, notification of the company as debtor is required under Section 1280, German Civil Code ("BGB")

24 For a summary on the issue and discussion, *see* Werner, R. (2008) *Zur Formbedürftigkeit der Verpfändung von Kommanditanteilen an einer GmbH & Co. KG, GmbHR*, p755. However, this reaches the conclusion that no notarisation is required (p758).

point, it is advisable that as a matter of precaution the pledge over the limited partnership interest is also notarised where the shares in the general partner in the form of a German GmbH are pledged.[25] As for notarisation in Germany or the equivalent procedure of notarisation outside Germany, the above considerations apply. Similarly, as in the case of GmbH shares (dealt with above), voting rights are not part of the pledge, and limited partners' interests cannot regularly be made subject to encumbrances without the consent of the general partner. Although the pledge in the limited partnership interest *per se* does not require a notification of the limited partnership, such notification is required under the German Civil Code ("BGB")[26] as almost invariably claims to dividend payments will be pledged as well.

Shares in a German AG are also encumbered by way of pledge. However, in the majority of cases such shares are materialised and therefore the right in the shares is embodied in the share certificate which could be a bearer certificate (*Inhaberaktie*), but may alternatively also be a registered share (*Namensaktie*). While there is no specific form requirement for the relevant pledge agreement which can be documented through simple written form and the pledge of non-materialised AG shares is a pledge of rights, the pledge of materialised shares is a pledge of securities and it is required that the beneficiaries of the pledge obtain possession of the share certificates in order to perfect the pledge. In the case of registered shares, an endorsement of the relevant share certificates is necessary. Also, the granting of possession to the pledgee(s) varies technically depending on whether the pledgor holds direct physical possession of the share certificates and those could be physically delivered, or whether the share certificates are deposited with a third party (depository) where the direct delivery is replaced by providing for indirect possession and the actual possessor will be instructed to keep possession forthwith not for the pledgor, but for the pledgee(s)

[25] *See* also Merkel in Schimansky/Bunte/Lwowski, *Bankrechts-Handbuch*, (3rd edn), 2(93), 154. If the general partner is a legal entity in a form other than a German GmbH, perhaps even an entity under non-German laws (e.g., a UK Ltd) the pledge over the shares in the general partner has to follow the form requirements for that entity, and if there is no notarisation requirement, there is also none for the pledge of the limited partner's interests.

[26] Section 1280, German Civil Code (*BGB*).

instead. The required procedure is different in cases where (x) the depository holds possession of those share certificates to be pledged as individual share certificates, in contrast to cases where (y) the concerned share certificates form part of a global share certificate also physically deposited with that depository, or where (z) the depository bank only keeps the shares in their books while the actual (global) share certificate is deposited with a central custodian like Clearstream. Accordingly, specified factual information is required to create the security interest. In this context, it might also be worth noting that possession also requires the intent of the actual possessor to possess, either for themselves or for a third party / third parties. Such intent cannot be split and a syndicate member cannot, by way of construction, hold possession of share certificates for itself as pledgee (possession for itself) *and* at the same time for other syndicate members as further pledgees (possession for third parties). Thus, where share certificates are pledged to a syndicate including the relevant custodian bank, two alternative solutions are available:

(a) either possession of the share certificate(s) has to be granted to a depository outside the syndicate holding possession on behalf of all syndicate members as pledgees; or
(b) pledges are created in different ranks *in rem* (e.g., a first-ranking pledge in favour of the syndicate members other than the custodian bank with the custodian bank keeping forthwith possession *for* those syndicate members as pledgees and a second-ranking pledge in favour of the custodian bank) with a contractual arrangement between the relevant pledgees to treat the pledges contractually equally in view of potential enforcement proceeds, in order to overcome the hurdle created by the legal impossibility to hold possession of an asset at the same time for oneself and for other parties.

Securities

Security over securities in general is also created by way of pledges as accessory security rights. To the extent that the securities are materialised, the above considerations for materialised shares (which also constitute securities) apply.

