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## German *Schuldschein* Loans Grow in Popularity

*Schuldschein* loans, which offer straightforward documentation and easy transferability, are an interesting alternative financing instrument for borrowers and investors.

Traditional German debt instruments called *Schuldscheindarlehen* (*Schuldschein* loans) are used as alternative forms of financing in the commercial sector and have been popular among institutional investors despite not gaining much importance outside the German market. In the years following the financial markets crisis of 2008–2009, as the bond markets practically came to a halt, international investors became increasingly interested in *Schuldschein* loans to the extent that the Loan Market Association recently published a guide on the loans. The following describes some core aspects concerning German *Schuldschein* loans.

### What is a German *Schuldschein* loan?

Under German law, a *Schuldschein* loan is a regular loan agreement between two parties that is typically assigned by the lender to one or more investors. In connection with a *Schuldschein* loan, a borrower normally issues a certificate of indebtedness, or *Schuldschein* (although *Schuldschein* loans are now increasingly concluded without the borrower issuing a physical *Schuldschein*). The *Schuldschein* can have different legal quality. It can be an acknowledgement of debt (*abstraktes Schuldversprechen*) that creates an independent obligation of the borrower and constitutes a self-sufficient evidence of such obligation. More commonly, however, it is structured as evidence of the loan's receipt amount by the borrower, in which case the lender must prove that his or her claim exists in cases of dispute, which is, however, facilitated by presenting the *Schuldschein*. In all cases, the existence of the *Schuldschein* facilitates makes it easier for the investor to enforce its claims under the *Schuldschein* loan, even though the *Schuldschein* does not have to be presented for enforcement purposes.

According to German law, the *Schuldschein* is not a security, and no prospectus is required for issuing a *Schuldschein*. Therefore, *Schuldschein* loans cannot be listed at an exchange or settled through a clearing system, such as Clearstream. Consequently, the provisions of the German Securities Trading Act that include the insider-trading prohibition or ad hoc transparency requirements are not applicable to *Schuldschein* loans.

### How did the market for *Schuldschein* loans develop?

*Schuldschein* loans have been used in Germany for many years, but only a relatively small number of experienced investors and issuers have been active in the market. However, since the years following the financial markets crisis, *Schuldschein* loans have enjoyed increased popularity among investors and issuers. The loan amounts normally range from €20 million to €500 million, with maturities between two and 10 years. Occasionally, *Schuldschein* loans provide for longer terms between 15 and 30 years, in which case the borrower has a statutory termination right after 10 years in cases of fixed-interest loans. Generally, large German and European corporates issue *Schuldschein* loans, but public authorities and banks also use them as debt-financing instruments. Investors in *Schuldschein* loans are traditionally banks, insurance companies, and, to an increasing extent, investment funds. However, because of current low interest rates and the lack of alternative investments, *Schuldschein* loans, which normally pay relatively high interests, have become more interesting for other investor groups.

## How are *Schuldschein* loans concluded?

*Schuldschein* loans are either directly concluded between the investor and the borrower, which is normally arranged by an investment bank as arranger or broker, or, more commonly, indirectly concluded between the arranger acting as primary lender and the borrower. In such a case, the arranger assigns and transfers his or her contractual position to one or more investors. Although *Schuldschein* loans are structured to meet the demands of secondary market trading, investors normally pursue a “buy and hold” strategy. In secondary transactions, the arranger of a *Schuldschein* loan will often act again as an intermediary between the original investor and the buyer. The arranger may also act as the administrator or agent of the *Schuldschein* loan for its entire term, even if the loan documentation does not necessarily assign such a role to him or her.

