BAYER KRAUSS HUEBER

Corona Virus in Germany -

Practical Advice for US Bond- and Noteholders of German Issuers and Sellers

Jan D. Bayer, Esq

BAYER KRAUSS HUEBER

Frankfurt   Munich

April 3, 2020

Contact:

Email: jan.bayer@bkh-litigation.de

Tel: +49-172-656-8153

Abstract

In response to the corona virus lockdown of the German economy, the German government has enacted or is in the process of enacting a whole array of emergency measures as well as direct and indirect state aid schemes to support ailing businesses and consumers. This memorandum aims at summarizing those aspects of such programs that are of relevance for US bond- and noteholders of German businesses. Also, based on the author’s experience following the crises after September 11 and Lehman, this memorandum will render some advice as to what bond- and noteholders may have to expect in German financial restructurings going forward.

Corona Virus in Germany -

Practical Advice for US Bond- and Noteholders of German Issuers and Sellers

Summary of German Emergency Measures

Emergency measures enacted or to be enacted by the German government may be broadly categorized as follows:

- Suspension of certain contractual and statutory duties, e.g., suspension of termination rights upon non-payment of rent or utility bills, suspension of tax prepayments, suspension of mandatory insolvency filing duties for those businesses distressed solely by corona virus effects (but not those already stressed at the time), and suspension of principal and interest payments for consumers;
- Short-time working schemes in which the state assumes responsibility for the payment of employees' wages so as to prevent mass layoffs;
- Direct credit aid to SMEs;
- Credit programs by the German state bank KfW, in which KfW takes (a) 80% of the credit risk for emergency loans of up to EUR 1 bn., or, in larger emergency financings, (b) up to 80% of the credit risk of syndicated emergency financings, limited to a maximum of 50% of the debtors overall debt; and
- Direct state aid through silent participations and/or direct state equity participations in large businesses (with government-backed corporate bonds under discussion).

The effects of such measures on bond- and noteholders vary. Some of the measures may have indirect consequences for the credit quality and covenant compliance of certain issuers, e.g., residential and commercial real estate companies and utilities that experience cash flow shortfalls from withheld rent and bills, respectively. In reverse, the credit quality of issuers suspending rental payments may deteriorate as those withheld rents are to be paid in the future, including late interest of about 8% p.a.

Moreover, given that landlords have certain statutory security rights in Germany, they would principally rank ahead of unsecured creditors in a future insolvency of the issuer.

Similar considerations apply to KfW emergency financings. In practice, such emergency financings may not as easily be available as expected (or communicated by issuers) as (a) commercial banks fronting such financings may not be willing to assume the 20% residual risk, and/or (b) the requesting business cannot sufficiently demonstrate its going-concern-case and repayment ability, and/or (c) the requesting business does not meet the “corona-distress-test” as it was already stressed on December 31, 2019. Even if such emergency financings are available, the credit quality of unsecured debt will deteriorate in light of the massive onboarding of secured credit, unless mitigated by individual negotiations with the issuer.

Direct state aid for businesses (e.g., currently under discussion for German carrier Lufthansa) may improve the credit quality of the issuer. It will come, however, at a political price, be it in form of political pressure on unsecured creditors for concessions (e.g., haircut or permission to prepay government instruments), be it in political influence on the issuer, be it in CFIUS-like involvement of the German government in equity sales to foreign investors (which has already been announced so as to prevent a “ garage sale” of the German economy to foreigners).

Despite all these emergency measures, bond- and noteholders should expect a significant increase in insolvency proceedings in Germany. Many of such proceedings may come in the format of so-called protective shield proceedings pursuant to Sec. 270b of the German Insolvency Code. This proceeding is somewhat comparable to the US Ch. 11, providing for a three-month automatic stay and debtor-in-possession supervised by a court-appointed monitor during the preparation of an insolvency plan. Bond- and noteholders should ensure proper representation on the preliminary creditor committee so as to avoid being disadvantaged by secured lenders and equity.

