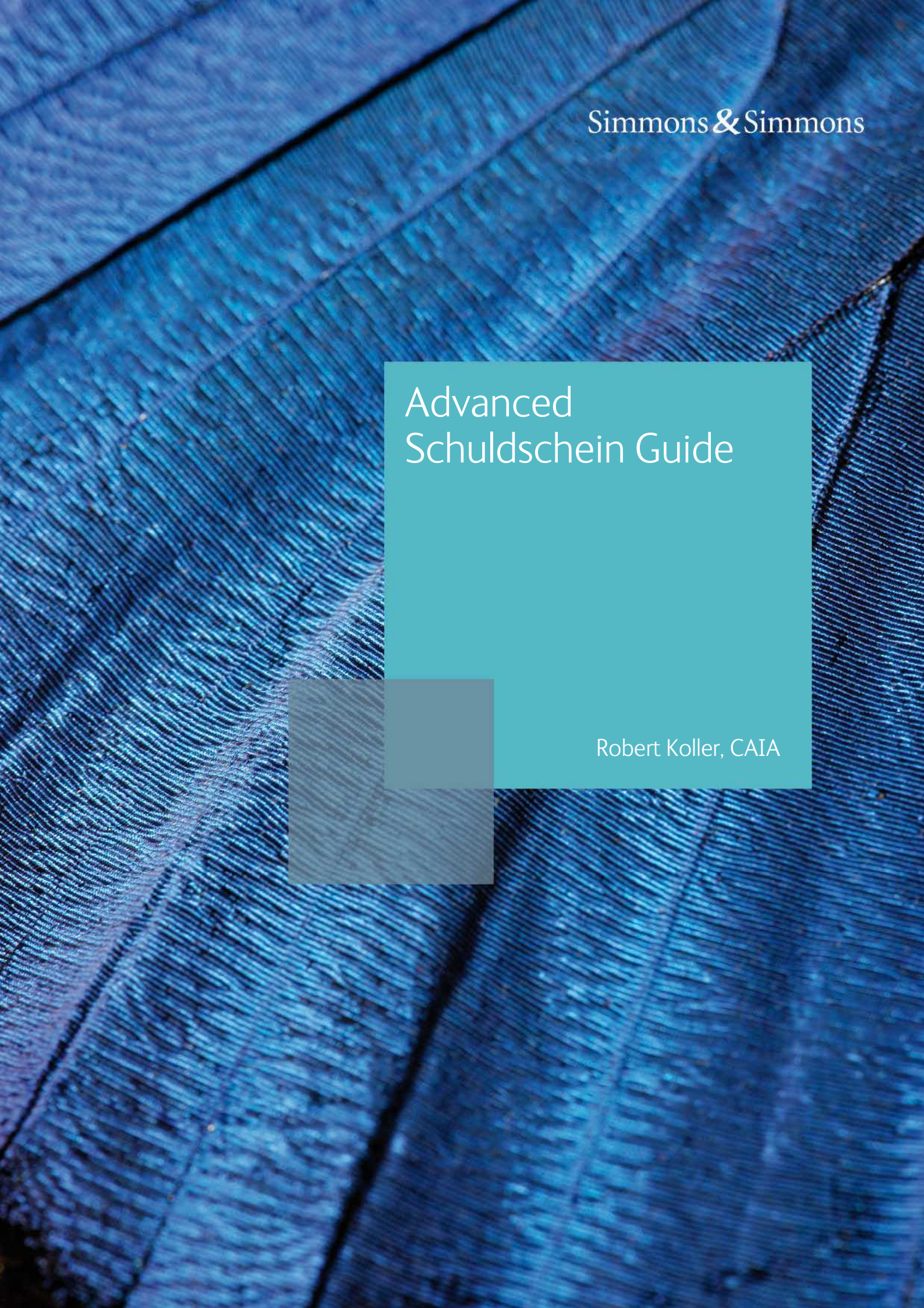
Simmons & Simmons
Advanced
Schuldschein Guide
Robert Koller, CAIA

A SIMMONS & SIMMONS LLP PUBLICATION
The Advanced Schuldschein Guide

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CityPoint, One Ropemaker Street, London EC2Y 9SS, United Kingdom, T: +44 20 7628 2020.

This publication "The Advanced Schuldschein Guide" is an excerpt and translation of chapter 13 "Schuldscheindarlehen" by Robert Koller, CAIA, of the Handbook of Financing Stock Corporations (*Ekkenga/Schröer*, Handbuch der AG Finanzierung, Carl Heymanns Verlag, 2014, ISBN 978-3452271518).

The German version of "The Advanced Schuldschein Guide" can be found here: elexica.

A Mandarin summary of "The Advanced Schuldschein Guide" can be found here: elexica.

References in "The Advanced Schuldschein Guide" to chapter 9 are to *Hartwig-Jacob/Koller/Witt*, Issuance of Corporate Bonds [under German law] (Emission von Unternehmensanleihen), in *Ekkenga/Schröer*, Handbuch der AG Finanzierung, p. 751. The German text of which can be found here: elexica (German only).

The full book can be purchased here:

http://www.amazon.de/gp/product/345227151X/ref=as_li_tf_tl?ie=UTF8&camp=1638&creative=6742&creativeASIN=345227151X&linkCode=as2&tag=wwwuniversntecom

Preface

Schuldschein loans have existed in Germany for decades and its precursors even longer. Despite being a fundamentally German law instrument due to its defining characteristics, in particular a lean documentation, flexibility, a certain fungibility and a favourable accounting treatment, it has become an internationally accepted instrument for raising funds in the capital markets.

This Advanced Schuldschein Guide is a translation of an article originally published in the Handbook of Financing Stock Corporations (*Ekkenga/Schröer*, Handbuch der AG Finanzierung, Carl Heymanns Verlag, 2014, ISBN 978-3452271518) and is aimed at professionals in the capital markets and loan space, in particular outside Germany, who want to get a deeper understanding of the functioning and legal basis of Schuldschein loans. It is suitable for issuers and investors as well as financial intermediaries and will be a useful guide for anyone seeking to enter this market or to better understand it, including possible pitfalls.

The guide will explain, amongst other things, the nature of a Schuldschein loan, why it is called so and why it is considered a capital markets instrument despite being a loan, advantages and disadvantages, an overview over the market and the placement process, characteristics of the Schuldschein loan as a German law instrument, covering the legal framework, regulatory issues and the restructuring of Schuldschein loans. Both legal as well as commercial aspects will be dealt with.

This Advanced Schuldschein Guide does not claim to be and is not an exhaustive source of information in this regard. Anyone interested to enter into a Schuldschein loan transaction should seek legal advice prior to entering into any such agreement and should also consult with its tax and banking advisors.

Frankfurt, April 2014

Robert Koller, CAIA
Partner

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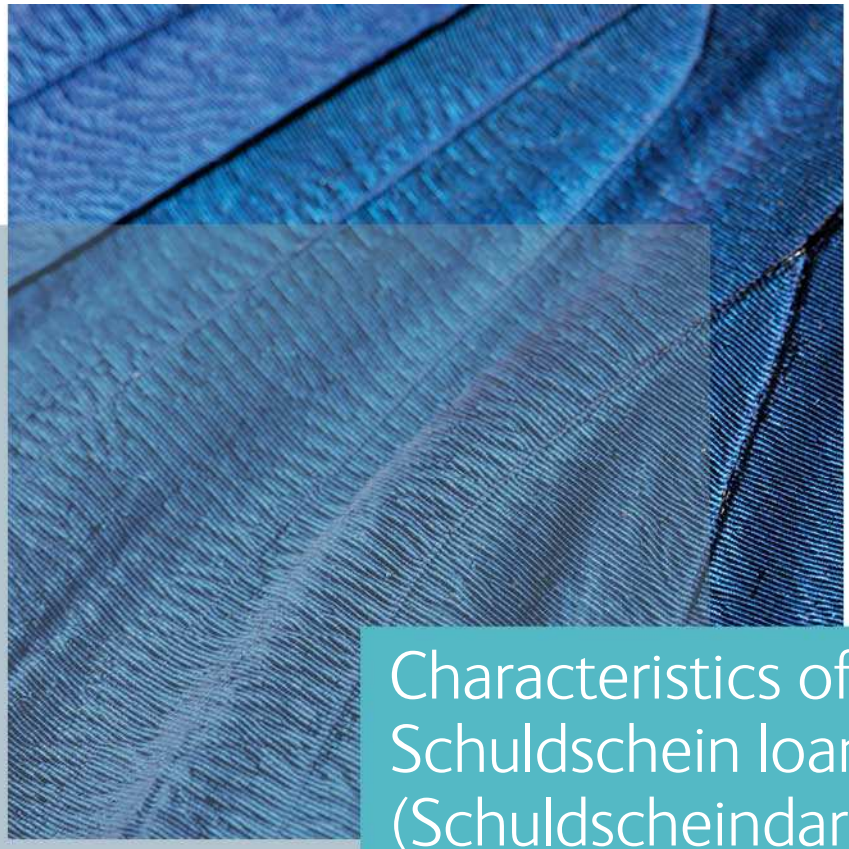

Characteristics of Schuldschein loans (Schuldscheindarlehen)

A. Characteristics of Schuldschein loans (*Schuldscheindarlehen*)

1 The German Schuldschein loan (also known as "assignable loan agreement", "debt note", and "debenture bond") is generally understood as being a special form of loan contract pursuant to section 488 et seqq. German Civil Code (*Bürgerliches Gesetzbuch* – BGB) used for similar purposes as other capital markets instruments such as bonds (*Anleihen*). They are therefore (large) medium to long-term loans[1] the terms and conditions of which often emulate those of bonds, but can also be considerably shorter, and which are granted to enterprises, financial institutions and SSAs[2] by institutional investors. Despite the clear classification as a capital markets instrument made in practice, legally speaking Schuldschein loans are not securities. Instead, they are loans structured in such a way that they are as similar as possible to a security. The certificate of indebtedness (*Schuldschein*) issued when the loan is taken out and from which the Schuldschein loan gets its name is not classified as a security but simply as a document evidencing the underlying loan (sections 371 and 952 German Civil Code).[3] However, especially in the international environment the term Schuldschein is often used synonymously for the actual loan.[4]

2 Unlike securities, Schuldschein loans are transferred either by way of assumption of contract or by assignment.[5] By contrast, securities in the strict sense of the word are transferred in accordance with the principles of property law by transferring the relevant certificate or by entering them into an electronic register (if issued in global note form). Compared to traditional loans, transferring Schuldschein loans is contractually simplified. This is due among other things to consent to the assignment being given in advance in order to conform to the characteristics of a capital markets instrument. Thus their fungibility is somewhere between that of a bond and a syndicated loan since investors often require them to be transferrable practically without any restrictions.[6]

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1 The overwhelming majority of Schuldschein loans have a term of between three and ten years; see *BayernLB*, 'Corporate Schuldschein goes international' (September 2012) p. 6.

2 *Sovereign, supranational and agency*, with the term "sovereign" mostly also being understood as so-called "sub-sovereigns", i.e. subdivisions of sovereign states. The abbreviation can be understood as covering all public-sector entities – whether on a national or supranational level.

3 Müller, in: Kümpel/Wittig, *Bank- und Kapitalmarktrecht*, para. 15.265.

4 See Schmitt, *BB* (2012) 2039.

5 Which is why no *bona fide* acquisition is possible for Schuldschein loans.

6 Wehrhahn, *BKR* (2012) 363.

Advantages and disadvantages of Schuldschein loans

B. Advantages and disadvantages of Schuldschein loans

3 Schuldschein loans offer many advantages compared to other forms of financing – especially bonds and syndicated loans – and a number of disadvantages as well. The choice of a suitable instrument for a specific borrower and a specific financing mix always depends on the specific case and a variety of different factors. Some of the differences compared to other forms of financing are outlined below.

