Focus on Europe: Recent Developments Affecting Distressed Asset Investors and Lenders in Germany

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Impact on Investments from Proposed Changes in Law Governing Limited Liability Companies

The German limited liability company (*Gesellschaft mit beschränkter Haftung,* abbreviated "*GmbH*") is by far the most popular corporate form used by investors in German businesses. At the end of May, the German government published a draft Act on the Modernization of the Law on Limited Liability Companies and the Prevention of Malpractice (generally referred to as "MoMiG"). Once enacted, this law will be the most substantial reform in the 115-year history of the German Law on Limited Liability Companies and will have a very significant impact on future investments involving GmbHs. MoMiG is expected to become effective in the first six months of 2008. While changes to the draft may still occur, it is expected that fundamental reforms will be enacted.

Accelerating Incorporation

The MoMiG draft aims to facilitate and to accelerate the founding of GmbHs, mainly by providing for the following measures:

- Reduction of the amount of the statutory minimum equity (share capital) from €25,000 to €10,000; and providing for an "entrepreneur's GmbH" (*Unternehmergesellschaft (haftungsbeschränkt)*) that can be incorporated with less than the statutory minimum equity, but must save 25 percent of its annual profits until it has increased its share capital to the minimum equity amount.

- Standardization of the incorporation process by introducing templates for a company's articles of association and trade register application. Use of these templates will reduce founding formalities from full notarial recording of the articles of association to a mere certification of signatures.

- Acceleration of the registration process. An electronic trade register and online-filing were already introduced as of the beginning of 2007. The MoMiG draft further accelerates the registration of the GmbH in the trade register by abolishing the requirement that any permits required for the business of the company must have been granted before the GmbH can be registered.

Simplifying Share Purchases

MoMiG will ensure that the identity of a GmbH's shareholders is disclosed to the public. Existing laws already require the directors of a GmbH to submit a list of shareholders to the trade register when the company is founded, and to update the list in the event of a change in shareholders. Once submitted to the trade register, the shareholder list is available to the general public, so that the identity of the shareholders can be established. The MoMiG draft provides for further incentives to ensure that shareholder lists are kept up to date. This was not always the case in the past. Following a change of shareholders, the company is required to consider as shareholders only those persons who are on the shareholder list submitted to the trade register. Only such persons will be entitled to voting rights and dividends, so that buyers will need to ensure that the shareholder list is updated. The exercise of voting rights and other shareholder rights by a buyer will also be deemed valid if the updated shareholder list is submitted to the trade register immediately after the exercise of such rights.

MoMiG will enable a bona fide acquisition of GmbH shares from a person who is on the list of shareholders even if he or she is not the true holder of the shares. Under current law, a flaw in a chain of acquisitions bestowing title on an existing "shareholder" may make a share purchase from that person invalid. The MoMiG draft allows the buyer to acquire the shares even if the seller does not hold title, if the seller has been on the shareholder list submitted to the trade register for at least three years, no objection to the list was filed, and the buyer is not aware (or not culpably unaware) of the defect in the title of the seller. Under certain circumstances, a bona fide acquisition of shares is also possible under the MoMiG draft even if the seller has been on the shareholder list for less than three years.

Limiting Capital Maintenance Rules

Payment of funds by a GmbH to its shareholders is currently limited by capital maintenance rules aimed at preventing the distribution of share capital to shareholders. German courts have interpreted these rules broadly, which, among other things, restricts the ability of a GmbH to extend loans to shareholders and can impede the operation of an intercompany cash-management system designed to regulate intercompany loans. MoMiG leaves the capital maintenance rules in place but limits the scope of their applicability:

- A GmbH will be able to extend loans to a shareholder if its claim to repayment of the loan is valued at par (*i.e.*, the shareholder can be expected to repay the loan).
- Capital maintenance rules will not restrict payments to a shareholder under a "domination" or "profit and loss transfer agreement" (*i.e.*, an agreement whereby one company controlled by another agrees, principally for tax purposes, to channel net profits to the controlling company).

Facilitating the Repayment of Shareholder Loans

The MoMiG draft proposes to simplify the complex rules on shareholder loans that are currently in force:

- It provides for the subordination of all shareholder loans to the claims of ordinary creditors in any insolvency proceeding of the GmbH. The current distinction between shareholder loans granted while a company is already in financial difficulties (so-called "equity-replacing loans" or "equitably subordinated loans") and other shareholder loans will be redundant.

- Exceptions that have proved to be important specifically to distressed-debt investors will continue to apply: loans of a shareholder who holds 10 percent or less of the shares and is not a director of the company will not be subordinated. There is no subordination of loans if the lender buys shares of the GmbH while it is already in financial distress, with the aim of restructuring the company. "Financial distress" refers to the inability of the GmbH to settle its liabilities that are due (illiquidity), pending illiquidity or overindebtedness.

