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Germany – upfront fees in syndicated lending in light of recent Federal Court of Justice judgements

For German law consumer credits (*Verbraucherdarlehen*) work fees (*Bearbeitungsentgelte*) can only be charged upfront if the consumer (*Verbraucher*) has been given a real choice between paying an upfront work fee or a higher interest rate over the lifetime.

Equally, a bank cannot validly through its general business terms require a consumer to reimburse the bank for third party expenses it incurs when performing its contractual or statutory obligations or any other task that it performs predominantly in its own interest.

It is our view that this case law does not restrict typical upfront fees and expense provisions in syndicated loans to corporate borrowers.

Contrary to consumers, corporate borrowers are not inappropriately disadvantaged when banks on syndicated loan transactions charge an upfront work fee which does not substantially exceed the costs the bank actually incurred or otherwise pass on third party expenses actually incurred.

Further, most of the upfront fees charged in syndicated lending transactions are charged not for work undertaken by the bank in its capacity as lender but for additional services rendered by a finance party which services are mostly not rendered predominantly in its own interest. These services should be clearly described in the relevant documentation.

Introduction

The Federal Court of Justice's view with respect to consumer credits

In two judgements delivered on 13 May 2014, the Federal Court of Justice ruled that in a German law governed loan agreement with consumers, banks cannot through general business terms charge an upfront work fee for costs incurred to make available or disburse the funds, unless the work fee is repaid *pro rata temporis* when the loan is prepaid prior to its original maturity date. The Federal Court of Justice held that upfront work fees put consumers at an inappropriate disadvantage when compared to the guiding principle as laid down in section 488 Civil Code (*Bürgerliches Gesetzbuch*) pursuant to which the remuneration for the lenders for making available and keeping available the funds is through

interest accruing over the term of the loan.[1]

On 8 May 2012, the Federal Court of Justice had already delivered a similar judgement with respect to an expense provision in general business terms, holding that the bank would not be entitled to recover third party expenses from the consumer which it incurred in its own interest (e.g. costs for taking and releasing transaction security).[2]

As a result, according to the Federal Court of Justice, in the context of consumer credits the costs for the following work can be recovered only through (1) an interest payment or (2) upfront work fees with a *pro rata temporis* reimbursement if the consumer credit is prepaid or (3) an upfront work fee if the consumer has been given a choice between a non-refundable upfront work fee or a higher interest payment:

- evaluation of the creditworthiness of the consumer, including expenses for external technical and other advisors,
- preparation of the credit documentation, including expenses for external legal counsel,
- conducting talks with the client, noting down the specific client needs and relevant client data,
- evaluating and executing the credit documentation,
- funding itself and disbursement of the funds, and
- potentially further costs incurred after the credit documentation has been signed for implementation, examination and monitoring of the credit.

Inconsistent views of district courts (*Landgerichte*) and higher regional courts (*Oberlandesgerichte*) on commercial loans

The Federal Court of Justice only referred to loans granted to consumers. Several local courts and district courts have applied the case law to work fees for commercial loans (*gewerbliche Kredite*) as well as loans to merchants (*Kaufmann*) or entrepreneurs (*Unternehmer*) while other courts (including two higher regional courts) held that the arguments of the Federal Court of Justice are limited to consumer credits.

In this newsletter, Bettina Steinhauer, partner in the finance group in Frankfurt, explains why upfront fees as well as related provisions on expenses in syndicated lending transactions with corporate borrowers (including private equity borrowers and special purpose vehicles) remain permissible.

Differences between consumer credits and syndicated loans

The Federal Court of Justice's rulings were limited to consumer credits. It is for consumer credits that the Federal Court of Justice held that the non-refundable upfront work fee and related expense provisions put consumers at an inappropriate disadvantage when compared to the relevant statutory provisions. There is no express indication that the Federal Court of Justice would extend its views to upfront fees and expense provisions typical for syndicated lending transactions with corporate borrowers most of which would typically qualify as merchants (*Kaufmann*) under German law.