Continued Obligations of Issuers

Contrary to consumers (which may be extended to SME), German emergency measures will not exempt businesses from the ongoing compliance with indenture or NPA terms. Thus, all covenant and interest payment duties principally remain in place both in respect of bank credit and unsecured debt. Any amendments would have to be made in accordance with the terms of the respective documentation.

Bond- and Noteholders, however, should be aware of enforceability issues. The German emergency package will suspend the strict statutory duty of management to file for an insolvency of the business within three weeks after the business becomes either over-indebted or cash-insolvent. Businesses (a) whose financial distress is solely caused by the corona-virus, and (b) which are (i) in serious restructuring discussions with creditors, and/or (ii) have reasonable expectations for any form of state aid, in each case sufficient for a successful going concern, may not have to file for insolvency through September 2020 (with the author expecting that this may be extended). Thus, businesses may ride out missed interest payments and covenant breaches as even an acceleration of the debt may not lead to immediate insolvency. Creditor applications for insolvency may not be granted by German insolvency courts if the debtor makes credible that the exemptions apply. Bond- and Noteholders may therefore be limited to go through an expedited documentary court proceeding to protect their rights in case of a default.

Also, issuers may invoke a German type force majeure event under Sec. 313 of the German Civil Code in order to withhold payment or request changes to the terms, especially covenant resets. While the applicability of such rule is extremely narrow, it has been applied by German courts in extreme scenarios such as the German mega-inflation in the 1920s, and may therefore be applied in an almost complete economy shutdown as currently imposed on Germany. If and to what extent that may also affect NPAs governed by New York law and/or the enforcement of US court judgments in Germany is untested.

KfW Programs

The KfW programs are the most relevant for Bond- and Noteholders besides additional credit lines to large German companies extended by the private banking sector (for example, the 12 bn. additional credit line just extended to Daimler by a bank consortium).

In either case, these financings will be secured credit, i.e., will rank ahead the unsecured debt of the issuer in any future insolvency. The credit quality for unsecured debt will therefore deteriorate.

KfW currently offers two programs:

- **SME.** Under this program KfW covers up to 80% of the loan default risk of the front bank for loans to large enterprises and up to 90% for loans to small and medium-sized enterprises. Entitled are businesses that have been in the market for at least five years. Businesses can draw down up to EUR 1 bn. in loans. However, the loan amount per business (or group) is limited to a maximum of (i) 25% of the annual turnover in 2019, (ii) 200% of wage costs in 2019 or (iii) the current liquidity requirements for the next 12 months for large companies (or 18 months for small and medium-sized companies). In addition, for loans exceeding 25 million euros, the loan amount may not exceed the ceiling of 50% of the company's total debt. The loans are granted with a term of up to five years with the possibility of a repayment holiday of one year. The conditions provide for a reduced interest rate of no more than 2 % and fixed interest rates for the entire term.
- **Syndicated Credit.** Under this program, KfW provides loans of several billions of Euro in a consortium with commercial banks, with KfW assuming up to 80% of the credit default risk, but not more than 50% of the company's (group’s) total debt. The restrictions on the loan amount provided for in the SME program also apply to the KfW loan portion of a syndicated loan.

Bond- and noteholders should not expect that troubled companies will be granted such credit easily. Commercial banks are wary of even the 10 or 20% residual credit risk assumed, and frequently request additional collateral not readily available. Moreover, the viability test to be applied by both the fronting banks and KfW (in larger credits) for businesses requesting such loans is rigid. Businesses must be able to demonstrate that they can repay the credit within five years under the assumptions that the business remains shut (i) through June 30, 2020, and, as a stress scenario, (ii) through September 30, 2020.

