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Enforcing security interests in German real estate inside and outside insolvency proceedings

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The enforcement of security over real estate in Germany used to be the domain of German commercial banks, which mainly handled such enforcements with their in-house teams or specialised real estate administrators (*Zwangsverwalter*). In recent years, however, things have changed with the marked increase in real estate portfolio investment in Germany. This has occurred as a result of the growth of specialised investors, real estate investment trusts (REITs) and public real estate investment companies, as well as the refinancing of such investments through commercial mortgage-backed securities (CMBS).

In any such portfolio investment, the following main security interests are usually granted to, or to the benefit of, the lenders (or, indirectly, the CMBS noteholders):

- Mortgages (land charges) encumbering real estate property (land and buildings).
- Pledges over shares or partnership interests in the borrower and, depending on the particular structure, its affiliates and subsidiaries.
- Pledges over the accounts of the borrower.
- The assignment of rent receivables and insurance proceeds.

Almost all of these portfolio investments are subject to considerable default risks or may already be in default. This may be in relation to loan-to-value covenant breaches or because upcoming maturities will reach several billion Euros throughout 2012 and 2013. As a result, lenders increasingly need in-depth specialist advice on enforcement routes and are often unable to handle enforcements in-house. The routes available to lenders can involve:

- Immediate actions to secure cash flows.
- Enforcement of pledges over shares or partnership interests.
- Enforcement of mortgages on the insolvency of the property-owning borrower.

This chapter provides an overview of the alternative routes available in these areas. It also outlines some of the insolvency law considerations that may be of relevance where a property-owning borrower is not resident in Germany (*see box, COMI considerations*).

IMMEDIATE ACTIONS TO SECURE CASH FLOWS

Once an enforcement event has occurred, the first priority for any secured creditor is to enforce account pledges to take over the cash flows generated by the properties. Enforcement actions relating to account pledges can only be taken once a secured claim is due and payable (*Pfandreife*) within the meaning of section 1228, sentence 1 of the German Civil Code (*Bürgerliches Gesetzbuch*) (BGB). Otherwise, credit amounts of the relevant accounts can only be released by the account-holding bank jointly to the pledgor and the pledgee. In addition, until a payment default has occurred, the borrower is exclusively authorised by the credit documentation to operate the pledged accounts.

However, if a secured claim has become due and payable (*Pfandreife*) and legal requirements (set out in sections 1273 and following and 1204 and following of the BGB) have been met, the pledgee may send a notice to the account-holding bank revoking the borrower's authority to operate the accounts and requiring that any amounts be transferred to an account designated by the pledgee. This allows for an immediate cash sweep.

In addition, to avoid the borrower directing rental income to accounts that are not pledged to the benefit of the creditor, it is advisable to notify tenants of the assignment of rental claims and to require that any rental payments be paid into a designated account. Following such notice, the tenant can no longer discharge its payment obligation under the assigned lease claim by payment to the borrower's account.

Such immediate action usually only temporarily satisfies the needs of creditors. If a consensual financial restructuring cannot be agreed among all relevant parties, further enforcement action must be taken. This may involve the commencement of insolvency proceedings in relation to the assets of the borrower. Note that enforcement action concerning property to realise proceeds for repayment of outstanding obligations is only possible:

- Indirectly, by enforcement of pledges over shares or partnership interests in the borrower (or its shareholders).
- Directly, by enforcement of mortgages encumbering real estate properties.



SELLING SHARES OR PARTNERSHIP INTERESTS BY PUBLIC AUCTION

After the occurrence of an enforcement event, the following procedures must be initiated by the pledgee:

- The pledgee must warn the pledgor of the imminent sale of the shares or partnership interests (*section 1234, paragraph 1, BGB*).
- The place and date of the auction must be publicly announced (*section 1237, paragraph 2, BGB*).
- The pledgor and any other person who has a right in the pledged shares or partnership interests must be separately notified of the place and date of the auction (*section 1237, BGB*).
- The pledge must ensure that the waiting period between the pledgee's warning and the auction, which is typically reduced by provisions in the pledge agreement to a period of between five and ten days, has expired.

The public announcement of the auction should be made at least two to three weeks before the date of the auction, if this is not explicitly contractually reduced. The period set for the public announcement must be observed regardless of any shorter warning period agreed in the pledge agreement. In practice,

the warning given to the pledgor, the notification requirements concerning the place and date of the auction, and the public announcement are usually made simultaneously.