## What are the advantages and disadvantages of *Schuldschein* loans?

*Schuldschein* loans allow borrowers to raise funds from outside the core banking group, which is particularly interesting for borrowers without direct access to the capital market. On the other hand, investors have the opportunity to invest in entities they normally would not invest in. Because *Schuldschein* loans usually utilise relatively simple documentation and are not subject to any prospectus or listing requirements, they can be issued quickly and at relatively low cost, while the used private-placement method allows preserving a certain degree of discretion. Because they are bilateral contracts and not securities, the loans’ documentation may be tailored specifically to the contracting parties’ demands.

However, compared to publicly listed debt instruments, there are no uniform transparency requirements for *Schuldschein* loans, and it may be difficult for an investor to receive information from a borrower. The lack of public transparency and registration may create obstacles for secondary market transactions, as secondary investors basically have no other source of information about the undisputed existence and validity of the *Schuldschein* other than the loan documentation and the seller’s representations. Finally, *Schuldschein* loans are usually unsecured debt instruments, although they may be supported by a guarantee in some cases.

## How flexible is the structure of the bilateral contract?

Generally, a *Schuldschein* loan’s documentation is relatively simple. Although there is no general market standard agreement for *Schuldschein* loans, *Schuldschein* loan documents show a high degree of standardization. English language documents are widely used for *Schuldschein* loans’ documentation. Because *Schuldschein* loans are not subject to specific regulation, parties are free to negotiate special clauses that serve their needs. In addition to general undertakings, such as disclosure and cease-and-desist obligations, special “grounds for termination” clauses are commonly used.

*Schuldschein* loans are normally “plain vanilla” instruments with a fixed maturity and interest rate. However, there are also different types of structured *Schuldschein* loans in the market, starting from *Schuldschein* loans with an interest rate based on a swap rate to *Schuldschein* loans that are based on how well a basket of certain assets performs. Such structures may allow certain investors who are restricted from investing directly in certain derivative products to invest in a structured *Schuldschein* loan that provides for similar economic exposure.

## How is a *Schuldschein* loan transferred?

There are two options for transferring a *Schuldschein* loan: by assignment and by assuming a contract. Although an assignment solely transfers (all or a partial amount of) the claim for repayment and interest as well as dispositive rights to the assignee, assuming a contract includes the transfer of the original lender’s contractual obligations as a whole. Both options normally require contractual consent or a written form, although this is not a requirement under German statutory law. *Schuldschein* loans are not subject to any filing or registration, i.e., the transfer of a *Schuldschein* loan will be enacted by simple agreement and will not necessarily be made public. *Schuldschein* loans are often sold in tranches to several investors. In such cases, the original *Schuldschein* document often remains with the original *Schuldschein* lender or arranger, who acts as the deal’s administrator.

## Are the participants in a *Schuldschein* loan subject to German banking regulation?

Granting *Schuldschein* loans in Germany may be subject to certain regulatory requirements—as pursuant to the German Banking Act—because granting money loans constitutes banking business, which requires a license from the German Financial Services Supervisory Agency. This is why a *Schuldschein* lender needs to be a properly licensed credit institution if the transaction is executed in Germany. On the other hand, the mere acquisition of a fully disbursed *Schuldschein* loan by an investor does not constitute lending business that requires a license.

## By which laws are *Schuldschein* loans governed?

A *Schuldschein* loan is typically governed by German law and provides for exclusive jurisdiction of German courts. The choice of German law for a *Schuldschein* loan is valid and binding, even if the parties to the *Schuldschein* loan have no connections to Germany. However, in cases where the parties to the *Schuldschein* loan are both domiciled in the same jurisdiction outside Germany, a German court would also consider the mandatory provisions of that jurisdiction's laws if they contradict German law. This does not apply if there is a minimum connection to Germany between the parties or the terms of the *Schuldschein* loan, in which case German law would exclusively apply.

The parties may choose arbitration to resolve their disputes, although arbitration is infrequently used in German law contracts because many German market participants consider these proceedings costly, time intensive, and less effective than proceedings at state courts. If the *Schuldschein* loan's documentation is in English, a German translation may be necessary for court proceedings.

## Contacts

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