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# GERMANY II

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## THE ROLE OF MEZZANINE FINANCINGS IN GERMAN CORPORATE FINANCE

### INTRODUCTION

As an era of inexpensive debt finance comes to an end, small and medium-sized enterprises in Germany are experiencing severe difficulties in obtaining or relying on traditional bank loans. Mainly triggered by Basel II and under examination by a general change of the banks' approach to corporate finance, the rating of a business is in the focus. Enterprises which did not have to be concerned with their creditworthiness in the past are currently often suffering from poor equity ratios of around 25 per cent, and sometimes even well below 10 per cent. In order to secure future bank financing at competitive conditions for these enterprises it is one of the main current challenges in German corporate finance to increase such capital ratios as quickly as possible.

Hence it is not surprising that private debt instruments are becoming increasingly more popular – an opportunity for foreign and domestic investors which also helps the development of the enterprise itself. Since private equity investments are frequently strongly being resisted, particularly by senior entrepreneur-style owners of family-businesses who fear to lose control over their lifetime's work, mezzanine financings, in many instances, offer an attractive solution. Under German law the relevant instruments have always been available but they are now being revived, adapted and deployed in intelligent ways.

### INFLUENCING FACTORS

Intelligent selection and use of the appropriate mezzanine financing

instruments calls for a full understanding of the factors which influence on this type of finance. In this context the concept of a 'magic pentagon' is of assistance, highlighting the key aspects to consider in each mezzanine financing: (1) impact on rating; (2) impact on the company's balance sheet; (3) appropriate compensation of the investor; (4) extent of influence on and control over the business by the investor; and (5) taxation.

The prevalent instruments for mezzanine finance in Germany are described below against the background of such influencing factors.

### SUBORDINATED LOANS

Subordinated loans (*Nachrangdarlehen*) are currently the most commonly used instrument for mezzanine financings.

- (1) The mezzanine investor is subordinated to certain senior debt lenders, or even all current and future creditors of the business, as a provider of junior debt. In return for this higher risk profile the investor receives a considerably higher rate of return in comparison to the rate of return under regular debt finance. Depending on the degree of subordination the credit rating of the financed business can be enhanced.
- (2) As far as treatment in the balance sheet is concerned no improvement of the situation can be achieved either under the accounting principles of the German Commercial Code ('HGB'), IFRS or US-GAAP as their prevailing character as debt finance does not allow for the subordinated loan to be allocated to equity.
- (3) Subordinated loans offer great flexibility in respect of the compensation to be agreed upon with the investor. Since they are predominantly treated as true exchange agreements they are also to a great extent free from general corporate law restrictions. Compensation may be profit-related, interest may be capitalised in whole or in part, and subordinated loans can – as all other mezzanine instruments – be combined with all kinds of equity and non-equity kickers. Some restrictions apply with regard to the agreement on profit-related payments in case of the financing of a public company, as for example, the maximum amount to be disbursed under a profit sharing agreement may not exceed a certain threshold (s 301 German Stock Corporation Act).
- (4) The extent of influence on and control over the business by the investor is normally being determined indirectly by covenants and undertakings included in the credit documentation. However, in addition further direct rights of the investor may be agreed upon which are independent of such covenants and undertakings but are subject to certain limitations. Without such specific contractual arrangements only a minimum protection, confined to disclosure of general information and the annual accounts, is offered by statutory law.
- (5) Compensation payable to the investor, such as interest, is eligible for reduction of the tax burden of the financed business. The investor has

to pay taxes on income from investment of capital or on trade earnings as the case may be. Furthermore, the financed business has to pay withholding tax on capital to the tax office on behalf of the investor.

### CONVERTIBLE BONDS AND OPTION BONDS

With respect to public companies convertible and option bonds are subject to s 221 of the German Stock Corporation Act ('AktG'). Irrespective of this they may, however, also be issued by limited liability companies ('GmbH'). Whereas convertible bonds under German law grant a right to the investor to repayment of capital (and maybe also interest) by means of shares in a company at a previously agreed ratio and at a certain point in time, an option bond grants the right to acquire shares in the company at a predetermined price in addition to repayment of the capital.

