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Lending to a Company in Germany: Legal and Documentation Issues

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A Practice Note providing an overview of the key legal and documentation considerations for a loan agreement which is subject to English law or the law of a US state where a borrower, guarantor or security provider is incorporated in Germany.

This Note is intended to be used for a loan financing where a borrower, guarantor or security provider (an obligor) is incorporated in Germany. While the issues to be considered in relation to an obligor when drafting a loan agreement, guarantee, or security document will be broadly similar regardless of an obligor's jurisdiction of incorporation, there will typically be jurisdiction-specific issues that will need to be considered.

It is important to identify any legal or documentation issues, specific practices or concerns early in a loan finance transaction which involves an obligor incorporated in a jurisdiction other than the governing law of the loan financing documentation. This will then make it easier to ensure that these issues, practices and concerns do not have a negative impact on the transaction timeline or lead to unnecessary transaction costs. Transaction-specific advice from lawyers in the appropriate jurisdiction should be taken in due course and appropriate amendments will need to be made to the documents used in the transaction.

This Note looks at the key legal and documentation issues for a corporate loan made under a loan agreement which is subject to English law or the law of a US state to an obligor incorporated in Germany. It covers the following:

- Legal issues such as corporate authority and corporate benefit, laws of general application to lending, granting of security interests and guarantees, laws affecting the amount of interest charged and whether the concepts of facility agent and security trustee are recognised in Germany.
- Documentation issues such as typical contractual terms (for example, representations, undertakings (or covenants) and events of default), jurisdiction and arbitration provisions, and execution formalities.

This Note assumes the following:

- The obligor is a company incorporated in Germany.
- The loan agreement is subject to English law or the law of a US state.

Legal Issues

Corporate Authority

The constitution (*Satzung/Gesellschaftsvertrag*) of a company incorporated in Germany has an impact on a loan finance transaction on the levels of borrowing, securing or guaranteeing.

A company incorporated in Germany acting as a borrower is generally able to enter into any loan financing documentation without any consent or approval of its shareholders. However, the private bye-laws (*Geschäftsordnungen*) of companies incorporated in Germany typically contain restrictions on their entering into loan agreements or any equivalent agreements that amount to a borrowing. These restrictions normally include a specified threshold and the company's representatives are not allowed to enter into relevant agreements with obligations exceeding that threshold without the previous consent of the shareholders.

Any loan agreement signed by the parties in breach of such a borrowing restriction is binding on the company, unless the lender is not acting in good faith. A lender would not be acting in good faith if it knew or, at least, would have been aware of such a borrowing restriction if it had made the typical enquiries expected of a lender in such a situation.

It is common practice for the lender's counsel to review each obligor's constitutional documents (consisting of a constitution (*Satzung* or *Gesellschaftsvertrag*), a list of shareholders/partners (*Gesellschafterliste*), any by-laws

(*Geschäftsordnungen*) and a commercial register excerpt (*Handelsregisterauszug*)) for any restrictions in the course of the due diligence procedure conducted by the lender or the lender's counsel before entering into a loan agreement. If the envisaged loan will cause the borrower to exceed any such restriction, then a shareholders' resolution approving the transaction is required. In any event, even if there are no concerns about the managing directors' authority to enter into finance documents on behalf of a company, a shareholders' resolution approving the transaction is generally considered as the best practice and is usually required by a lender as a condition precedent to funding.

Corporate Benefit

Under German law, an obligor is not generally obliged to prove to lenders that any borrowing, provision of security or a guarantee has a corporate benefit to the obligor. However, it is common to include a clause stating the purpose of the borrowing into the loan agreement.

Laws of General Application Relating to Lending, Granting of Security, and Guarantees

There are no laws or regulations that are relevant to a lender making a loan to a company incorporated in Germany under a loan agreement governed by English law or the law of a US state. However, there are regulatory issues to be observed by a lender when lending in Germany.

However, security and guarantees given by a company incorporated in Germany may be subject to challenge in the following cases:

- Security may be ineffective or invalid if:
  - the lender restricts the company's economic freedom of action (*section 138, paragraph 1, German Civil Code* (*Bürgerliches Gesetzbuch*) (BGB);
  - the lender deceives other creditors of the company to improve its own position (*section 138, paragraph 1, BGB*);
  - the value of the secured assets materially exceeds the secured obligations (known as over-collateralisation);
  - the company has been coerced by the lender to provide security (*section 123, paragraph 1, BGB*); or
  - the security causes a breach of the German preservation of capital rules for corporates.
- Security or a guarantee may be subject to challenge under the German Insolvency Code (*Insolvenzordnung*).

