SCHULDSCHEIN LOANS IN CROSS-BORDER RESTRUCTURINGS

Schuldschein loans are no longer the sole preserve of German *Mittelstand* borrowers, and have started to play an increasingly prominent role in cross-border restructurings. This note examines some of the key issues that all parties will need to be aware of in relation to a restructuring involving Schuldschein loans. These considerations will also be relevant to parties considering a "new money" Schuldschein transaction.

Key issues

- Market estimated to be €27-€35bn
- Borrower and lender perspectives - explored
- Challenges in restructurings
- Solutions in consensual and formal processes

INTRODUCTION

The Schuldschein loan market has grown substantially and become more international in recent years. The private nature of the market makes its size difficult to estimate, though a January 2019 report by Scope Ratings placed the size of issuance in 2018 at €24.5bn, down 10% year-on-year from 2017, but over three times higher than in 2013.

That expansion has in part been driven by the extension of Schuldschein loans to "cross-over" borrowers with sub-investment grade characteristics, and borrowers outside of the core German, Austrian, and French Schuldschein markets. This has in turn resulted in Schuldschein loans becoming involved in cross-border restructurings and insolvencies. Recent cross-border examples include: Steinhoff International (which had €730m in principal of Schuldschein loans outstanding at the start of its restructuring), Carillion plc (which had $155m), Premier Oil plc (which had $130m), and Folli Follie (which had €51m). German Schuldschein borrower, Gerry Weber, also failed to repay €31m of Schuldschein loans when they matured in November 2018, underlining that core-market Schuldschein loans are not immune to default.

This note summarises what Schuldschein loans are, why borrowers and lenders participate in the Schuldschein loan market, the challenges that Schuldschein loans can present in a restructuring, and approaches to dealing with Schuldschein loans in a restructuring – both consensually and by using a court and/or insolvency process.

WHAT ARE SCHULDSCHEIN LOANS?

There is no strict legal definition of a Schuldschein loan. The term "*Schuldscheindarlehen*" literally means "a loan evidenced by a certificate of indebtedness". However this is not a strict legal requirement for a Schuldschein loan and most Schuldschein loans today are issued on an uncertificated basis.

There are however market conventions that define what is typical for a Schuldschein loan. The box at the end of this briefing highlights six attributes which are key in a distressed context.

WHO BORROWS SCHULDSCHEIN LOANS, AND WHY?

The "classic" Schuldschein borrower is a German Mittelstand company, with "investment grade" characteristics but which is too small, or which otherwise does not want to seek a rating. Austrian and French companies with similar credit strength have traditionally been the next largest cohorts.

More recently, the Schuldschein market has broadened to include:

- Borrowers who are "cross-over" (i.e. sub-investment grade) credit risks; and
- Borrowers in jurisdictions outside the traditional/core Schuldschein markets. Schuldschein loans have been borrowed by companies in the UK, South Africa, Brazil, and the Middle East (among others).

These two factors have combined to bring Schuldschein loans into more corporate restructurings.

The attractions of Schuldschein loans for borrowers include:

- *Market access*: Schuldschein loans provide access to a wider/different pool of creditors to traditional syndicated loan or bond markets.
- *Lower transaction costs*: Schuldschein documentation is short, simple, and presents minimal disclosure obligations, meaning that transaction costs are typically lower than for syndicated loans or bond documentation.
- *Maturity profiles*: By market convention, it is common to borrow Schuldschein loans on the same terms but with different maturity dates, corresponding to higher/lower interest rates. This can give borrowers the ability to create a more tailored maturity profile than with traditional syndicated loans or (at least certain types of) bonds.
- *Covenants*: Often, Schuldschein loans will provide greater covenant flexibility and/or headroom than syndicated loans. For example, financial covenants may be left out or given additional headroom to avoid "hair trigger" defaults; and baskets may be defined as a percentage of assets rather than in absolute terms to permit the business to grow. This reflects the absence of any ability for the "majority lenders" to make amendments to these provisions, or to waive events of default on behalf of the Schuldschein lenders as a whole.

WHO LENDS SCHULDSCHEIN LOANS, AND WHY?

Traditionally, Schuldschein loans were originated by a small number of large European banks, and then distributed primarily to German savings banks (*Sparkasse*). In recent years, the universe of buyers has widened to include, among others, pension funds, insurers, and other types of banks (notably banks headquartered in Asian jurisdictions).

