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Lending to a Company in Germany: Structuring the Transaction

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A Practice Note looking at the key considerations involved in structuring a loan to a company incorporated or located in Germany (which may also involve a guarantor or security provider incorporated or located in, or assets located in, Germany), where the lender is incorporated in another jurisdiction.

It looks at considerations such as tax, costs and regulatory issues, and issues that can affect taking security and guarantees.

Lawyers advising a lender who is proposing to make a loan to a borrower incorporated or doing business in another jurisdiction need to be aware of a variety of issues that can affect the structure of the loan transaction. In addition, if a transaction also involves a guarantor or security provider incorporated or doing business in another jurisdiction, or the assets over which security is being taken are located in another jurisdiction, then there will be other issues to consider.

It is important to identify these issues in the early stages of structuring a transaction, as they can have an impact on key elements of the transaction structure, such as:

- Who the borrower, guarantor, and security providers (obligors) will be.
- Whether taking guarantees and types of security will be feasible in light of the costs involved.
- The lender's ability to enforce security interests and guarantees.
- The lender's rights in an insolvency of the borrower or other obligors.

This Note looks at the following issues which may affect the structure of a loan transaction:

- Tax considerations and implications, including withholding taxes, documentary taxes, and other types of taxes that may affect a lender or borrower.
- Costs affecting the transaction, including registration fees, notaries' fees, and any other similar costs imposed on the transaction.
- Issues involved in taking a guarantee or security.
- Issues involved in enforcing a loan, guarantee, or security interest.
- Lenders' rights in an insolvency of a borrower, guarantor, or security provider.

Tax Implications

The taxes applicable to a loan transaction with a borrower who is incorporated in, or doing business in, a different jurisdiction from the jurisdiction where the lender is incorporated or doing business may have a significant impact on the transaction and whether it is feasible.

Withholding Taxes

Foreign lenders granting loans to German companies are generally not subject to taxes on interest payments made by the borrower. However, foreign lenders making loans secured, directly or indirectly, by German real property are subject to German taxes on the loan interest payments. Those lenders must file a tax return in Germany, and the government tax authorities can impose a withholding tax obligation on the borrower's payments of interest to the lender. The rate of tax is currently 15% for corporate taxpayers.

However, Germany is a party to many "double taxation" treaties that can reduce or eliminate the tax for a foreign lender, depending on where the foreign lender is a tax resident.

Documentary Taxes

Under German law, there is no obligation to pay stamp duties and other documentary taxes. However, a purchaser buying from a lender who is enforcing its security must pay a real estate transfer tax (*Grunderwerbsteuer*) (RETT) in certain situations (see Real Estate Transfer Tax).

Costs Affecting a Transaction

Registration Fees

In Germany, most securities do not need to be registered and registration fees do not need to be paid. However, registration fees accrue on registration of the following for the benefit of a lender with the relevant registry:

- A land charge (*Grundschuld*) or mortgage (*Hypothek*).
- A ship mortgage (*Schiffshypothek*).
- A lien on an aircraft (*Pfandrecht am Luftfahrzeug*).
- A pledge of shares in a corporation or limited partnership interests.

The Act on Costs of Voluntary Jurisdiction for Courts and Notaries (Court and Notary Costs Act (*Gerichts- und Notarkostengesetz*)) governs the amount of the registration fees. Registration fees:

- Are based on the value, which is:
  - the nominal amount of the debt for a land charge, mortgage, ship mortgage, or aircraft lien;
  - based on the equity capital under the German Commercial Code attributable to pledged shares in a corporation or pledged limited partnership interests absent other indications of a higher value (section 54, paragraph 1, and section 55, Court and Notary Costs Act); and
  - the lower of the amount of the secured claim or the value of the collateral (section 54, paragraph 2, Court and Notary Costs Act) (for any other security).
- Range from EUR60 to EUR26,585 (exclusive of value-added tax (VAT) and out of pocket expenses). However, there is no registration fees for a pledge of shares in a corporation or limited partnership interests.

For assistance in calculating a registration fee, see the Handelsblatt website.

Notaries' Fees

Although notarisation generally is not required for loan agreements, guarantees, or security documents under German law, in some situations notarisation may be required due to the nature of security or may be beneficial for both the lender and the borrower, guarantor, or security provider.

For more information on when notarisation may be required or beneficial, see Practice Note, Lending to a Company in Germany: Legal and Documentation Issues: Execution Formalities.

Similar to registration fees, the Court and Notary Costs Act (*Gerichts- und Notarkostengesetz*) stipulates the notaries' fees, which are based on business value. For information on calculating business value, see Registration Fees.

Notaries' fees range EUR60 to EUR26,585 (exclusive of VAT and out of pocket expenses).

If a share pledge agreement is notarised in English, a notary can charge a surcharge of 30% of the notaries' fees.

For assistance in calculating notaries' fees, see https://www.vr-bayernmitte.de/privatkunden/kredit-baufinanzierung/service/notarkosten-grundbuchkosten.html.

Issues in Taking a Guarantee or Security

Financial Assistance

Unless it is a party to a domination or profit and loss pooling agreement, none of the following (nor any of its subsidiaries) may grant financial assistance to acquire its shares:

- A German stock corporation (*Aktiengesellschaft*) (AG).
- A stock partnership (*Kommanditgesellschaft auf Aktion*) (KGaA).
- A European company (*Societas Europaea*) (SE).