Bank accounts

Security over bank accounts is taken in a form different from that which is used to provide security over other receivables,[27] by way of a pledge over bank accounts. As a pledge this accessory security right can only be established in favour of the actual creditors of the secured claim, with such creditors being party to the pledge as beneficiary/beneficiaries. In order to perfect such pledge of a right, the third-party creditor (i.e., the account-keeping bank) has to be notified of the pledge,[28] and only upon receipt of the relevant notification is the pledge perfected. Such pledge of rights flowing from the bank account is, pursuant to German conflict of laws rules, governed by the law of the encumbered right, that is, German law account pledge agreements effectively cover bank accounts kept in Germany under German law. Should the (German) chargor keep bank accounts outside Germany, security over these bank accounts has to be taken in accordance with the laws of that place.

In this context German banks use standard terms of business pursuant to which the account-keeping banks have security over the accounts they keep. In order to create a first-ranking pledge in favour of another creditor, the account holder is required to obtain a waiver and release of this pre-existing pledge from the account-keeping bank. While such account-keeping bank is under no obligation to waive its rights under its standard business terms, it is quite common that such request (which is usually made together with the notification of the pledge) is complied with. Either the existing pledge is waived, thereby producing the desired effect *in rem*, or at least agreement is expressed that the contractual pledge of the third-party creditor shall be treated senior to the pledge of the account-keeping bank, which does not provide the effect *in rem* but has to be read as contractual subordination and which is also widely accepted. (Security Principles favouring the interests of the borrower often provide that there shall be no obligation for the chargor to change its banking arrangements if no such waiver of its prior ranking rights is obtained from the account-keeping bank.)

No requirements other than the above as to the form of the agreement have to be observed; simple written form is sufficient.

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[27] *See* below.

[28] Notification is to be made pursuant to Section 1280, German Civil Code.

Receivables
Security over receivables can legally be created by way of pledge or assignment of such receivables. While a pledge of a right/claim requires the notification of the third-party debtor[29] in order to perfect the security, an assignment is perfected between assignor and assignee only and a notification is not required to perfect the security right. Thus, security over receivables is granted almost always by way of assignment (*Sicherungabtretung*) as non-accessory security and the receivables are assigned to the security agent with the contractual purpose to serve as security for the relevant liabilities. However, the receivables need to be described precisely in order to comply with the German law requirement of specification (*Bestimmtheitsgrundsatz*) to allow for the transfer *in rem* of the relevant receivables, if the requirement of specification is not complied with the assignment is void. While it is not required that the relevant third-party debtors are notified of the assignment, absent such notification the third-party debtor may discharge its debt through payment to the assignor as former creditor.[30] Accordingly, a notification of the third-party creditor of the assignment will prevent this effect and once the creditor is aware of the assignment, payment has only discharging effect if made to the assignee as new creditor. While German conflict of laws rules determine that the law governing the relevant receivable to be assigned also governs the effectiveness of the transfer/encumbrance of the receivable and thus only the assignment of German law governed receivables should be dealt with in a German law security assignment,[31] assignment of the relevant receivables may also be excluded or restricted in relation to German law receivables pursuant to the terms of the underlying agreement between the third-party debtor and the (potential) assignor. Generally, a claim may not be assigned if performance cannot be made to a person other than the original creditor without a change of the contents of the claim or if the assignment is excluded by agreement with the obligor.[32] However, this principle

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[29] Section 1280, German Civil Code.
[30] *See* Section 407, para. 1, German Civil Code.
[31] Although it may well be possible that a relevant applicable law does not provide for any further requirements to achieve an assignment other than those under German law and thus the effect of the assignment of the non-German law receivable may well be achieved by the German law security instrument, the parties will prefer to choose (from a German conflict of laws perspective) a security instrument governed by the laws of the relevant receivable(s) in order to achieve utmost comfort in relation to an effective encumbrance.
[32] Section 399, German Civil Code.

