KIRKLAND **ALERT**

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New Guidelines for Protecting Secured Lenders' Share Foreclosure Rights in German Bankruptcies

On September 24, 2015, the German Supreme Court held that secured lenders of insolvent German debtors are not stayed from foreclosing on stocks in a German corporation (*Aktiengesellschaft*) in an insolvency of the pledgor, *but only where those stocks have been placed in trust for the benefit of the lenders*.[1] Importantly, the court explicitly acknowledged but left open the question whether secured lenders also have authority to foreclose on pledged shares in German limited companies (*Gesellschaft mit beschränkter Haftung*, "GmbH") or limited partnerships (*Kommanditgesellschaft*, "KG") in an insolvency of a pledgor where those shares have *not* been placed in a trust. The court's decision means that secured lenders must be more vigilant in negotiating secured lending structures in Germany. Moreover, even assuming that secured lenders successfully preserve their foreclosure rights, the challenges to actually effecting a German share or stock pledge foreclosure remain.

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Background

The case before the German Supreme Court concerned an individual debtor who held certificated stocks in a German stock company (*Aktiengesellschaft*) that it had pledged to secure a bank loan. The company had experienced financial difficulties in the years leading up to insolvency commencement. As a result, its secured lender demanded that the pledged shares in the company be placed in a custodial trust for the lender's benefit.[2] Subsequent to commencement of the bankruptcy, the secured lender foreclosed on the collateral. The insolvency administrator responded by suing the lender for multiple hundreds of millions of Euros in alleged damages.

Generally, § 166 of the German Insolvency Code (*Insolvenordnung*, "InsO") permits the bankruptcy trustee to dispose of "movable things" (*bewegliche Sachen*) that have been pledged to secure a debt, but only if the "thing" in question is in the trustee's possession. If § 166 InsO applies and the trustee is entitled to enforce, the effects are wide-reaching: (A) Under § 21 InsO, a stay against foreclosure and other enforcement action can be imposed during the postpetition and pre-commencement period;[3] and (B) per §§ 170 and 171 InsO, after a sale of the share collateral during the bankruptcy case, up to 9 percent of the proceeds are deducted and go into the estate to account for (e.g., the bankruptcy trustee's) assessment and disposition costs.

Here, the German Supreme Court ruled that § 166 InsO applied on its face to certificated stocks in a German stock company, meaning that, in a basic scenario where the insolvent entity continues to hold certificated stocks in its own name, the right

to enforce remains with the insolvency trustee. Where, however, as in the case at hand, the later insolvent debtor-entity, prior to insolvency, places the stocks in a custodial trust to secure the lender's loan to it, the lender retains the right to foreclose on the stocks, even during the pending insolvency. And notably, while the court acknowledged the open issue of whether § 166 InsO grants enforcement rights over non-certificated GmbH shares to the trustee or instead to secured lenders, the court expressly declined to rule on it.

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The Effect of the Court's Ruling

The German Supreme Court's ruling represents its most recent and authoritative pronouncement on secured lenders' foreclosure rights with respect to pledged shares and stocks. Subsequent to the ruling, the governing law as to pledged stocks and shares now is thus:

- certificated stocks pledged to secure a debt but which are consolidated in a global note can be disposed of by the bankruptcy trustee; *provided* that he has physical control them;
- if he does not (e.g., if they have been transferred to a custodian or otherwise placed in trust for the benefit of secured lenders), the secured lender retains the right to conduct the foreclosure on the stock collateral;
- whether § 166 InsO grants foreclosure rights to the insolvency trustee for shares in a German limited company (i.e., "GmbH") or partnership (i.e., "KG") (as well as to other "rights" such as IP) that have not been placed in trust, remains unsettled, as the court declined to rule on the issue;[4]
- although the court did not say so specifically, shares in a GmbH that *have* been placed in trust should be protected from insolvency trustee foreclosure (i.e., secured lenders retain foreclosure rights).

The ruling provides additional guidance to secured lenders on how to structure pledges of German entities' shares or stocks, particularly, in those not uncommon situations where a German holding company with value mainly in its operating subsidiaries pledges stocks or shares in those subsidiaries to secure claims under a syndicated loan and later falls into insolvency.

The Remaining Debate Over Foreclosure on GmbH Shares

Whether secured lenders or instead the insolvency trustee has the right to foreclose on GmbH or KG shares in an insolvency of the GmbH's or KG's parent entity remains controversial, as the German Supreme Court itself acknowledged. Those arguing for secured lender rights have pointed to the German Civil Code's definition of "things" which does not include "rights" such as shares in a GmbH[5] as well as to the German Code's legislative history's clear distinction between "rights" and "things."[6] The opposing view have characterized § 166 InsO's exclusion of "rights" as an oversight and argued courts should fill the legislative gap.[7] A decision from the

German Supreme Court siding with the former view would continue the recent erosion of bankruptcy trustees' outsized influence in German insolvency matters.[8] Until that decision comes, however, secured lenders lending into uncertain structures should insist that pledged shares are placed in a custodial trust to secure their claims.

Strict compliance with the statutory provisions is critical: Failure to do so can result in the winning bidder not obtaining good title to the assets.

Continued Challenges of Foreclosing on Shares

The German Supreme Court's ruling does nothing to soften the challenge of actually carrying out a foreclosure on shares or stock. Share and stock foreclosures are governed by §§ 1220 et seq. of the German Civil Code, provisions enacted in the 1800s when collateral consisted of cows and chickens and not shares in companies. In other words, the German Code lacks the detailed procedural guidelines that have been developed in other jurisdictions (such as the Article 9 of the Uniform Commercial Code).