Financial assistance could be a loan, a guarantee, or collateral provided as credit support.

Capital Maintenance

Collateralising a loan to a parent company with assets of any of its subsidiaries or providing a subsidiary's guarantee of the loan may violate the capital maintenance provisions under German company law. These provisions prohibit payment or distribution of:

- The assets of a limited liability company (*Gesellschaft mit beschränkter Haftung*) (GmbH) that are required to maintain the GmbH's minimum share capital (*Stammkapital*) (section 30, paragraph 1, Limited Liability Company Act (*Gesetz über die Gesellschaft mit beschränkter Haftung*)).
- Contributions by the shareholders to the minimum stock capital of an AG (section 57, paragraph 1, sentence 1, German Stock Corporation Act (*Aktiengesetz*)).

Under the capital maintenance provisions, a guarantee or grant of security by a GmbH or AG for a debt of its direct or indirect parent (upstream guarantee or security) or for a debt of one of its affiliates (that is, a third company directly or indirectly controlled by its

shareholder or in which its shareholder has a direct or indirect interest, such as a sister company) (cross-stream guarantee or security), may constitute such a payment or distribution if:

- The lender enforces the guarantee.
- The GmbH or AG grants security in rem (such as a land charge or mortgage).
- The lender enforces another type of security.

German law considers any of the following to be a payment by the GmbH or AG to its direct or indirect parent or to its affiliate:

- A payment under a GmbH's or AG's upstream or cross-stream guarantee.
- A GmbH's or AG's grant of upstream or cross-stream security in rem.
- The lender's enforcement of a GmbH's or AG's upstream or cross-stream other than in rem security.

However, the prohibitions do not apply if either:

- A domination agreement or profit and loss pooling agreement exists between the GmbH or AG and its parent or affiliate.
- The GmbH or AG has a fully recoverable indemnity or refund claim against its parent or affiliate.

The violation of these prohibitions may not invalidate a GmbH's or AG's grant of a guarantee or security against a lender or other third party. However, until the parent or affiliate returns to the GmbH or AG the payment which reduced the GmbH's or AG's minimum capital, the GmbH or AG may refuse to perform towards its parent or affiliate (but not the lender). Such a right to refuse will limit the enforceability of the security or the guarantee by the secured party to the extent that the GmbH or AG would not have the minimum required capital.

Although the German capital maintenance law does not apply directly to a third-party lender, collateralisation of, or payment under a guarantee of, a loan which results in a GmbH's or AG's capital being less than the minimum capital may be immoral and void if the lender cooperates with the GmbH's or AG's parent or affiliate as borrower to the detriment of the GmbH or AG (*Kollusion*) or other creditors (*sittenwidrige Kredittäuschung*) (section 138, paragraph 1, German Civil Code).

A managing director of a GmbH and the board of directors of an AG may have personal liability for the GmbH's or AG's grant of an upstream or cross-stream guarantee or security interest in certain circumstances (section 826, German Civil Code, section 43, German Limited Liability Company Act, and section 93, German Stock Corporation Act). To avoid this liability, an upstream or cross-stream guarantee or grant of security usually includes a clause that limits the assets against which a lender can realise to those assets that are not subject to capital maintenance requirements.

Corporate Benefit

Under German law, an obligor generally does not need to prove to lenders that any provision of security or a guarantee has a corporate benefit to the obligor. However, to explain the corporate benefit for a guarantor or security provider, it is common to include a clause in the loan agreement stating the purpose of the borrowing.

Each managing director of a GmbH, and each member of the executive board of an AG, must act generally in the interests of the GmbH or AG regarding all actions the managing director or executive board takes on its behalf. If a GmbH managing director violates the "diligence of a prudent businessman" (section 43, paragraphs 2 and 3, German Limited Liability Act, and section 347, German Commercial Code), or an AG executive board member violates the diligence of a prudent businessman – the business agent rule in section 93, paragraph 1, sentence 2, of the German Stock Corporation Act not exculpating the executive board member:

- The managing director or executive board member is liable to the GmbH or AG for any damage suffered by the GmbH or AG.
- If the managing director or executive board member were to have acted at a lender's behest to the detriment of the GmbH or AG, the lender could be liable for incitement, aiding and abetting, or complicity (section 830, paragraphs 1 and 2, and section 826, German Civil Code).

A GmbH managing director or an AG executive board member who exceeds their corporate powers may even be prosecuted for breach of trust (*Untreue*) under section 266 of the German Criminal Code and embezzlement (*veruntreuende Unterschlagung*) under section 246 of the German Criminal Code. If a lender colludes with the GmbH managing director or AG executive board member and incites, aids and abets, or is complicit in the GmbH managing director or AG executive board member exceeding their corporate powers, the lender could also be prosecuted and sentenced in connection with the alleged act (section 25, paragraph 2, and sections 26 and 27, German Criminal Code).

Fraudulent Conveyance

A loan agreement, guarantee, or security agreement is void if a contracting party receives consideration that is clearly disproportionate to its own performance (section 138, paragraph 1, German Civil Code). In

German finance practice, this is usually the case when a lender either receives interest at an excessive rate or is initially over-collateralised (that is, the value of any collateral is highly disproportionate to the loan amount).