is affected if the underlying agreement constituting the third-party debt is a commercial transaction (*Handelsgeschäft*) for both sides concerned. In that case, Section 354a of the HGB applies, which provides that irrespective of any agreement to the contrary, receivables resulting from a commercial transaction may always be assigned with effect *in rem*.[33] However, the downside is that payments on the debt made by the third-party debtor to the assignor as original creditor will have a discharging effect even if the third-party debtor was fully aware of the assignment. Thus, the assignee will be interested in getting comfort on the absence of assignment restrictions in the underlying agreements relating to the assigned receivables, even if only by way of representations and undertakings by the relevant assignor. Enforcement of the security in receivables will be made in accordance with the terms of the assignment agreement and by way of collection of the amounts due from the third-party debtors. In relation to trade receivables resulting from the provision of goods and/or services it is also common practice that only upon the occurrence of an event of default or even the occurrence of an enforcement event (which could include not only an event of default but also a certain notice period or acceleration of the secured facilities) third-party debtors are notified of the assignment in order not to interfere with the assignor's business relationship with its customers. This is in contrast to the treatment of receivables resulting from certain specific relationships where the third-party debtor frequently receives a notification of the assignment right on the perfection of the assignment, e.g., in the case of assignment of monetary claims under a share purchase agreement or claims under certain specific insurances. The assignment agreement will contain provisions pursuant to which the assignor has to deliver executed copies of notifications of the assignment "in blank" for the purposes of notification of the third-party debtors, delivery of the blank notifications to be made either at the time the assignment is executed or upon further request by the assignee on the occurrence of certain specific circumstances.

[33] With the sole exception of a case in which the original creditor is a credit institution (*Kreditinstitut*) within the meaning of the German Banking Act, such exception being introduced with effect from 19 August 2008 by way of the German Risk Limitation Act (*Risikobegrenzungsgesetz*).

In relation to trade receivables, so-called "extended reservation of title" arrangements are very common. These mean that suppliers of goods on one hand retain title to the goods delivered until their claims are discharged by the relevant acquirer of the goods, but on the other hand the relevant acquirers are also permitted to resell such goods and/or manufacture them and then sell on such products while the original supplier of goods receives title to the receivables originating from the relevant sale by the original acquirer of those goods. "Extended reservation of title arrangements" have priority over assignments for security purposes. While generally priority in time is relevant (i.e., extended reservation of title arrangements have priority over assignments for security purposes which are only entered into after the extended reservation of title arrangements are perfected), German courts have ruled that lenders which should know that their debtors need to operate under extended reservation of title arrangement act in bad faith if they nevertheless force their borrowers/debtors to agree to general assignments of receivables,[34] as such lenders are held to participate or rather cause intentional breaches of contract by the relevant assignors vis-à-vis their suppliers. As a consequence, German courts treat such assignments as void. In order to avoid these consequences, German practice has established a carve-out in assignments of receivables in relation to receivables which are subject to such extended reservation of title arrangements. Thus, it is imperative in practice that assignments of trade receivables (where there is even a minor probability that extended reservations of title arrangements come into play) contain a carve-out so that no attempt is made to assign such receivables to the beneficiary of the relevant security. A mere obligation of the assignee to re-transfer such receivables to the supplier or to pay out any proceeds is not sufficient.

No requirements other than the above as to the form of the agreement have to be observed; simple written form is sufficient.

Fixed and current assets

Security over physical, movable, fixed and current assets is created under German law by way of a transfer of title to such assets for

[34] *See* for example Reinke/Tiedke *Kreditsicherung* (5th edn), 2006, no. 953 with further reference to a wide variety of court decisions.

