

Streamlining post-deal German M&A

Author: | Published: 11 Dec 2013

How loan-portfolio acquirers in Germany can avoid post-acquisition troubles

After acquiring a portfolio, buyers may face substantial troubles in two regards: when enforcing the portfolio claims against the portfolio debtors, and asserting claims under the representations and warranties against the portfolio-seller. Such troubles in particular arise if the portfolio has been sold a number of times already. In this context, it is important to reflect on how to handle and avoid such troubles by appropriate provisions in the loan sale and purchase agreement (LSPA).

The buyer will usually have the opportunity to perform a due diligence review of the portfolio. However, large portfolios can consist of more than 1,000 loans, and therefore the review of each loan relationship may not be practically possible, or the buyer may not be willing to invest the necessary time and cost. This often results in reviewing a sample of loans only.

In addition to the review of the loan files, the buyer will get a database of the portfolio, known as the data tape. Such data tape includes information as to all loans and debtors (anonymised in case of performing loans), such as the outstanding receivable amount, interest rate, encumbrances, kind and location of the encumbered real property. On the basis of such information, the buyer will determine the purchase price for the portfolio.

The portfolio will then be transferred to the buyer at closing. The transfer of receivables and collateral of non-performing loan portfolios will often be effected by singular succession (*Einzelrechtsnachfolge*) without the debtors' consent by separate transfer forms for each receivable and collateral (so more than thousand transfer declarations may have to be signed at closing). At the closing date the complete portfolio documentation, in particular the mortgage deeds and enforceable copies (*vollstreckbare Ausfertigungen*) have to be delivered to the buyer. To the extent the respective documents are not in the possession of the seller, the seller will assign its claims for delivery against the third party possessors to the buyer. Given the multitude of declarations and documents which have to be exchanged at completion, it is obvious that at the closing date the buyer will not be able to check whether such declarations and documents are complete.

Potential post-acquisition problems

After acquisition of a portfolio, problems often arise upon entering into enforcement measures when a loan has become non-performing.

The portfolio documentation, for example, may not be complete. Should mortgage deeds be missing, the buyer may not be able to get a new (further) enforceable copy of the mortgage deed as issuing such a copy is restricted under German law. Without the initial enforceable copy of the mortgage deed, the mortgage may not be enforced by the buyer. The reason for a missing mortgage deed may be that the deed is still in the possession of a legal predecessor of the seller, or has already been filed with an enforcement authority. In fact, it might well be that it cannot be investigated where the deed is actually located.

In such cases it is of no use to the buyer if the seller has assigned its claims for delivery against the third party possessors to the buyer, since such claims cannot be asserted against an unknown third party.

In the event a mortgage certificate (*Grundpfandbrief*) is missing, this may also prevent the buyer from enforcing the mortgage as the debtor will be entitled to object to such enforcement.

Portfolios on the market have often been sold a number of times already, meaning a buyer is not acquiring the portfolio from the original creditor but from such original creditor's legal successors. To save registration costs, in some cases the transfer of a mortgage may not have been registered with the land register so that the seller disposing of such mortgage may not be the registered owner. If the seller or its predecessors are not the registered owners of a non-certified mortgage (*Buchgrundpfandrecht*) the consent of the original creditor or its successors, as the case may be, to the registration of the seller is necessary. Without such consent, the buyer may not be able to realise the mortgage.

"From the buyer's point of view, the LSPA should contain a specific mechanism allowing the binding determination of the damage occurred"

The assignment declarations, by which the seller has assigned the portfolio mortgages to the buyer, may include incorrect mortgage details, or assignment declarations signed by seller's predecessors may be incorrect or missing. If the buyer then wants to initiate enforcement proceedings as legal successor of the title to the mortgage, it has to provide evidence of such legal succession to the competent public notary to obtain an enforceable copy of the mortgage deed. Should the assignment declarations be incorrect or missing, such evidence cannot be presented.

The data tape information could be incorrect. Although this does not hinder the enforcement, the proceeds the buyer will realise out of such enforcement could be much lower than expected by the buyer when having calculated the purchase price for the respective portfolio asset. If, for instance, the encumbered real estate is supposed to be a multi-family house pursuant to the data tape, the purchase price paid for such asset would not be appropriate if it turns out that in fact an agricultural area without buildings has been encumbered.

The need for specific contractual provisions

In principle, all of the potential problems described above are identifiable within legal due diligence. So such due diligence should precede any acquisition of a loan portfolio. Otherwise, it will hardly be possible to appropriately cover the risks associated with a portfolio by standardised contractual provisions only, without specific protective provisions based on the due diligence findings. However, as set out above, in particular when acquiring a large portfolio it is frequently not feasible to review all loan engagements. Therefore, it cannot be excluded that the sample of loans actually reviewed will not reveal all portfolio risks.