Overcollateralisation (Übersicherung)

The value of collateral can generally exceed the amount of a secured loan. Overcollateralisation is justified to a certain extent by the legitimate interest of a lender, as collateral may decrease in value or may generate lower than expected realisation proceeds. However, a disproportionate overcollateralliation for the benefit of a creditor is not allowed. Disproportionate overcollateralisation occurs:

- At closing if the collateral value is disproportionately higher than the secured obligations.
- After closing when the collateral value continuously (that is, without interruption or gaps) exceeds 110% (or, if the value is uncertain, 150%) of the secured obligations.

In some extreme cases (such as when the collateral value provided is almost twice as high as the loan amount and the lender is not only aware of this fact, but willingly takes advantage of it), overcollateralisation at the time of closing makes a security agreement null and void under section 138, paragraph 1, of the German Civil Code.

However, if overcollateralisation occurs after closing because the collateral value increases without a corresponding expansion of the loan (including as a result of a loan repayment without a release of security or a request for additional collateral without an increase in the loan amount), a borrower or other security provider may request the lender to release certain collateral if both:

- The total collateral value exceeds 110% (or, if the value is uncertain, 150%) of the secured obligations.
- The excess collateral value exists not only temporarily, but permanently.

The lender can only decide what collateral to release (*ermessensunabhängiger Freigabeanspruch*). It cannot decide whether to release collateral.

Equitable Subordination

If insolvency proceedings are opened over a company's estate, all shareholder loans and claims economically equivalent to shareholder loans (for example, receivables with respect to which the company is the account debtor and a shareholder is the creditor) will be subordinated to all other creditors' claims (known as subordinated insolvency creditors under section 39, paragraph 1, no. 5, of the German Insolvency Code).

In addition, an insolvency administrator may challenge:

- Any repayment of these loans and claims within one year before the filing of the insolvency petition.
- Any grant of a security interest for any such loan or claim made or given during the ten years before the filing.
- Payments made to a third-party lender who is not a shareholder of the insolvent company, as a subordinated unsecured creditor if:
  - the lender is unsecured and has a degree of control over the company's business comparable to that of a shareholder due to covenants in the finance documents; or
  - a pledge agreement grants it a position of an atypical pledgee due to extension of the pledge to membership and profit subscription rights (including the right to vote and the right to receive dividends), whether it has these rights before or after default.

Environmental Laws

A lender has no liability under German environmental laws for the actions or omissions of a borrower, guarantor, or security provider, including if the lender forecloses on real property that is contaminated and has environmental issues. Although contaminated sites (such as at petrol stations, paint shops, industrial wastelands, and dry cleaners) impair the usability of the relevant property and thus constitute a defect, any liability is excluded when acquiring the property in the course of a foreclosure (section 56, sentence 3, German Compulsory Auction Act (*Zwangsvollstreckungsgesetz*)).

Despite this, loan documents governed by German law often contain undertakings requiring the borrower, guarantor, or security provider to:

- Comply with all environmental laws.
- Implement procedures to prevent liability under environmental laws.
- Inform the lender of any environmental claims or any circumstances that are reasonably likely to result in an environmental claim.

Gagging (*Knebelung*)

A grant of collateral to a lender can be null and void if the lender does any of the following:

- Unacceptably restricts the security provider's economic freedom of action.
- Makes the security provider completely economically dependent.
- Leaves the security provider with marginal independent economic power.

(Section 138, paragraph 1, German Civil Code.)

However, extensive collateralisation does not automatically lead to gagging if both:

- The collateralisation is appropriately related to the size of the loan.
- The security provider can continue to manage its business independently.

Credit Deception (*Kredittäuschung*)

The provision of any collateral to a lender who makes a loan to a borrower who is not creditworthy (for example. the borrower either is about to file for insolvency or is highly likely to not be able to meet its obligations in the immediate future) is null and void if the lender acts immorally towards other creditors of the borrower (section 138, paragraph 1, German Civil Code). Typically, immoral behavior is assumed when the lender either:

- Hopes to gain time to improve its own position at the expense of other creditors by granting a new loan to the insolvent borrower.
- Seeks to deceive other creditors about the borrower's creditworthiness to induce them to make further loans for the benefit of the insolvent borrower.

However, a deception of other creditors cannot be assumed if obvious collateral (such as a land charge) is provided or the borrower's financial difficulties are known from its balance sheet or publications in the press.

Coerced Collateralisation

A security provider who is unlawfully threatened to provide collateral may challenge the provision of collateral within one year after the coercion no longer exists (section 123, paragraph 1, and section 124, paragraphs 1 and 2, German Civil Code).

Examples of unlawful threats include a lender threatening:

- To cancel a loan to force the borrower to take action unrelated to the loan (such as waiving a legal remedy or settling a doubtful receivable).
- Criminal charges against a borrower who has committed credit fraud if the borrower does not provide collateral for a previous loan.

For more information on taking a guarantee or security, see Practice Note, Lending to a Company in Germany: Legal and Documentation Issues: Laws of General Application Relating to Lending, Granting of Security, and Guarantees.

