ALERT MEMORANDUM

Schuldschein Forecast – Rain or Shine?

March 9, 2018

Schuldschein loans have been in the news recently. Historically Schuldschein loans were predominantly borrowed from German lenders by German companies with a strong credit profile who accessed the private market for these German law governed loans. In the last few years the market has internationalised significantly, with non-German borrowers and lenders entering the market for this form of financing. Some reports suggest that, since the financial crisis, the percentage of non-German borrowers in the market has grown from less than 20% to nearly 50%. High profile non-German groups whose Schuldschein loans have come to light in distressed circumstances include Premier Oil, Steinhoff and, most recently, Carillion.

This memorandum takes a look in detail at how the presence of Schuldschein loans in the debt stack of a non-German group may affect the restructuring of the debt of that group.

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What is a Schuldschein loan?

Schuldschein loans are loans arranged in the German private placement debt market which has given, traditionally, German and, to a lesser extent, continental European corporates access to deep-pocketed but risk averse investors, such as German co-operatives and savings banks. These loans are usually unsecured and documented using a (relatively) short form loan agreement governed by German law plus a separate paying agency agreement. Borrowers had to be considered of high credit quality, but did not and do not need to have a public credit rating from one of the international rating agencies. Lenders rely on publicly available information where the borrower is listed (as they often are) and if an information package is required, it is usually fairly light and easy for the borrowers to prepare (especially when compared with a high yield bond offering memorandum or even a bank information memorandum typical for European syndicated loans). Instead of public ratings, investors often rely on the internal ratings of the arranging banks who are presumed to act as the gatekeepers to the market by admitting only solid credits.

How to restructure the terms of a Schuldschein?

Schuldschein loans typically do not have any collective action clauses which allow any hold out minority to be contractually bound by the changes approved by the majority, so even financial covenant amendments need the consent of all lenders. In syndicated loans, whilst changes to the fundamental money terms, such as amounts owed and maturity date, require all lender consent as a contractual matter, there are restructuring tools which are available to cram down dissenting lenders, despite the terms of the loan agreement. The most popular of these tools in a European restructuring is the UK scheme of arrangement which is frequently used by companies incorporated in jurisdictions outside of the UK, often by amending the terms of the relevant loan agreement to English law. In the case of a Schuldschein loan, however, a change of the governing law would need all lenders to consent, because there is no collective action clause.

Effectiveness of the UK scheme of arrangement as a tool to restructure a Schuldschein loan

When deciding whether to sanction a scheme of arrangement in respect a non-UK company, the UK courts will have to consider three issues: (i) whether there is 'sufficient connection' with the UK; (ii) whether the UK courts have jurisdiction, taking into account the effects of European law applicable in the UK; and (iii) whether the scheme is likely to be recognised and implemented in the relevant jurisdictions, in particular, in the jurisdiction of incorporation of the debtor company.

The sufficient connection test

Historically, UK courts have assumed that a sufficient connection exists where the debtor has its centre of main interests[1] ("COMI") in the UK, or at least has significant assets in the UK. In loosening previously stricter requirements, sufficient connection has also been established by UK courts on the basis of English governing law and jurisdiction clauses in the debt documents subject to the scheme. Of course, satisfying the court of the sufficient connection test by pointing to the governing law of the agreement would not work in the case of a Schuldschein loan governed by German law, so an attempt to scheme that loan would not get very far unless the debtor can satisfy the test through other factors, such as its COMI.

The jurisdiction test

In 2017, Premier Oil successfully implemented a debt restructuring partly by way of a scheme in the Scots courts. However, that scheme did not apply to Premier Oil's Schuldschein because, according to the scheme's circular, it was "not clear that the Court

[1] Article 3(1) of the Recast Insolvency Regulation describes the debtor's centre of main interests as the place where the debtor conducts the administration of its interests on a regular basis and which is ascertainable by third parties. In the case of a company, there is a rebuttable presumption that its centre of main interests is the place of its registered office. That presumption shall only apply if the registered office has not been moved to another Member State within the three month period prior to the request for the opening of insolvency proceedings.

has jurisdiction" in respect of the Schuldschein loans.