security purposes to the secured person or rather a Security Agent, thereby creating non-accessory security rights. The corresponding accessory security right would be a pledge of the relevant assets, which requires physical possession of the relevant assets by the beneficiary of the pledge, the pledgee(s), and therefore is not adequate in a commercial environment where it is important that the chargor may operate with (fixed) assets, manufacture (current) assets and/or sell them on. While the transfer of title for security purposes also requires agreement on transfer and the transferee obtaining possession of the relevant assets, in the case of a transfer (as opposed to a pledge) physical possession can be replaced by an agreement between the parties that the chargor shall possess the relevant assets for and on behalf of the transferee.[35] Corresponding to the requirement of specific description of receivables in order to effectively create security over receivables,[36] the physical assets transferred or to be transferred need to be described precisely in order to comply with the German law requirement of specification (*Bestimmtheitsgrundsatz*) to perfect the transfer *in rem* of the relevant assets. This can be achieved by listing the assets and establishing a contractual requirement to provide updated lists which describe the relevant assets in a way which would enable any third party (and specifically a bailiff) to physically identify the relevant assets without any further information and research. However, in the case of current assets which inevitably vary a lot over a relatively short time, such lists economically do not reflect the intention of the parties to grant security over certain assets kept at certain business premises at any time. Accordingly, the German law requirement of specification is also sufficiently complied with in the case of assets kept in a certain area which is precisely identified in clearly marked maps or otherwise precisely identified. Security is thus taken over assets stored in certain areas by way of the so-called *Raumsicherungsübereignung*. This instrument is most frequently used in relation to security over fixed and current assets and is a common tool which requires the grantor to provide precisely marked maps of the business premises which form part of the security transfer agreement so that the relevant assets located in the relevant marked areas are transferred for security purposes. In addition thereto, quite often there are additional obligations to provide updated lists of assets at

[35] So called *Besitzkonstitu*.

[36] *See* above.

regular time intervals, but given that the structure of security over assets stored in a certain area is granted, such lists normally only serve informational purposes. Thus current assets are covered by the agreement when they are stored in the secured area, and also future assets are covered once they are brought into the secured area once the agreement is in place. As per German conflict of laws rules, such transfer of title to assets can only be perfected in relation to assets situated in Germany, but would not cover assets situated outside Germany, where the relevant transfer of title is regulated by the laws applying to the place of the relevant asset.

No requirements other than the above as to the form of the agreement have to be observed; a simple written form is sufficient.

IP rights

Security over IP rights is taken under German law either under the form of a pledge (as an accessory security right, which is strictly linked to the debt secured by such pledge) or under the form of an assignment (which as a non-accessory security right could be simply vested with the Security Agent and is not linked *in rem* to the secured obligation). While both forms are used in the German market, there is a slight tendency toward assignment. An assignment offers, *inter alia*, a somewhat easier enforcement procedure,[37] as the relevant rights could be sold in an ordinary way. In contrast to this, a pledge over IP rights requires that the security assets be auctioned off (as it has to be assumed that the relevant IP rights do not have any Stock Exchange or determined market value (*Börsen oder Marktpreis*), absent which no free sale is permissible when enforcing a pledge[38]). Both currently held and future IP rights could be made subject to the relevant security and no specific form requirements have to be observed for the relevant agreement; simple written form is sufficient.

Real property

Security over land situated in Germany can be established in two alternative forms, both of them to be registered in the German land register (*Grundbuch*) kept with the relevant local courts (*Amtsgericht*)

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[37] *See* Albrecht, C. and Hombrecher L. *Aspekte der Vertragsgestaltung bei der Kreditsicherung mit Markenrechten*, WM 2005, pp1689 and 1695.

[38] *See* Section 1221 and Section 1235, German Civil Code.

where the real property concerned is situated. Thus, only certain real property which is precisely identified can be encumbered (as opposed to future real property that the relevant charger may possibly acquire in the future). One form of encumbrance is a "mortgage" (*Hypothek*), which is an accessory security right which is strictly linked to the debt secured by it, in contrast to the second alternative, a "land charge", which is a non-accessory security right. As such the land charge is basically independent of the underlying debt and is thus the more frequently used alternative. In order to contractually link the land charge to a certain security purpose, generally a separate "security purpose agreement" is entered into defining which debt is contractually secured by that right and providing for certain contractual rights and obligations of the chargor and the beneficiary of the security right. While both a mortgage and a land charge instrument require notarial form (thus triggering also notarial fees, and also additional fees for the registration of the relevant security right in the land register), the security purpose agreement does not require any specific form and thus does not need to be notarised, simple written form is sufficient.