4 In relation to the borrower:

- Investor base: Schuldschein loans allow borrowers to target a wider group of investors than is usual for syndicated loans. However, unlike with bonds the lenders are known and not anonymous, meaning that the terms of the loan can be agreed with the individual investors.[7] In Schuldschein loans the investor profile is usually limited to banks and institutional investors who focus on "buy and hold" investments.
- Publicity: Once the Schuldschein loan has been taken out, only the reporting obligations towards the investors have to be complied with. As the instrument is not listed on a stock-exchange, no follow-up requirements concerning listing have to be complied with. However, at the same time this is a disadvantage since the secondary market is considerably less liquid than is the case with bonds. Moreover, the proximity of Schuldschein loans to the capital markets is demonstrated by the fact that similar marketing documents are required as for bonds, e.g. roadshow presentations.
- Associated costs: As the documentation required is relatively limited, the associated costs are significantly lower than for bonds or syndicated loans. In particular, no securities prospectus is needed (see para. 90). Besides this, most of the time a rating is not necessary (see below), which has an equally positive impact on costs.
- Relatively time efficient: The average time taken to place a Schuldschein loan is approximately two to four months, whereas for a bond it is approximately three to six months (without an existing issue program).[8]
- Early redemption: Due to the relatively illiquid secondary market, the possibilities for buying back the Schuldschein loan (either in whole or in part) and for discharging it by confusion are relatively limited.[9] Another disadvantage compared to bonds is the range of additional statutory termination rights on the part of the borrower (see para. 40) which do not exist for bonds and therefore offer a lower level of investment security for Schuldschein loans.
- Restructuring: A Schuldschein loan may prove difficult to restructure if the borrower runs into financial difficulties. This is because of the lack of rules relating to creditor majorities and the lack of applicability of the German Bond Act (*Schuldverschreibungsgesetz* – SchVG) (see para. 105 et seqq.).
- Maturities: Bonds allow for maturities of several decades, even if this tends to be the exception. Syndicated loans tend only to be placeable for short terms – not least because the regulatory regime was changed by the package of measures introduced under Basel III. Longer terms of up to ten years are definitely common for Schuldschein loans (see para. 1).

7 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 7.
8 *LBBW*, 'Diversifikation mit Corporates und Corporate Schuldscheindarlehen' (May 2013) p. 23.
9 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 8.

- Low minimum volume: Bonds are hardly ever issued under €100m as it is not always worthwhile for the banks considering the relationship between the time and effort taken and the returns. In contrast, individual Schuldschein loans can be taken out for a sum as low as €15m. Syndicated loans start at approximately €25.[10]
- Tranching option: The flexible documentation means that it is possible to split Schuldschein loans in several smaller loans with different maturities and interest rates (if appropriate even with a mixture of fixed and floating-rate Schuldschein loans).
- Rating: A rating is not necessary for Schuldschein loans to be granted and it is often possible to use the in-house rating and/or scoring of the arranging bank.[11]
- Total volume: The long marketing period and the limited information available to the borrower mean that the target volume is not guaranteed.

5 In relation to the investors:

- Accounting: Investors can generally recognise Schuldschein loans at amortised cost/nominal value under both IFRS/ IAS and German GAAP rules. This prevents repercussions on the income statement, since changes in market prices are not reflected in the valuations (unless in case of a long-term impairment).[12]
- Security for investors: If the borrower is a credit institution whereas the investor is not, Schuldschein loans are covered by the deposit guarantee scheme to which the credit institution belongs. For private banks this is the deposit protection fund (*Einlagensicherungsfonds*) for private banks.[13]
- Extended investment universe: For many investors access to many borrowers is only possible through a Schuldschein loan since in many cases the relevant company has not issued any bonds and it might not be possible to invest in a syndicated loan, either.
- Eligibility as central bank collateral: Schuldschein loans are eligible for use as central bank collateral under certain conditions and may be used as collateral in the European System of Central Banks (see para. 87 et seqq.).
- Secondary market: Since Schuldschein loans are not listed, there is no organised stock market, and compared to bonds their liquidity and fungibility is therefore considerably more limited. Trading in Schuldschein loans nevertheless takes place on the OTC[14] market. As they are not classified as securities, Schuldschein loans are not cleared either, i.e. transferred electronically. Instead, the Schuldschein certificate itself or the underlying contract normally have to be physically delivered or exchanged.

10 *LBBW*, 'Diversifikation mit Corporates und Corporate Schuldscheindarlehen' (May 2013) p. 22.
11 *LBBW*, 'Diversifikation mit Corporates und Corporate Schuldscheindarlehen' (May 2013) p. 22.
12 See *LBBW*, 'Diversifikation mit Corporates und Corporate Schuldscheindarlehen' (May 2013) p. 23; Mül- bert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 11; Theiselmann, *GmbH-StB* (2012) 52; Müller; in: Kümpel/Wittig, *Bank- und Kapitalmarktrecht*, para. 15.266.
13 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 9. The future situation with regard to deposit guarantees is uncertain since under the draft Bank Recovery and Resolution Directive (BRRD) for recovering and resolving insolvent banks Schuldschein loans are likely to be subject to bail-in; during a crisis creditors could consequently lose their claims under these instruments or they will be able to be converted into bank equity.
14 Over-the-counter.

Overview of the market

C. Overview of the market

6 The Schuldschein loan has established itself as an important new development on the debt markets over the past few years and has become an increasingly frequent alternative to syndicated loans and borrowing by issuing bonds. Schuldschein loans are often regarded as a suitable instrument to enter the capital market.

7 The issue volume in 2012 was approximately €12.1 billion, from around €9.7 billion in 2011. 60% of the total of 102 Schuldschein loans entered into in 2012 involved unlisted companies. The average volume per issue in 2012 was around €120 million. At the end of 2012, the total market for Schuldschein loans had a volume of €72.4 billion, which represents the highest value since 2003. In contrast, the market volume for corporate bonds in 2012 was around €241 billion (excluding banks). The volume-adjusted average term of Schuldschein loans in 2012 was 5.3 years.[15]

8 Since they are classified as loans, Schuldschein loan cannot be traded on stock exchanges or cleared through clearing houses. Nevertheless, a secondary market with limited liquidity exists where Schuldschein loans are traded over-the-counter.

I. Market participants

1. Borrowers

9 Whereas in the past the borrowers[16] mainly came from the SSA sector, nowadays they are increasingly companies from the small- to mid-market segment.[17] The largest debtors in the Schuldschein market are the German federal states (*Länder*) followed by municipal authorities (*Gemeinden*). Schuldschein loans play only a minor role in financing the German Government (*Bund*).[18] Borrowers who do not belong to the public sector and who tap the Schuldschein market are mostly well-known companies with a good credit standing from all conceivable lines of industry. A rating is not necessary in order to be able to take out a Schuldschein loan, although investors mostly base their decision on an informal assessment of the creditworthiness of the relevant company. Savings banks (*Sparkassen*) and cooperative banks as well as commercial banks and public-sector banks constitute another important group of borrowers.

2. Investors

10 Schuldschein loans are highly attractive above all for institutional investors with a mid- to long-term investment horizon. This is due in particular to the favourable treatment afforded to them under German and international accounting regulations (see para. 5) and also to their concise and flexible documentation. Of the institutional investors, one of the most important investor groups consists of insurance companies, industry pension schemes and pension funds. Apart from this, investment funds and Pfandbrief banks (banks issuing covered bonds) and commercial banks also play an important role as investors.

a) Insurance companies as investors

11 For insurance companies to invest in Schuldschein loans it is usually required for the loan to be suitable for investment in the insurance company's restricted assets (*gebundenes Vermögen*) (section 54(2) sentence 1 no. 1 German Insurance Supervision Act (*Versicherungsaufsichtsgesetz* – VAG) in conjunction with section 2(2) no. 3 and 4 of the German Regulation on the Investment of Restricted

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15 *Capmarcon Capital Spezial* (1/2013) p. 11 et seqq.

16 Borrowers are also often informally referred to as "issuers" because of the similarity of the Schuldschein loan to capital markets products.

17 Schmitt, *BB* (2012) 2039.

18 *UniCredit Research*, Sector Report, 'German Schuldschein Loans – A Primer' (September 2011) p. 8 et seqq.

Assets of Insurance Undertakings (*Anlageverordnung* – AnlV). This should be taken into account when the documentation is being drafted by the arranger or borrower.[19]

12 Using Schuldschein loans held by public-sector borrowers in the restricted assets of insurance companies is relatively simple. They do not have to be backed by security and can be taken out by the Federal Republic of Germany and other the EEA states, the federal German states (*Länder*), municipalities (*Gemeinden*), equivalent regional authorities within the federal states, international organisations of which Germany is a member, and debtors whose loans are guaranteed by one of the above bodies. Apart from this, Schuldschein loans taken out by winding-up agencies (*Abwicklungsanstalten*) pursuant to the German Act on Establishment of a Financial Markets Stabilisation Fund (FMStFG), for which a duty of one of the above bodies to compensate losses exists, are eligible. Thus public-sector companies organised as private enterprises who do not offer such a guarantee are not covered.[20]

13 For Schuldschein loans taken out by corporate borrowers, the borrower's creditworthiness should be taken as a basis and in particular whether a "top name" company[21] is involved (provided that the relevant Schuldschein loan includes a negative pledge[22] and possibly covenants[23]) or whether the loan is backed by security that would indicate that the contractually agreed interest payments and repayments are guaranteed.[24] When assessing creditworthiness, either the "Principles for the Granting of Loans to Companies by Insurance Undertakings – Borrower's Note Loans" (*Grundsätze für die Vergabe von Unternehmenskrediten durch Versicherungsgesellschaften – Schuldscheindarlehen*) agreed with the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzaufsicht* – BaFin) or a rating by a recognised rating agency may be used[25]. The security provided for the loan in question is also taken into account.[26]

14 We often find a clause excluding set-offs by the borrower in Schuldschein loans; as a rule such an agreement will be effective. As insurers normally only act as lenders if the Schuldschein loan is suitable for investment in their restricted assets, the borrower has to declare a waiver of the right to set-off.[27] Similar applies if the loan is intended to serve as cover assets for Pfandbriefe (covered bonds). The debtor usually waives the right to declare set-offs and to assert any rights of retention.

15 The introduction and implementation of the Solvency II Directive[28] may lead to even greater changes in relation to the investment criteria for insurance companies because under Solvency II a risk-based approach to assessment should be taken in relation to individual investments and no prescriptive rules should be made. Although the German regulator BaFin has supposedly promised to continue treating Schuldschein loans in the same way, outside Germany at least there is significant doubt as to whether

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19 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 14.

20 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 15.

21 Companies with an excellent credit status and a prominent position in their industry are regarded as being "top names" (*erste Adressen*). If the insurance company determines the borrower's credit rating based on its rating by a well-known rating agency, a limited negative pledge limited to capital markets or financial liabilities (see chapter 9) is sufficient (see Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 49).

22 See also Kalusche/Maier, *Versicherungswirtschaft* (2000) 854 et seq.; for more details see chapter 9.

23 See chapter 9.

24 See *BaFin Circular* 4/2011 (VA) and Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 16.

25 The issuer must then be able to show at least one investment-grade rating.

26 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 paras 17–21.

27 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 paras 14 and 89.

28 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

such a course of action conforms to the Directive.[29] Despite this, Solvency II should also bring advantages such as the possibility to invest in entities outside the EEA as well.

b) Other investors

16 Regulated investors apart from insurance companies may be subject to different investment restrictions. This affects for example UCITS funds, money-market funds, banks and pension funds. In addition, investors who are essentially free to decide how to invest may be subject to contractually agreed restrictions. Therefore, it is particularly important to ensure that the requirements of the investors who are to be targeted are also taken into consideration in the documentation even before a Schuldschein loan is marketed.