As a result, repeating a common complaint in Germany, credit is made available under the KfW programs predominantly to those businesses that have no actual need for emergency financing. It remains to be seen if the Government reacts to calls to (i) make KfW loans subordinated debt, (ii) have KfW assume 100% of the default risk, or (iii) have KfW guaranty newly issued corporate bonds.

Short-term Working Scheme

The short-term working scheme permits businesses to pass wages onto the German government for up to 12 months without laying off the workforce. While this means an immediate relief for the cash flow, and this money is not repayable to the government, the employees remain on the payroll of the business, i.e., will return at the end of the scheme. Layoffs necessary in a restructuring of the business must therefore be made separately and at considerable costs.

Direct Government Aid

In addition to the indirect government credit support, the emergency package of the German government comprises direct government equity support modelled after the 2008 Bank Restructuring Act that was used to provide equity help to German banks in the financial crisis. This aid may take the form of silent partnerships or direct equity holdings. Bond- and noteholders should expect that this aid will predominantly be available to (a) German icon companies, and (b) German companies with technology or public importance considered by the government worthwhile to protect. In other words, it should not be expected that the German government will necessarily step up to protect real estate businesses, retail or fashion companies, and the like. In some of these cases, German states may step in under their own rescue programs (e.g., Bavaria got its own program), but this should not be taken for granted.

As already mentioned, experience from the financial crisis shows that the German government may exercise its influence to arm-wrestle creditors and shareholders in any bail-out situation directly, or indirectly through the press, regulatory agencies or even courts, so the improved credit quality will come at a price.

Conclusions on Emergency Package

From the viewpoint of bond- and noteholders, the German emergency package is unlikely to prevent a significant number of defaults by German debtors. The credit quality of those debtors who can obtain emergency financing through commercial banks or KfW will significantly deteriorate. Bond- and noteholders in German icon companies may receive the benefit of a government equity injection, but should be prepared to be asked for some sort of concession.

Some Practical Considerations

Bond- and noteholders should expect a series of defaults and insolvencies in Germany in 2020 and beyond. These insolvencies will be triggered by the unavailability of credit to companies that were already stressed (e.g., suppliers in the car industry) or that have no reliable re-start due to supply chain issues or changed consumer habits. In addition, many companies may not reliably comply with the suspended insolvency filing requirements, resulting in cautionary filings to prevent management (criminal) liability. Finally, many companies may use the corona virus crisis in order to deleverage through an insolvency at perceived favorable terms.

The German financing market is dominated by secured bank financing. Large German commercial banks enter the crisis still significantly weakened from the financial and Euro crises. While purported capital levels have improved, appetite for adding significant risks to their credit books by providing fresh liquidity is going to be limited. Non-German banks are likely to retract from the German market.

Nonetheless, German commercial banks will naturally assume the lead in any German restructuring, frequently operating through bank steering committees completely disregarding unsecured Bond- and Noteholders, unless such unsecured creditors forcefully assert their rights. Restructuring models of German banks diverge from international standards. For example, it is not uncommon that German banks require a fiduciary trust over the equity of the debtor as part of the restructuring so as to prevent equitable subordination while maintaining a potential upside/preventing an immediate write-down of the debt.

Bond- and Noteholders should also expect that restructuring professionals at German banks are in scarce supply as these departments were significantly downsized in the past decade.

In the German corporate world, especially in mid-size or family-owned companies, international restructuring standards are widely unknown. German companies will frequently enter restructuring discussions with the assumption that creditors will simply forgive their debt with the equity remaining largely unaffected or providing only small amounts of fresh equity.

Bond- and Noteholders should also expect significant language barriers. While issuer management frequently communicates in English, bank restructuring personnel and especially insolvency professionals and courts do not.

*****

Jan. D. Bayer has more than twenty years of experience in financial restructurings, predominantly in buy-side bondholder and note restructurings. Her represented par lenders in numerous note and CMBS restructurings following the financial crisis. Most recently, he was instrumental in preventing a fraudulent COMI shift in the widely followed Galapagos restructuring.