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Client Alert
Commentary

Latham & Watkins Restructuring & Special Situations Practice

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Mitigation of Clawback and Liability Risks for COVID-19 Era Financings in Germany

The Federal Ministry of Justice and Consumer Protection (BMJV) is currently finalizing the law to mitigate the consequences of the COVID-19 pandemic in civil, insolvency, and criminal proceedings with extraordinary commitment. It shall be adopted less than two weeks after the beginning of the extensive restrictions on public life and the economy in Germany due to the COVID-19 pandemic.

A central element of the law is to facilitate the raising of debt capital in order to support companies in the current situation. For this purpose:

- liability risks in connection with the granting of loans are reduced,
- contestation events under insolvency law are temporarily alleviated with regard to collateralization and redemptions of new financing, and
- subordination of new shareholder loans is temporarily suspended.

The BMJV and restructuring experts (including Latham lawyers) have collaborated closely to design these provisions.

The special regulations under insolvency and liability law are accompanied by a suspension of the obligation to file for insolvency for companies that have become illiquid or over-indebted in the sense of insolvency law as a result of the COVID-19 pandemic (see also Latham's prior *Client Alert* for more on insolvency filings and liability for managing directors). The law is intended to provide time for the provision of the privileged financing described above as well as the granting of federal and state aid financing to affected companies.

Furthermore, the legislator has announced changes in relation to already disbursed financings, in particular moratoria on terminations of facilities agreements. Latham will address this in a separate *Client Alert*.

Limitation of Lenders' Liability

When granting restructuring loans, there is often the risk of so-called Lenders' Liability. Lenders are liable pursuant to sec. 826, 138 German Civil Code if they can be accused of having granted a loan in a manner *contra bonos mores* to secure their own positions, only temporarily prolonging the borrower's struggle for survival, and thereby disadvantaging other creditors. In order to avoid liability risks, practitioners operate within a complex system consisting of: a short-term bridge financing, preparation of a restructuring concept in accordance with the standards of the Federal Court of Justice in cooperation with a restructuring expert, and — after the issuance of a positive restructuring confirmation — a long-term restructuring financing.

However, there is no time for such a procedure in the current economic situation caused by the COVID-19 pandemic. Also, due to the large number of companies now to enter a crisis situation, sufficient resources for the preparation of restructuring concepts and the issuance of restructuring opinions are not available in the market.

Against this background, the legislator states that in the current situation — irrespective of whether the borrower is currently illiquid or over-indebted — the granting of new loans and collateral for new loans should not be regarded as *contra bonos mores*. Doubts about the legal validity of the agreed collateral are also to be dispelled. This applies in any case in which the borrower was not already illiquid or over-indebted on an earlier testing date, probably 31 December 2019.

Privileges for new collateral and the redemption of COVID-19 era financing

A further important step to enable swift lending is to reduce the clawback risks for lenders. Until now, lenders have had to fear that — if the rescue efforts were unsuccessful and insolvency proceedings are opened over the debtor's estate — lenders could be obliged to repay payments received and lose their collateral position based on clawback rights of the insolvent company's insolvency administrator. In order to mitigate these risks, restructuring concepts and opinions are prepared in crisis situations. However, as outlined, there is no practical chance for that in the COVID-19 pandemic. Therefore, under the new law, for loans granted until 30 September 2020 the following shall not be considered to be disadvantageous to the creditor:

- The repayment until 30 September 2023
- The provision of collateral

These provisions — at least temporarily — remove the ground for clawbacks against said transactions and creates more legal certainty for new lenders. Again this requires that the borrower was not already illiquid before the COVID-19 pandemic occurred in Germany.

The privileges are intended to cover all types of financing, *i.e.* not only traditional cash loans but also commercial credits and other forms of financing. Both principal and interest payments on new financings are privileged.

At the same time, the legislator has emphasized that the privileges shall not apply to existing financings without additional liquidity effects. This particularly concerns the mere novation or prolongation and economically similar acts, which result for instance in a back-and-forth payment.

Privileges for shareholders in relation to COVID-19 era financing

The law also provides considerable incentives for shareholders to make further liquidity available. In particular, two adjustments shall be implemented with regard to new shareholder loans granted until 30 September 2020:

- The privileged treatment of shareholder loans under clawback provisions
- The suspension of a subordination of shareholder loans in insolvency

Thus, the repayment of new shareholder loans by 30 September 2023 should not be considered disadvantageous to creditors if the shareholder loans are granted in a time window until 30 September 2020. This privilege does not include the provision of collateral in favor of the shareholder. In this respect, there is still a certain gradation between shareholder financing and third-party financing with respect to clawback risks.

Furthermore, the statutory subordination of shareholder loans (section 39 (1) no. 5 German Insolvency Code) shall be suspended for new shareholder loans granted prior to 30 September 2020 and receivables from economically similar acts in insolvency proceedings applied for by 30 September 2023. Contractual subordinations, which in traditional financing often also cover future shareholder loans, remain to be observed in principle. By the statutory equalization of shareholder loans with ordinary insolvency claims, a traditional insolvency law principle, known as *Equitable Subordination*, which is observed in most jurisdictions, is set aside in order to create incentives for additional financing in times of the COVID-19 pandemic in Germany.

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This could be interesting for you as well:

Remedy for Managing Directors in the Time of COVID-19: Suspension of insolvency filing obligations and limitation of liability risks in Germany

Legal Update – COVID-19: Public Finance Support (State Aid) in the EU and UK

Legal Update – COVID-19: Immediate Measures to Gain State Aid Financing (KfW Credit et al)

Legal Update – COVID-19: What Companies Need to Know About Data Privacy

Legal Update – COVID-19: Aktuelles zur Kurzarbeit