In recent years, there has been much discussion as to whether potential bidders must be given the opportunity to conduct comprehensive due diligence of the legal entity at their request. However, an analysis of the relevant legislation does not support this proposition.

Pledge agreements typically provide that the public auction can be effected by the pledgee anywhere in Germany. The pledgee typically instructs a German notary public. Bids at the auction can be made by any third party as well as by the pledgor and the pledgee (bids can also be made by credit bid). Any restrictions (whether intentional or caused by negligence) that preclude potential bidders from making a bid may result in an illegal auction, with the result that the transfer of shares or partnership interests to the purchaser is not legally effective or that the pledgee is liable to the pledgor for damages.

There are no minimum price requirements where shares or partnership interests are auctioned.

ENFORCEMENT OF SHARE AND PARTNERSHIP INTEREST PLEDGES

Depending on the relevant structure of the borrowing entity and its affiliates and subsidiaries, the following are commonly used as security interests:

- Pledges over shares (*Geschäftsanteile*) in German limited liability companies (*Gesellschaften mit beschränkter Haftung*) (GmbH).
- Pledges over limited and/or general partner interests (*Kommandit- und Komplementäranteile*) in German limited partnerships (*Kommanditgesellschaften*) (KG).

While share and partnership interest pledge agreements typically contain detailed provisions on the rights and obligations of the parties before the occurrence of an enforcement event, provisions on the enforcement procedure tend to be scarce. The only way a pledgee can enforce such pledges without the pledgor's cooperation is through the sale of the shares or interests by public auction (*öffentliche Versteigerung*) (see *box, Selling shares or partnership interests by public auction*).

Any other method of enforcement, in particular, a private sale (*freihändiger Verkauf*) or forfeiture (*Verfall*), is only available if the pledgor and the pledgee agree on such a procedure after an enforcement event (a payment default) has occurred. Any provisions in the pledge agreement that differ from this are null and void (*section 1245, paragraph 2, BGB*).

Enforcement generally requires an enforceable court judgment authorising the enforcement of the pledge by the pledgee (*section 1277, sentence 1, BGB*). However, this requirement is generally waived in German pledge agreements.

The enforcement of pledges may coincide with the pledgor's and/or borrower's insolvency triggered by the borrower's cash flow insolvency following the acceleration of the secured claims. While the start of insolvency proceedings over the pledgor's assets does not affect the pledgee's right to enforce the pledges, insolvency of the property-owning borrower may make an enforcement of pledges over its shares or partnership interests unnecessary as the insolvency administrator assumes control over the assets of the borrower's insolvency estate. However, if the lender does not want the borrower to become insolvent, German practitioners have developed ways to overcome cash flow insolvency in such a scenario.

ENFORCEMENT OF MORTGAGES

In general, there are two complementary components to a mortgage creditor's enforcement rights:

- Forced administration (*Zwangsverwaltung*).
- Forced sale by public auction (*Zwangsversteigerung*).

Once a secured claim has become due and payable, a mortgage creditor can initiate a forced administration under which a court administrator (*Zwangsverwalter*) collects rent from properties on behalf of the mortgage creditor and manages the properties. The enforcing creditor receives the interest due under its loan facility and certain amounts in repayment of the principal, after ongoing costs and the court administrator's fees are paid (usually 10% of the rent).

In addition, a mortgage creditor can initiate a forced sale by public auction arranged and supervised by the court. The sale proceeds are distributed to mortgage creditors in accordance with the ranking of their mortgages after payment of enforcement costs and expenses.

COMI CONSIDERATIONS

The analysis of any available enforcement route will be substantially impacted by the insolvency regime applicable to the borrower. Given that many German real estate acquisition structures comprise property-owning borrowers residing in EU jurisdictions outside Germany (for example, The Netherlands) to achieve a favourable tax structure, the insolvency regime applicable to an insolvency proceeding of any such property-owning borrower depends on where the legal entity's "centre of main interests" (COMI) is.

Numerous factors have been taken into account in various EU member states when addressing the question of COMI, including:

- Location of management and board meetings.
- Residency of directors.
- Tax residency.
- Location of the company's books and records.

- The manner in which day-to-day management is conducted.
- Whether third party approvals are necessary before key decisions are taken (for example, in the case of management being conducted by a corporate services provider) and, if so, where those third parties are located.
- The location of accounts.

