

THE UNSUCCESSFUL THREAT TO SECOND LIEN FINANCINGS IN GERMANY – THE PRIMACOM CASE*Lars Westpfahl and Steffen Bressler*

^{LT} Allocation of jurisdiction; Debt restructuring; Exclusive jurisdiction; Germany; Jurisdiction clauses; Loan agreements

The 2000 “war chest facility”

PrimaCom entered into the cable business in the 1990s. In 2000, in the face of expected radical changes to the cable TV and internet market, PrimaCom spotted its opportunity to become one of Europe’s leading cable providers. Having previously acquired several cable TV companies, in September 2000, at the height of industry euphoria, PrimaCom planned to acquire a large Dutch provider of media and communication services. PrimaCom needed cash for such a substantial transaction and to guarantee further significant growth, PrimaCom could have chosen safe and robust financing structures that would have afforded it protection from the vicissitudes of the market. Yet PrimaCom decided to go down a far more aggressive avenue. Rather than enter into a long-term financing arrangement, it agreed to a senior credit facility (with an almost all-embracing security package), together with a working capital facility that it was intended would be replaced by a high yield bond offering within a short period. Whilst this did not provide a stable or permanent capital structure, it did create the potential for shareholders to maximise their opportunity for a considerable profit.

First stage restructuring

In 2000 and 2001, PrimaCom continued to implement its growth strategy through acquisitions funded by third-party finance and several other acquisitions of German and Dutch cable TV operators in 2001. However, this expansion took place at a time when the technology boom had clearly peaked. The market’s perception of such cable TV businesses had become unfavourable and the European debt market had weakened to the extent that, by the first quarter of 2002, it had become virtually impossible for a cable TV business in Europe to get financing. Interest rates for leveraged loans to European borrowers in the telecommunications and cable TV sector rose sharply. Thus, towards the end of 2001, PrimaCom was unable to place a bond or to refinance the working capital facility. Worse still, PrimaCom’s financial situation had not only deteriorated but had become unstable. Operating losses were reported and the stock had fallen dramatically. Given the obligation to draw down the working capital facility in full and use the proceeds to pay the senior facility in advance, PrimaCom was at serious risk of defaulting under both the working capital and the senior facility, which would have led to inevitable insolvency.

Against this background, and after lengthy and protracted negotiations, a “first stage restructuring” (to put it mildly) was put in place. Most importantly, the working capital facility was replaced by a second lien financing with a significantly reduced cash interest burden. Financial covenants in both the new facility and the (old) senior facility were set at levels which were intended to give PrimaCom greater flexibility. These changes reflected the underlying desire of all the parties to put in place a

facility that would enable PnmaCom to turn around its business, refinance its balance sheet, and execute its business plan. Most importantly, the equity interest of shareholders remained intact.

Like the (old) senior facility, the new facility was governed by English law and provided for the exclusive jurisdiction of the English courts.

Failure of next restructuring attempt

During 2003/2004, PrimaCom's financial stability worsened. In particular, the continuing depreciation in the value of the cable sector made it necessary for PrimaCom to adjust the value of its holdings downwards by a considerable margin. Several requests by PrimaCom to its second secured lenders for an extension of time for the payment of interest due made it clear by the end of 2003 that the attempt that had been made in 2002 to give PrimaCom an opportunity to turn around its business had failed, and that there was no option other than to embark upon a full restructuring of PrimaCom's finances. Incidentally, this problem was not unique to PrimaCom - many other cable and telecommunications businesses underwent radical recapitalisations.

At Primacom's invitation, its second secured lenders proposed a plan whereby the entire (second secured) debt would, in effect, have been converted to equity, with PrimaCom's shareholders receiving a modest but reasonable cash return. The transaction was approved by PrimaCom's supervisory board and presented to the annual shareholders' meeting, together with an affirmative recommendation by Primacom's management. In the invitation, it was stressed that, due to Primacom's financial situation, there would be no alternative to the restructuring proposed. At the shareholders' meeting a majority voted in favour of the transaction, but the required majority vote of 75 per cent was not achieved. This was partly due to significant activism by one of the shareholders in advance of - and at - the meeting.

Challenges to the second secured facilities

The active shareholders also managed to be elected to the supervisory board. This caused most of the other members of the board to resign which, in turn, gave the remaining supervisory board the opportunity to push for dismissal of the previous management. This was the starting signal for a new strategy to be followed by PrimaCom. The next two interest payments were not made on time but, in order to prevent the standstill period from expiring, they were paid late on both occasions. No official reasons were given for late payment. However, it transpired that PrimaCom had commissioned an expert opinion on the validity of the second secured facility, in particular on its interest terms.

Initiation of tactical lawsuits in breach of contract

In December 2004, without any warning, PrimaCom began proceedings in the District Court of Mainz contesting the claims for interest by the second secured lenders. In supporting its challenge of the second secured facility, PrimaCom, inter alia, argued as follows: firstly, that the payment in kind and cash-interest margin of the second secured facility would breach German usury laws and, secondly, that its pledges,

covenants package and share option amount to equity control rendering the claims equity replacing. Shortly thereafter, PrimaCom began another set of proceedings in the District Court of Frankfurt contesting the validity of the share pledges. Whereas, in the statements of claim, PrimaCom, for good reason, did not even mention the exclusive jurisdiction clause, after having received the second secured lenders' statements of defence, it argued that the jurisdiction and governing law clauses were invalid due to allegations of duress, i.e. that these provisions were imposed upon them as a means of avoiding German principles of immoral lending.