The different results can be justified on the basis that syndicated loans to corporate borrowers constitute an own category different from that of consumer credits. For syndicated loans to corporate borrowers the various fees and expenses typically charged to the borrower are not, after weighing the interests of the lender against those of the borrower, to the borrower's inappropriate disadvantage – as the lender would have to demonstrate.

Consumers have additional rights of voluntary prepayment which could be substantially adversely affected

For consumers, the Federal Court of Justice found that the work fee increased the amount of the loan taken out by the consumer and hence the consumer is paying interest on the portion of the loan that corresponds to the work fee.

The Federal Court of Justice further referred to those provisions of German law that provide that a consumer can repay a loan other than a loan secured through real estate at any time (section 500 (2) Civil Code), with the amount of break costs being capped (section 502 Civil Code). That right of the consumer, which cannot be contracted out of (section 511 Civil Code), could become meaningless if the consumer could not exercise it in practice due to high upfront work fees which are not refunded *pro rata temporis* in case of a prepayment. The upfront work fee also circumvents the fee cap on break costs in the event of an early repayment which applies to consumer loans (section 502 Civil Code).

[1] BGH NJW 2014, 2420 - 2431; BGH NJW-RR 2014, 1133 – 1135.

[2] BGH WM 2012, 1344 – 1351.

Syndicated loans have a less generous regime of voluntary prepayments

In syndicated lending, the loan amount would usually be determined by the mid to long term financing needs of the borrower – the upfront fees would not come on top of that amount. In event driven syndicated loans such as leverage buyouts or project finance, the financing needs of the borrower which would have to be covered either through the loan or through the equity portion would take into account all transaction costs, including bank fees but also advisory fees incurred by the borrower for technical or legal advice or due diligence assistance.

Further, German law does not cap the amount of break costs in loan agreements with corporate borrowers. The lender of a loan to a corporate borrower with a fixed interest rate until maturity could thus recover its costs in full, either through interest payment or, in case of a prepayment, break costs. Hence the (non-refundable) upfront work fee does not put the corporate borrower at a relevant disadvantage. The lack of a relevant disadvantage would also apply to loans with a maturity in excess of 10 years as typical upfront work fees would not substantially exceed the amount of costs actually incurred and would thus not in practice substantially restrict the borrower's statutory right to prepay the loan ten years after it has been disbursed (section 489 (1) no 2 of the Civil Code).

For syndicated loans where the interest rate is fixed for each consecutive interest period German law provides that the borrower is entitled to prepay the loan at the end of the interest period by giving one month prior notice (section 489 (1) no 1 Civil Code). Further, if according to an increased costs provision in a loan agreement a lender can pass on increased costs at any time rather than for the next interest period only, the borrower is entitled to prepay the loan at any time by giving three months notice (section 489 (2) Civil Code). These prepayment rights cannot be restricted or excluded (section 489 (4) Civil Code), whether through general business terms or individually negotiated terms. According to the Federal Court of Justice[3] non-refundable upfront work fees must therefore not exceed the actual costs incurred by the lender by a substantial amount in order to not restrict the right to prepayment. There is no need to further protect the borrower that is not a consumer through section 307 of the Civil Code.

Level playing field between corporate borrower and bank

The Federal Court of Justice held that in loan agreements with consumers the rules that it established are required to achieve a level playing field ("*Waffengleichheit*") between a bank and a consumer. However, as between a bank and a corporate borrower in a syndicated loan agreement there cannot be an assumption that the corporate borrower is per se in a weak negotiating position and hence needs the protection of the law. For example, in the area of syndicated lending it would not be unusual for the borrower to invite several banks to a beauty contest and for it to propose the key terms of the loan, including the pricing. It would equally not be unusual for the borrower to pick the bank's legal counsel. As a rule corporate borrowers are in a position to generate competition between lenders and to consider alternatives to a bank loan, e.g. bonds, including *Mittelstandsanleihen* or other private placements. Further, a typical borrower under a syndicated loan will have conducted similar transactions before, either because it has a syndicated loan in place already or because it has several bilateral bank loans in place.