II. Internationalisation of the market for Schuldschein loans

17 The Schuldschein loan is meanwhile so established that not only German public institutions take out Schuldschein loans, but also foreign regional or local authorities such as the Republic of Austria, the Kingdom of Belgium or the Spanish autonomous regions (federal states).[30] This also applies to a list of foreign authorities such as the ICO,[31] Bank Nederlandse Gemeenten or Nederlandse Waterschapsbank.[32]

18 Foreign companies and commercial banks are becoming increasingly active on the market for Schuldschein loans. In September 2012, around 30% of all issues were by foreign debtors, which corresponds to just under a quarter of the total volume in euros.[33] Austrian borrowers are by far the parties appearing most frequently on the market for Schuldschein loans. This is followed by companies from Switzerland, France and the Netherlands and also from the United Kingdom and Portugal.[34]

19 International investors are also cropping up more frequently on the Schuldschein market. Apart from the favourable treatment under the international IFRS accounting rules, the same criteria as for German investors are often decisive. Besides this, it is possible to invest in companies with a good credit standing, many of which are not active on the international capital markets or on the international market for syndicated loans.[35]

20 Recent transactions by Sainsbury's,[36] an English supermarket chain, in two tranches of €100 million and £100 million[37] as well as by French company Neopost for €50 million and $50 million, all of which were placed predominantly with Asian investors, were notable for their non-European investor base.[38] Another example is a €170 million Schuldschein loan from Swiss company Lonza last year that was subscribed by 41% Asian investors and 11% Australian investors.[39] A €220 million Schuldschein loan issued by French group SEB and placed with investors not only in Europe but also Asia and Latin America was equally noteworthy.[40]

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29 *The Association of Corporate Treasurers*, 'PP15+ working group on developing a UK Private Placement market', Interim report (December 2012) p. 25.
30 *UniCredit Research*, Sector Report, 'German Schuldschein Loans – A Primer' (September 2011) p. 9.
31 *Instituto de Crédito Oficial*, Spain.
32 *UniCredit Research*, Sector Report, 'German Schuldschein Loans – A Primer' (September 2011) p. 10.
33 *BayernLB*, 'Corporate Schuldschein goes international' (September 2012) p. 3 et seq.
34 *BayernLB*, 'Corporate Schuldschein goes international', (September 2012) p. 5 et seq. See also Meves, 'Financing Specialty', *CFO Insight* (Spring 2012) p. 36.
35 See Legeland, 'Stable, flexible and not just for Germans', *Euroweek – Financing Corporates* (2012) p. 36.
36 Legeland, 'Stable, flexible and not just for Germans', *Euroweek – Financing Corporates* (2012) p. 36.
37 Meves, *CFO Insight* (Spring 2012).
38 See Neopost press release of 29 October 2012.
39 Dentz, *CFO Insight*, 'German Schuldschein goes international' (October 2012).
40 ' Case Study – Groupe SEB', *Commerzbank* (2012).

Placement and marketing

D. Placement and marketing

21 The placement of a Schuldschein loan with investors can take place in either a direct or indirect manner (direct versus indirect system). However, the direct system is significantly more frequent than the indirect system.[41]

I. Direct system

22 In the direct system the loan agreement is concluded between the borrower and the (end) investors directly. The role of arranger, being that of a broker, is limited to mere facilitation of the loan.[42]

II. Indirect system

23 In this alternative the loan agreement is initially concluded between the lender and the arranger as the initial borrower.[43] The (end) investors have to transfer the payment for their share to the arranger the same day and the arranger then transfers the investors' shares in the Schuldschein loan to them.[44] Alongside this, a separate agreement is made between the arranger and borrower on the arrangement of the loan, which can be classified as an agency agreement (*Geschäftsbesorgungsvertrag*) with the characteristics of a service agreement.[45] See para. 67 et seqq. (Assignment) and para. 74 et seqq. (Assumption of contract) regarding the alternatives for transfer.

III. Stages of a Schuldschein transaction

24 The placement and take-up of a Schuldschein loan typically takes place in three steps.[46]

1. Preparation

25 Once the borrower has finished its own preliminary considerations as to the maximum and minimum volumes, acceptable price margins, maturities, clarification of internal responsibilities, scheduling and similar, the borrower instructs one or more banks as arrangers. They are given the task of marketing the planned Schuldschein loan to investors and structuring the loan.[47] The instruction normally takes place on a best-efforts basis (see chapter 9) in an engagement letter to which a term sheet covering the main commercial terms and conditions is meanwhile attached as a schedule. Thus the arranger is not responsible for the venture being successful but simply for using its best endeavours to place the loan.[48] At this stage, which can take two to four weeks, the draft Schuldschein documentation and information on the borrower (e.g. credit report) is compiled or drawn up ready for marketing.[49]

2. Marketing

26 At this stage, the arranger and/or any other banks involved contact potential investors, possibly in association with the borrower. For this purpose the documents and information drawn up at the previous stage are often provided to potential investors in the context of a roadshow, an internet data room or over the telephone. Investors then have four to six weeks to reach a decision on whether to invest in the Schuldschein loan. After talks with the potential investors, the arranger will determine the target sum and the commercial terms and conditions in consultation with the borrower.[50] After an in-

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41 See Wehrhahn, *BKR* (2012) 365.
42 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 23 et seq.; Wehrhahn, *BKR* (2012) 365.
43 Hessling/Theiselmann, *Forderungspraktiker* (2010) 228.
44 Hessling/Theiselmann, *Forderungspraktiker* (2010) 228, 229.
45 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 25.
46 Theiselmann, *GmbH-StB* (2012) 51.
47 The analysis of existing financing facilities often plays a special role here in order to ensure that their ranking, covenants and other obligations are as synchronous as possible to those of existing forms of financing.
48 Wehrhahn, *BKR* (2012) 365.
49 Theiselmann, *GmbH-StB* (2012) 51.
50 Hessling/Theiselmann, *Forderungspraktiker* (2010) 229; Wehrhahn, *BKR* (2012) 365.

house analysis and approval of the credit investment, the investor sends a subscription declaration (*Zeichnungsbestätigung*) in which it undertakes to take on part of the loan taking into account a minimum margin and a maximum amount.[51]

3. Closing

27 At this stage the order book is closed and the final price is fixed by the arranger. In the event of "oversubscription" the amount is shared out among the various investors who have submitted a subscription declaration. Finally, the signing, drawdown and – in the indirect system (see para. 23) – the same-day transfer of the shares in the Schuldschein loan to the investors take place.

[51] Hessling/Theiselmann, *Forderungspraktiker* (2010) 228.

Features of the contract

E. Features of the contract

I. Form

28 The loan agreement is free of any required legal form, although in practice written form is always chosen for evidential purposes. The Schuldschein certificate from which the loan gets its name is merely to be regarded as a document under the terms of section 371 German Civil Code (BGB) establishing or confirming[52] the liability. Since a loan agreement exists in written form, the evidential function of the actual Schuldschein certificate does not play a crucial role, which is why a separate certificate of indebtedness is often not issued.[53] Instead, the loan agreement is itself designed to be a certificate of indebtedness and the legal grounds of the liability can be governed either in or alongside the Schuldschein certificate.[54] If the legal grounds are not contained in the Schuldschein certificate, reference is made to the relevant provisions in the associated loan agreement. As Schuldschein certificates are not securities and cannot be cleared, the documents are held in safe-keeping either by the lenders, the registrar or the paying agent in paper form.

29 In the event of dispute, the lender bears the burden of proof regarding the fact that the loan has actually been paid out, although this is often fulfilled by submitting the Schuldschein certificate as proof of the payment. In some circumstances the confirmation contained in the Schuldschein certificate can acquire significance as an abstract or causal acknowledgement of debt (*Schuldanerkenntnis*) which leads to the burden of proof being reversed.[55]

30 Often, only the most important elements of the contract such as the total amount of the loan, the interest rate, interest payment dates, redemption date and assignment conditions and other conditions specific for Schuldschein loans are contained in the loan agreement. Provisions usual in bonds or in other jurisdictions, such as business day conventions (see chapter 9) or termination rights (see chapter 9), are not required since they are already governed by statutory provisions or in case law and are applicable under German law. But since they are structured in a similar way to capital markets instruments these provisions are nevertheless found in Schuldschein loans, and especially in international or large-volume transactions. Structured Schuldschein loans require more detailed documentation due to their special characteristics.

31 Apart from the actual Schuldschein loan, the documentation often also contains a model assignment agreement, the paying agency agreement[56] and, if applicable, model notices of termination as schedules to the loan agreement.

32 Similar to bonds, also in case of Schuldschein loans the option exists of setting up so-called "programmes" that serve as a framework for recurrent fundraising, saving on both time and costs. Unlike securities, when a Schuldschein loan is taken out no prospectus is needed pursuant to the German Securities Prospectus Act (*Wertpapierprospektgesetz*)[57], even if the loan is subject to a public offer. No such duty emerges under the German Investment Products Act (*Vermögensanlagengesetz* – VermAnIG) either, as opposed to registered notes (*Namensschuldverschreibungen*).[58] The information on the borrower necessary for marketing is often contained in a so-called "roadshow" presentation, and

52 Hessling/Theiselmann, *Forderungspraktiker* (2010) 228.
53 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 30 et seq., including further notes.
54 Schmitt, *BB* (2012) 2039.
55 Wehrhahn, *BKR* (2012) 364.
56 See Wehrhahn, *BKR* (2012) 367.
57 See s. 1 *WpPG*.
58 See s. 1 *VermAnlG*.

in some cases even in an information memorandum similar to a prospectus both of which are subject to the relevant rules on civil liability (see chapter 12).

II. Interest

33 The interest on Schuldschein loans can be structured by a variety of different methods, in just the same way as bonds (see chapter 9). The most frequent alternatives are definitely fixed or floating-rate loans. Mixed forms and discounted or compounded zero-coupon or structured Schuldschein loans can also be found besides this. In structured instruments the interest rate depends on an underlying (for instance certain indices, shares or commodities), in a similar way to structured notes.

34 It is not unusual for Schuldschein loans to be divided into various tranches, each with different maturities and different interest rates (mostly fixed and floating-rate tranches). Even if all tranches are together regarded as part of a single overall loan, they have to be treated separately for legal purposes and each of them represent independent loans, especially as far as termination rights are concerned.[59]

35 Like with bonds, the level of the interest rate also depends on a range of factors. These include general market interest rates, the general economic situation, the debtor's creditworthiness, term, loan size and similar factors. Owing to their reduced fungibility compared to bearer notes (*Inhaberschuldverschreibungen*), investors may demand a liquidity premium from the lender in Schuldschein loans.

36 In floating-rate Schuldschein loans the level of the interest rate is based on a reference interest rate plus (or in rare cases minus) a margin, in the same way as in all other debt capital markets. The contractual terms and conditions are no different than those used for debt securities (see chapter 9). However, the extensive statutory provisions regarding loans in the German Civil Code (BGB) mean that the type of interest can have effects on the statutory rights of termination the borrower is entitled to exercise (see para. 37 et seqq.).

III. Redemption and termination

37 Like other loans, Schuldschein loans have to be paid back on the agreed maturity date unless and to the extent that they have already been repaid in part or in full. Redemption is mostly in the form of a bullet payment (see chapter 9), although partial or full amortisation of principal is possible over the term. The amount to be repaid at the end of the term of the relevant Schuldschein loan is essentially equivalent to the original amount borrowed. In structured Schuldschein loans, however, the amount repaid can vary from the amount borrowed.