As a result, if the COMI of the property-owning borrower is or is believed to be in a jurisdiction other than Germany, any main insolvency proceedings that are commenced against the borrower would be subject to the courts of that jurisdiction. This may, depending on the specifics of the applicable insolvency regime, have a significant impact on the insolvency proceeding as such, but also in relation to the rights of mortgage creditors during the proceedings.

Properties that are acquired by auction are free of the enforced mortgage and any lower ranking encumbrance by operation of law (that is, no consent or release is required).

The strictly formalised procedures involved in a forced administration and a forced sale by public auction are beyond the scope of this chapter. Note, however, that minimum price requirements generally apply in a forced sale at the first public auction and that the mortgage creditor should expect a minimum period of about six to 12 months between the court application for the auction and the first auction date. However, depending on the size of the property portfolio and the competent court's workload, this period can be significantly longer.

If insolvency proceedings over the assets of the property-owning borrower have begun, in principle, the court-appointed insolvency administrator has the sole right to sell all assets belonging to the insolvency estate. However, any creditors secured by mortgages over real estate (regardless of their ranking) are and remain entitled to enforce their mortgages by forced administration and/or by forced sale in a public auction, even after insolvency proceedings have begun.

The insolvency court can suspend a forced sale in limited circumstances that are typically not applicable in the context of real estate portfolio investments (for example, to prevent the auction of production facilities where the entire business is to be sold as a going concern or where the auction would lead to significantly lower recovery of funds).

If mortgage creditors do not enforce their mortgages, the insolvency administrator can either dispose of the relevant properties or collect rent on them.

Disposal of property

The insolvency administrator can dispose of the relevant properties by:

- **Private sale.** However, in this scenario, the insolvency administrator would need a release of the mortgages by

the relevant mortgage creditors, unless a buyer is willing to acquire the relevant property subject to the continuing mortgages.

- **Public auction.** A forced sale by public auction may be initiated by the insolvency administrator and is useful if, for example, the consent of the mortgage creditors to release their mortgages could not otherwise be ensured.
- **Release of the property to the mortgage creditors.** This allows the mortgage creditors to realise the value of their property by way of a forced sale at public auction.
- **Realisation agreement.** This procedure is commonly used as sales proceeds generated by a public auction are typically 15% to 30% lower than the proceeds that can be recovered by private sale. It involves the insolvency administrator and all mortgage creditors entering into an agreement to sell the relevant property by private sale. A combined "administration and realisation agreement" is often entered into; this sets out the insolvency administrator's fees and covers both the disposal of property by private sale and the collection of rent by way of "cold administration" (see below, *Rent collection*).

The decision as to which realisation option should be pursued by a mortgage creditor depends on issues of practicality and fee considerations. If there are several mortgage creditors with different rankings, in practice, all mortgage creditors need to be part of the agreement with the insolvency administrator. Otherwise, a mortgage creditor not party to the agreement would probably enforce its rights under the mortgage and apply for a forced sale by public auction. In addition, any lower ranking encumbrance will only be automatically released in a forced sale by public auction, but not in a private sale. As a result, in a private sale, any purchaser would only acquire the property subject to the remaining lower ranking encumbrances, which would affect the purchase price.

Rent collection

The insolvency administrator collects rent on behalf of the mortgage creditors and passes on the proceeds after deducting



statutory fees of 4% for identification of the receivables and 5% for the realisation of those receivables. The statutory fees are not paid to the insolvency administrator in person, but to the insolvency estate, and these fees increase the amount that can be distributed to the unsecured creditors after certain deductions have been made.

If, as is normally the case, the rent from the properties has been assigned by the borrower to the benefit of the (mortgage) creditors, the insolvency administrator cannot collect on behalf of the insolvency estate any rent that is paid within a period of up to six weeks from the date that the insolvency proceedings are begun. Instead, these rental payments are collected by the insolvency

administrator on behalf of the assignee and paid to the assignee after the deduction of its statutory fees (9% in total, as above).

As indicated above, mortgage creditors can also enter into an agreement with the insolvency administrator regarding the administration of the relevant property; this may involve the administrator taking over the property and collecting rent on behalf of the mortgage creditors (cold administration (*kalte Zwangsverwaltung*)). This allows for negotiation of the insolvency administrator's fees for administration of the properties and avoids payment of statutory court administrator's fees (usually 10% of rental payments (*see above, Enforcement of mortgages*)).

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