One gating item to bringing Schuldschein loans into the jurisdiction of the UK courts for the purposes of a scheme is the uncertainty as to whether the Recast Judgments Regulation[2] would curtail the jurisdiction of the UK courts. The general principle under the Recast Judgments Regulation is that persons domiciled in a Member State must be sued in the courts of that Member State. The UK courts have so far avoided deciding definitely on the issue of whether a scheme involves the scheme debtor 'suing' the scheme creditors.

Nevertheless, a practice has developed whereby the court assumes that the Recast Judgments Regulation does apply, meaning that the scheme company needs to find an exemption to the general rule, such as Article 8(1) which says that a person domiciled in another Member State may be sued together with other defendants in the courts of the Member State where any one of them is domiciled (such as the UK) provided that the claims are so closely connected that it is expedient to hear and determine them together to avoid the risk of irreconcilable judgments resulting from separate proceedings. Scheme companies have therefore used the presence in the UK of one of more creditors to establish jurisdiction of the UK courts.

That being said, the question of the domicile of creditors would likely be irrelevant, in any event, if the Schuldschein loan agreement were to contain an exclusive submission to the courts of Germany[3].

The effectiveness test

The court will also need to be persuaded that the scheme is likely to be recognised and implemented in the relevant jurisdictions. This is primarily a question of German law to determine whether the German law governed terms of the Schuldschein would be validly amended by the scheme. Similar to the position under English law, the default position under German law is that a German law contract cannot be amended or discharged by order of the court of another jurisdiction, unless the decision of such court must be given effect to in Germany by the German courts. In the case of a scheme, the German courts might be required to give effect to the UK court's decision sanctioning the scheme pursuant to the Recast Judgments Regulation.[4]

It has been suggested in legal writings and by restructuring practitioners in Germany that a UK court's sanction of a scheme could be recognised as a "judgment" for the purposes of the Recast Judgments Regulation, with the effect that the scheme would become enforceable in Germany. This approach was mainly discussed in respect of the effect in Germany of schemes restructuring debt governed by English law (as in the *Rodenstock* and *Apcoa* cases), but might also be available with respect to the German law governed obligations subject to a scheme. The debate about whether the Recast Judgments Regulation would be applicable to schemes centred in particular around whether the UK court's sanction of a scheme involved an adversarial proceeding, resulting in a judgment, or whether it constitutes a court-sanctioned composition proceedings (to which the Recast Judgments Regulation would not apply).[5] The German Federal

[2] Regulation (EU) 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast).

[3] Article 25 of the Recast Judgments Regulation says that if the parties to an agreement, regardless of their domicile, have agreed that the courts of a Member State are to have jurisdiction, then those courts shall have jurisdiction, unless the agreement is null and void as to its substantive validity under the law of that Member State.

[4] The Recast Insolvency Regulation (Regulation (EU) 848/2015 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast)) does not apply to a scheme as a scheme is not an insolvency proceeding within the scope of the Recast Insolvency Regulation.

[5] It has also been debated whether characterising a scheme as a court settlement could provide a route to enforcement of schemes via Article 59 of the Recast Judgments Regulation which says that a court settlement which is enforceable in the Member State of origin shall be enforced in another Member State. A court settlement is defined in Article 2(b) as "a settlement which has been approved by a court of a Member State or concluded before a court of a Member State in the course of proceedings". This argument, however, was definitively rejected by the UK court in the recent hearing for the scheme of Far-Eastern Shipping Company plc. For further detail on the court's analysis of schemes in the

Court in the 2012 *Equitable Life* case, which involved the recognition of a scheme initiated by a UK insurer in respect of insurance contracts with German residents, was sympathetic with the former argument (as indeed was much of the commentary on the case). In the end however, the court expressly did not rule on the matter because of the mandatory provisions of the EU Regulation 44/2001 (the predecessor to the Recast Judgments Regulation which applied at the time of the case but which was substantively similar to the Recast Judgments Regulation in terms of the recognition of judgments) which required an insurer to bring proceedings in the EU Member State in which its creditor is domiciled[6]. So the utility of the Recast Judgments Regulation as an enforcement route for schemes relating to Schuldschein loans is yet to be definitively determined by the German courts. In the meantime, there are still good arguments in favour of the Recast Judgments Regulation operating to generally satisfy the 'effectiveness' test with respect to German law loans.