38 Where if redemption payments are made by instalment, the order of redemption is fixed by contract in accordance with the legal provisions under section 367 German Civil Code (BGB) in conjunction with section 366 German Civil Code (although it is possible to amend these provisions by contract). This means that if a payment is made that is not sufficient to pay back the entire debt, it is first credited towards the costs, then towards the interest and finally towards principal. Therefore, any other redemption terms set by the borrower are irrelevant. Default interest is not affected by this, as set out in section 288 German Civil Code. In Schuldschein the due date is mostly set on a certain calendar day, which is why a separate notice pointing out that the debtor is in arrears is not required (section 286(2) no. 1 German Civil Code). Default interest on interest payments that are agreed but not paid are not permitted due to the prohibition of compound interest under section 289 German Civil Code. However, the lender is able to claim for damages as a result of delayed performance or for additional losses under

[59] Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 39.

the general rules on damages (sections 289(2), 288(4), 280(1) and (2) and 286).[60] Agreeing lump-sum damages, for example 1% p.a. above the agreed interest rate, is also permitted. At the same time, the borrower has the possibility of proving that the damage was less than the agreed lump sum; this effectively leads to a reversal of the burden of proof in relation to the level of damages.[61]

1. Ordinary termination (*ordentliche Kündigung*)

39 Under section 488(3) sentence 1 German Civil Code (BGB), an ordinary termination is generally excluded in a contract with a fixed-term (maturity date).[62] In addition, the borrower's statutory rights of termination are frequently excluded to the extent legally permissible in Schuldschein loans.[63] A termination agreement is nevertheless possible for Schuldschein loans, although this constitutes an amendment to the contract and falls under section 311(1) German Civil Code. The cancellation is generally linked to a compensation for prepayment or made conditional on such compensation.[64] Apart from this, the borrower also has the option of buying back the Schuldschein loan and in this way causing it to expire by confusion (which is not possible for bonds).[65]

40 In contrast, section 489 German Civil Code allows for important specific possibilities for termination. This section only applies to loan agreements that have an agreed fixed (subsection 1) or adjustable (subsection 2) interest rate.[66] Consequently, the borrower is able to give notice on a Schuldschein loan with a fixed lending rate in part or in full if the fixed lending rate ends before the time scheduled for redemption and no new agreement is reached regarding the rate.[67] The notice period is one month and notice can be given not earlier than with effect from the end of the day on which the fixed interest ends. As a result, the borrower has a termination option in loan agreements where the fixed interest rate ends before maturity.

41 The second scenario in section 489(1) no. 1 German Civil Code relates to loan agreements in which an adjustment of the lending rate is agreed in defined periods of up to one year (see second part of the sentence). In this case, the borrower can give notice with effect from the end of the day on which the preceding rate fixing ends. Loan agreements with graduated interest rates are also covered by this definition if an interest rate expressed in a fixed percentage can be determined for each of the fixed interest periods.[68] So floating-rate Schuldschein loans which bear interest for the scheduled interest periods based on a model such as reference interest rate (e.g. EURIBOR) + margin fall under section 489(1) no. 1, second part of sentence, German Civil Code.[69] Agreeing on an interest cap, floor or collar is not sufficient.[70]

42 In loan agreements with a fixed interest rate, the borrower is entitled to give notice in any event after ten years observing a notice period of six months.[71] This termination right applies to all kinds of fixed-interest loans regardless of the agreed term, purpose of the loan, borrower (but see 45 below), interest rate or duration of the fixed interest. The condition for exercise of the termination right is full settlement of the loan. The ten-year period only starts to run after all sums under the loan have been

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60 Ernst, in: *MünchKommBGB*, s. 289 para. 7.
61 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 60 et seq.
62 Weidenkaff, in: Palandt, *BGB*, s. 488 paras 22 and 26.
63 Wehrhahn, *BKR* (2012) 367.
64 Weidenkaff, in: *Palandt*, *BGB*, s. 488 para. 27.
65 Wehrhahn, *BKR* (2012) 367.
66 Berger, in: *MünchKommBGB*, s. 489 para. 4.
67 Section 489(1) no. 1, beginning of sentence *BGB*.
68 Berger, in: *MünchKommBGB*, s. 489 para. 6.
69 See *Mülbert/Bernauer*, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 63; *Berger*, in: *MünchKommBGB*, s. 489 paras 6 and 9.
70 *Berger*, in: *MünchKommBGB*, s. 489 para. 6.
71 Section 489(1) no. 2 German Civil Code (BGB).

paid out by the lender. Furthermore, notice can only be given with effect from a point in time six months after receipt of the notice of termination (section 130 German Civil Code), i.e. no earlier than ten-and-a-half years after full settlement.[72]

43 Schuldschein loans with adjustable lending rates are governed by section 489(2) German Civil Code. This provision grants the borrower the right to give notice at any time provided that a notice period of three months is observed. In contrast to section 489(1) no. 1 German Civil Code, subsection 2 only covers agreements in which the change in interest rate can occur at any time.[73] Thus the concept of adjustable interest rates (*veränderliche Zinssätze*) should not be confused with the name for floating-rate loans (*variabel verzinsliche Darlehen*). If the loan has only initially been settled in part, the termination right is limited to this part of the loan. In contrast, if it has already been paid out in full, a partial termination is not possible, unlike in subsection 1.[74] Examples of loans with adjustable interest rates are Schuldschein loans incorporating a so-called "step-up" or "step-down" clause (see chapter 9) which makes adjustment of the interest rate conditional on the borrower's creditworthiness[75] or loans providing for special interest rates dependent on development of the business alongside a fixed interest rate ("equity kicker").[76]

44 The lending rate is to be regarded as the fixed or adjustable periodic percentage applied to the loan each year.[77] The term "lending rate" merely serves to make a terminological distinction from other types of interest rate such as default interest or effective annual interest rates and represents the contractual interest rate.[78]

45 The termination rights contained in section 489(1) and (2) German Civil Code are mandatory under section 489(4) sentence 1 of the Code and cannot be excluded either by general terms and conditions or by individual agreement. Any conflicting agreements leave the validity of the Schuldschein loan itself untouched but are void under section 134 of the Code. Agreements making it more difficult to give notice or making termination dependent on additional conditions (for example an extension of notice periods or agreement of inadmissible compensation for prepayment) are also void.[79] Certain borrowers are not subject to these restrictions under section 489(4) sentence 2 German Civil Code. This exception applies in principle to certain German legal entities governed by public law (the German Government (*Bund*), special government trusts (*Sondervermögen des Bundes*), federal states (*Länder*), local governments (*Gemeinde*) or associations of local governments) and also for the European Communities (European Union, European Atomic Community) as well as foreign regional authorities.[80] This is particularly important for Schuldschein loans with a term of more than ten years and borrowers who can be qualified as public-sector borrowers under the terms of section 489(4) sentence 2 German Civil Code since this termination right is frequently excluded in such scenarios.

46 Whilst making the right to terminate more difficult is excluded, making it easier is not excluded by section 489(4) German Civil Code. This includes shortening or waiving the minimum loan term, for example. If the lender contractually agrees to an earlier possibility to terminate than provided for under

72 See Berger, in: *MünchKommBGB*, s. 489 para. 11.
73 Berger, in: *MünchKommBGB*, s. 489 para. 15.
74 Berger, in: *MünchKommBGB*, s. 489 para. 14.
75 Berger, in: *MünchKommBGB*, s. 489 para. 6.
76 Berger, in: *MünchKommBGB*, s. 489 para. 15.
77 Section 489(5) *BGB*.
78 Berger, in: *MünchKommBGB*, s. 489 para. 23.
79 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 67; Berger, in: *MünchKommBGB*, s. 489 para. 19.
80 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 68; Berger, in: *MünchKommBGB*, s. 489 para. 21.

section 489 German Civil Code, it is free to demand compensation for prepayment or a lump sum for costs.[81]

47 In principle, the notice of termination does not have to be given in any specific form and a reason for termination does not necessarily have to be given, although written form is often agreed.[82] As the notice of termination is a declaration of intent that only becomes complete upon receipt by the other party it may be declared either expressly or implicitly, providing that the agreed requirements as to form are met.[83] However, section 489(3) German Civil Code states that the borrower's notice of termination has not been effected if it fails to pay back the amount owed within two weeks of the notice of termination taking effect. The termination is provisionally effective until the two-week time limit has passed.[84] If the termination is effective, it leads to the agreement being dissolved, the claim for redemption under section 488(1) sentence 2 German Civil Code becoming due and to the borrower's (if any) and lender's claims against each other being offset.[85]

2. Extraordinary termination (*außerordentliche Kündigung*)

48 If there is a substantial deterioration in the borrower's financial circumstances or the value of security provided for the loan, or if such deterioration is likely to occur and repayment of the loan is jeopardised even if the security is realised, the lender is entitled to give notice. This right to give notice may always be exercised with immediate effect before the loan has been paid out and generally without notice after it has been paid out.[86] Personal security (e.g. guarantees) and liens on property or real estate (*Grundpfandrechte*) both come into question as security. The borrower's financial circumstances always have to be taken into account at the same time.[87] Thus section 490(1) German Civil Code (BGB) offers a right to terminate for good cause if there is an acute risk of default,[88] e.g. if the borrower defaults on payment (although an assessment of the overall circumstances also has to be performed). The restrictive wording in section 490(1) German Civil Code for termination after the loan has been paid out is only to be understood as a statutory expression of the need for a comprehensive assessment of the financial situation taking into account all of the borrower's interests. In this context the principle of untimely termination (*Kündigung zur Unzeit*) should be heeded.[89] Section 490(1) German Civil Code can be amended by contract.[90]

49 Under section 490(2) German Civil Code the borrower is entitled to give notice with immediate effect if a loan with a fixed lending rate is involved and it is secured by a charge on property or on a ship. It is important to bear the restriction in mind that at least six months must have passed since full drawdown and that this must be necessary in order to protect the borrower's legitimate interests. The Code gives the need to realise the security for other purposes as an example of a legitimate interest. The notice period is three months.[91]

50 If the borrower exercises its right to give notice against the lender, then under section 490(2) sentence 3 German Civil Code it has to compensate the lender for damages suffered as a result of the early termination (prepayment penalty), i.e. the amount corresponding to the interest in continuation of the

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81 Berger, in: *MünchKommBGB*, s. 489 para. 20.
82 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 82.
83 Berger, in: *MünchKommBGB*, s. 489 para. 17.
84 Berger, in: *MünchKommBGB*, s. 489 para. 16.
85 Berger, in: *MünchKommBGB*, s. 489 para. 1.
86 Section 490(1) *BGB*.
87 Berger, in: *MünchKommBGB*, s. 489 para. 6.
88 Berger, in: *MünchKommBGB*, s. 489 para. 8; Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 72.
89 Berger, in: *MünchKommBGB*, s. 489 paras 14 and 17 f.
90 Berger, in: *MünchKommBGB*, s. 489 para. 22.
91 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 71.

facility agreement.[92] If the lender gives notice, a prepayment penalty is not possible, although a potential claim for damages exists.[93] The termination leads not only to the lender's claim for repayment under section 488(1) sentence 2 German Civil Code falling due, but also to the loan agreement terminating and to the contractual relationship being converted in a winding-up relationship.[94]

51 Section 490(3) German Civil Code makes clear that the general principles set down in section 313 German Civil Code (frustration of contract (*Störung der Geschäftsgrundlage*)) and section 314 German Civil Code (termination of contracts for the performance of a continuing obligation for good cause (*Kündigung aus wichtigem Grund bei Dauerschuldverhältnissen*)) continue to apply. Section 490(1) and (2) German Civil Code are to be regarded as legislative provisions applicable in special situations if their conditions are fulfilled.[95]

52 If there are special circumstances existing outside the loan agreement, in exceptional cases it is possible to amend the agreement or to give immediate notice under section 313 German Civil Code on account of frustration of contract.[96]

53 Under section 314(1) German Civil Code both parties may give immediate notice for good cause. The condition for this is that the full loan amount has been paid out to the borrower and that taking into account all the individual circumstances and weighing up all interests it is not reasonable to expect the loan agreement to be continued until the end of the contractual period.[97] Termination for good cause is only ever permitted within a reasonable period from the time the reason for termination becomes known.[98]

54 Schuldschein loans often contain a non-exhaustive list of circumstances constituting a good cause for termination by the lender[99] defining this provision in more detail. These often emulate or correspond to those contained in bond terms and conditions (known as "events of default" – see chapter 9), especially in international loans. Although these clauses are in principle allowed[100], the contractual provisions regarding grounds for termination may not significantly restrict the right to an extraordinary termination. If this is the case, the general rules on notice of termination for good cause continue to prevail.[101] An extension of the rights of termination for good cause so that criteria for termination can be agreed that would not constitute good cause for termination under the statutory rules can in principle be agreed with binding effect. Granting a "call right" in favour of the lender that is not linked to any conditions and is therefore at its absolute discretion is ineffective on account of its gagging nature.[102] A right to termination on the part of the borrower comes into consideration under section 314 German Civil Code if the lender commits a serious breach of contract, for example. Possibilities for termination relating to withholding tax are also frequently agreed to the benefit of the borrower ("gross-up" – see chapter 9).[103]

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92 Berger, in: *MünchKommBGB*, s. 489 para. 30.
93 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 86; Berger, in: *MünchKommBGB*, s. 490 para. 30.
94 Berger, in: *MünchKommBGB*, s. 489 para. 20.
95 Berger, in: *MünchKommBGB*, s. 489 para. 46.
96 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 81; Berger, in: *MünchKommBGB*, s. 489 para. 67 et seqq.
97 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 73; Berger, in: *MünchKommBGB*, s. 489 para. 48.
98 Section 314(3) *BGB*.
99 Wehrhahn, *BKR* (2012) 367; Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzie- rung am Kapitalmarkt*, s. 21 para. 73; Berger, in: *MünchKommBGB*, s. 489 para. 56 et seqq.
100 Berger, in: *MünchKommBGB*, s. 489 para. 58.
101 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 74.
102 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 75 f.
103 Berger, in: *MünchKommBGB*, s. 489 para. 49.

