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GERMAN BUSINESS RESTRUCTURING AND REORGANIZATION NEWS

CONTENTS

IMPACT ON INVESTMENTS FROM PROPOSED CHANGES OF THE LAW ON 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 resolved on a draft Act on the Modernisation 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 the fundamental reforms as such 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.

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

- Accelerating 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 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. 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 buyers will need to ensure that the shareholder list is updated.

- MoMiG will enable a bona fide acquisition of GmbH shares from a person who is on the list of shareholders even if he 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, 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, even within the course of a cash pool arrangement. MoMiG leaves the capital maintenance rules in place but limits the scope of their applicability:

- GmbHs will be able to extend loans to a shareholder if the shareholder can be expected to repay the loan.

- Capital maintenance rules will not restrict payments to a shareholder under a domination or a profit and loss absorption agreement.

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 an insolvency of the GmbH. The current distinction between shareholder loans granted while the company was already in financial difficulties (so-called "equity-replacing" or "equitably subordinated" loans) and other shareholder loans will be redundant.

- Exceptions that have proved to be important 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 this is already in financial distress, with the aim of restructuring the company.

- 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.

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 unlimited or limited tax liability in Germany. The law is scheduled to become effective on 1 January 2008. The following new rules will apply:

LOSS DEDUCTION

If more than 50 percent of the share capital, the participation rights or the voting rights in a corporation are 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 are 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.

INTEREST DEDUCTION LIMITATION RULES

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 expenses 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 expenses ("Net Interest") will be limited to an amount of 30 percent of the EBITDA of the entity.

Net Interest 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 interest paid to (i) a shareholder who holds directly or indirectly more than 25 percent, (ii) any party related to the shareholder, or (iii) a third party who may take recourse to the shareholder or the related party, is not more than 10 percent of the Net Interest.

- 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 the interest paid by the entity or any other consolidated entity to (i) a shareholder who holds directly or indirectly more than 25 but less than 50 percent, (ii) any party related to such shareholder, or (iii) a third party who may take recourse to such shareholder or the related party, is not more than 10 percent of the Net Interest.

CAN THE SECURITY CREATED BY A GLOBAL ASSIGNMENT OF TRADE RECEIVABLES BE CHALLENGED IN THE ORIGINATOR'S INSOLVENCY?

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*) have in the recent past raised the concerns of financial institutions involved in asset-based lending that such global assignments would not survive the insolvency of the originator.

The courts lowered the threshold for avoidance of the security interest granted over those receivables that were generated in the last three months before the insolvency application regarding the originator (or thereafter). While this is the most critical hardening period under German insolvency law, additional requirements must generally be met before a security created during this period can be challenged and the asset needs to be returned to the estate. In the case of global assignments, a section of the German Insolvency Code was applied that allows the security interest over receivables that were created during this hardening period to be challenged if:

- The receivables were created in the last month before the insolvency application, or

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

Since the most recent trade receivables, specifically the ones 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, in consequence, the originator's asset base against which banks are willing to extend financing. Lenders have cause for hope, since some Regional Courts (*Landgerichte*) have refused to follow this approach. According to their view, the assignment of trade receivables created in the last three months before the insolvency application requires at least that the originator is unable to settle its due liabilities at the time and that the lender must be aware of this. The risk that the assignment of recently created trade receivables will be challenged is significantly reduced 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 this issue by the end of 2007.

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