Issues in Enforcing a Loan, Guarantee, or Security Interest

Enforcement Generally

German law in general and the German Code of Civil Procedure (*Zivilprozessordnung*) in particular do not restrict foreign lenders from initiating enforcement proceedings in Germany. However, some additional provisions may apply, including:

- EU regulations on the service of documents or taking of evidence (if the lender has its business seat within the EU).
- Any bilateral treaty between Germany and the foreign jurisdiction in question (if the lender has its business seat outside the EU).

Enforcement of Loans

Enforcement of a loan requires termination of the underlying loan agreement (meaning terminating a lender's commitment to extend credit under the loan agreement and accelerating the loan agreement obligations) based on a contractual or statutory right to do so.

A loan agreement usually gives a lender a contractual right to terminate the loan agreement after the occurrence of an event of default which has not been remedied or waived. However, depending on the severity of the default and the factual circumstances, a court may determine that an acceleration is invalid if the lender did not consider the borrower's legitimate interests while accelerating the loan (section 314, German Civil Code).

A lender has a statutory right under the German Civil Code to terminate a loan agreement prematurely if both:

- A significant deterioration of either the borrower's financial situation or the value of any collateral has occurred or is likely to occur.
- This deterioration will jeopardise repayment of the loan or enforcement of the collateral.

Enforcement of Guarantees

Since a guarantee under section 311, paragraph 1, of the German Civil Code is a non-accessory security and secures the obligations under the underlying loan agreement:

- The guarantee does not depend on the existence or extent of the repayment claim under the loan agreement.

- Any defenses stemming from the loan agreement between the borrower and lender are excluded as a matter of law and cannot be used by the guarantor.

A lender may enforce a guarantee as soon as the borrower does not pay its obligations under the loan agreement, as this will trigger the guarantor's obligations under the guarantee.

If a guarantor pays a borrower's debt, a repayment claim does automatically not pass to the guarantor by operation of law. The repayment claim only passes to the guarantor if the lender expressly assigns it to the guarantor.

Enforcement of Security Interests

The conditions for a lender's enforcement of its security interest vary depending on the type of security granted.

However, in general, the security in question needs to be granted in an effective way and to be mature for enforcement (*Pfandreife*). Maturity for enforcement differentiates between:

- Accessory securities (such as a bank account pledge, share pledge, or mortgage), for which the amount secured increases or decreases in proportion to any increase or decrease in the secured claim (which, for an increased claim, would allow a lender to demand the increased secured claim from the security provider). Accessory securities become mature for enforcement immediately when the secured claim under the loan agreement has become due and payable. This is the case when:
  - the lender accelerates all its payment claims under the loan agreement due to an event of default; or
  - insolvency proceedings over the borrower's estate have been opened due to a statutory provision (section 41, German Insolvency Code). Although the opening of an insolvency proceeding prohibits enforcement by individual creditors and safeguard measures imposed by the insolvency court to ensure an organised approach of the creditors according to instructions given by the insolvency administrator protect the borrower's estate, with the opening order by the insolvency court, the secured claim under the loan agreement becomes mature.
- Non-accessory securities (such as a land charge, security assignment of receivables, or security transfer of movables). Non-accessory securities all have a security agreement under the law of obligations (*schuldrechtlicher Sicherungsvertrag*) in common and follow other rules with respect to maturity for enforcement. Specifically:
  - a land charge, which must be connected to the secured claim through a security purpose agreement (*Sicherungszweckvereinbarung*) to clarify which claim is to be secured, becomes enforceable on its termination by the security provider or secured creditor and for 6 months after this termination (section 1193, paragraph 1, and paragraph 2, sentence 1, German Civil Code); and
  - a security assignment of receivables and a security transfer of movables become enforceable when the borrower fails to pay amounts due under the loan agreement and the lender accelerates all its payment claims under the loan agreement due to an event of default.

Before a lender may enforce its security interest, it is common practice to inform the security provider of the lender's intention to do so.

However, for real estate liens such as a land charge or mortgage, the lender can require the owner of the property to permit the foreclosure (*Zwangsvollstreckung*) under section 1147 of the German Civil Code. To ensure enforcement can be carried out without any problems, the party creating the real estate lien must submit to immediate foreclosure (*Unterwerfung unter die sofortige Zwangsvollstreckung*), which constitutes a special enforcement title. In this way, a lender can avoid any delays and uncertainties in subsequently obtaining a beneficial court decision, which is the standard enforcement title, and involves time and money.

How a lender can enforce its security interest depends on both the type of security interest and the collateral. The following table provides a general overview:

Collateral	Method or Methods of Enforcement
Real estate	Forced sale (*Zwangsversteigerung*) or receivership (*Zwangsverwaltung*). A private sale (*freihändiger Verkauf*) can only occur if the security provider agrees to it after the enforcement event occurs. The lender and security provider cannot agree to a private sale before enforcement.
Movable assets transferred for security purposes	Public auction or private sale.
Accounts receivable	Lender collects from account debtor.

Collateral	Method or Methods of Enforcement
Bank account	Lender collects amounts in the pledged account.
Intellectual property rights	Either: • Private sale (if rights assigned or security provider agrees). • Public auction (if rights pledged (but not assigned) and security provider does not agree to a private sale).
Assets without a market or stock exchange price	Public auction. A private sale can only occur if the security provider agrees to it after the enforcement event occurs. The lender and security provider cannot agree to a private sale before enforcement.
Assets with a market or stock exchange price	Market sale.

