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CLIENT ALERT

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RISK LIMITATION ACT: AN INTRODUCTION

On July 4, 2008, the German Federal Council has ratified the Risk Limitation Act (Risikobegrenzungsgesetz) and Act on the Modernization of Framework Conditions for Venture Capital and Equity Investments (Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen). Below, we have outlined the impacts of these new legal regimes on voting rights transparency and takeover control thresholds, the resale of loans and Germany's venture capital industry.

THE RISK LIMITATION ACT: AMENDMENTS TO STOCK EXCHANGE LAW AND SECURITIES ACQUISITION AND TAKEOVER ACT

The Risk Limitation Act institutes changes to the German Insider and Stock Exchange Law (Wertpapierhandelsgesetz, WpHG) and the German Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz, WpÜG) concerning the disclosure of voting rights (section 22 para. 2 WpHG) and the calculation of the control threshold when making a statutory takeover offer.

- Revision of Acting in Concert
  At the center of the reforms is the scope of the concept of "acting in concert" which refers to coordinated efforts of shareholders resulting in them being considered a single entity for the purposes of the voting rights regulations. Generally, shareholders are considered to be "acting in concert" when they exercise voting rights or otherwise cooperate with the objective of permanently and considerably changing the corporate policies of a company. Following the revisions to the relevant laws under the Risk Limitation Act, a determination of what constitutes "acting in concert" must now take into account all of the concerted behavior of shareholders, whereas before the law was only concerned with behavior during a shareholders' meeting. According to the legislature's stated intent, only concerted behavior which has a material and lasting effect is relevant. The revisions do not apply to existing agreements which did not result in a prior case of shareholders acting in concert.

- Stricter Sanctions for Non-Compliance with the Regulations on Voting Rights Transparency
  Under prior law, the non-compliance with the provisions regarding voting rights transparency pursuant to section 21 et. seq. WpHG resulted in a loss of rights in the shares in question. What appeared to be a strict penalty was, in effect, rather weak because under the old rules shareholders regained their rights with immediate effect upon establishing compliance by filing the required disclosures. Revised section 28 WpHG strengthens the penalty by prolonging the loss of rights by six months in the case of a willful or grossly negligent violation of reporting duties. Note that the six-month period does not apply to shareholders who are sanctioned for an inaccurate disclosure of voting rights so long as the amount stated in the shareholder's filing does not deviate from the actual amount by ten percent or more.

- Reporting the Intent to Acquire
  Pursuant to new section 27a WpHG, when a shareholder acquires voting rights amounting to 10 percent or more, a reporting obligation arises. The shareholder is required to notify the issuer

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of its objectives with respect to the shares acquired and to disclose the origin of the funds used for their acquisition within 20 business days of reaching or exceeding a reporting threshold. The shareholder must also provide the issuer with notice of any change in its objectives for such shares. Under the new rules, issuers are required to disclose the information that they receive from its major shareholders pursuant to the regulations. In addition, if a shareholder fails to state its objectives for the shares, the issuer must announce this fact as well. An issuer may opt out of this reporting regime by including a provision to that effect in its articles of association. Further, capital investment companies, foreign management companies and investment companies may be exempt from the reporting requirements under certain conditions and acquisitions of shares pursuant to takeover bids covered by the WpÜG are also not subject to the new law. There is no stated penalty for breaches of the new duty to disclose. The regime becomes effective on May 31, 2009.

- New Notification Requirements for Holders of Registered Shares
  Pursuant to section 67 of the German Stock Corporation Act (Aktiengesetz, AktG), registered holders of shares are now required to provide the issuer with personal data and additional information concerning the shares registered in their name. A company's articles of association may stipulate the circumstances under which it is permissible for shares to be registered in the name of a nominee. Specific rules apply for domestic and foreign investment funds. However, all issuers have the right to demand that registered holders disclose whether they are the beneficial owners of shares registered in their names. For shares held in a nominee account, the registered holder is required to provide the issuer with data on the beneficial owner, including the level of ownership in the company. Any breach of these duties results in a loss of voting rights in the shares in question.

THE RISK LIMITATION ACT: IMPROVED CUSTOMER PROTECTION ON LOAN SALES

The Risk Limitation Act provides for improved debtor and consumer protection in the context of assignments and the sales of loan receivables. We have summarized the key aspects of the reforms below. On the whole, the measures reflect current market practices and, therefore, are unlikely to have a significant impact on secondary loan markets.

- Disclosure Obligations in Real Estate Loan Agreements
  In order for a lender's rights under a real estate loan agreement to be assignable the agreement must contain a clear statement to the effect that the receivables under the agreement may be assigned or that the contractual relationship may be transferred to a third party (section 492 para 1a BGB).

- Duty to Inform Borrower upon Transfer
  Lenders are now required to immediately inform the borrower of any transfer in the lender's rights under a loan agreement (section 496 para 2 new BGB) unless the lender will still be the servicer of the loan.

- Extension of Call Protection on Real Estate Loans
  Amended section 498 para 3 BGB stipulates that foreclosure pursuant to para 1 may proceed only if the borrower has been behind in payments on the loan for two months and the aggregate value in arrears has been equal to at least 2.5 percent of the nominal value of the loan over the period. This protection should allow for foreclosure proceedings to commence following approximately six months of default provided that certain other requirements are met. This extended protection applies to all new real estate loans and has retroactive effect on existing loans which are transferred after the effective date of the regulation.