55 A termination may possibly breach the principles of section 242 German Civil Code (principal of good faith or equity) and the prohibition of contradictory behaviour inferred from this. For example, termination does not come into question in the event of a breach of financial covenants if the lender has not taken any action despite being aware of the breach.[104] The duty to show consideration derived from the principle of good faith (*Treu und Glauben*) has to be taken into account in both ordinary and extraordinary termination. This always has to be considered on a case-by-case basis.[105]

56 If the statutory grounds for termination are extended by contract and the borrower makes use of this, a prepayment penalty only has to be paid if this has been agreed. The parties are essentially free to agree its value. It is generally reasonable to agree a fixed penalty equivalent to 2% of the loan capital subject to the (early) termination.[106]

IV. Security and trustees (*Treuhänder*)

57 Security can also be provided for Schuldschein loans, in just the same way as bonds and other forms of loan. However, in practice we only come across this in extremely rare situations. The most frequent alternatives are guarantees (see chapter 9 for their characteristics and how they work). Pledging of securities or receivables or their provision as security are equally possible, although under insurance regulations this is only suitable if the security can be directly channelled to the restricted assets of an insurance company.[107]

58 Schuldschein loans can also be secured by liens on property or real estate (*Grundpfandrechte*) in the same way as all other loans. A general aim of Schuldschein loans is to make them as fungible as possible, leading to them being structured in a similar way as bonds. Thus securing them with non-accessory security such as land charges (*Grundschuld*) entails certain obstacles. If the security is created directly for the benefit of the lender, this makes assigning parts of the loan agreement or the entire loan agreement considerably more difficult compared to unsecured loan agreements, since the relevant land charge and all the other non-accessory security has to be transferred. [108] The borrower's consent is not required in order to transfer the security unless the parties have agreed otherwise.[109] For this reason, security trustees (*Sicherheitentreuhänder*) are appointed in Schuldschein loans, in a similar way as for bond issues. The land charge is created in favour of the trustee and managed by the trustee on the lenders' behalf.[110]

59 If it is planned to include the loan in the restricted assets of insurance companies, special provisions apply in relation to the loan's value, priority, annual percentage rate and other criteria.[111]

V. Covenants

60 Due to the far-reaching statutory rules on loans in general and the associated case law, the documentation for Schuldschein loans can be kept very short, since areas not provided for in the context of freedom of contract can fall back on a legal framework. Nevertheless, these rules, which are useful in many situations, do not always cover all the areas required for particular loans. Therefore, the advantage of concise documentation always entails a basis risk which is mostly cushioned by the fact

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104 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 79; Berger, in: *MünchKommBGB*, s. 489 para. 54.
105 Berger, in: *MünchKommBGB*, s. 489 para. 55.
106 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 85 et seq.
107 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 54.
108 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 121).
109 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 98.
110 See Wehrhahn, *BKR* (2012) 366.
111 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 55 et seqq.

that – at least originally – Schuldschein loans were mainly only granted to public bodies or other debtors with the highest credit status.

61 The extension of the group of borrowers to include other target groups results in a need for additional rules to limit the basis risk.[112] The internationalisation of the Schuldschein loan is leading to the inclusion of relevant covenants because these are in common use internationally. All kinds of covenants appearing in bonds in the international market for syndicated loans are conceivable. However, these are often limited to just a few clauses, in particular negative pledges and isolated financial covenants (see chapter 9).

62 One point to which special attention has to be paid is making sure that the agreed (financial) covenants are adhered to. In contrast to bonds, the covenants agreed in Schuldschein loans tend to be "maintenance based" (and not "incurrence based" like bonds – see chapter 9). And unlike in international syndicated loans there are no provisions for majority decisions by the creditors[113] and no active body ensuring that the covenants are supervised in the vast majority of Schuldschein loans. Thus the practical enforceability of certain covenants should be examined and structured on a case-by-case basis. In some circumstances reporting duties may arise for loan sums exceeding €750,000 under section 18 German Banking Act (*Kreditwesengesetz* – KWG).

63 If a financial covenant is breached, especially a financial covenant, it often happens in a syndicated loan that the group of creditors grants a waiver for the case in question (possibly by majority decision). This is difficult to realise for Schuldschein loans, as mentioned above, since there are neither any majority decisions nor any joint representatives unlike in German law bonds. Therefore the consent of each individual creditor is required (see para. 105 et seqq.). For Schuldschein loans taken out by sovereigns, an additional factor is that the rules on so-called "collective action clauses" are not directly applicable since Schuldschein loans do not qualify as government bonds (*Staatsschuldtitel*).[114]

VI. Transfer

64 In contrast to bonds, Schuldschein loans cannot be transferred by delivering the certificate of indebtedness or the associated loan agreement (according to the principles of property law) due to their lack of qualification as a security. Schuldschein loans can only be transferred in two ways: on the one hand, the Schuldschein loan can be assigned to other lenders in part[115] or in full; on the other, it can take place by assumption of contract. Up to now no standard market practice has emerged, which is why both methods can be found on the German market.[116] In contrast, the borrower is often not entitled to transfer its rights and duties under the Schuldschein loan,[117] but can allow these to be exercised by its successors in a fiduciary capacity.

65 Upon transfer of the partial loan claims under a Schuldschein transaction, the (new) lenders acquire co-ownership of fractions of the actual (original) Schuldschein certificate by operation of law.[118] The assignees can ask for a certified copy to be handed over but not for the temporary surrender of the

112 See Berger, in: *MünchKommBGB*, s. 489 para. 39.
113 Wehrhahn, *BKR* (2012) 366.
114 See Art. 12(3) of the *Treaty establishing the European Stability Mechnismus (ESM)*: From 01 January 2013 all new euro area government securities with a maturity above one year include collective action clauses in a way which ensures that their legal impact is identical in all jurisdictions in the euro area.
115 Minimum transfer amounts of €500,000 or €1m are frequently agreed.
116 Müller; in: Kümpel/Wittig, *Bank- und Kapitalmarktrecht*, para. 15.265.
117 Wehrhahn, *BKR* (2012) 367.
118 Wehrhahn, *BKR* (2012) 366.

(original) Schuldschein certificate.[119] In some circumstances it may be agreed that one or more new Schuldschein certificates should be issued at the time of assumption of contract.

66 In the majority of cases, whether by way of assumption of contract or assignment, it can be presumed that the transfer will be carried out for a fee, meaning that purchase of a receivable under the terms of sections 433 and 453 German Civil Code exists. Providing that nothing else is agreed, the transferring lender is liable to the accepting lender solely for the validity of the claim (liability for the *bona fide* nature of the claim (*Veritätshaftung*)) but not for the borrower's creditworthiness.[120]

1. Assignment

67 In this model, the transfer of the Schuldschein loan or parts of it takes place as set out in sections 398 et seqq. German Civil Code (BGB). The pro-rated claim for repayment and pro-rated interest claims and, to the extent permitted, all the subsidiary rights associated with the claim are normally assigned in the assignment agreement.[121] In addition, the relevant final lender is authorised to assert the rights not assigned to it autonomously in its own name and independently from the other final lenders[122] (section 183 German Civil Code). Once the assignment has taken place, the claims under the Schuldschein loan exist as independent claims and rank *pari passu* unless the parties have agreed otherwise.[123] Coordination between all the lenders is only possible through a trustee agreement (*Treuhandvertrag*) in which a German-law trustee (*Treuhänder*), for example the arranging credit institution, is appointed.[124] In this form of transfer the original lender[125] continues to be a party to the Schuldschein loan into which it originally entered[126] and is able to continue exercising any rights resulting from the agreement, such as termination rights and rights in relation to security.[127]

68 Since the Schuldschein loan itself does not have to be concluded in any particular form, the same applies to the assignment agreement.[128] But in practice it is always concluded in writing. The contract for the relevant Schuldschein loan often contains a model assignment agreement and a model notification letter to the borrower. As a rule, provisions are made for disclosure of the change in creditor to the borrower. These requirements may lead to the Schuldschein loan no longer being eligible for use in central bank credit operations unless no requirements of consent and notification are agreed in the event of assignment to a central bank in the Eurosystem.[129] The law states that the debtor's consent is not required; neither is a notification to the debtor required, although it is often contractually agreed.[130]

69 Yet the borrower does have possibilities for limiting assignment (section 399 German Civil Code). The most extreme restriction – prohibition of assignment – may be agreed either explicitly or implicitly. Apart from this, it is possible to agree a diluted prohibition of assignment, for example by specifying the agreement of a minimum assignment amount, requiring use of a certain form of assignment agreement (including written form), excluding particular lenders (for instance competitors), limiting assignment to a certain group of legal entities (for instance insurance companies, funds or banks) or specifying the need to gain the borrower's consent, etc.[131] If a prohibition of assignment is agreed, this means that no

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119 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 106.
120 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 paras 95 and 108.
121 Wehrhahn, *BKR* (2012, 365 et seq.); Müller; in: Kümpel/Wittig, *Bank- und Kapitalmarktrecht*, para. 15.265.
122 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 96.
123 Wehrhahn, *BKR* (2012) 366.
124 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 paras 96 and 119.
125 Often described as "initial lender".
126 Wehrhahn, *BKR* (2012) 366.
127 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 97.
128 Roth, in: *MünchKommBGB*, s. 398 para. 33.
129 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 92.
130 Roth, in: *MünchKommBGB*, s. 398 para. 58.
131 Roth, in: *MünchKommBGB*, s. 398 para. 31 et seqq.

disposable right under the terms of section 137 German Civil Code exists. Consequently, an assignment is ineffective and a change in creditor does not take place. Subsequent consent by the borrower is possible but unlike in a case where assignment is subject to consent (*Zustimmungsvorbehalt*) does not have retroactive force.[132]

70 Section 354a German Commercial Code (*Handelsgesetzbuch* – HGB) limits the possibilities for restricting the free assignability of monetary claims in bilateral commercial transactions (or if the debtor is a legal entity governed by public law or a special trust under public law (*öffentlich-rechtliches Sondervermögen*). This provision states that an assignment carried out contrary to an agreed prohibition of assignment is effective, although the borrower is allowed to continue treating the assignor as its creditor.[133] Subsection 2 contains a counter-exception preventing an effective assignment from applying despite a prohibition of assignment where the creditor is a credit institution.

