Consent fee to second-ranking mortgagees – a means to capitalise a nuisance value or an illegitimate payment to be returned?

On 20 March 2014, the German Federal Court of Justice rendered a judgement on payments which are made to second ranking mortgagees who are – based on the property's value – out of the money. Although these creditors would not receive any proceeds in the context of a compulsory auction, they would have to agree to the deletion of their mortgage if the property value were due to be realised in a private sale. While these second-ranking creditors would theoretically have a legal obligation to consent to the cancellation without receiving any payment, they will, in practice, often receive a consent fee in order to avoid any litigation and to allow for the quick sale of an unencumbered property. The court in the recent judgment held that insolvency administrators cannot claim back the consent fee if the payments are made to the sole detriment of first-ranking creditors who renounce their right to also receive this part of the proceeds in favour of those creditors. This judgement might have an impact on negotiations between insolvency administrators and secured creditors regarding the private sale of an insolvent debtor's property.

Key issues

- Creditors with second-ranking mortgages must consent to a private sale of the property if they are out of the money
- Due to litigation risk insolvency administrators will often still pay consent fees to allow for a faster and more profitable private sale
- Consent fees are to be paid back if these are made out of the insolvency estate. They can be kept if they only reduce the proceeds of the first-ranking creditor

Background

In German insolvency proceedings the owners of mortgages and land charges have a right to separate satisfaction and can enforce their collateral through a forced administration or a public auction.

In most cases, however, a "cold administration" followed by a private sale by the insolvency administrator is the preferredoption for the creditor since it offers more control and promises higher recoveries. Secured creditors therefore favour this method of enforcement and insolvency

administrators also have an interest in such an arrangement due to the estate contribution (a certain percentage of the purchase price) which is usually paid in this case by the secured creditor which will also increase the administrator's personal remuneration.

Within a public auction, all security rights will automatically cease to exist and the second-ranking creditor will only receive payments if the auction proceeds are sufficient to fully repay the first-ranking mortgagee. This statutory regime does not apply to private sales. As a result, a deal will largely depend on the mortgagees' consent for the cancellation of the mortgages. This consent requirement is the gateway for second-ranking creditors to capitalise the nuisance value of their second ranking mortgage and to demand payment of a consideration for their voluntary consent ("*Lästigkeitsprämie*", "consent fee").

Established case law: insolvency administrator can reclaim payments made to the detriment of the insolvency estate

Pursuant to case law of the Federal Court of Justice from 2008, any amounts paid by the insolvency administrator to second-ranking creditors as consideration for their consent can be claimed back since this payment contradicts the fundamental principle of equal treatment of creditors. The court argued that even if the proceeds were considerably higher than what could have been achieved in a public action, the insolvency estate did not benefit from this sale since all the proceeds went directly to secured creditors. It should be noted that a particular feature of the 2008 decision was that the secured creditor and the insolvency administrator did not agree on an estate contribution to be paid out of the purchase price. As a result, any payment out of the insolvency estate to the second-ranking creditor directly reduced the estate to the detriment of unsecured insolvency creditors.

Payments to the detriment of first-ranking creditors cannot be claimed back

In its most recent judgement regarding this matter, the Federal Court of Justice clarified that insolvency administrators cannot claim back payments which are made to the sole detriment of first-ranking creditors who renounce part of the proceeds in favour of second-ranking creditors. In that case, the insolvency estate is not affected by this sale and the payment of the estate contribution.

Continuing legal uncertainty as to the necessity for a global commercial assessment

Both judgements make it clear that the basis for any potential repayment claim is the violation of the principle of equal treatment of creditors arising from the payment of the consent fee out of the insolvency estate to one particular creditor.

However, the judgements still do not address the commercially relevant question of the overall economic result for the insolvency estate taking into account the transaction as a whole. From an unsecured creditors' perspective, the issue of whether or not the estate contribution exceeds the consent fee paid to the second-ranking creditor is relevant. If it does, it should be irrelevant for the unsecured creditors as to whether the consent fee was funded out of the purchase price or out of the insolvency estate. In this case, the payment to the second-ranking creditor is not to be viewed as a violation of overriding principles of German insolvency law – even if the second-ranking creditor would not have received any proceeds at all in a public auction and only capitalises its nuisance value.

In our view, insolvency administrators should only then be able to reclaim consent fees paid if the estate is negatively affected by the sale, which is the case if the consent fee paid by the estate is smaller than the amount paid to the estate by the first-ranking creditor. Additionally, the individual insolvency creditor indirectly benefits from a private sale through a usually higher satisfaction of the mortgagee who will then have a lower residual claim in terms of the insolvency distribution.