That notwithstanding, secured creditors and their able advisers have developed a general approach for using those provisions to exercise share pledge rights and ultimately gain control over the entity in question. The difficulty is in ensuring compliance with the Civil Code's ambiguous conditions regarding the public nature of the foreclosure,[9] the place where it is to be held,[10] notices to creditors and interested parties,[11] the scope of diligence that bidders are allowed to engage in, the terms of auction and permissible bids,[12] and the ability of secured lenders to "credit bid" their claims.[13]

Strict compliance with the statutory provisions is critical: Failure to do so can result in the winning bidder not obtaining good title to the assets.[14] Moreover, in syndicated loans, only the security agent, not the individual lenders themselves, typically is a party to the share pledge agreement; yet, the claims held by the lenders are those used to credit bid. Industry practice is for the borrower therefore to grant the security agent an undertaking to pay the amount of the debt, creating a "claim" in favor of the security agent, even though no debt is owed to it.[15] Courts have yet to decide whether this arrangement suffices to facilitate credit bidding at a foreclosure sale.

Conclusion

The German Supreme Court has provided additional guidance on how to attempt to protect secured parties' rights to foreclose on stock (and potentially share) collateral even during a pending insolvency process. While secured lenders still will need to navigate the difficult terrain in actually effecting a share foreclosure in Germany, the court, with its ruling that a trust structure protects secured lenders' stock foreclosure rights in insolvency, has given secured lenders a potential pathway for avoiding a highly value-dilutive aspect to foreclosure processes. Risks remain and the trust structure[16] still is largely untested in insolvency processes — in particular for GmbH and KG shares — but, in future, secured lenders should consider employing a custodial trust when negotiating pledges of stocks and shares in secured financing structures.

1 German Supreme Court (Bundesgerichtshof) (hereinafter "BGH") Judgment September 24, 2015 – IX ZR 272/13.

2 Specifically, the trust agreement provided for, in addition to transfer of the shares to a custodian, transfer of voting rights under the shares to the custodian (with the economic interests in the shares remaining with the debtor-transferor), but with a requirement that the custodian exercise rights under the trust agreement in the interests of the debtor-transferor including with respect to board appointments. In addition, the trust agreement provided for a negation of the debtor-transferor's ability to issue binding instructions to the custodian, and that the trust agreement could be terminated only with all party consent.

3 In contrast to U.S. chapter 11, this stay statutorily at least is not "automatic." However, a stay against enforcement of collateral generally usually is granted during the three months following the filing date before formal commencement of a case.

4 Notably, the court cited sources arguing that § 166 InsO should apply to shares in a limited company, appearing to give those sources credence.

5 See § 90 German Civil Code ("things" are only tangible objects).

6 Palandt/Ellenberger, BGB, 74th ed 2015, § 90 BGB ¶ 1 (a "thing" is a tangible object); Appellate Court Frankfurt (OLG Frankfurt) Order April 10, 1981 – 20 W 460/80 (holding that share in a German limited company is a „right" within the meaning of the German Civil Code and not a „thing"); MüKo/Reichert/Weller GmbHG § 15 ¶ 52 (same); Nerlich/Römermann/Becker January 2015 § 166 InsO ¶ 36; MüKo/Tetzlaff InsO, 3. ed. § 166 ¶ 7; Local Court of Karlsruhe (AG Karlsruhe) Judgment February 7, 2008 – 12 C 490/07; Teztlaff LSK 2007, 478, 482; Wallner ZInsO 1999, 453-57; Sessig/Fischer ZInsO 2011, 618, 624 et seq.

7 Bitter/Alles KTS 2013, 113, 143; Uhlenbruck/Brinkmann InsO 14. ed. § 166 ¶ 36; but see Primozic/Voll NZI 2004, 363, 365 Fn. 35-37(citing Grundlach/Frenzel/Schmidt NZI 2001, 119, 123 (discussing constitutional protection of property rights in Article 14 of the German Constitution (*Grundgesetz*) with respect to statutory rules that deviate from substantive law); BT-Drs. 12/2443 at 178, 183 (legislative history indicating clear distinction between „things," „claims," and „other rights").

8 See, e.g. Smid WPg-Sch 2011, 8 (discussing strengthening of creditor rights in insolvency pursuant to 2012 German insolvency law reform).

9 See § 1235 German Civil Code (requiring only that a sale of collateral be via public auction other than for collateral with a market value, which may be via private sale).

10 See § 1236 German Civil Code (requiring that the sale take place where the collateral is kept, unless doing so might not lead to a successful auction).

11 See § 1237 German Civil Code (requiring publication of place and time, in particular to the debtor and parties with an interest in the assets).

12 See § 1238 German Civil Code.

13 See § 1239 German Civil Code (providing that if the secured lender submits the highest bid, the purchase price shall be considered to have been paid); see generally Tetzlaff ZInsO 9/2007, 479, 480-82 (describing generally the difficulties with compliance with statutory provisions, including

whether the Code requires that parties be allowed to conduct extensive diligence).

14 See § 1243 para. 1 German Civil Code.

15 See generally Gsell/Krüger/Lorenz/Mayer/Weber § 488 BGB (19 May 2015) ¶¶ 352-355.5 & Fn.1620 (noting prevailing view in legal literature that creation of "abstract" promise to pay loan amount provides sufficient basis to grant a collateral pledge) (citing Bourgeois BKR 2011, 103, 104 et seq.; Danielewsky/Dettmar WM 2008, 713; Hoffmann WM 2009, 1452, 1453 et seq.; KilgusBKR 2009, 181, 185 et seq.; Reuter BKR 2010, 102 (107)).

16 One particular non-insolvency structuring consideration that lenders should evaluate is whether transfer of the shares to a custodian will trigger any so-called "change of control" clauses in the

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If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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