71 Use of the assignment alternative means that in an assignment the borrower is able to assert any defences it was entitled to raise against any previous buyers in the assignment chain also against later assignees in accordance with section 404 German Civil Code. The opposite also applies, i.e. that any defences it was no longer entitled to raise against a previous creditor cannot be asserted against an assignee.[134] Despite this, alternative arrangements are permitted.[135] The new final lender has to accept any payments made by the borrower to the previous creditor as applying in relation to itself in accordance with section 407 German Civil Code unless the debtor was aware of the assignment at the time of the payment or performance of the legal transaction. The difference then has to be settled between the old lender (assignor) and the new lender (assignee).[136] If a paying agent is provided for in the loan agreement, then all payments by the borrower usually have to be settled through the agent. It is often agreed that even the payments to the paying agent as authorised receiving agent are sufficient for performance. Thus the paying agent has to be informed about the assignment and has to make the payments to the new lender. If it does not comply with the agreement and makes the payment to the assignor, the difference still has to be settled between the old lender and the new lender but the paying agent makes itself liable for damages.[137]

72 Under section 406 German Civil Code new lenders have to accept any setting-off of the borrower's claims against the previous lender or lenders against themselves. Like in section 407 German Civil Code, the borrower's knowledge of the assignment leads to this provision not applying – providing that the debtor became aware of it at the time the debt was acquired. Set-offs are also excluded if the claim became due later than the assigned claim. If an exclusion of set-off (see para. 14) was agreed, this continues to be valid if the relevant conditions are satisfied.[138]

73 According to section 401 German Civil Code, the relevant (new) lenders can exercise all the subsidiary and preferential rights directly and may realise any accessory security directly; however, this does not apply to contractual rights to amend affecting the legal relationship as a whole. These rights do not automatically pass to the other party at the time of assignment and relate in particular to the right of rescission and right of termination.[139] Thus the right of termination has to be exercised by the initial lender following assignment as well. In order to allow the (new) lender to exercise the right of

132 Roth, in: *MünchKommBGB*, s. 398 para. 36 et seqq.
133 Roth, in: *MünchKommBGB*, s. 398 para. 39 et seqq.
134 Roth, in: *MünchKommBGB*, s. 404 para. 17.
135 Roth, in: *MünchKommBGB*, s. 404 para. 18.
136 Roth, in: *MünchKommBGB*, s. 407 para. 13.
137 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 100.
138 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 101.
139 Grüneberg, in: Palandt, *BGB*, s. 401 para. 6.

termination, it is necessary to assign the claim's subsidiary rights separately[140] or as least in an agreement[141] by which the assignee is authorised to exercise the right of termination in its own name.[142] On the other hand, provided that all the necessary conditions exist the borrower is free to give notice on the existing claims individually. The notice of termination has to be given to the initial lender.[143]

2. Assumption of contract

74 The German Civil Code (BGB) governs the assignment of individual claims and the assumption of individual obligations, but not a transfer of an entire contractual relationship. Assumption of contract is when one party takes the place of an existing party in a contract.[144] Case law and legal theory have found assumption of contract as transfer of an entire obligatory relationship to be admissible. Thus the original lender leaves the contractual relationship completely as a result of the assumption of contract and is replaced by a new lender.[145] The loan contract is continued between the new lenders (and the old lenders, provided that they have kept part of the loan) and the borrower without any changes as far as its contents are concerned.[146]

75 As assumption of contract involves a disposition over the entire contractual relationship, it requires the consent of all the participants.[147] A trilateral agreement between the borrower, old lender and new lender is possible. However, the interests of the parties can be taken into account more effectively by structuring the relationship in a contract between the outgoing party and acceding party with the consent of the other party, i.e. normally the borrower. The consent may be given in advance; this is mostly dealt with in the loan agreement itself.[148] The advance consent may also contain certain limitations similar to those in an assignment (see para. 69 et seqq.). Thus it can be limited to specific lenders or exclude other lenders.[149] If the borrower's consent has not been given, which leads to the assumption of contract becoming ineffective, or if the assumption of contract is ineffective for other reasons, the assignment contained in it may nevertheless be effective.[150]

76 Similar to an assignment, in this alternative the Schuldschein loan frequently already contains a model form for the assumption of contract as a schedule. The assumption of contract agreement must be in same form as the agreement being taken over, i.e. in the context of a Schuldschein loan it is in principal free from any requirements regarding form.[151] Nevertheless, it is advisable to enter into a written agreement (not only for evidential purposes).

77 Security of a non-accessory nature has to be transferred to the (new) lender(s) separately by assignment.[152] If the security is of an accessory nature, this is not necessary, in exactly the same way as for assignments.[153]

78 The borrower is protected by the fact that (in contrast to an assignment) the assumption of contract can only be effectively agreed with its consent. Under section 404 German Civil Code, the acceding

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140 Müller; in: Kümpel/Wittig, *Bank- und Kapitalmarktrecht*, para. 15.265.
141 Müller, in: Kümpel/Wittig, *Bank- und Kapitalmarktrecht*, para. 15.265.
142 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 102.
143 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 103.
144 Grüneberg, in: Palandt, *BGB*, s. 398 para. 41.
145 Wehrhahn, *BKR* (2012) 365 f.
146 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 109.
147 Grüneberg, in: Palandt, *BGB*, s. 398 para. 42.
148 Grüneberg, in: Palandt, *BGB*, s. 398 para. 42.
149 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 107.
150 Grüneberg, in: Palandt, *BGB*, s. 398 para. 42.
151 However written form is often stipulated in the contract, which is why a model assignment agreement is appended.
152 Section 413 in conjunction with s. 398 *BGB*.
153 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 110.

party is entitled to raise all the defences applying under the loan agreement itself, but not defects relating to the underlying transaction since the assumption of contract, being a disposition, is abstract. Furthermore, the acceding party can raise claims for defects in the agreement of the assumption of contract, as can the other two parties. Any challenge against the assumption of contract itself always has to be declared to the other two parties. If the borrower has already given its consent to the assumption of contract in advance and therefore has no knowledge of this, the provisions under sections 398 et seqq. German Civil Code apply to the borrower accordingly, especially sections 406 et seqq. German Civil Code.[154]

79 Unlike in an assignment, only the final lender is entitled to exercise rights to amend the contract because only it is still party to the agreement. The opposite also applies, i.e. that the borrower is also only able to exercise the rights to amend the contract to which it is entitled – provided all the necessary conditions exist – against the final lender.[155]

[154] Grüneberg, in: Palandt, *BGB*, s. 398 para. 44; Roth, in: *MünchKommBGB*, s. 398 para. 190 et seqq.; see para. 68 et seqq.
[155] Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 112.

Regulatory aspects

F. Regulatory aspects

80 The granting and acceptance of Schuldschein loans may both raise questions related to regulatory law. These may be considered either the deposit business or lending business. Furthermore, the bank arranging the Schuldschein loan has to observe certain legal requirements. Besides this, eligibility of Schuldschein loans for use by central banks is a particularly important aspect for their acceptance. Finally, it is important to look into whether a requirement to publish a prospectus exists.

I. Deposit and lending business

81 Granting Schuldschein loans falls under section 1 sentence 2 no. 2 German Banking Act (KWG)[156] and therefore constitutes a banking transaction (lending business). Under section 32(1) sentence 1 German Banking Act, providing Schuldschein loans commercially or granting such loan agreements on a scale requiring a commercially organised business undertaking is only allowed in Germany with the written authorisation of the regulator BaFin.[157] The criteria for a commercially conducted business (*Gewerbsmäßigkeit*) are often met earlier than those for a commercially organised business undertaking (*in kaufmännischer Weise eingerichteter Geschäftsbetrieb*). Banking business is conducted commercially if the undertaking is not just established on a short-term basis and its operator is intending to make a profit through the business.[158]

82 An assumption of contract or assignment of the Schuldschein loan – i.e. secondary market – does not fall under the definition of "granting" since taking over a loan is to be regarded as an acquisition of a debt in return for payment.[159] Other rules only apply if the party acquiring the loan also makes credit decisions, for example in loans that have not yet been paid out in full or in mutually agreed debt rescheduling since it is necessary to re-establish the debt in these circumstances (section 780 German Civil Code (BGB)).[160]

83 On the other hand, taking out a Schuldschein loan can fall under section 1 sentence 2 no. 2 German Banking Act and hence constitute a banking transaction for the borrower (deposit taking business). This is to be understood as accepting funds from third parties as deposits or other unconditionally repayable funds from the public, unless the claim for repayment is represented by debt securities in the form of bearer notes (*Inhaberschuldverschreibungen*) or order bonds (*Orderschuldverschreibungen*). It follows from this that accepting funds in return for handing out a Schuldschein or registered notes (*Namensschuldverschreibung, also n-bonds or NSV*) are situations involving deposit transactions.[161]

84 The criterion that the funds are unconditionally repayable set out in the second alternative of section 1 sentence 2, no. 1 German Banking Act is mostly not met for structured Schuldschein loans since they may participate in losses of the underlying unless the borrower concerned has given the creditors a so-called "capital guarantee". The same applies for subordinated loans or loans that otherwise participate in losses. Under customary law deposits for which a typical bank security is granted are exempted (Schutzgesetz). This is the case when the debtor's balance is pledged or the security is created in the form of liens on property or real estate, for example.[162] Another exception could exist (for foreign lenders) if the principle of passive freedom of services intervenes, i.e. if a German creditor (investor/lender) has actively approached the borrower (outside Germany) and not the other way round.

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156 The interpretation of the term "loan" leads to section 488 German Civil Code (typical contractual duties in a loan contract).
157 Wehrhahn, *BKR* (2012) 364.
158 Schäfer, in: Boos/Fischer/Schulte-Mattler, *Kreditwesengesetz*, s. 1 para. 17 f.
159 Same applies for an undisclosed or public sub-participation.
160 Schäfer, in: Boos/Fischer/Schulte-Mattler, *Kreditwesengesetz*, s. 1 para. 46.
161 Schäfer, in: Boos/Fischer/Schulte-Mattler, *Kreditwesengesetz*, s. 1 para. 39.
162 Schäfer, in: Boos/Fischer/Schulte-Mattler, *Kreditwesengesetz*, s. 1 para. 43.

If the lender's activities are to be regarded as deposit business but it does not have the necessary licence in Germany, the agreement may be ended by either party. For the borrower this follows from the nature of section 32 German Banking Act as a protective statute (*Schutzgesetz*) within the meaning of section 823(2) German Civil Code.[163]

II. Arranging

85 The role of the arranger, i.e. to arrange loans between potential borrowers and creditors, is essentially not subject to any licensing requirement under section 32(1) German Banking Act (KWG). The condition for this is that the arranger does not carry out any preliminary financing of the Schuldschein loan (direct system; see para. 22) as this would again constitute lending business (see para. 81). Apart from this, the arranger may not take on any responsibility for repayment of the loan since it would fall under the licensing requirement for guarantee business under section 1 sentence 2 no. 8 German Banking Act. Finally, the arranger may not accept the borrower's application in its own name; instead it must clearly be accepted in the name of the credit institution so that the arranger is not regarded as carrying on commercial banking business itself.[164] Anyone wishing to arrange the conclusion of loan agreements on a commercial basis or to introduce other parties to opportunities to conclude such agreements requires permission from the competent authority in accordance with section 34c German Industrial Code (*Gewerbeordnung* – GewO).

86 Categorisation as investment brokering (section 1(1)(a) sentence 2 no. 1 German Banking Act) or investment advice (section 1(1)(a) sentence 2 no. 1a German Banking Act) does not apply due to the lack of classification of Schuldschein loans as financial instruments (see para. 92).

III. Eligibility for central bank use

87 Under section 6.2.2.1 (Credit claims) of the Guideline of the European Central Bank of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem Schuldschein loans are explicitly recognised as eligible (non-marketable) securities.[165]

88 The following admission criteria have to be met:

- The credit claim may not afford rights to any subordinated claims.
- The credit claims must have a fixed principal amount and unconditional repayment and a coupon that cannot become negative. Discounted zero coupon, fixed-rate coupon and floating-rate coupon claims linked to an interest reference rate are accepted.
- Debtors may be public-sector entities, international or supranational organisations or non-financial undertakings.
- The debtor must be established in the euro area.
- The minimum size for cross-border use of the security is €500,000.
- No more than two governing laws may be agreed as binding.
- The debt instrument must be denominated in euros.