However, it cannot be said for certain that a court would follow this line of argument.

Until the Federal Court of Justice explicitly clarifies the requirements for the existence of a contradiction of the fundamental principles of insolvency proceedings, it should be ensured from the perspective of a second-ranking mortgagee that the consent fee is paid from the proportion of the proceeds that belong to the first-ranking creditor and not the percentage to be paid to the estate.

Other recent relevant decisions on this subject matter: Secured creditors who are out of the money have an obligation to consent to the cancellation of the mortgage

Lower German courts (Regional Courts of Regensburg and Leipzig) ruled in 2009 and 2013 that, within insolvency proceedings, creditors whose security over a debtor's property is economically worthless

due to them being out of the money, are legally obligated to consent to the cancellation of the real estate lien without being entitled to compensation. The insolvency administrator has the right to file a claim against the creditor to have the cancellation established. This obligation arises from a duty of loyalty that exists between every debtor and its creditor. A decision by the Higher Regional Court of Nuremberg in 2013 emphasised that this duty is irrespective of existing contractual relationships. The court found that tax claims can form a basis for duties of loyalty (although an appeal on this decision has yet to be ruled on). In 2011, the Higher Regional Court of Schleswig even ordered a creditor which did not consent to the cancellation of its security right to pay damages that resulted from a lower purchase price in a public auction compared to a private sale.

The need for consent fees still exists

Until the Federal Court of Justice has confirmed the existence of duties of loyalty and the requirements for a respective claim against the second-ranking creditor, any insolvency administrator has to face potentially lengthy court proceedings, as well as uncertainty about the result of such litigation. This can only be avoided by way of an expedited sale if the creditor gives its consent to the cancellation which, in turn, will probably be dependent on the payment of a consent fee. Insolvency administrators will therefore still have an incentive to give in to second-ranking mortgagees' demands if this is also supported by the first-ranking mortgagees.

Creditors with first-ranking security rights may want to demand that the insolvency administrator file a claim against the second-ranking mortgagee in order to have their rights cancelled. In line with the aforementioned case law, this claim will most likely be successful if the administrator can prove that the creditor would not receive any proceeds in a public auction. However, given the litigation risks and the likelihood that a potential purchaser will neither be willing to wait for the end of a lengthy litigation process nor to acquire the property with the second-ranking mortgage remaining registered, insolvency administrators and creditors with first-ranking mortgages will have to face the fact that, even though they are in a very strong position on paper, they will have to give up parts of the proceeds in favour of other secured creditors to make a fast and profitable private sale possible. A second-ranking mortgagee can be threatened with the possibility of a future damage claim which could be asserted if the insolvency administrator can prove that the outcome of the public auction was appreciably lower than the outcome in a private sale. However, if the second-ranking mortgagee remains unmoved, consent fees will need to be paid in practice.

Outlook: Obligation to cancel share pledges and legal situation prior to insolvency?

Share pledges, mortgages and land charges are treated in the same way in German insolvency proceedings and all give rise to rights of separate satisfaction. It is therefore not unlikely that the duty to consent to the cancellation also exists in relation to share pledges which are commercially worthless if such a claim is asserted by the insolvency administrator appointed in the insolvency proceedings over the assets of the shareholder.

In most cases, however, such claims are of interest prior to insolvency proceedings. According to established case law of the Federal Court of Justice, creditors do not owe any fiduciary duties prior to the debtor becoming insolvent. Although this is widely criticised in relation to creditors of companies which are in financial difficulties or on the verge of insolvency, unless the court changes its case law in this respect, the duty to consent only exists in insolvency proceedings which have already been instituted and it is only the insolvency administrator who can file a respective claim. Therefore, in pre-insolvent restructurings, second-ranking creditors can still exploit their nuisance value and will be able to insist on the payment of a consent fee.

To be considered for future contracts

There are several possible ways in which contracts can be drafted to reduce the necessity to pay consent fees. Wherever possible, security rights should only be granted in favour of one security trustee acting for senior lenders and second lien/mezzanine lenders in order to avoid the existence of first-ranking and second-ranking mor tgages from the outset. The provisions of the intercreditor agreement would apply as regards the distribution of proceeds and majority thresholds for security releases.

Alternatively, the parties can expressly provide for a claim against second-ranking security holders in the security agreement, in the event that these are out of the money, to

consent to a cancellation to their security rights. While this would still mean that a claim would have to be filed if the creditor is unwilling to give its consent, any litigation risks are reduced since the parties do not have to rely on case law that has not yet been confirmed by the Federal Court of Justice.

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