For cross-border Schuldschein loans, there are broadly two main categories of Schuldschein lender. The first are institutions seeking to build a diversified portfolio of loans with a modest amount of capital and at limited cost. Schuldschein loans are attractive to such institutions owing to their short-form and ostensibly simple documentation (which can take less time to review than lengthy syndicated or bond documents); no or low minimum participation size (participations as small as €500k are relatively common); and free transferability (Schuldschein lenders typically "buy to own" but the in-principle ability to trade remains important). In

addition, such institutions take comfort from the absence of any "majority lender" concept in Schuldschein loans that would allow institutions with larger exposures to make amendments with which they may not be comfortable.

The second category of Schuldschein lender are institutions who have other exposures to a borrower. Whereas some German borrowers rely primarily on the Schuldschein market for debt capital, this is rarely true of international borrowers, who will typically have other creditor relationships e.g. under syndicated loans or notes. Institutions with existing exposures to a borrower may see participating in a Schuldschein loan as an attractive means of increasing their exposure. Again, free transferability, and the inability for other lenders to give amendments or waivers on their behalf, are usually key attractions - these features may allow them to apply a more favourable capital or accounting treatment, and be integral to their ability to make the loan. Moreover, Schuldschein loans often pay a slightly higher yield than syndicated loans, particularly where a lender accepts a slightly longer term.

WHAT CHALLENGES DO SCHULDSCHEIN LOANS PRESENT IN A RESTRUCTURING?

Some of the features that make Schuldschein loans attractive at origination can present significant challenges in a stressed/distressed scenario. Short-form documentation which may once have appeared straightforward can prove complex when a borrower comes under financial strain and needs (for example) to take actions which were not in contemplation at the time the Schuldschein documents were agreed. This complexity can be compounded where a document has been drafted in both English and German - no translation is ever perfect, and even a non-binding translation can colour parties' (and potentially a court's) understanding of the document. Moreover, in a cross-border restructuring Schuldschein loans will rarely be the only form of debt financing. Complexity can arise from the interaction between the Schuldschein loan and other financing arrangements. For example, provisions in a borrower's Schuldschein loans will often be based on equivalent terms in its other English or New York law financings but may be construed differently under German law. The LMA's recently released standard form documentation for Schuldschein loans will no doubt help alleviate these issues to some extent. But they are unlikely to cure them altogether.

At a more commercial level, the corollary to accessing a different pool of investors is that those investors come with their own characteristics. At least some Schuldschein lenders in a restructuring are likely to be institutions who were attracted to the Schuldschein market precisely by the prospect of building a broad loan portfolio for a modest investment. These institutions are likely to have a relatively small exposure to the borrower, and limited institutional resources to manage a complex restructuring. Nevertheless, each Schuldschein lender's consent will be required to effect an amendment or waiver to their Schuldschein loan; and each Schuldschein lender will have an individual right to demand immediate repayment of its loan following a "termination event". As noted in the box at the end of this note, these termination events which will typically include standard "events of default", as well as certain statutory termination events. Schuldschein lenders with cross-holdings into a group's other financings may also seek to use discussions around waivers or consents under their Schuldschein loans as a means of pushing the wider restructuring in a direction which is amenable to them.

Moreover, owing to free transferability, the make-up of the Schuldschein lender group is liable to change both before and during a restructuring. A relatively passive bank lender can very quickly be replaced by a group of activist funds,

each of whom will have the same individual consent rights, and the same individual rights to demand repayment, as every other Schuldschein lender.

HOW CAN SCHULDSCHEIN LOANS BE DEALT WITH IN A RESTRUCTURING?

Sometimes, Schuldschein lenders will have relatively little ability to influence the course of a restructuring. This will typically be the case where they are "out of the money" – for example, because they have made loans to a holding company with no material assets other than shares, without guarantees from the operating group, and where the operating group is itself insolvent. In these circumstances, the relatively disparate nature of a Schuldschein lender group, and each lender's typically smaller exposure relative to other types of creditor, can make it even harder for the Schuldschein lenders to influence the course of a restructuring than it is for other out of the money creditors to do so.

On the other hand, where Schuldschein lenders are "in the money" (for example, because they have received guarantees from the operating companies) then their individual consent and acceleration rights can make them difficult to ignore.