Customary reps and warranties in LSPAs often do not cover the post-acquisition problems described above. Particularly in non-performing loan transactions, the reps and warranties granted by seller are in most cases rather limited. There may be, for instance, no warranty protection for the completeness of the portfolio documentation or the

correctness of the data tape information. Therefore, the respective risks might not be covered by the warranties at all. In addition, the damage claims under the reps and warranties are usually subject to liability limitations, such as *de minimis* rules or threshold amounts excluding seller's liability if the agreed amounts will not be reached. In principle, a cap will also apply limiting the liability to a certain maximum amount. In some of the cases described above (for example, if portfolio documents are missing or the data tape information is partly incorrect) it could be questionable whether the agreed threshold amounts have actually been exceeded. So the buyer could have bought a portfolio asset for a significant purchase price but is not able to realise such asset because a portfolio document of supposedly minor importance is missing.

In addition, the buyer is in general not primarily interested in secondary claims for monetary damages under the reps and warranties, but to remediate the specific problem in order to realise the respective portfolio asset at short notice. Therefore, it is necessary to cover such problems by specific covenants and ancillary obligations of the seller. To some extent, usual provisions in LSPAs contain such covenants and obligations, but substantial gaps frequently remain. In many cases, the following issues are uncovered:

- The transfer declarations or registration approvals (*Eintragungsbewilligungen*) of the seller's legal predecessors as to the transfer of portfolio assets are missing or not sufficiently documented, whereas the seller provided all transfer declarations to be signed by itself (so the seller fulfilled its primary performance obligations). In this case the seller should also be obliged to procure all other missing approvals and transfer declarations of prior creditors (if necessary back to the original creditor).
- The mortgage certificates or mortgage deeds are missing and in the possession of an unknown third party. In this case the seller should be obliged to perform all actions necessary for the identification of the third party possessor and the issuance of a new certificate/deed if required.

From a buyer's perspective, such obligations of the seller should not be subject to any liability thresholds or caps. Ideally, the LSPA should further contain specific reps and warranties, in particular a guarantee that the substantial (value relevant) data tape information is correct and the portfolio documentation is complete. Any guarantee claims, however, would be subject to liability thresholds and caps.

Remedies in case of warranty claims, proof of damages

If there is a breach of contractual warranties, the assessment and proof of the buyer's damages might be difficult. This is particularly so if the respective breach (defect) precludes the buyer from initiating foreclosure measures. This might be the case if the buyer is unable to prove its legal title to the respective portfolio asset (mortgage) due to missing portfolio documents or a defect to the chain of title. In such a case, the buyer cannot realise the asset, and under customary provisions in a LSPA it would have to prove which damage incurred to it in connection with the respective warranty breach. For example, the buyer would have to prove which proceeds it would have realised out of the asset without the warranty breach. The amount of such realised proceeds might be quite unclear. First, before the execution of foreclosure measures it is unclear which realisation proceeds the buyer will actually receive out of the realisation of the defect portfolio asset. Second, it is unclear which proceeds the buyer would have realised if there would have been no defect to the portfolio asset.

A concrete calculation and proof of the actual damage is hardly possible, and the burden of proof lies on the buyer. Therefore, from the buyer's point of view, the LSPA should

contain a specific mechanism allowing the binding determination of the damage occurred. Such mechanism needs to ensure that potential future realisation proceeds are taken into account when calculating the buyer's damage, whereby no proof of such damage in accordance with the requirements of formal German procedural law should be required. A possible mechanism could be established as follows:

- The buyer provides an estimate of the expected net proceeds (ie the expected realisation proceeds less any costs and expenses for the respective portfolio asset). If the buyer does not expect any proceeds (for example, if the defect to the portfolio asset does not allow the realisation at all) the estimated realisation amount can also be zero.
- Thereafter, the seller will be entitled to review the estimate provided by the buyer and to raise objections. If the seller agrees to the buyer's estimate or fails to object, the buyer's estimate will be final and binding on both parties. If the seller objects to buyer's estimate and the parties cannot agree on the items in dispute, either party may refer the matters in dispute to a jointly appointed expert. Such expert will then prepare the final estimate with binding effect for both parties.

The seller then owes monetary damages in the amount of the purchase price paid for the respective portfolio asset less the net proceeds already realised and the binding estimated future proceeds. However, the seller's liability is often excluded as to lost profits of buyer and limited to the received purchase price. Therefore, any profit expectation of the buyer will in general not be compensated.

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