Banks make substantial upfront investment in syndicated lending

In syndicated lending, the amount of work to be undertaken by each lender upfront is considerably higher than the work involved in a consumer credit. The loan agreement is very tailored towards the specific needs of the borrower and, more importantly, it is negotiated with the borrower. Even if negotiations were to be seen as taking place in the interest of the lender, for this kind of credit it would not seem inappropriate if the work fee was recovered upfront irrespective of the original lifetime of the loan. The amount of work banks need to invest does not depend on the lifetime of the loan. Further, the borrower, not the bank, determines through the exercise of prepayment rights whether the lifetime is shorter than the actual maturity date. This also applies to expenses for the fees of external legal counsel of the bank, taking into account in particular that the borrower is also represented by external legal counsel. Finally, the upfront investment of a bank and its employees working on a syndicated loan goes beyond the duties that a lender would typically owe to a borrower and while some of this may also be in the interest of the bank the ambitious timetables for these transactions which often require all market participants to

[3] BGH, NJW 1990, 2250, 2251.

work outside normal working hours or even be available on a 24/7 basis are usually driven by the borrower's needs.

Differences between lenders

Further, in the interest of an efficient and fast process, some lenders are more involved in the origination and documentation process than others. These lenders can only be remunerated through a fee as the interest is usually the same for all lenders, including after potential transfers, e.g.:

- where the lender acts as documentation agent to ensure a more efficient documentation process,
- where the lender provides an underwriting and syndication is postponed to after signing,
- where the lender arranges a facility, e.g. by preparing an information memorandum, coordinating with other potential lenders etc.

And although the participants are themselves responsible for making their own credit decisions and checking the documentation, there is of course some risk attached to these tasks that remains with the lender who performs the task and that can be remunerated.

Finally, not all lenders in a syndicated loan agreement have the same yield requirements, expressed as per annum yield. The upfront fees allow to differentiate between lenders and help in reaching those yield requirements.

Commercial practice (*Verkehrssitte*)

According to the Federal Court of Justice, a provision would not usually be deemed inappropriate if both parties agree that the provision has been the norm for a long period of time and is largely accepted between parties.[4] Market participants in syndicated lending can confirm that upfront fees and related expense provisions have been the standard for more than 15 years, it being difficult to find examples for transactions (outside the area of restructuring) which do not provide for non-refundable upfront fees and third party expense provisions. Thus market participants know and accept that pricing and expenses are related.

It is the understanding of all market players that the bank will be entitled to recover its upfront external expenses and that is done either through a higher upfront fee which covers the expenses or a lower upfront fee combined with a separate expense provision. In addition, the fact that the costs for uncertain measures like security enforcement are not included in the interest calculation but covered through separate expense provisions is also in the interest of a borrower, given the very low likeliness of these costs ever being incurred.

For the reasons outlined above, there are no special needs or interests of corporate borrowers in syndicated lending with which a non-refundable upfront work fee or an expense provision is not compatible.

Upfront fees are not work fees

The case law of the Federal Court of Justice confirms that even for consumer credits lenders can be remunerated for their services in the following situations:

- the fee is for legally independent services (*rechtlich selbständige Sonderleistung*) provided by the lender or other finance party which services are in addition to the making available of the funds (*Kapitalbelassung*) (and ancillary obligations of the lender in connection therewith) and not predominantly in the interest of the lender; or
- the fee is as work fee but dependent on the term of the loan (*laufzeitabhängig*).

Commitment fee and utilisation fee

On this basis, the typical commitment fee as well as the typical utilisation fee which are both paid over a period on un-drawn respectively drawn amounts are hence not caught by the case law of the Federal Court of Justice and remain permissible.