However, security over real property may generally not be enforced (through sale of the real property by way of public auction) without an enforceable instrument (court judgment etc.). Thus, there is regularly an additional agreement of the relevant chargor to submit to immediate foreclosure (*Unterwerfung unter die sofortige Zwangsvollstreckung*) to create the necessary enforceable instrument at the onset. Such submission to immediate foreclosure also requires notarial form and may either physically form part of the notarial deed establishing the mortgage or land charge, or may be established in a separate notarial instrument. Depending on the value secured and the details of the submission to immediate foreclosure, notarial fees may differ in cases where there is only one combined instrument or there are two separate instruments.

While the required notarial form in relation to share pledges (relating to shares in German limited liability companies etc.) may be complied with even where the deed is notarised outside Germany, provided that certain prerequisites are met,[39] notarisation of mortgages or land

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39 *See* above.

charges as well as the submission to immediate foreclosure has to be completed in Germany.

In relation to taking security over German real property in the context of lending transactions, any non-German lenders may under certain circumstances and as a result of having claims secured by German real-property become subject to German non-resident taxation. This is not levied by way of a tax withholding, but by way of a tax assessment with respect to the respective lender. If the jurisdiction of domicile of such non-German lender has entered into a double taxation treaty with Germany, the lender will, in most cases, be protected by the double taxation treaty as such treaties (e.g., the US/German treaty) usually allocate the right to tax interest payments, even if being made secured by German real estate, to the jurisdiction of the lender only. However, in some exceptional cases the double taxation treaties allow Germany as the situs state of the securing real estate to tax any payments by way of non-resident taxation.[40]

Other contractual security rights, statutory security rights

Somewhat less common in ordinary lending transactions is security over aircraft and ships. German law security over ships is granted by way of mortgages (which have to be registered in the competent ship registry which is kept with certain local courts (*Amtgerichte*)) in accordance with the provisions of the German Act on Rights over Ships (*Schiffsrechtegesetz/Gesetz über Rechte and eingetragenen Schiffen und Schiffsbauwerken*) and the Code on Ship Registers (*Schiffsregisterordnung*). German law security over aircraft on the other hand is, most commonly, also created by way of registered mortgages in accordance with the provisions of the German Act Relating to Rights over Aircraft (*Gesetz über Rechte an Luftfahrzeugen*).

In addition to contractually created security rights, statutory security rights are of relevance when taking contractual security. Thus, it is noteworthy that landlords acquire a pledge by operation of law with

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[40] It might be advisable to agree on appropriate indemnification language for the concerned lender in the underlying loan agreement. Alternatively, sometimes agreement is reached that security in German real estate shall only benefit lenders which are either resident in Germany or benefit from a double taxation treaty which does not allow Germany to tax payments by way of non-resident taxation, while all other lenders are "carved out" from the benefit of the German real-estate security.

respect to all assets held by a lessee on the leased premises[41] in relation to the claims from the relevant renting relationship. Such pledge takes priority over security in such assets granted by way of contractual agreement with third-party creditors. However, such landlord's pledge may be waived by contractual agreement between landlord and lessee and sometimes such waiver is required by the third party taking security over the relevant assets. Comparable security rights are created by operation of law in favour of the contractor (*Werkunternehmer*; e.g., craftsmen and builders) in relation to assets that the relevant contractor holds in possession,[42] but also in relation to commission agents (*Kommissionäre*),[43] carriers (*Frachtführer*),[44] forwarding agents (*Spediteure*)[45] and commercial warehouse keepers (*Lagerhalter*).[46] Contractual arrangements for waivers may be requested by third-party beneficiaries of security over the relevant assets or, alternatively, and more commonly, a right of the third-party creditor may be established to pay any outstanding amounts to the relevant holder of such statutory security right on behalf of the debtor in order to extinguish the relevant statutory security right with the benefit that then full access to the security assets for beneficiary of the contractual security is achieved.

10.4.2 Equitable subordination

Under the law in force until effectiveness of the MoMiG, the old Section 32a, GmbHG provided that shareholder[47] loans be reclassified as equity and thereby subordinated in an insolvency scenario in case the respective loans:

(a) are made during a financial crises; or
(b) are not immediately cancelled at the outbreak of the financial crisis.