Real Estate Transfer Tax

A purchaser buying from a lender who is enforcing its security must pay a real estate transfer tax (*Grunderwerbsteuer*) (RETT) in the following situations:

- A purchase at a foreclosure auction of German real property.
- A direct or indirect acquisition of shares in an entity which owns German real estate or any heritable building rights (*Erbbaurechte*) in German real estate by a partnership or corporation if at any time during the ten years ending on the date of, and after giving effect to, the acquisition the partnership or corporation will have:
  - held at least 90% of the shares of the entity; or
  - acquired at least 90% of the shares of the entity.

  Heritable building rights are the right to own or build a structure on land owned by another (for example, a condominium (*Wohnungseigentumsrecht*)).

(Section 1, German Real Estate Transfer Tax Act (*Grunderwerbsteuergesetz*).)

RETT rates range between 3.5% and 6.5% of the purchase price, depending on the location within Germany of the property sold at the foreclosure auction or owned by the entity whose shares are acquired.

As a result of RETT:

- A purchaser may be less willing to purchase the security or may want to pay a lower purchase price for the security.
- A lender must pay the RETT if the purchaser does not do so.

Lenders' Rights in Insolvency

Insolvency and Reorganisation Procedures

German law provides for the following insolvency or reorganisation procedures:

- Out-of-court restructuring (*außergerichtliche Sanierung*) (see Out-of-Court Restructuring (außergerichtliche Sanierung)).
- Restructuring plan (*Restrukturierungsplan*) (see Restructuring Plan (*Restrukturierungsplan*)).
- Formal insolvency proceedings (see Formal Insolvency Proceedings (*Insolvenzverfahren*)).

Out-of-Court Restructuring (*außergerichtliche Sanierung*)

In an out-of-court restructuring, restructuring measures are carried out outside of formal insolvency proceedings. The condition for an out-of-court restructuring is a lack of an obligation to file for insolvency (that is, a company as debtor is neither (actual or impending) illiquid nor over-indebted).

An out-of-court restructuring can be accomplished by either:

- **Bank loan restructuring**, In the event of payment difficulties, a company will usually approach a bank and ask for a restructuring loan. However, the bank's freedom of action is restricted, as the granting of a loan to a company in crisis may be immoral (section 138, German Civil Code) or an act detrimental to creditors and thus subject to a later insolvency

challenge if the out-of-court restructuring fails. For a restructuring loan ensuring liquidity during the intended restructuring, a restructuring appraisal according to the Institute of Public Auditors in Germany's IDW S6 standards (*Sanierungsgutachten*) is mandatory.

- **Out-of-court settlement.** In an out-of-court settlement, creditors' partial or temporary waivers of their outstanding claims in situations where they are in a better position than in formal insolvency proceedings (creditors' restructuring contributions) are negotiated depending on existing collateral. The chances of restructuring depend largely on the creditor structure and the debtor's previous behaviour towards its creditors before the crisis giving rise to the out-of-court settlement. However, claims of creditors who were not included in the settlement will remain unaffected.

An out-of-court restructuring can result in:

- Lower costs (due to no fees for court proceedings or remuneration of an insolvency administrator).
- The ability to implement restructuring measures without the knowledge of external parties.

However, if, during an out-of-court restructuring, a reason for opening insolvency proceedings arises (see Formal Insolvency Proceedings (*Insolvenzverfahren*)), statutory law (section 15a, German Insolvency Code) requires the company's managing director to file an application to open insolvency proceedings to avoid civil law liability or criminal prosecution for delaying insolvency.

Restructuring Plan (*Restrukturierungsplan*)

A restructuring plan is a settlement between a debtor in financial difficulties and its creditors and can be concluded either outside or within the scope of court proceedings.

A restructuring plan:

- Requires the debtor to be imminently insolvent (section 18, German Insolvency Code), which means the debtor will probably not be able to fulfil its existing payment obligations when they become due. As a rule, a forecast period of 24 months is to be taken as a basis. If the debtor is over-indebted or illiquid, a restructuring plan cannot be used. The debtor must file for insolvency.
- Is very similar to the English Scheme of Arrangement and the German insolvency plan (sections 217 to 269, German Insolvency Code) (see Formal Insolvency Proceedings (*Insolvenzverfahren*)).
- Consists of:
  - a descriptive part that aims to evaluate the debtor's assets and illustrate the causes of the crisis, and that must describe how the restructuring plan may improve the debtor's situation, establish comparability by displaying how the situation of the debtor and the creditors would be without the restructuring plan, and describe how the individual affected creditors are intended to be classified into groups and the relevant criteria for these groups are to be made plausible; and
  - a formative part that must set out the measures to be taken to restructure the debtor, which can be both measures of financial restructuring (for example, debt rescheduling, debt release, deferments, debt conversions) and of corporate restructuring (for example, sale of individual assets or entire business units, conversion measures, sale of the debtor's business as a whole).

Only creditors whose legal position will be changed by the restructuring plan can vote on whether it should be adopted. Adoption requires approval by at least 75% of those entitled to vote in each group.

Once the restructuring plan is implemented, the company continues operating normally.