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- Defense Under Security Agreements
  The new section 1192 para. 1a sentence 1 BGB, which complements section 1157 BGB, specifically extends the defenses of a landowner against a lien created under a security agreement such that they can be raised against the assignee of the secured party under the agreement. This new law reflects current market conditions because it has become the standard practice in loan portfolio transactions for the purchaser of a loan to make covenants for the benefit of the provider of collateral that it will comply with the duties under the security agreement with regards to the creation of liens on the security.

- Debtor's Claim for Damages Irrespective of Fault Due to Wrongfully Executed Foreclosure
  Section 799a German Civil Process Order (Zivilprozessordnung, ZPO) provides for a claim for damages irrespective of fault in the event that foreclosure on a deed within the meaning of section 794 para. 1 Nr. 5 ZPO is deemed to be impermissible due to an action raising an objection pursuant to section 767 ZPO, or a petition for modification pursuant to section 323 ZPO.

- Non –Assignment Provisions between Merchants
  Pursuant to new section 354a HGB, merchants may now agree on an effective covenant against assignment when making loan arrangements. Under the current law, assignments of receivables from mutual commercial transactions have historically been held to be valid under German law even if the agreement included a provision against assignment. However, new section 354a para 2 HGB provides that an assignment of receivables in violation of a non-assignment clause would be invalid if the receivable is a loan receivable of a credit institution. This amendment represents a substantial modification to the prior law.

- No Special Termination Rights in the Case of Loan Sales
  The proposed special termination right in favor of borrowers in the event of a loan sale was not enacted as a part of the new legislation.

ACT ON THE MODERNIZATION OF FRAMEWORK CONDITIONS FOR VENTURE CAPITAL AND EQUITY INVESTMENTS: FIRST REGULATION REGARDING VENTURE CAPITAL COMPANIES BY GERMAN LAW ACT FOR THE PROMOTION OF VENTURE CAPITAL INVESTMENTS (WAGNISKAPITALBETEILIGUNGS-GESETZ, WKBG)

The WKBG is an essential component of the Act on the Modernization of Framework Conditions for Venture Capital and Equity Investments (Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen, MoRaKG). The intention of the draft bill was to improve the legal framework for venture capital companies. As a result, young companies are to receive more equity capital.

- Implementation
  A venture capital company (Wagniskapitalbeteiligungsgesellschaft) may exist as a corporation or partnership and has to have its registered seat in Germany. Its share capital or the contributions of its shareholders have to amount to at least Euro 1 m with a minimum denomination of Euro 25,000 per share. The business of the venture capital company has to be conducted by two technically competent and reliable directors. Object of the company is the holding, management and sale of venture capital shares.
  The Federal Financial Supervisory Authority (Bundesanstalt für die Finanzdienstleistungsaufsicht, BaFin) is responsible for recognizing a venture capital company and for monitoring the continued existence of the legal prerequisites.

- Target Companies
  Venture capital investments are equity investments in target companies. Target companies are corporations with registered seat in a member state of the European Economic Area. At the time of acquisition by the venture capital company they must not be older than 10 years, must have an equity capital of not more than Euro 20 m and may not be listed on a stock exchange.

- Investment Restrictions
  A single investment may not account for more than 40 percent of the total assets of the venture capital company. The entire venture capital investments have to account for at least 70 percent of the total assets of the venture capital company. The venture capital company may not acquire more than 90 percent of the equity of a target company. An investment in a target company may not be held for more than 15 years. By no later than five years after its recognition as venture capital company, the venture capital company may be neither a subsidiary nor a company under a dominant influence within the meanings in section 290 of the German Commercial Code (Handelsgesetzbuch, HGB).

- Tax Relief
  Where a venture capital company in the legal form of a partnership only holds venture capital investments in corporations, it shall be categorized as asset administrating for tax purposes pursuant to section 19 WKBG and shall be not subject to German trade tax. This shall only apply to the extent certain features which have always been considered detrimental in terms of trade tax do not exist. The BMF-letter of December 16, 2003 (the so-called "PE-letter") shall remain effective according to the legislator's reasoning. On the issue of whether a venture capital company qualifies as asset administrating for German trade tax purposes there is, in practice, no greater certainty than there is for partnerships not enjoying the status of a venture capital company (the UBGG, the already existing law on enterprise investment companies, grants full trade tax exemption to investment companies irrespective of their legal form). Most useful in this context is the legal clarification that specific activities otherwise detrimental in terms of trade tax may be carried out via corporate subsidiaries.

Under certain circumstances, exceptions from a possible limitation of loss offset applies in case of the acquisition and sale of shares in a corporation (target company) by a venture capital company. That is, the existing losses or loss carryovers continue to exist despite a change in shareholder.

Regardless of the status of a venture capital company a special tax allowance for income tax purposes applies to the sale of shares in target companies after January 1, 2008.

As part of the counter financing of the tax relieves the transition from the half-income method to the partial-income method (exemption of 40 percent of the income) for income from the shares in corporations will also apply to the increased profit share of the directors of a fund (Carried Interest).

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