Restriction on Interest Rates, Accrual of Default Interest and Other Fees Payable

There are no restrictions under German law with respect to the amount of interest, accrual of default interest as a result of an event of default or other fees payable by the borrower to the lender if the loan agreement is governed by English law or the law of a US State.

If, however, despite an effective choice of law, all other circumstances at the time of the choice of law indicate that German law would be more appropriate, the provisions of German law, which cannot be derogated from by agreement, will apply. For example, if all parties entering into a loan agreement governed by English law or the law of a US State are incorporated and established in Germany, the mandatory norms of German law (for example, the prohibition of compound interest (*Zinseszinsverbot*) under section 248 BGB) cannot be circumvented by choosing a foreign governing law. An intention to circumvent is not required.

Is the Concept of a Facility Agent or Security Trustee Recognised?

Facility Agent

German law recognises the concept of a facility agent acting on behalf of a group of lenders party to a loan agreement governed by English law or the law of a US state. There are no provisions under German law that would override the duties of a facility agent's duties as set out in such a loan agreement.

Security Trustee

German law recognises the concept of a security trust. So, it will recognise the appointment of a security trustee pursuant to a loan agreement (or other loan financing transaction document) governed by English law or the law of a US state.

Note however, that it is necessary under German law that certain security, so called accessory security (akzessorische Sicherheiten) (for example, pledges over bank accounts or shares in a company), actually secures a claim of the relevant secured party, that is, of the security agent. Therefore, the facility agreement usually provides for a parallel debt obligation, according to which the borrower acknowledges a separate, immediately payable debt to the security agent pursuant to section 780 of the German Civil Code (Buergerliches Gesetzbuch), which proceeds to be reduced as an outstanding debt under the finance documents.

Set-Off

The right of set-off is regulated in German law in sections 387 - 396 BGB. It is permissible to prohibit

set-off (*Aufrechnungsverbot*) by a German borrower in a loan agreement, as long as the agreement provides for exceptions for claims which are either undisputed or which have been finally decided upon by a court (*rechtskräftig festgestellt*) (section 309 no. 4 BGB *e contrario*).

However, German set-off laws are not applicable to a loan (or security) agreement, which is governed by English law or the law of a US state. So, a provision in such a loan agreement providing that a borrower incorporated in Germany may not set off any amounts due to it by a lender against amounts due from it to the lender is enforceable under German law.

Unlawful or Illegal Purpose of Loan

Under German law, there is no impact on a lender's rights as agreed in a loan agreement governed by English law or the law of the US state if the purpose of a loan is unlawful or the loan proceeds are used by a borrower for an unlawful or illegal purpose.

However, if the borrower uses the funds for a purpose other than that provided for in the loan agreement, the borrower would be in breach of its obligations under the loan agreement, A breach will typically constitute an event of default which will entitle the lender to cancel all or part of its total commitments under the loan agreement and to declare all or part of the loans, together with the accrued interest, to be immediately due and payable.

Documentation Issues

Finance Documentation: Mandatory Clauses and Layout

There are no mandatory requirements as to the layout or contents of a loan agreement. For information on execution formalities that may be required for a loan agreement, guarantee or security document, see Execution Formalities.

Conditions Precedent

If a borrower under a loan agreement governed by English law or the law of a US state is incorporated and established in Germany, German law does not require any specific conditions precedent to be included in that loan agreement.

However, standard conditions precedent to be satisfied by a German borrower include the following:

- Delivery of copies of constitutional documents (consisting of a constitution (*Satzung* or *Gesellschaftsvertrag*), a list of shareholders/partners (*Gesellschafterliste*), any by-laws (for example, rules of procedure (*Geschäftsordnungen*)), a commercial register excerpt (*Handelsregisterauszug*)) and corporate authorisations (*Gesellschafterbeschlüsse*) for each obligor approving its entry into the transaction documents.
- Delivery of financial information in respect of each obligor, including financial statements (*Jahresabschlüsse*), budgets and business plans.
- Execution of finance documents, including the transaction security documents, any intercreditor agreements, subordination agreements, fee letters and any hedging documentation.
- Delivery of copies of acquisition documents, if the loan facility is to fund the acquisition of shares or assets of a target company or a property.
- Delivery of copies of any intra-group loan agreements.
- Evidence of execution of any documents relating to the perfection of security interests (for example, notices to third parties).
- Delivery of reports and certificates by consultants and legal advisers and reliance letters addressed to the lenders in respect of such reports and certificates.
- Delivery of all documents required by the lender to fulfil its internal "know your customer" requirements.
- Delivery of legal opinions on capacity, due execution and corporate authority (borrower's counsel) and enforcement of finance documents (lender's counsel).