In some situations, it may seem tempting for a borrower to repay its Schuldschein lenders in order to focus on larger priorities, particularly where the Schuldschein loans are a relatively small proportion of a borrower's capital structure. However, Schuldschein loans typically do not contain a right of voluntary prepayment. Even where they do contain such a right, or Schuldschein lenders are willing to be repaid, a Schuldschein borrower's other finance documents may restrict such a repayment. Moreover, even in the absence of a formal restriction, creditors to a distressed borrower are rarely supportive of another creditor group being paid ahead of them.

In practice, from a borrower's perspective it will therefore often be necessary to engage the Schuldschein lenders in restructuring negotiations. This can be a time and resource intensive process, given the need to engage with each institution and the characteristics of a typical Schuldschein lender group.

There is a risk of Schuldschein lenders seeking to extract "ransom" value by opposing an otherwise widely supported restructuring. However, with possible exceptions, this has not been our experience in practice. Instead, Schuldschein lenders have typically wanted to participate in restructuring discussions, principally for commercial and reputational reasons.

There will therefore often be good commercial and legal reasons for Schuldschein lenders to seek a negotiated restructuring. When Schuldschein lenders participate in restructuring negotiations, they will of course want to negotiate around their particular priorities. These will vary from institution to institution (which has an added significance given the requirement for each individual institution to consent). But as a general rule, Schuldschein lenders' priorities will be coloured by their reasons for investing in Schuldschein loans in the first instance. By way of illustration, a "typical" Schuldschein lender is likely to place significant value on the individual control rights that it has over its loan; as well as holding an instrument on broadly market terms, which dictate that a corporate Schuldschein loan should be a first-ranking unsecured instrument. A "typical" non-Schuldschein lender with an unsecured English-law loan, by contrast, may require security as part of a restructuring, and expect to enter into an intercreditor agreement further regulating when they may demand repayment, in addition to the "majority lender" restrictions in their existing loan. The interests of Schuldschein and other lenders can clearly come into tension.

On the Premier Oil restructuring, this tension in fact arose, and was ultimately resolved by converting the Schuldschein loans into an English law term loan, which was secured and made subject to an intercreditor agreement on market terms. The Schuldschein lenders received a modest amount of additional economics to compensate them for the loss of their unilateral rights. All of the Schuldschein lenders consented to that restructuring, though other restructurings may call for a different approach.

CAN COURT AND/OR INSOLVENCY PROCEEDINGS BE USED TO COMPROMISE SCHULDSCHEIN LOANS?

As with any restructuring, where a fully consensual deal cannot be reached, a borrower and/or its creditors may need to resort to a court process and/or insolvency proceedings.

In the context of cross-border restructurings, the two most common types of proceedings are those under English law (notably schemes of arrangement) and US chapter 11 bankruptcy proceedings. As Schuldschein loans are governed by German law, we also consider the ability to use German proceedings to restructure.

Schemes of arrangement and other English proceedings

English law schemes of arrangement are attractive in cross-border restructurings for many reasons, including their flexibility, body of precedent, and the fact that they are company law rather than insolvency law proceedings.

There is a perception among certain market participants that Schuldschein loans cannot be compromised using a scheme of arrangement. The true position, at least at the time of writing, is more nuanced. What impact Brexit may have on this position remains a point of uncertainty.

Under the current law, there is (at least) a respectable argument that: (i) schemes of arrangement are "civil and commercial" proceedings for the purposes of the EU Judgments Regulation; and accordingly (ii) where a contract reserves exclusive jurisdiction for such proceedings to the courts of Germany, as a Schuldschein loan is likely to do (and as would be in-line with the LMA standard), an English court is precluded by Article 25 of that Regulation from opening scheme proceedings insofar as they affect the Schuldschein loan, without the Schuldschein lender's consent. The issue has never been litigated, and there are counter-arguments which a borrower could make. A Schuldschein lender may be willing to litigate long beyond the point at which a restructuring needs to be implemented in order for the borrower's business to survive, noting that their exposure to the borrower may be small, but that setting a precedent for schemes of arrangement compromising Schuldschein loans may be damaging to their portfolio as a whole. By the same token, a borrower and its other creditors may reason that a Schuldschein lender would prefer to reach a consensual, out-of-court outcome.

Where a borrower determines that it is unable to use a scheme of arrangement to compromise a Schuldschein loan outside of insolvency, it is far more likely to be able to do so if it first enters into insolvency proceedings in England, as this opens up a different jurisdiction regime under the EU Insolvency Regulation. Alternatively, it could propose a company voluntary arrangement, which is another form of insolvency proceedings which can be used to compromise unsecured indebtedness. Whether this is practical or not will depend (among other things) on how damaging insolvency proceedings are likely to be for the borrower and its business and, if its centre of main interests is not already in the UK, the cost and practicality of moving its centre of main interests.