89 Additional requirements also have to be met for credit claims, such as notification of the debtor, the absence of restrictions in relation to creation of security or realisation of the credit claim and the

163 Schürmann, in: *Bankrechts-Handbuch*, s. 69 para. 9.
164 See Schäfer, in: Boos/Fischer/Schulte-Mattler, *Kreditwesengesetz*, s. 1 para. 51.
165 See footnote 57 of the *Guideline of the European Central Bank of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem*.

absence of restrictions related to banking secrecy and confidentiality.[166] Apart from this, the credit standards for non-marketable assets under section 6.3.3.1 point b of the Guideline of the European Central Bank of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem also apply. A credit claim is only eligible if it has a credit assessment accepted by the Eurosystem. Under section 6.3.1 of the Guideline (regarding the scope and elements of the Eurosystem credit assessment framework) the minimum acceptance threshold for external authorised rating agencies is BBB- by Fitch and Standard & Poor's, Baa3 by Moody's and BBB by DBRS.[167] The rule is that the best rating applies.[168] If borrowers are not externally rated, the in-house credit analysis process of Deutsche Bundesbank may be used as one of the permitted credit assessment systems.

IV. Prospectus requirement and public offerings

90 As described under para. 1, Schuldschein loans are not securities but loans. It follows from this that they are not securities under the terms of section 2 no. 1 German Securities Prospectus Act (*Wertpapierprospektgesetz* – WpPG) and therefore do not fall under the requirement to issue a prospectus under section 3 Securities Prospectus Act or the rules on liability under sections 21 et seq. Securities Prospectus Act. In contrast to debt securities issued as registered notes (*Namensschuldverschreibungen*), Schuldschein loans also do not fall under section 1 of the German Investment Products Act (VermAnIG) either. Documents used for marketing Schuldschein loans can nevertheless be subject to general prospectus liability under civil law. Such documents often include a disclaimer in order to reduce the risk that marketing documents fall under the civil-law definition of a prospectus.[169] In view of the rules relating to the deposit business (see para. 81 et seq.) it would also be conceivable to take out a Schuldschein loan by way of a public offering.

91 As they are not classified as securities under section 2(1) German Securities Prospectus Act Schuldschein loans (and the associated Schuldschein certificates) do not fall under the limitations of the German Securities Trading Act (*Wertpapierhandelsgesetz* – WpHG). However, short-term Schuldschein loans are to be classified as money-market instruments (section 2(1)(a) German Securities Trading Act).[170] Where Schuldschein loans are not traded on organised/regulated markets, most of the rules under the German Securities Trading Act in relation to money-market and financial instruments do not apply to Schuldschein loans.[171]

92 Finally, Schuldschein loans also do not fall under the definition of "financial instruments" in section 1(11) German Banking Act since they do not qualify as debt instruments (*Schuldtitel*) or securities (*Wertpapiere*).[172] Consequently, the safekeeping and management of Schuldschein certificates does not constitute banking business under section 1(1) sentence 2, no. 5 German Banking Act (deposit business) and the rules of the German Securities Deposit Act (*Depotgesetz* – DepotG) do not apply.[173]

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166 Section 6.2.3.1 (Additional legal requirements for credit claims) of the *Guideline of the European Central Bank of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem.*

167 See footnote 63 of the Guideline of the European Central Bank of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem. Also European Central Bank, 'Collateral Eligibility Requirements a Comparative Study Across Specific Frameworks' (July 2013, p. 14).

168 Footnote 76 of the Guideline of the European Central Bank of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem.

169 Wehrhahn, *BKR* (2012) 364 et seq.

170 See Art. 4 BaFin-Merkblatt – 'Hinweise zu Finanzinstrumenten nach § 1 Abs. 11 Sätze 1 bis 3 KWG (Wertpapiere, Vermögensanlagen, Geldmarktinstrumente, Devisen und Rechnungseinheiten)' (as at: August 2012) and Deutsche Bundesbank, 'Merkblatt über die Erteilung einer Erlaubnis zum Erbringen von Finanzdienstleistungen gemäß § 32 Abs. 1 KWG' (as at: April 2013) p. 8.

171 Wehrhahn, *BKR* (2012) 365.

172 See Schäfer, in: Boos/Fischer/Schulte-Mattler, *Kreditwesengesetz* (s. 1 para. 217 et seqq. in relation to registered notes (*Namensschuldverschreibungen*)).

173 Wehrhahn, *BKR* (2012) 365.

V. Banking secrecy

93 There are no legal provisions or legal definitions relating to banking secrecy.[174] However, for banking customers, the right to "free development of personality" (Article 2(1) Basic Law for the Federal Republic of Germany (*Grundgesetz* – GG)) and for the bank itself the right of "occupational freedom" (Article 12 Basic Law) come into question as constitutional foundations.[175] The basis of banking secrecy under civil and customary law is found in the obligation to show consideration to the other party's rights, legal interests and other interests (section 241(2) German Civil Code (BGB))[176] under the contractual relationship arising when the business contract is initiated as per section 311(2) no. 1 German Civil Code. A contractual basis such as that found in the general terms and conditions of banks only has a declaratory significance.[177] Thus the bank is under an obligation to maintain comprehensive confidentiality, even in the absence of an express agreement, as a particular embodiment of the principle of good faith which even exists if the individual business transaction does not come about.[178]

94 The duty of confidentiality covers all facts and evaluations based on these facts for which the client wishes confidentiality. The actual will of the client is also binding if there is no reasonable interest in confidentiality[179]. Bank customers may also release the credit institution from the obligation to maintain banking secrecy at any time. This release does not have to be in written form and may also by implied by the customer's behaviour.[180] Facts that are no longer confidential do not have to be kept secret, which means that interpretation is called for in each individual case. It is not likely to be deemed sufficient if the data is known to a range of people inside and outside the bank.[181] Instead, what matters will be that confidential information is known to a broad section of the public, or at least to "the market".

1. Assignments and banking secrecy

95 When a Schuldschein loan is assigned, the assignee can only be informed in detail if the borrower has released the arranging or assigning bank from its duty to maintain secrecy. Such permission is either necessary of the loan agreement itself or must be given afterwards.[182] Thus passing on the borrower's data or data of the Schuldschein loan without the borrower's consent essentially constitutes a breach of banking secrecy. Frankfurt Higher Regional Court (*OLG Frankfurt*) assumed in a decision that banking secrecy prevents assignment in consumer loans – unlike in bilateral commercial transactions.[183] However, the Federal Court of Justice (*Bundesgerichtshof* – BGH) came to a clear-cut decision that neither banking secrecy nor the Federal Data Protection Act (*Bundesdatenschutzgesetz* – BDSG) can prevent an effective assignment.[184]

96 The duties of information under section 402 German Civil Code (BGB) may still breach banking secrecy despite a valid assignment (or a valid assumption of contract). The consequences under civil law can be a claim for damages in which the bank breaching the requirement of banking secrecy is liable for breach of obligation if the breach is intentional or negligent (section 280 German Civil Code).[185] However, it

174 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 1.
175 Eckl, *DZWIR* (2004) 221 et seqq.
176 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 8.
177 Eckl, *DZWIR* (2004) 221 et seqq.
178 Bunte, in: *Bankrechts-Handbuch*, s. 2 para. 11.
179 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 10.
180 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 31.
181 Eckl, *DZWIR* (2004) 221 et seqq.
182 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 94.
183 Frankfurt Higher Regional Court (*OLG Frankfurt*), judgment 8 U 84/04 of 25/05/2004.
184 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 60.
185 Eckl, *DZWIR* (2004, 221 et seqq.). According to Eckl, liability under sections 823 et seqq. German Civil Code is also conceivable since the breach of banking secrecy may constitute a breach of the general right to free development of

can be very difficult to prove losses since not every disadvantage arising as a result of the breach of banking secrecy is eligible for compensation.[186] The bank's customer has to be put in the position they would be in if the breach of the duty of confidentiality had not occurred (the standard in section 249 German Civil Code).[187] One tool, which will normally come too late, is the right to insist that the bank refrains from passing on the information.[188] In addition, one opinion put forward in the legal literature[189] is that under the standardised terms and conditions for banks (*AGB-Banken*) a bank customer is entitled to give notice for good cause. If the standardised terms and conditions for banks have not been agreed, such a right may be derived from the principle of good faith (*Treu und Glauben*),[190] although its use will certainly be more restricted that the general terms and conditions for banks.

97 In contrast, a breach of banking secrecy is permitted if a distressed loan is involved or, more generally, the borrower fails to meet its duties under the loan agreement, provided that this breach of duty is more serious than the piercing of banking secrecy. However, a loan is only distressed if the bank is entitled to early terminate it. This is especially the case if the borrower has breached its payment obligations under the loan. The justification behind this is to protect the bank's legitimate interests, since it will have to (and is permitted to) present the data in public proceedings if the matter is brought to court.[191]

98 Whether a borrower who has already given its consent to assignment in a Schuldschein loan has given its implicit consent to a release from the duty of confidentiality at the same time is open to question. This has probably to be answered in an affirmative way, since in contrast to a traditional loan it would otherwise not be possible to circulate the Schuldschein loan if the assignment is allowed but the necessary release from banking secrecy has not been given and may lead to claims for damages under civil law.[192] Due to the fact that in Schuldschein loans the assignment is usually restricted in such a manner that only minimum amounts of €500,000 or €1m can be assigned, it could be argued that this also applies by analogy to banking secrecy. In normal circumstances this should go hand-in-hand, although circumstances exist such as "re-packaging" of individual Schuldschein loans in notes or sub-participations where the confidential data may be disclosed to the assignee but the assignee also wants to disclose it to the holders of the notes and/or its own sub-participants. It must also be possible to argue that passing on the confidential data is allowed even where lower sums are involved, since the assignee has a legitimate interest (see para. 97 et seq.) in settling its obligations under the Schuldschein loan and relieving its balance sheet, for instance. In addition, assignment restrictions relating to a minimum amount are usually not aimed at not disclosing the confidential data to another group of persons; instead, their aim is to keep the administrative burden as low as possible and to limit the investor group to institutional investors. These objectives are not put at risk by re-packaging or sub-participations provided that the notes re-packing the Schuldschein loan are only sold to institutional investors. But if they are listed on a stock exchange or sold to non-institutional investors as well, the question of whether a duty of confidentiality exists arises again. It is then necessary to weigh up the interests of the borrower and those of the assignee. In this case, preventing re-packaging or sub-participations in smaller amounts as well is not to be regarded as a specific interest on the part of the borrower. Furthermore, it does not entail any extra administrative work by the borrower and the data in

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personality (*allgemeines Persönlichkeitsrecht*) or the right to an established and active business (*eingerichtetes und ausgeübtes Gewerbebetrieb*). Likewise: Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 300.

186 Eckl, *DZWIR* (2004) 221 et seqq.

187 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 306.

188 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 308.

189 Eckl, DZWIR (2004) 221 et seqq. Likewise: Krepold, in: Bankrechts-Handbuch, s. 39 para. 310.

190 See Berger, in MünchKommBGB, s. 490 para. 49.

191 Krepold, in: *Bankrechts-Handbuch*, s. 39 paras 58a and 59 et seqq.

192 Similar to cheque certifications, Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 37.

the Schuldschein loans is intended to be circulated on the market anyway, as mentioned above.[193] Besides this, it is difficult to see what damage could be incurred by the borrower from such a construction. Even an assignment to an assignee who could carry out dubious enforcement measures based on the applicability of another regulation[194] should not lead to losses since the conflict of laws rules provide comprehensive safeguards for such situations. Despite this, the safest basis for re-packaging or sub-participations is always an explicit consent to transmission of data by the borrower.

99 Finally, especially where Schuldschein loans are being re-packaged, it is questionable whether banking secrecy is applicable at all if the loan is a special purpose vehicle (not connected to a bank) or was assigned to another company.[195] In such a case, a duty of confidentiality arising from the principle of good faith in general business dealings may still exist, although the bars will be considerably lower than those for banking secrecy. Although the protection afforded by banking secrecy rules also applies for the bank, it only applies to the extent intended to protect the customer.[196] Due to the constitutional foundations of this safeguard (and likewise that provided by privacy rights) it is questionable whether these protective rules apply to Schuldschein loans that are subject to German law but do not have any German contracting partners anyway.