Repayment and Voluntary Prepayment

If a borrower under a loan agreement governed by English law or the law of a US state is incorporated and established in Germany, German law has, in general, no impact on that loan agreement in relation to repayments or prepayments.

However, a repayment or voluntary prepayment of the loan in favour of a foreign lender must be reported by the German borrower to the German Central Bank (*Bundesbank*) if the following conditions are satisfied:

- The repayment or prepayment exceeds EUR 12,500 (or its equivalent in another currency).
- The repayment or prepayment relates to the granting, taking up or repaying of loans with an originally agreed term or availability period of more than twelve months.

(*section 11 paragraph 2 of the German Foreign Trade and Payments Act (Außenwirtschaftsgesetz)* and *section 67 paragraph 1 no. 2, paragraph 2 no. 1 and 3 of the German Foreign Trade and Payments Ordinance (Außenwirtschaftsverordnung)*).

Representations and Warranties

If a borrower under a loan agreement governed by English law or the law of a US state is incorporated and established in Germany, German law has no impact on that loan agreement in relation to representations and warranties.

However, the standard representations and warranties in relation to the following are typically given by a German obligor:

- Status.
- Power and authority.
- Binding obligations in each finance document and security document.
- Non-conflict with other obligations.
- Governing law and enforcement.
- No insolvency.
- No default.
- No misleading information.
- No security or quasi-security.
- No breach of laws.
- Legal and beneficial ownership of assets.
- No proceedings pending or threatened.

Undertakings

German law does not restrict in any way the undertakings typically given by a borrower, guarantor or other obligor incorporated in Germany in a loan agreement governed by English law or by the law of a US state.

A lender is not liable under German environmental laws for the actions or omissions of a borrower, guarantor or security provider incorporated in Germany.

If a borrower breaches a negative pledge and creates security over any of its assets in favour of a third party, this will be an event of default (and breach of any other undertaking in a loan agreement will also be an event of default). An event of default will typically entitle the lender to cancel all or part of its total commitments under the loan agreement and to declare all or part of the loans, together with the accrued interest, to be immediately due and payable. In general, a breach of a negative pledge has no impact on the validity of the security created under German law. However, there is an exception if the borrower and the third party cooperated intending to damage or deteriorate the lender's legal position. In this case, the relevant security agreement would be invalid due to collusion (*section 138, paragraph 1, BGB*).

Events of Default

If a borrower under a loan agreement governed by English law or the law of a US state is incorporated and established in Germany, German law has no impact on that loan agreement in relation to events of default.

Examples of standard events of default in relation to a German obligor include the following:

- Non-payment of any amount payable pursuant to a finance document on the due date.
- Non-compliance with the financial covenants or any provision of a transaction security agreement.
- Non-compliance with any provision of the finance documents.
- Misrepresentation.
- Insolvency of the borrower or a member of the borrower's group, which has its centre of main interests in Germany.
- Insolvency proceedings.
- Unlawfulness and invalidity.
- Cessation of business.
- Change of ownership.
- Litigation commenced or threatened concerning the transaction documents.
- Any corporate action, legal proceedings or other procedure or step concerning the suspension of payments (*Zahlungseinstellung*).
- A moratorium of any indebtedness.
- Winding-up (*Auflösung*).
- Dissolution (*Auflösung*).
- Administration (*Zwangsverwaltung*).
- Reorganisation (*Reorganisation*) of any member of the group.
- An arrangement with any creditor with respect to payment obligations of borrower.
- The appointment of a liquidator (*Insolvenzverwalter*), custodian (*Sachwalter*) or administrator (*Zwangsverwalter*).
- Enforcement of any security over any assets of the borrower or any member of the group.

There are no restrictions in German law that could affect a lender's ability to waive an event of default or that could restrict a borrower, guarantor or material subsidiary's right to remedy an event of default to the extent that remedy is permitted under German law.

Loan Transfers

There are no restrictions under German law relating to a transfer of a lender's outstanding rights and obligations under a loan agreement, guarantee or security agreement governed by English law or by the law of a US state. However, borrowers usually try to restrict a lender's right to transfer, for example by prohibiting a transfer to certain types of institution (for example, hedge funds) or a borrower's competitors. Borrowers with a strong position may even insist on a provision prohibiting a transfer without the prior consent of the borrower (which may not be unreasonably withheld).

Jurisdiction Clause

The use of so-called asymmetric or unilateral jurisdiction clauses has become common in financing documents in international lending transactions.