Underwriting fee

The underwriting fee charged by banks in case of an underwriting, i.e. committing to fund an amount in excess of their final hold amount, is legally permissible as it is charged for a service which is legally separate from that of making available the funds under the loan agreement. In essence, it is a fee paid in order for the bank to agree to the request of the borrower to bear the syndication risk for a longer period than it would ordinarily do and hence for agreeing to defer (primary) syndication. Whether it is expressed as a percentage of the total commitment of the bank or just of the amount underwritten (i.e. the committed amount minus the intended final hold amount) should not make any difference. Market participants would understand what the fee is paid for, irrespective of how it is calculated. However, as any uncertainty about what the fee is paid for will be to the detriment of the

[4] BGH NZM 2005, 504 – 506.

lender, it would be prudent for the fee provision to set out in more detail than is currently done for what service exactly the fee is paid.

Arrangement fee

The same applies to that portion of the arrangement fee which the arrangers receive for arranging the facility, i.e. without the participation fee element. This arrangement fee is paid for services which are legally separate from those relating to making available the funds. In a typical mandate letter, the task of the arranger is described as "to arrange and manage the primary syndication" of the facilities. That the role of the arranger is separate from that of a lender is also evidenced by those transactions where the borrower uses its own strong and long standing relationship in a "self arranged transaction" without asking one or more of the lenders to act as arranger.

Charging an arrangement fee for separate services rendered implies, though, that there is a real role for an arranger to perform and that this is not just a title. In club deals it has to be decided on a case by case basis whether the argument about the arrangement fee being paid for additional services rendered by the arranger can be upheld. If not, courts might re-qualify the arrangement fee as a work fee. If the rules set up by the Federal Court of Justice for consumer credits were to be applied to syndicated loans to corporate borrowers, the work fee could only be charged if negotiated individually, i.e. if the borrower had been given a choice between paying an upfront work fee or no work fee but a higher interest rate. Alternatively, lenders could seek to argue that the arrangement fee in a club deal should not be re-qualified into a work fee as it is the parties mutual understanding that the fee is one integral element of the pricing of the transaction which cannot be separated from its other elements, including the interest rate, but also the maturity of the facility and the credit protection provided for in the loan agreement. In case the upfront fee is part of the pricing but not paid for additional services, the fee must not operate so as to in practice restrict the statutory termination rights of the corporate borrower (section 489 (4) Civil Code); otherwise it would be void.

Participation fee

The participation fee is the fee which the arranger determines will, together with the interest offered, attract the number and quality of lenders the borrower requires. It is sometimes shown as a separate fee to be paid by the borrower to each participant, usually as a percentage of the commitment of that participant. On other occasions it is part of the arrangement fee and not set out separately.

As the name of the fee indicates, it is an upfront fee charged for the lender agreeing to participate rather than for legally separate services rendered by the participant in addition to it agreeing to participate in the loan.

If the participation fee is agreed between the arranger and the borrower as part of the arrangement fee but without being shown separately, one could argue that once it has been established that a fee is paid for legally separate services the bank is free to decide how that fee is calculated, subject only to the *ordre public*. In addition, one could treat the participation fee element as costs incurred by the arranger in its capacity as such which – as long as they are reasonable – should be recoverable.

There remains a risk though that courts will re-qualify the amount of the participation fee as a work fee. If so and if the rules set up by the Federal Court of Justice for consumer credits were to be applied to syndicated loans to corporate borrowers, the participation fee can still be charged if negotiated individually. According to the Federal Court of Justice, this requires that the borrower is given a choice between paying the participation fee as upfront work fee or paying a higher interest over the lifetime of the facility. By contrast, it would not be sufficient if the bank was prepared to only discuss the amount of the participation fee but not the fee itself. To avoid a requalification of the participation fee into a work fee, lenders could argue that it is the mutual understanding of the parties that the fee is one element of a more complex pricing structure, which includes further elements such as the interest rate, the maturity of the facility and the credit protection contained in the facility agreement. In that case, the fee must not operate so as to in practice restrict the statutory termination rights of the corporate borrower (section 489 (4) Civil Code); otherwise it would be void.