In addition, outside outright insolvency but during a financial crisis, such shareholder loans may not be repaid insofar and to the extent

[41] Section 562, German Civil Code.
[42] Section 647, German Civil Code.
[43] Section 397, HGB.
[44] Section 441, HGB.
[45] Section 464, HGB.
[46] Section 475b, HGB.
[47] Applicable for shareholders holding more than 10 per cent of equity in the concerned GmbH.

that such repayment would cause the net assets of the relevant company to fall below its registered share capital (*stammkapital*) or, where such assets are already below that amount, to cause such amount to be further reduced. The same applied to loans from third parties which were not shareholders but had an (economically) equivalent position and were thus treated as "quasi shareholders" with the effect that any claims for repayment of loans were also treated as equitably subordinated. It goes without saying that the taking of security in assets did not improve that situation in favour of such lenders qualifying as "quasi shareholders", as with a subordinated claim for payment only, there was no right for preferred treatment in view of the proceeds of enforcement.

With the exception of one landmark decision of the BGH in 1992[48] in relation to a savings institution which held pledges in its borrowers and, in addition, had massive contractual and factual influence over the management of the borrower group, there is no further specific German case law in relation to such equitable subordination of claims of lending banks. However, there had always been concern when lending to a German corporate that Section 32a, GmbHG might have applied to financial institutions which, for example, through tough covenants dealing with questions which would otherwise only be dealt with by the shareholders and are thus "typical shareholder points", controlled (mostly in combination with pledges over the relevant entities and, most importantly, factual influence) the basic corporate matters of a borrower and would, as a result thereof, be treated by German courts as a quasi-shareholder. Thus, in documenting facilities agreements it has been common in Germany to restrict those covenants therein dealing with "typical shareholder questions" so as to make them less "strict" and thereby prevent any impression that the lenders would make determinations originally reserved to the shareholders (e.g., nomination of management, mergers of group members, capital increases or decreases or other determinations which are linked by definition to be the responsibility of the shareholders). This concept of so-called "restrictive covenants" provides that certain covenants are not directly applicable to German obligors, but only indirectly (this is also referred to as "information concept").

[48] German Federal Supreme Court decision 13 July 1992, II ZR 251/91; BGHZ 119, 191.

If that concept is implemented, the respective German obligors are under obligation to:

(a) inform the Facility Agent in advance of any actions which would otherwise be prohibited by the respective covenants; and
(b) to abstain from taking such actions if the lenders determine that taking such actions would have material adverse consequences for the lenders' risk or security position (and non-compliance would trigger an event of default).

While there are no court decisions on these "restrictive covenants", it is widely believed that their implementation will help avoid the lenders being qualified as "quasi shareholders". However, a court will finally make a determination also with a view to the factual circumstances and the factual influence of the lenders, and will not be restricted to review the facilities documentation only.

However, it has to be noted that with the MoMiG having come into effect, Section 32a, GmbHG has been abolished and the issue of subordination of shareholder loans will now be dealt with by the provisions of the InsO. As a consequence thereof, the prerequisite of a financial crisis during which the loan was granted or not recalled has fallen away, as have the repayment restrictions outside insolvency proceedings. Thus, prior to insolvency, a shareholder loan may now be repaid at any time and generally no restrictions apply.[49] However, once insolvency proceedings have been started, 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 application for the opening of insolvency proceedings are subject to avoidance under the provision of the new Section 135, German Insolvency Code (as amended by MoMiG) regardless of whether such repayment prior to insolvency occurred in a financial crisis or otherwise. Despite those changes, the rules established through German court decisions as to third parties to be treated like shareholders, as quasi shareholders if they have "shareholder-like influence", will remain in place. The risk is that such third parties,

[49] An exception applies where (re)payments to the shareholder necessarily lead to the illiquidity of the company. In such case the managing director(s) may be obligated to reimburse the company.

even if being repaid months before insolvency and even in a situation which is not to be qualified as financial crisis (but for example on the occasion of a change of control), have to face the possibility that an insolvency administrator sets aside such repayment and reclaims the monies received. Accordingly, in order to avoid such risks, lenders will continue under the new law to establish structures allowing sufficient control of their borrowers without being prone to an assessment of having sought shareholder-like influence.