Quite obviously, the German proceedings were opened in order to frustrate the second secured lenders' attempts to enforce their rights under the second secured facility and seek appropriate relief in the English court. This is in light of Art.27 of the Brussels Judgment Regulation which provides for a mandatory stay for courts other than that first seised where proceedings involve the same course of action and between the same parties. In addition, PrimaCom's management was trying to underscore their choice not to reflect the interest payment obligation when assessing its balance sheet and cash flow insolvency.

The response of the second secured lenders

By arguing that the jurisdiction and governing law clauses had been imposed on it as a means of avoiding German principles of immoral lending, PrimaCom was trying to have the German courts enquire into the substance of the matter, i.e. whether in fact economic power had been abused. This challenge, however, could only have been successful if the relevant provision of the Brussels Judgment Regulation (Art.23) allowed an implied abusiveness test. The second secured lenders argued that this was not the case and that there were unequivocal decisions by the European Court of Justice that a court would not be entitled to entertain this. By way of precaution they rejected on a factual basis the allegation of duress.

Against the usury challenge, the second secured lenders' argument was two-fold. Based on expert opinions by arguably the most reputable German authority on banking law and by an international investment bank, which calculated the effective annual interest of the loan and examined the market interest rate at the time of the facility's execution, they showed that interest rates were by no means usurious. Thus, they did not even have to resort to the fact that, due to the choice of English law to govern the contract German law could only apply via public policy considerations; in any event only with the effect of a reduction of the interest rate to a permissible level.

The equitable subordination challenge was rejected as well, again based on an expert opinion by a German law capacity. Whereas it is true that, in exceptional cases, German courts have extended the concept of equitable subordination even to non-shareholders, this has always been on the basis of shareholder-like influence on the borrower. By contrast, nothing in the second secured facility (including standard pledge agreements and standard covenant package) suggested such influence.

In return, the second secured lenders began proceedings in the English courts, the exclusive jurisdiction that the parties had agreed as part of the facility. First, they sought (and obtained) an injunction against the sale of certain PrimaCom assets;

secondly, they brought an action to obtain declarations on the validity of the interest and capital repayment provisions. They were aware of the high probability that, against background of Art.27 of the Brussels Judgments Regulation, the declaratory proceedings would be caught by a mandatory stay. It was, however, also intended to get the English court “first seised after the German proceedings were brought to an end. In fact, the English court stayed the declaratory proceedings, not without, however, strong language, characterising the German proceedings as an attempt to frustrate the second secured lenders’ efforts to seek appropriate relief in the English court.

Dismissal of German actions

It was only in September 2005 that the District Court of Mainz, at the end of the first hearing, dismissed the action for lack of international jurisdiction. Only days later, the same result was indicated by the District Court of Frankfurt. These outcomes helped to convince PrimaCom to enter into serious settlement negotiations.

Lessons learned

Internationally operating financial institutions insist on the exclusive jurisdiction of English (or New York) courts for disputes arising from and on English (or New York) law to govern loan agreements. They do so because both laws are well developed in the area of commercial lending and set clear guidelines on which both lenders and borrowers can rely. These standards are operated by a relatively robust court system, which has little time for frivolous litigation.

Whereas a pre-emptive claim by a desperate borrower may not be greeted sympathetically by an English court and it may excuse litigants from full “pre-action protocol” normally required in civil litigation, the Brussels Judgments Regulation and recent case law by the European Court of Justice create opportunities for tactical litigation created by the purely national and highly diverse litigation regimes in the Member States and the willingness of parties to take the benefit of those tactical opportunities. Desperate borrowers who try to win time by suing their lenders in a court that does not have jurisdiction will ultimately fail. However, there will be more cost, delay and uncertainty. This is especially true where a foreign court’s procedure may delay unreasonably the determination of its (lack of) jurisdiction, not least because it may be unable to separate the jurisdiction issue and the merits and therefore hold a full trial on jurisdiction and the merits rather hearing the jurisdiction debate as a preliminary issue. The other court may lack the expertise, experience and specialist procedures which give rise to choice of the exclusive jurisdiction court in the first place. Also, it may not be able to award costs to recompense the party that successfully challenges its jurisdiction, or may only award limited costs recovery. For example, the majority of legal fee costs cannot be recovered in Belgium and the Netherlands, and may not be recovered under the tariff system in Germany. Finally, the other court’s jurisdiction may have an automatic right of appeal from the decision at first instance so that, even if the first instance court declines jurisdiction in favour of the exclusive jurisdiction court, the other party could draw out the procedure further through an automatic appeal.

The most obvious antidote is to win the race to the courthouse, be the first to commence proceedings and to do so in the exclusive jurisdiction forum.

Another possible solution to get over the jurisdictional bar is to include an arbitration clause in the loan agreement. Admittedly, it is not ultimately resolved whether, if the borrower commences court proceedings in breach of an English arbitration clause, these court proceedings can be restrained by way of anti-suit injunction and legal certainty can only be achieved by referring the question to the European Court of justice. However, there is promising case law decided by English courts. If, as is often the case, a commercial lender is not enthusiastic about being forced to take a loan agreement to arbitration, a so-called hybrid arbitration/court clause could be considered, i.e. an arbitration clause that gives the lender the sole option to bring court proceedings in a jurisdiction of its choice.

On the substance, it should be taken into consideration that high return instruments such as high yield notes, second lien and even mezzanine financings to German borrowers are exposed to defences under German law such as the concept of usury and equitable subordination - even if the loan agreement is governed by English law. Although, absent extreme conditions, ultimately the defence will fail, the risk of costs and delay can be mitigated by documenting the assumed market rate and consideration for the pricing and carefully considering the structure of the financing.

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