The effects of trading

As we have seen, in the case of a scheme, the ability of the Schuldschein debtor and lenders to restructure a Schuldschein loan using a scheme may depend not only on the terms of the Schuldschein loan but also other circumstances. Of particular relevance in this respect could be the domicile of the holders of the instrument. This is a granular analysis, as Schuldschein issuers have often entered into several different Schuldschein loans (see for example the number of instruments entered into by the *Steinhoff* group). Trading may also affect the outcome as UK-domiciled holders could trade out of or into the Schuldschein loans which typically have fewer transfer restrictions than syndicated loans for equivalent borrowers.

context of the Recast Judgments Regulation and the Recast Insolvency Regulation, please see our earlier alert memorandum: English schemes of arrangement: points to note from a recent example.

[6] Article 8, 12(1) and 35 of the EU Regulation 44/2001 on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters.

Schuldschein loans as a hold-out tactic?

Because of the lack of ruling in *Equitable Life* on the status of a scheme under the predecessor to the Recast Judgments Regulation, there remain arguments in support of the Schuldschein creditors' hold-out position when faced with a restructuring of German law debt by way of a scheme, especially if there are no UK-domiciled creditors and the Schuldschein provides for the exclusive jurisdiction of the German courts.

Company voluntary arrangement to the rescue?

However, even if the scheme is not a threat to Schuldschein hold-out creditors, there is another restructuring tool by which minority unsecured creditors can be crammed down: the company voluntary arrangement ("CVA") under the Insolvency Act 1986. This is a "voluntary arrangement under insolvency legislation" to which the Recast Insolvency Regulation does apply.

Like the scheme, the CVA can be used by companies incorporated outside the UK but unlike the scheme, non-UK companies need to shift their COMI to the UK to use a CVA. Debtors use three main techniques to attempt to shift their COMI: changing registered office; moving assets and liabilities to the desired jurisdiction; and merging with another company in the desired jurisdiction. However, crude attempts to shift COMI (for example, by simply changing registered address) in an effort to forum shop and thereby evade debts have been disallowed by the courts[7]. Courts will insist on a genuine COMI shift (as achieved in the landmark restructurings of German groups *Schefenacker* and *Deutsche Nickel* which used a CVA following a successful COMI shift) which aims to achieve the best outcome for creditors in the subsequent insolvency proceedings.

A CVA may only apply to unsecured creditors, but Schuldschein loans are generally unsecured and issued by groups whose credit is often strong enough to ensure that other borrowings were unsecured as well (at least before the issuer got into distress).

[7] For example, the English courts in *Hans Brochier Holdings Ltd v Exner* decided that a German company's attempted COMI shift to the UK had been ineffective.

Once proposed, approval by 75% (in value) of the responding (unsecured) creditors is required to bind all (unsecured) creditors, even those who were unknown to the insolvency practitioner and so did not have notice of the CVA. Unlike a scheme, the Recast Insolvency Regulation[8] does apply to a CVA, so the German courts generally have to recognise a CVA and give it the same effect in Germany as in the UK. In the context of a CVA, then, the Schuldschein debt will likely not have the same hold-out value as it may have in a scheme. However, the requirement to move the debtor's COMI to the UK in order to carry out the CVA can be costly and have negative tax consequences which may encourage the debtor and other creditors to sweeten the terms offered to the Schuldschein loan holders in order to reach as consensual deal rather than go down the CVA route.

What about proceedings in Germany?

While German law currently does not offer pre-insolvency proceedings in order to restructure German law loans such as Schuldschein loans, non-German debtors could in theory relocate their COMI to Germany and make use of a German in-court restructuring by way of an insolvency plan proceedings coupled with debtor in possession proceedings. Whether this would be an attractive alternative however, would have to be carefully considered and has, up until now, not been tested.

Conclusion

Whether you are looking at a Schuldschein loan with a view to hold-out or to see whether your efforts to restructure might be held up by the presence of a Schuldschein loan, there are several factors which will need close analysis in order to determine which restructuring tools will be available and whether they are likely to prevail or fail.

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[8] Regulation (EU) 848/2015 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast).

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