10.5 Availability of effective remedies upon enforcement and impact of the German insolvency regime on creditors

In relation to enforcement of security, again the two different types of accessory security and non-accessory security rights have to be distinguished. Basically, in order to be enforced/realised, accessory pledges require that the legal requirements with regard to the realisation of pledges are met (*Pfandreife*), that is, that the secured obligations have become due and payable.[50] Thus, enforcement cannot be triggered upon occurrence of a "simple" event of default like non-compliance with undertakings etc., unless the relevant facilities agreement has been terminated and thus all obligations have become payable. However, a normal payment default would suffice to start enforcement, provided that the parties have contractually waived the requirement for an enforceable instrument (*vollstreckbarer Titel*), which absent such waiver would be required for the enforcement.[51] Accordingly, pledge agreements generally provide for such waiver in the relevant enforcement provisions. In the case of non-accessory security rights, there is generally no legal requirement to obtain enforceable instruments to enforce the relevant security, as title to the relevant asset which serves as security is transferred in full, with a contractual arrangement that the rights in the asset may only be used for specific purposes upon occurrence of specific events. The parties are generally free to agree upon the events whose occurrence may trigger the permission to enforce the security. Thus, termination/ acceleration of the facilities is not a required prerequisite for

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[50] Section 1228, para. 2, BGB.
[51] Section 1277, BGB.

enforcement of the security, and occurrence of any event of default or even default could, if so agreed between the parties, give a right to enforce. Borrowers, of course, will want to set the time for enforcement as late as possible in the process and therefore often only termination/acceleration of the secured facilities is agreed as an "enforcement event", with the facilities having become due and payable. However, in relation to security over real property, neither the accessory mortgage (*Hypothek*) nor the non-accessory land charge (*Grundschuld*) may be enforced without an enforceable instrument and no waiver is possible in relation thereto. This is why normally, directly upon the establishment of the relevant security over the concerned real property, a submission to immediate foreclosure is obtained.[52] The enforcement of security over assets which are encumbered generally is achieved by way of sale. In the case of pledges, German law requires that the relevant assets be auctioned off by way of public auction unless the assets have a value determined at a Stock Exchange or other determined market price.[53] A further exception applies for pledges of claims/receivables (including those relating to bank accounts (as "ordinary" receivables are normally encumbered by way of assignment rather than by way of pledge). Upon entitlement to enforce the pledged receivable can be collected by the pledgee (without involvement of the pledgor) and the third-party debtor is obligated to pay to the pledgee (always provided that the receivable has become due and payable pursuant to the underlying agreement).

At the onset of insolvency, the creation of security rights and their enforcement is impacted.[54] In this respect, the conditions under which transactions can be challenged in those circumstances need to be taken into account. An insolvency trustee may challenge and thus may avoid any transactions made (and the security granted) over the concerned assets in Germany, *inter alia*, if:

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52 *See* above.

53 *See* Section 1235, BGB. Any agreement entered into prior to the enforcement of the pledge to waive such requirement of a public auction and to proceed to a free sale instead is void.

54 The text below this footnote in this section only concentrates on the impact on security in distress. However, lending to distressed companies *per se* and, for example, the question of when facilities should be accelerated and/or whether new facilities can be granted in distress is also an issue which requires legal attention. For a general overview see, for example, Obermüller, *Insolvenzrecht in der Bankpraxis* (7th edn), 2007, p635 et subs.