Formal Insolvency Proceedings (*Insolvenzverfahren*)

The board of directors (*Vorstand*) or the managing director (*Geschäftsführer*) of a corporation (such as a GmbH or AG) must commence formal insolvency proceedings if the corporation either is:

- Illiquid (that is, it cannot meet its payment obligations when due and payable, which is assumed if it cannot settle its payment obligations within three weeks and its debts then due and payable amount to more than 10% of its total debts).
- Over-indebted (that is, its assets no longer cover its debts), unless it appears that as a going concern it is highly likely to survive (*positive Fortführungsprognose*) within the next 12 months.

Commencement must occur within three weeks after the corporation becomes illiquid or within six weeks after the corporation becomes over-indebted (section 15a, paragraph 1, German Insolvency Code). Failure to do so is a criminal offence (section 15a, paragraphs 4 to 6, German Insolvency Code), punishable by imprisonment for no longer than three years or a fine ranging from EUR5 to EUR10.8 million based on the monthly net income of the delinquent members of the board of directors or managing director.

In case of imminent illiquidity (that is, a corporation is likely to be unable to make payments when due during a forecast period of 24 months), the corporation's representatives (excluding the creditors) may file for insolvency (section 15, paragraph 1, German Insolvency

Code). By filing an application at an early stage of the crisis, the corporation benefits from the privilege of insolvency proceedings in self-administration.

After the filing of an application to open insolvency proceedings, preliminary insolvency proceedings are initiated, which usually last between two and three months. During this time, the insolvency court examines if:

- A reason to open insolvency proceedings exists.
- The corporation's assets are sufficient to cover the costs of the proceedings.

The insolvency court will issue an order to open formal insolvency proceedings only if both criteria are met.

German law provides for the following formal insolvency proceedings:

- **Regular insolvency proceedings (*Regelverfahren*).** If the insolvency court decides to open regular insolvency proceedings, it will appoint an insolvency administrator, who will become responsible for running the debtor's business. The debtor loses the power of disposal (section 80, German Insolvency Code) and all agreements entered into and all actions taken by the debtor without the insolvency administrator's knowledge are ineffective (section 81, German Insolvency Code).

  A regular insolvency proceeding aims to satisfy creditors by:

  – a liquidation of the debtor's estate and distribution of the liquidation proceeds to all creditors (liquidation); or

  – a sale of all or parts of the debtor's business to an investor (transferring reorganisation).

  If the liquidation value of the debtor's estate is higher than its going concern value, the insolvency administrator will decide to liquidate the debtor's business. However, if the insolvency administrator manages to find an investor, the debtor's assets will be sold and transferred directly to the investor in an asset sale or indirectly in a sale of shares in a new company formed to own the assets.

- **Debtor-in-possession management or self-administration (*Eigenverwaltung*).** This proceeding allows a debtor to manage and dispose of its assets on its own, but under the supervision of a custodian (*Sachwalter*) appointed by the insolvency court. Liabilities outside the ordinary course of business can be created or incurred by the debtor only with the custodian's consent, and only the custodian can contest actions or omissions from the time before the opening of insolvency proceedings (sections 280 and 275, German Insolvency Code).

  For particularly significant transactions such as taking out a loan, the creditors' committee (*Gläubigerausschuss*) must grant its consent (section 276, German Insolvency Code). However, the decision regarding which of the mutually unfulfilled contracts are to be fulfilled and which are not must be made by the debtor (section 279, German Insolvency Code).

  The debtor's objectives are the same as those of an insolvency administrator in a regular insolvency proceeding. The debtor must apply for self-administration as an add-on to an insolvency filing.

  An insolvency court is not likely to grant an insolvency proceeding in self-administration if the creditors are likely to be disadvantaged or the debtor does not submit a comprehensive concept why self-administration is more useful than a regular insolvency proceeding.

  When it applies for an insolvency proceeding in self-administration, the debtor can also apply for a protective shield proceeding (*Schutzschirmverfahren*), which is a proceeding that is an add-on to an application for the commencement of an insolvency proceeding and combines self-administration with the aim of submitting an insolvency plan at an early stage. This can facilitate the debtor's restructuring. To apply for a protective shield proceeding, a debtor must submit a statement from an expert in insolvency matters (such as a legal advisor, tax advisor, or auditor) confirming:

  – the debtor's imminent illiquidity or over-indebtedness; and

  – the likely success of the restructuring.

  In such a case the insolvency court will grant the debtor the possibility to prepare an insolvency plan within the next three months.

- **Insolvency plan (*Insolvenzplan*).** As another alternative to regular insolvency proceedings and insolvency proceedings in self-administration, an insolvency plan can be submitted. An insolvency plan is a settlement reached with the debtor's creditors and, in contrast to a restructuring plan (see Restructuring Plan (*Restrukturierungsplan*)), it affects all creditors of the debtor. Although an insolvency plan can be used as a means of liquidation, transferring reorganisation, or reorganisation of the debtor, the common practice is for the insolvency plan to aim at reorganisation while maintaining the debtor's legal existence.

  Either the debtor or the insolvency administrator, acting at its own discretion or at the direction of the creditors' meeting (*Gläubigerversammlung*), may submit an insolvency plan. The debtor can submit a so-called prepackaged plan together with the application to open formal insolvency proceedings (section 218, German Insolvency Code).