Waiver and amendment fee

Waiver and amendment fees are fees paid for legally separate services as the bank is not legally required to consider waiver or amendment requests. Hence this fee is paid for an additional service in the interest of the borrower as consideration for the bank agreeing to waive its rights. According to a judgement of the dis-

trict court of Bonn[5] this even applies to a waiver and amendment fee which is charged upfront in anticipation of certain waiver or amendment requests. Waiver and amendment fees are therefore not affected by the case law of the Federal Court of Justice, nor are expense provisions for reasonable expenses incurred by the lenders in the context of an amendment and waiver request.

Agency fee

The agent is appointed by, and paid for by, the borrower but is the agent for the other finance parties. The agent's tasks are clearly separate from, and in addition to, those of the lenders to make available the funds. The agent does not have to be a lender or affiliated to a lender, as is shown by specialized trust service providers acting as agents. The agent assumes certain administrative tasks, including facilitating payments to/from the borrower. It acts as central point of communication with and by the borrower, facilitates the formation of views within the lending syndicate and implements the decisions taken by the lending syndicate, e.g. by executing a waiver or an amendment agreement. Moreover, the agent does generally not relieve the individual lenders from their monitoring or other duties. Its tasks are mechanical. For example it forwards to the individual lender any information it receives from the borrower, thus facilitating the communication also in the interest of the borrower. It does not evaluate or otherwise check that information as this is a task that remains with the individual lender. The agent's tasks are therefore comparable to those of a common representative in German law bonds introduced by the German legislator in the Act on Notes (*Schuldverschreibungsgesetz*) in 2009. This role was seen to be in the interest of the issuer and as the noteholders did not own any joint assets from which the common representative could be paid the legislator decided to require the issuer to pay the common representative. Although the Federal Court of Justice[6] held that the guiding principles applicable to the "price" for a loan and the "price" for any other type of contract are specific to each type of contract and despite the differences that exist between a loan and notes, the view expressed by the legislator on this point through the Act on Notes is worth noting. That the role of an agent is equally in the interest of the borrower is also seen in more complex *Schuldschein* loans where the borrower engages and pays for its own paying agent. The importance of the role of an agent for the lenders from the perspective of the borrower can finally also be seen in restructuring cases where the absence of an agent in typical *Schuldschein* loans is seen as serious impediment to a successful restructuring. It is therefore appropriate for the lenders to require that the agency fee is eventually paid by the borrower.

Security agency fee

As with the agent, the security agent is appointed by, and paid for by, the borrower but acts as security agent for the other finance parties. Its tasks include:

- to hold and administer the transaction security;
- to act as central point of communication to and from the chargor with respect to the transaction security;
- to implement decisions taken by the lending syndicate with respect to transaction security, including to release or enforce any transaction security.

As is the case with the agent, the security agent does not relieve the lenders from their monitoring and examination tasks. Its role is rather a role necessary in syndicated lending as it is neither technically possible nor practicable to have all lenders benefit from the same security package without involving a security agent. In addition, the fact that the security agent acts as central point of communication also facilitates the performance of the borrower's obligations and ensures a coordinated approach by the lenders on questions related to security. Further, as in the case of the agent, the lenders also have no joint assets from which to pay this fee. On the other side, the Federal Court of Justice held that banks take security in their own interest rather than that of the borrower. As a result, it could argue that the security agent's role is thus equally predominantly in the interest of the bank. If the case law of the Federal Court of Justice on consumer credits was therefore extended to syndicated loans the requirement for the borrower to pay the fees for the security agent as an (annual) upfront fee could be questioned by the courts who might argue that the costs can only be passed on through the interest element.

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[5] AG Bonn, judgement of 22 October 2014 - 114 C 380/14 -, juris.

[6] BGH NJW 2014, 2420, 2425.

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