(a) such transaction is effected during a period of three months prior to the filing of the insolvency petition and results in, or puts the creditor in a position to obtain or seek security (*Sicherung*) or satisfaction (*Befriedigung*), where the debtor is insolvent at the time of the transaction and the creditor has knowledge of such insolvency or of the relevant facts that support a compelling conclusion with respect to such insolvency;[55]

(b) such transaction is effected subsequent to the filing of the insolvency petition and results in, or puts the creditor in a position to obtain or seek security or satisfaction, where the creditor has knowledge of the insolvency or of the relevant facts that support a compelling conclusion with respect to such insolvency;[56]

(c) such transaction is effected during a period of one month prior to, or subsequent to, the filing of the insolvency petition and results in, or puts the creditor in a position to obtain or seek security or satisfaction, to which the creditor is not entitled in such way either at such time or at all;[57]

(d) such transaction is effected during the second or third months prior to the filing of the insolvency petition and results in, or puts the creditor in a position to obtain or seek security or satisfaction, to which the creditor is not entitled in such way either at such time or at all, where the debtor is insolvent at the time of such transaction or the creditor has knowledge at the time of such transaction that the transaction has adverse effects on the ordinary creditors of the debtor or has knowledge of the relevant facts that support a compelling conclusion with respect to such effect;[58]

(e) such transaction is effected during a period of three months prior to the filing of the insolvency petition and results in immediate adverse effects on the ordinary creditors of the debtor where at the time of such transaction the debtor is insolvent and the creditor has knowledge of such insolvency or of the relevant facts that support a compelling conclusion with respect to such insolvency;[59]

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[55] Section 130, para. 1, no. 1, InsO.
[56] Section 130, para. 1, no. 2, InsO.
[57] Section 131, para. 1, no. 1, InsO.
[58] Section 131, para. 1, nos 2 and 3, InsO.
[59] Section 132, para. 1, no. 1, InsO.

(f) such transaction is effected subsequent to the filing of the insolvency petition and results in immediate adverse effects on the ordinary creditors of the debtor where the creditor has knowledge of such insolvency, the filing of the insolvency petition or of the relevant facts that support a compelling conclusion with respect to such insolvency or such filing;[60] or
(g) such transaction is effected during a period of 10 years prior to, or subsequent to, the filing of the insolvency petition where the debtor has the intention to adversely affect the position of its creditors and the creditor has actual knowledge of such intention, such knowledge being assumed if the creditor has knowledge of the imminent insolvency of the debtor and the adverse effects caused thereby to the position of the debtors of the creditor.[61]

Assuming that the relevant security is not subject to challenge by the insolvency trustee and can thus be enforced, it is worth noting that the enforcement/realisation of the security will to some extent be integrated in the insolvency procedure and may be subject to the insolvency trustee's right to sell the assets concerned and realise the proceeds (which does not eliminate the security right of the creditor, but will give it a right to separate satisfaction (*abgesonderte Befriedigung*) from the proceeds of the realisation). Any realisation surplus that remains after satisfaction of the secured creditor will thereafter be allocated to the estate of the insolvent party. The secured creditor may be held liable to contribute to the costs of the realisation of the assets by way of, generally, four per cent ascertainment costs and five per cent realisation costs plus taxes (VAT), if applicable. The insolvency trustee will be entitled to include the encumbered assets in the sale if the insolvency trustee is in possession of the goods at the time the insolvency proceedings are opened. The insolvency trustee's right to realise proceeds begins with the opening of the proceedings and encompasses all book debts and such of the assets in the insolvent's estate as are in his possession. Thus, the secured creditor can realise the encumbered assets without being obligated to contribute to the costs, if this is done before the opening of proceedings for insolvency or the court order sequestrating the assets. Once proceedings have been opened, this right passes to the insolvency trustee,

[60] Section 132, para. 1, no. 2 InsO.
[61] Section 133, InsO.

provided that he is in possession of the encumbered asset. If the insolvency trustee is not in possession of the assets, the secured creditor may still continue at this stage with its own efforts to realise the security. However, at this stage the secured creditor is obligated to pay over or transfer any ascertainment costs and under certain circumstances VAT to the estate of the insolvency trustee. In case of assignment of receivables, the secured creditor may try to realise that security (without contributing any costs) until the point of time when insolvency proceedings are opened. After that point in time the insolvency administrator has this right to realisation and the entitlement to claim the relevant costs.