- The MoMiG draft allows GmbHs to repay shareholder loans prior to insolvency, even if the company is in financial difficulties. The only restriction is that, in a subsequent insolvency, the insolvency administrator will be entitled to set aside any repayment that occurred during the year preceding the insolvency application, and demand that the funds be returned to the estate. This is a major change to existing law, which prevents the repayment of equity-replacing shareholder loans for as long as the company is in financial difficulties, even if it is not insolvent.

Tax News: Deductibility of Losses and Interest Deduction Limitation

A newly-introduced German income tax law will have a very significant effect on distressed-asset investments and leveraged buyouts. The law restricts the deductibility of losses carried forward and limits the deduction of interest payable on debt financing by corporations that are subject to either full corporate or limited tax liability in Germany. The law is scheduled to become effective on January 1, 2008. The following new rules will apply.

If more than 50 percent of the share capital, the participation rights, or the voting rights in a corporation is transferred directly or indirectly to a buyer (or a party related to the buyer) within a five-year period, then losses carried forward by the corporation prior to such acquisition will no longer be deductible from its future earnings for tax purposes. If more than 25 percent of the share capital, the participation rights, or the voting rights is transferred within a five-year period, the corporation will not be able to deduct a pro-rata share of its carried-forward losses from its future earnings. These rules will also apply to situations comparable to a share acquisition (*e.g.*, a subscription to new shares issued by the corporation).

The new interest deduction limitation rules will apply to any form of debt financing (shareholder, related party and/or third-party financing) made available to an entity, regardless of whether it is a corporation or a partnership. Interest expense will be fully deductible up to an amount equal to the interest income generated by the entity in the same fiscal year. The deduction of further interest expense ("Net Interest") will be limited to 30 percent of the entity's EBITDA.

Net Interest, however, will be fully deductible if:

- It does not exceed €1 million in the respective year and, if the recipient is a shareholder or party related to a shareholder, if the interest payment is at arm's length.
- The entity does not belong to a group of companies, or belongs to a group of companies but is not included in the consolidated financial statements of the group, provided that not more than 10 percent of the Net Interest is paid to: (i) a shareholder who holds directly or indirectly more than 25 percent of the company's stock; (ii) any party related to the shareholder; or (iii) a third party who may take recourse to the shareholder or the related party.
- With respect to an entity that belongs to a group of companies and is included in the group's consolidated financial statements, the equity ratio of the entity as of the date of the previous balance sheet is equal to or higher than the equity ratio of the consolidated group, and not more than 10 percent of the Net Interest is paid by the entity to: (i) a shareholder who holds directly or indirectly more than 25 but less than 50 percent of the entity's stock; (ii) any party related to such shareholder; or (iii) a third party who may take recourse to such shareholder or the related party.

Can a Security Interest Created by a Global Assignment of Trade Receivables Be Challenged in the Assignor's Insolvency Proceeding?

The assignment of all existing and future trade receivables (referred to as a "global assignment") to a lender in order to secure loans is a very popular form of security in Germany. Various judgments of German Higher Regional Courts (*Oberlandesgerichte*), however, have in the recent past raised concerns of financial institutions involved in asset-based lending that such global assignments would not survive the insolvency of an assignor.

The courts lowered the threshold for avoidance of a security interest granted on receivables generated during the three-month period preceding the filing of an insolvency application with respect to the assignor (the most critical look-back period under German insolvency law). Specifically, the courts interpreted a provision of the German Insolvency Code to permit a challenge to security interests in receivables generated during the three-month look-back period as part of a global assignment if:

- The receivables were created in the last month before the insolvency application; or
- The receivables were created in the second and third months before the insolvency application, and (i) the assignor was unable to settle its due liabilities at the time, or (ii) the lender was aware that the assignment would disadvantage other creditors.

Because the most recent trade receivables (specifically, those created in the last month prior to the insolvency application) are the most valuable, these rulings substantially impair the security interest created by a global assignment and the asset base against which banks are willing to extend financing. Lenders have cause for hope, however, as some Regional Courts (*Landgerichte*) have refused to follow this approach. According to their view, an assignment of trade receivables generated during the three months preceding the filing of an insolvency application can be challenged only if the assignor is unable to settle its due liabilities at the time the receivables are generated and the lender is aware of the assignor's inability to do so. The risk that an assignment of recently created trade receivables can be challenged will be reduced significantly if the Regional Courts' view prevails. The question is the subject of an appeal to the German Federal Supreme Court (*Bundesgerichtshof*), the highest appellate court, which hopefully will resolve the issue by the end of 2007.

A detailed Jones Day Commentary entitled "German Tax Law: The New Rules Limiting Interest Deductions" can be found at http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4346.