An asymmetric or unilateral jurisdiction clause provides for the exclusive jurisdiction of the courts of a certain jurisdiction, but allows the lender (or other financing party) to initiate proceedings in any jurisdiction. The borrower, however, can only bring proceedings in the agreed exclusive jurisdiction. An asymmetric jurisdiction clause creates an imbalance between the parties so there are questions as to whether such a clause is valid.

In Germany, the prevailing opinion is that a clause permitting the lender to commence proceedings in any jurisdiction (while restricting the borrower to one specific jurisdiction if it wishes to commence legal proceedings) would be enforceable. A recent decision of the Federal Court of Justice (*Bundesgerichtshof*) (*Etihad/Air Berlin* dated 13 July 2021) strengthened this view by making it clear that an asymmetric jurisdiction clause is still effective even though it works exclusively for the benefit of one party.

Arbitration

Arbitration is a dispute resolution mechanism and is commonly used in loan agreements and arbitral awards are enforceable against a borrower, guarantor or security provider incorporated in Germany.

The procedure for enforcing arbitral awards in Germany is as follows:

- German arbitral awards

  For an arbitral award made by a German arbitration tribunal to be declared enforceable, a party must file an application at the higher regional court (*Oberlandesgericht*) that has local jurisdiction over the relevant arbitral tribunal (*section 1060, paragraph 1 of the German Code of Civil Procedure* (*Zivilprozessordnung,* (ZPO)).

  Once an arbitral award has been declared enforceable and has become final (*unanfechtbar*), or at least provisionally enforceable (*vorläufig vollstreckbar*) (in certain circumstances the beneficiary of an arbitral award can enforce a provisionally enforceable title), it becomes an enforceable title (*Vollstreckungstitel*) (*section 794 paragraph 1 no. 4a ZPO*) which has the effect of a final binding court judgment.

  A German arbitral award may be set aside if recognition or enforcement of that award leads to a result contrary to *ordre public* (*section 1059, ZPO*). For example, this may be the case if there are serious procedural defects, or if the award obliges a party to perform a service, the performance of which contravenes a law (*Verbotsgesetz*).

- Foreign arbitral awards

  Germany is a signatory to the New York Convention on the Recognition and Enforcement of Arbitral Awards. Foreign arbitral awards are therefore recognised and declared enforceable in Germany unless a party establishes that one of the grounds for refusal listed in Article V of the New York Convention exists.

  For a foreign arbitral award to be recognised and declared enforceable, a party must, as is the case for a German arbitral award, file an application at the locally competent higher regional court (*Oberlandesgericht*) in Germany (*sections 1061* and *1062, ZPO*).

Execution Formalities

There are no specific execution formalities to be observed under German law in relation to a borrower incorporated in Germany entering into a loan agreement governed by English law or by the law of a US state. There is also no requirement for any payments to be made to any public authority or registry when a German borrower enters into such a loan agreement.

However, as with any agreement entered into by a company incorporated in Germany, each person signing on behalf of the company must be a competent signatory of the company duly authorised to sign a written agreement on its behalf. For legal entities in Germany, there is a publicly available commercial register (*Handelsregister*) at the competent local court (*Amtsgericht*) where the details of the competent signatories for an entity are listed along with details of the signing rights of those signatories.

Most German-law governed security agreements do not require any special formal requirements to be effective. However, it is common for the following types of security agreement to be in writing (for evidentiary purposes):

- Security assignment agreement (*Sicherungsabtretungsvertrag*) relating to any current and future receivables.

- Security transfer agreement of movables (*Sicherungsübereignungsvertrag*).
- Bank account pledge agreement (*Kontoverpfändungsvertrag*).
- Pledge agreement relating to any intellectual property rights (*IP-Verpfändungsvertrag*).

Again, each person signing such a security agreement on behalf of the company must be a competent signatory of the company duly authorised to sign on its behalf.

However, additional formal requirements must be fulfilled in the case of the following types of security agreement:

- A share pledge agreement (*Vertrag über die Verpfändung der GmbH-Anteile*) creating a pledge of current or future shares in a subsidiary that is a German limited liability company must be notarised (*section 15, paragraph 4 and 5, GmbHG*). The notary will charge a fee for notarisation.
- A security agreement creating a land charge (*Grundschulden*) or mortgage (*Hypotheken*) over real estate (*Grundpfandrechte*) must be notarised. Again, the notary will charge a fee for notarisation.
- In addition, a land charge or mortgage must be registered at the land registry (*Grundbuchamt*) for the relevant property. An entry will be made in the land register (*Grundbuch*) and land registration fees must be paid.