100 No criminal-law consequences are to be expected from an assignment breaching the requirement of banking secrecy since in Germany there is no comprehensive protection of banking secrecy under criminal law[197] and section 203(2) German Criminal Code (*Strafgesetzbuch* – StGB) is not applicable to publicly owned banks.[198] Section 17 of the German Act against Unfair Competition Act (*Gesetz gegen den unlauteren Wettbewerb* – UWG) might apply within narrow boundaries. Apart from this, the person disclosing the confidential data may be subject to penalties under employment law.[199] A responsible supervisory authority could also demand that the bank make organisational changes in order to prevent confidential data being passed on in a similar way in the future.

2. Assignment and eligibility for central bank use

101 One of the conditions for use of Schuldschein loans by a central bank is the lack of restrictions arising from banking secrecy (see para. 89). Krepold[200] is correct in this respect when he assumes that the use of Schuldschein loans as security in the European System of Central Banks cannot fail due to the will of an individual borrower and that such use has to be tolerated a socially acceptable use of the borrower's refinancing.

193 At the same time this is linked to the question of whether the data is still confidential anyway. If this is not the case, it is no longer necessary to keep it confidential. However, this does not mean that the borrower is able to take action against the party who has breached confidentiality against its express or implicit will.
194 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 62.
195 Similarly Rosch, in: *jurisPK-BGB*, s. 399 *BGB*, para. 24.
196 See Eckl, *DZWIR* (2004) 221 et seqq.
197 Eckl, *DZWIR* (2004, 221 et seqq.).
198 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 60.
199 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 311 f.
200 Krepold, in: *Bankrechts-Handbuch*, s. 39 para. 298.

Paying agent and registrar

G. Paying agent and registrar

102 In a Schuldschein loan the role of a paying agent is essentially no different to that in a bond issue (see chapter 9). The agent's main task is to pass on principal to the borrower by the arranger or investors or payments of interest and capital to the lender or lenders and to convey certain notifications to the parties.[201] Unlike in bearer bonds, the payments under Schuldschein loans are made by the paying agent to the parties directly and not to the clearing system. The nature of the contract as a non-gratuitous agency agreement (*Geschäftsbesorgungsvertrag bei Entgeltlichkeit*)[202] as well as the liability and indemnification arrangements are mostly identical to those in bonds (see chapter 9).

103 To be able to meet its duties to pay interest and principal to the lender(s), the paying agent has to know their identity and bank account details. This is why the registrar function is also provided for in many Schuldschein loans.[203] The registrar, who is usually also acting as paying agent, is responsible for keeping a register in which all the creditors have to be entered. It is often contractually agreed that the paying agent only has to treat those entered into the register as creditors. Apart from this, there is often an agreement determining a cut-off date by which a transfer has to have taken place, since otherwise the paying agent (and therefore the borrower) has the right to make payments to the assignor in discharge of the debt. This cut-off date is mostly one or two weeks before the relevant interest payment date or redemption date. The cut-off date provision may be regarded as a deviation from section 407 German Civil Code (BGB) in the context of freedom of contract; at the same time, it may be seen as a contractual prohibition of assignment under section 399 German Civil Code. The result is the same in both cases, although under section 242 German Civil Code the paying agent will not be able to pay automatically to the assignor, even if it is notified late. Firstly, it is a contractual "can" rule and, secondly, certain conditions must exist hindering the paying agent in order to make a payment to the assignor despite the assignment. This may apply for example if the paying agent is notified on the Friday evening or weekend before the interest payment meaning, that a payment order already entered for Monday morning cannot be changed in time.

104 The notification to the registrar (and if applicable to the paying agent) regarding the assignment usually fulfils the requirements of section 409 German Civil Code since the registrar and paying agents are the borrower's agents. The explanations here regarding assignment can be applied by analogy to the assumption of contract (see para. 75 et seqq.).

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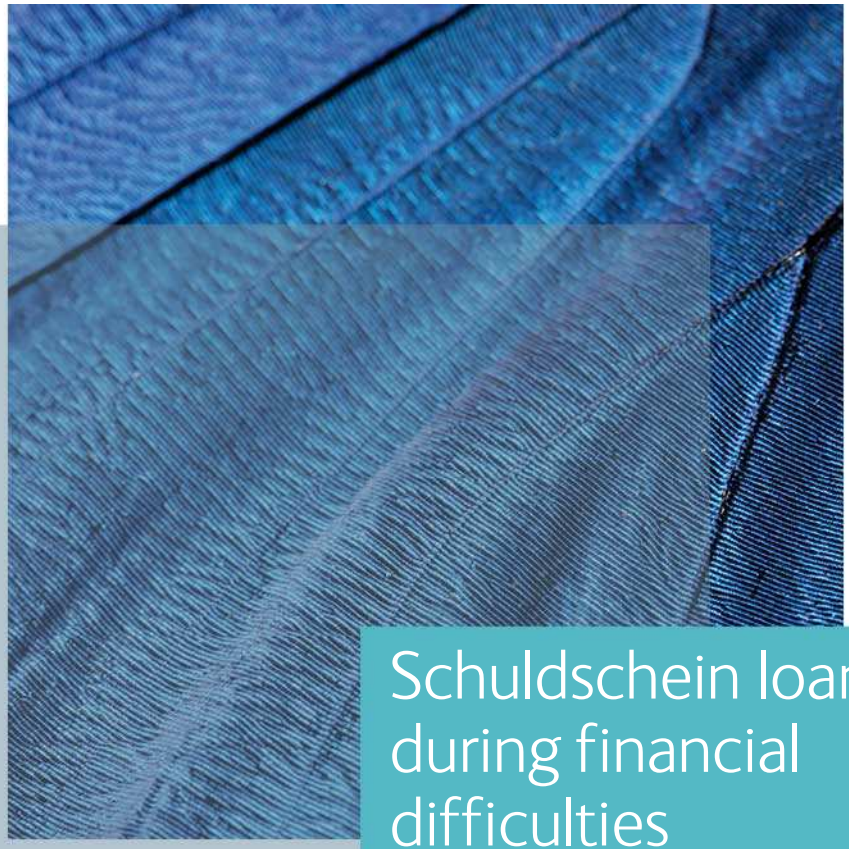
201 See auch Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, s. 21 para. 113 et seqq.

202 Wehrhahn, *BKR* (2012) 366.

203 In other cases these functions are performed by the paying agent directly.



Schuldschein loans during financial difficulties

H. Schuldschein loans during financial difficulties

105 If a company is suffering from financial difficulties, Schuldschein loans can make restructuring more difficult. In contract to syndicated loans where there is a possibility to attain majority decisions by the creditors with Schuldschein loans every lender has to be viewed in isolation. Whereas in syndicated loans it is possible to waive the right to terminate in the event of a covenant breach, usually by majority decision (waiver), each individual Schuldschein creditor is able to give notice themselves and request repayment.[204] This can lead to obstructions by individual creditors during the restructuring process.[205] In the assignment model this is aggravated by the fact that the original lender (mostly the arranger) always has to cooperate in the restructuring since it continues to be a party to the agreement.[206] This duty to cooperate arises because restructuring is mostly implemented by an amendment agreement that restructures the entire loan and because such an agreement can only be entered into by the final lender with the borrower. In addition, the final lender's cooperation is necessary because without its consent the changes are ineffective under section 185(1) German Civil Code (BGB). The initial lender is no longer the holder of the liability as a result of the assignment(s) and is therefore not authorised to dispose over the loan. However, each of the final lenders is alone responsible for the share held by it in the Schuldschein loan and can therefore agree to or reject (non-comprehensive) restructuring plans, for instance by granting a respite or similar.[207] This makes the process considerably more difficult when the borrower is in financial difficulties since it has to reach an agreement with each individual creditor. The arranging bank sometimes plays a moderating role in the coordinating process during a crisis, especially in the assignment model. Financial incentives determined by the debtor such as payment of an additional fee for the lender's consent may be helpful here.[208]

106 Apart from this, it may be helpful to look at whether termination can be used by the creditors as a means of pressure anyway. On the one hand, grounds for termination have to exist (e.g. a breach of covenant) and, on the other, it may constitute a wrongful exercise of a right. Various legal bases for this are stated in the legal literature[209], especially untimely termination (*Kündigung zur Unzeit*). This is set down as a secondary obligation and as duty of loyalty for all kinds of contracts in sections 627(2), 671(2), 675(1) and 723(2) German Civil Code. Untimely termination is given if it comes "out of the blue", i.e. without any prior warning and without the giving the borrower the chance to refinance, or if a rescue plan is put at risk if the rescue does not appear so futile that grounds for extraordinary termination would exist. Untimely termination does not lead to the notice of termination being ineffective; instead the creditor giving notice is liable for damages[210] covering reimbursement of the legal costs and, if applicable, higher interest costs for the refinancing required as a result of the termination.[211] Another legal basis which can lead to the termination being wrongful is the prohibition of excessive damage where the relationship between the benefit to the party giving notice and the disadvantage suffered by the borrower is grossly disproportionate. A notice of termination may also be ineffective on account of contradictory behaviour or if there are no doubts that the enforcement of the security is sufficient.[212]

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204 See Weiß, *Corporate Finance Law* (2010) 64 et seq.
205 Hessling/Theiselmann, *Forderungspraktiker* (2010) 228 et seq.
206 See Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, Unternehmensfinanzierung am Kapitalmarkt, s. 21 paras 104 and 125.
207 Mülbert/Bernauer, in: Habersack/Mülbert/Schlitt, Unternehmensfinanzierung am Kapitalmarkt, s. 21 para. 104.
208 Weiß, *Corporate Finance Law* (2010) 65.
209 Hessling/Theiselmann, *Forderungspraktiker* (2010) 229; Weiß, *Corporate Finance Law* (2010) 65.
210 Hessling/Theiselmann, *Forderungspraktiker* (2010) 229; Weiß, *Corporate Finance Law* (2010) 66.
211 Theiselmann, *GmbH-StB* (2012) 53.
212 Weiß, *Corporate Finance Law* (2010) 65 et seq.

107 However, all of the limitations on termination described above are exceptions to the rule, which is why other restructuring methods must be used in practice. If the negotiations with the lenders do not lead to success with all of them, i.e. to a waiver or an amendment of the contract, this does not mean that an existing right of termination will actually stand up in court.[213] Another alternative for stabilising a Schuldschein loan is to combine the loan with other financing instruments, to share security with other facilities[214] or to refinance it using alternative forms of financing. Replacing obstructive creditors in order to allow for restructuring on as broad a basis as possible is also an alternative when adjusting the contract.[215] Including provisions on creditor majorities is possible, although this would be foreign to the nature of the Schuldschein loan as an instrument which is as concise as possible and supported by a legal framework.

213 'De-facto standstill agreement; Weiß, *Corporate Finance Law* (2010) 66.
214 Weiß, *Corporate Finance Law* (2010) 66.
215 Hessling/Theiselmann, *Forderungspraktiker* (2010) 229.

Summary

I. Summary

108 The Schuldschein loan is a compact instrument governed by German law with features similar to those of capital markets instruments and which is mainly based on legislative provisions. It has proved to be particularly suited to borrowers with a high credit standing since the legislative provisions are sufficient and no debtor-specific adjustments are necessary. Nevertheless, the Schuldschein loan is increasingly spreading to companies without a rating or without an investment-grade rating and in the international market. Although this trend is leading to material changes in the ideas underlying the Schuldschein loan, these changes still are nowhere near the comprehensive provisions of standardised syndicated loans. It is important especially for international investors to familiarise themselves with the specifics of the German Civil Code (BGB) and case law such as statutory termination rights and prohibitions of assignment to be able to accurately assess all the risks of their investment.

109 Up to now no common standard has emerged in day-to-day practice (in Germany),[216] although with the direct and indirect procedures for placement as well as assignment and assumption of contract generally accepted processes have been created when transferring Schuldschein loans. Due to their contractually enhanced fungibility, Schuldschein loans represent a particularly interesting instrument for entering the capital market. For this reason, Schuldschein loans are often regarded as a precursor to a bond issue.

Translated from the German original text by Sarah Farnworth.

216 See Wehrhahn, *BKR* (2012) 366.

Contact sheet

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