Ability to Enforce

Only the commencement of a formal insolvency proceeding involving the borrower, a guarantor, or a security provider will affect a lender's ability to enforce its loan, guarantee, or security as follows:

- The repayment claims under the loan agreement or guarantee will become simple insolvency claims, which means the lender will be satisfied only up to a ratio (insolvency ratio) determined by the insolvency administrator which:
  - depends on the amount of open claims of the unsecured creditors (section 38, German Insolvency Code) and the amount of the debtor's estate that remains (remaining estate) after satisfaction of secured creditors with a segregation right relating to their assets from the debtor's estate (*Aussonderungsrecht*), secured creditors entitled to a preferential satisfaction (*absonderungsberechtigter Gläubiger*), and creditors of the insolvency estate (*Massegläubiger*) (remaining estate) (see Order of Satisfaction of Creditors' Claims and Realisation of Real Estate); and
  - is determined by dividing the remaining estate by the amount of open claims of the unsecured creditors.
- In general, existing security rights granted in favour of the lender will remain unaffected by the commencement of the formal insolvency proceeding, but the means of realisation will change depending on the type of collateral (see Realisation of Real Estate, Realisation of Movable Assets, and Realisation by the Creditor). A land charge or mortgage, bank account or share pledge, security assignment of receivables or security transfer of movables, and all contractual and statutory pledges (for example, of a landlord or lessor) are subjects of preferential satisfaction (*abgesonderte Befriedigung*) (see Order of Satisfaction of Creditors' Claims for a description of creditor claims entitled to preferential satisfaction).
- Any lawsuits affecting the debtor's insolvency estate are suspended until:
  - the lawsuits are re-opened in compliance with the German Insolvency Code; or
  - the insolvency proceedings are terminated.

  These lawsuits include enforcement proceedings except certain situations (such as if an unsecured creditor has obtained a security interest in the debtor's assets belonging to the insolvency estate by way of compulsory enforcement earlier than in the last month before the request for commencement of insolvency proceedings (section 88, German Insolvency Code)).
- Enforcement must be stayed if the debtor applies for and the insolvency court grants a protective shield proceeding (*Schutzschirmverfahren*) (see Formal Insolvency Proceedings (*Insolvenzverfahren*)).
- Individual enforcement measures cannot be taken against the debtor:
  - in a preliminary insolvency proceeding, if the insolvency court has imposed a preliminary protective measure (which prohibits individual enforcement measures against the debtor) to safeguard the debtor's assets (section 21, paragraph 2, sentence 1, no. 3, German Insolvency Code);
  - in an insolvency proceeding by an unsecured creditor (*Insolvenzgläubiger*) (section 89, paragraph 1, German Insolvency Code); or
  - in an insolvency proceeding, by creditors of the insolvency estate (*Massegläubiger*) (see Order of Satisfaction of Creditors' Claims) whose claims were not constituted by a decision of the insolvency administrator to fulfill the mutually unfulfilled contracts within the first six months after the commencement of the insolvency proceeding (section 90, paragraph 1, German Insolvency Code).

Realisation of Real Estate

The insolvency administrator may apply to the competent court for a compulsory sale (*Zwangsversteigerung*) or compulsory administration (*Zwangsverwaltung*) of real estate belonging to the insolvency estate, even if the real estate is subject to a right of preferential satisfaction (section 165, German Insolvency Code). However, the preliminary insolvency administrator may apply for a stay of enforcement in order to avoid any adverse effect on the debtor's financial condition. This applies in the following circumstances:

- When the debtor requires the real estate:
  - to keep conducting its business; or
  - for a transferring reorganisation by selling all or parts of its business to an investor.
- When enforcement would jeopardise or adversely impact the implementation of an insolvency plan.

Realisation of Movable Assets

The insolvency administrator may:

- Realise a movable asset by a private contract (*freihändige Verwertung*) if the asset covered by a right of preferential satisfaction is in the administrator's possession.

- Collect or otherwise realise claims assigned by the debtor as collateral under a security assignment agreement.

(Section 166, paragraph 2, German Insolvency Code.)

If the insolvency administrator is entitled to realise a movable asset or to collect a claim, the creditor entitled to a preferential satisfaction (*absonderungsberechtigter Gläubiger*) can ask the insolvency administrator for information on the condition of the asset or information on the assigned claims. (Section 167, German Insolvency Code.)

Before the insolvency administrator sells a movable asset or claim to a third party, the insolvency administrator must notify the creditor entitled to preferential satisfaction of the manner in which the asset or claim is to be sold. This gives the creditor an opportunity to point out another option for realisation that is more favourable to the creditor (which the creditor must point out within one week of the notification). A realisation option is deemed more favourable if costs are saved.

The insolvency administrator may, but is not obliged to, exercise the realisation option mentioned by the creditor (which means the creditor cannot prevent an all-out sale of assets in the context of a transferring reorganisation). However, the insolvency administrator must:

- Place the creditor in the same position as if the realization had taken place using the realisation option mentioned by the creditor.
- Pay the creditor entitled to preferential satisfaction the amount to which the creditor would be entitled if the option mentioned by the creditor had been used.

The creditor may also purchase the movable asset or claim.

(Section 168, German Insolvency Code.)