For the sake of completeness, it should also be noted that there are examples of Schuldschein loans providing non-exclusive jurisdiction to German courts. In these cases, a borrower's ability to use a scheme of arrangement may be less affected.

US chapter 11 bankruptcy

US chapter 11 bankruptcy proceedings can be attractive to borrowers owing to the flexibility of the US bankruptcy regime, the relative ease of establishing jurisdiction, the automatic stay of any action against the chapter 11 debtor or its assets wherever located, and (often most important of all) the purported worldwide jurisdiction of the US bankruptcy court. As a matter of pure German law, it is possible (and may even be likely) that chapter 11 bankruptcy proceedings would have no effect upon the ability of a local Schuldschein lender to enforce its Schuldschein loan. But in practice, few if any financial institutions – Schuldschein lenders included – are able to risk being held in contempt of court in the US.

We are not aware of any borrowers choosing to restructure using chapter 11 bankruptcy proceedings specifically to force Schuldschein lenders into a restructuring. But where a chapter 11 bankruptcy is otherwise appropriate, the effect may be to limit any special negotiating leverage that holding Schuldschein loans would otherwise provide.

German proceedings

The fact that a company has borrowed a Schuldschein loan does not, in itself, give that company access to German insolvency or restructuring proceedings. The German Bond Act (*Gesetz über Schuldverschreibungen aus Gesamtemissionen - Schuldverschreibungsgesetz*) allows certain quorums to pass amendments without unanimous consent. But this Act does not apply to Schuldschein loans: they are loans, not bonds.

Whether a borrower is able to access proceedings in Germany will therefore be a case-by-case analysis. A borrower whose centre of main interests was in Germany might (for example) be able to use "protective shield proceedings" (*Schutzschirmverfahren*) in combination with self-administration to provide a short period in which to negotiate a restructuring, without the risk of Schuldschein lenders taking direct action. A borrower with its centre of main interests elsewhere would need, at a minimum, to think very carefully about the practicality and merits of relocating to Germany in order to avail of these proceedings when there may be more attractive options elsewhere.

CONCLUSIONS

There are benefits to participating in the Schuldschein loan market from the perspective of borrowers and lenders, but doing so is not without its risks, particularly in a downside scenario. When a Schuldschein borrower faces financial difficulties, the company, its Schuldschein lenders, and its other stakeholders will need to give careful consideration to the often complex legal and commercial considerations that arise. Whilst Schuldschein loans may simplify borrowing, they will almost never simplify a restructuring.

Key features of Schuldschein Loans

1. German law and jurisdiction

Schuldschein loans are invariably governed by German law and subject to the jurisdiction of applicable German courts (often Frankfurt) most often on an exclusive or "one-way" exclusive basis (i.e. lenders can sue anywhere but can only be sued in Frankfurt).

2. Short-form documentation

A Schuldschein loan agreement is typically a short-form document, containing the "bare essentials" of a longer form loan agreement.

3. Transferable, but not securities

Schuldschein loan certificates (literally the "Schuldscheine") are typically freely transferable, in whole or in part, in a manner similar to bonds. However, Schuldschein loans are treated by German and European law as loans rather than as securities. Borrowing a Schuldschein loan will not subject a company to prospectus or ongoing market disclosure obligations. By the same token, a borrower cannot list its Schuldscheine on an exchange.

4. Typically unsecured

Schuldschein loans are typically unsecured obligations, though they may benefit from subsidiary guarantees. There are limited exceptions to this general rule however e.g. in the context of real estate, project, or other asset financings.

5. Bilateral relationship – no "majority lender" voting

Each Schuldschein lender has a bilateral relationship with the borrower. Generally, a Schuldschein lender will be entitled to exercise its rights without regard to how other lenders are exercising theirs. There is typically no "majority lender" concept entitling a majority of lenders to bind others to an amendment or waiver. There are sometimes exceptions to this principle where Schuldschein loans are made on a secured basis (see above).

6. Statutory termination rights

Whilst it is common for a Schuldschein loan agreement to contain negotiated "Events of Default" entitling each lender to terminate its loan and demand immediate repayment, certain termination rights are included automatically as a result of German law. These include where there is a "substantial deterioration in the financial circumstances of the borrower".

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