Following enforcement, the insolvency administrator must distribute the generated realisation proceeds to the secured party, usually reduced by a fee for the determination and realisation of the movable asset or claim (determination and realisation fee) of up to 9% of the proceeds of disposal of assets encumbered with the right for preferential satisfaction (*absonderungsberechtigte Gläubiger*) (flat rate) and any VAT (sections 170 and 171, German Insolvency Code).

Realisation by the Creditor

A creditor has a right to:

- Realise assets that are encumbered with a right of a preferential satisfaction that are not in the insolvency administrator's possession.
- Realise or collect any claim that is effectively pledged in favour of the creditor.

However, on application by the insolvency administrator and after hearing the creditor, the insolvency court may set a time limit within which the creditor must realise the asset or claim. After the time limit expires, the insolvency administrator may realise the asset or claim (section 173, German Insolvency Code).

Order of Satisfaction of Creditors' Claims

In a regular insolvency proceeding, insolvency plan, or debtor-in-possession management, outstanding creditors' claims are satisfied in the following order:

- Secured creditors with a segregation right (*Aussonderungsrecht*), who are third parties (such as equipment lessors) and own items that must be handed over (such as equipment under an equipment lease) (section 47, German Insolvency Code).
- Secured creditors entitled to a preferential satisfaction (*absonderungsberechtige Gläubiger*), who are creditors whose claims are secured by:
  - a land charge or mortgage (section 49, German Insolvency Code);
  - a contractual pledge (such as a bank account pledge or share pledge) or a statutory pledge (such as of a landlord or lessor) (section 50, German Insolvency Code); or
  - a security assignment of receivables or security transfer of movables (section 51, no. 1, German Insolvency Code).

  If the insolvency administrator realises on these creditors' security, proceeds from the realisation are distributed to creditors after deduction of the determination and realisation fee.
- Creditors of the insolvency estate (*Massegläubiger*), who are creditors with claims arising from or in connection with:
  - court fees accrued for the insolvency proceedings;
  - remuneration of the insolvency administrator; or
  - any contracts concluded by the insolvency administrator to carry on the debtor's business operations.

  (Sections 53 to 55, German Insolvency Code.)
- Unsecured insolvency creditors (*Insolvenzgläubiger*), who will be satisfied in the amount of an insolvency ratio. For information on the insolvency ratio, see Ability to Enforce.
- Subordinated insolvency creditors (*nachrangige Insolvenzgläubiger*), including:

  - creditors who have expressly subordinated their claims (section 39, paragraph 2, German Insolvency Code); and
  - the debtor's shareholders who lent it money before commencement of formal insolvency proceedings (section 39, paragraph 1, no. 5, German Insolvency Code).

For all other insolvency or reorganisation procedures, the underlying agreement determines the order of satisfaction of creditors' claims.

Void and Voidable Transactions

With the commencement of a formal insolvency proceeding, any transactions that are mutually unfulfilled are subject to the insolvency administrator's right to choose whether a contract should remain effective. This right of the insolvency administrator excludes orders, agency agreements, and powers of attorney with regard to the insolvency estate, which become automatically null and void by operation of law (sections 115 to 117, German Insolvency Code).

In addition:

- Under certain conditions, an insolvency administrator can contest acts and omissions that:
  - were made by the obligor before commencement of an insolvency proceeding; and
  - lead to a disadvantage of a special group of or all unsecured creditors.
- A creditor who has an enforceable debt title (*vollstreckbarer Titel*) against the obligor (such as an unappealable verdict of a court or a notarial declaration of a security provider to submit to the immediate foreclosure of a land charge or mortgage (*Unterwerfung unter die sofortige Zwangsvollstreckung der Grundschuld oder Hypothek*)) may contest the obligor's acts leading to a reduction of the obligor's assets, even if the obligor has not filed for commencement of insolvency claims or is neither over-indebted nor illiquid, if:
  - the creditor's claim is due;
  - the creditor has not been, or is not likely to be, fully satisfied from the obligor's remaining assets; and
  - one of the statutory grounds (such as intentional disadvantage of the creditors) is relevant.

(Section 11, German Avoidance Act (*Anfechtungsgesetz*).)

Regulatory Issues Affecting Foreign Lenders

Making a Loan

For a summary of the regulatory requirements that a foreign lender needs to comply with before it may make a commercial loan to a borrower in Germany, such as licensing, filing, or registration requirements, see Practice Note, Lending to a Company in Germany: Regulatory Issues: Restrictions on Making Loans.

Taking a Guarantee or Security Interest

For a summary of the regulatory requirements that a foreign lender needs to comply with before it can take a guarantee or a security interest from an entity in Germany, or a security interest over assets located in Germany, see Practice Note, Lending to a Company in Germany: Regulatory Issues: Restrictions on Taking Security or a Guarantee.

Enforcing Rights Under a Loan Agreement

For a summary of the regulatory requirements that a foreign lender needs to comply with before it can enforce its rights under a loan agreement against a borrower in Germany, see Practice Note, Lending to a Company in Germany: Regulatory Issues: Restrictions on Enforcing Rights Under a Loan Agreement.

Enforcing Security Interests

For a summary of the regulatory requirements that a foreign lender needs to comply with before it can enforce security interests in Germany, see Practice Note, Lending to a Company in Germany: Regulatory Issues: Restrictions on Enforcing Security.