- (1) German law clearly characterises convertible and option bonds as debt financing instruments. Hence a strong positive impact on the rating of a business is generally not to be expected when they are used.
- (2) When accounting according to HGB the amounts received from the investor in return for the conversion right or the option will have to be treated differently from the remaining capital contribution. Whereas the former have to be allocated to equity as capital reserves, the latter will have to appear as debt capital in the balance sheet. Under IFRS and US-GAAP no such differentiation is made but the amount will in whole be classified as debt capital.
- (3) With regard to compensation of the investor convertible and option bonds offer flexibility similar to that offered by subordinated loans. Thanks to their mention in s 221 AktG the restrictions with regard to public companies prescribed for subordinated loans do not apply.
- (4) On influence and control rights of the investor both instruments fall broadly in line with the possibilities and limitations set forth in the context of subordinated loans.
- (5) In general taxation of convertible and option bonds is contentious in Germany. It seems to be uncontroversial, however, that the financed business can deduct the compensa-

tion payable to the investor from its taxes. The details, in particular with regard to amounts received for the conversion right or option, are yet unclear. Taxation of the investor is equivalent to his taxation in the context of the subordinated loan.

### PARTICIPATION RIGHTS

Participation rights are said to be the latest development in mezzanine financing. Yet, this is somewhat untrue as they were used at the time of the early great industry financings, such as the Suez Canal. Like convertible and option bonds participation rights are mentioned in s 221 AktG. At the same time, however, there is no proper legal definition of them. According to the prevailing opinion they are based on a contract *sui generis* for the performance of a continuing obligation. They are not tied to a specific form of corporate organisation or status. On account of this they offer great flexibility in respect of all influencing factors of the magic pentagon, allowing for a truly hybrid nature between equity and debt capital.

- (1) A positive impact on the credit rating of a business can easily be achieved by subordinating the participation rights to the rights of senior lenders and/or the rights of creditors of the company as with subordinated loans.
- (2) The truly interesting aspect of participation rights is that, with an intelligent structuring of the instrument, a treatment as equity in the balance sheet can be achieved concurrently with the eligibility of payments to the investor for tax reduction under the accounting principles of the German Commercial Code. This is due to the fact that the legal and fiscal conditions for the assumption of equity are different: from a fiscal point of view equity requires the investor's participation in profit and any proceeds in a possible liquidation. From a legal point of view (a) subordination; (b) participation in profits and losses of the company; and (c) a long-term allocation of capital (five years as a rule) is required. Hence it is possible to create participation rights qualifying as legal equity and fiscal debt by excluding the investor's participation in proceeds in case of liquidation. When accounting according to IFRS or US-GAAP the same result cannot be

achieved as capital will only qualify as equity if a right of the investor to reclaim such capital is excluded.

- (3) It follows from the mentioning of participation rights in the German Stock Corporation Act, that such rights enjoy the same flexibility with regard to compensation arrangements with investors as convertible and option bonds.
- (4) Influence and control rights of the investors can be tailored to the parties' individual needs in the same way as with subordinated loans or convertible and option bonds.
- (5) As mentioned before with appropriate legal structuring compensation payable to the investor may be deducted from taxes of the financed business despite the legal qualification of the participation rights as equity. If the investor also participates in the proceeds in a possible liquidation taxation of the participation rights will be comparable to that of dividend distributions. In this case the financed business will not receive any tax reduction on compensations paid to the investor. The investor generates taxable income from investment of capital or on trade earnings as the case may be. Withholding tax on capital will be payable in addition.

### SILENT PARTNERSHIPS

Silent partnerships have a long tradition under German law. Their legal foundations can be found in § 230 et seq. of the German Commercial Code. They do not constitute a true corporate bond of the silent partner with the business or its shareholders. The construction is rather characterised as an internal arrangement (*'Innengesellschaft'*) stipulating rights and obligations arising from a capital contribution including later divestiture. Normally the silent partner is only liable to creditors of the company to the extent of his capital contribution.

In general one will have to distinguish between typical and atypical silent partnerships. From a legal technical point of view such distinction is made by determining whether a deviation from the basic legal concept set forth in the German Commercial Code can be observed. Such distinction is, however, somewhat academic. In practice it is far more important whether a silent partnership has to be classified as a joint venture for tax purposes (*'Mitunternehmerschaft'*)

or not. A joint venture for tax purposes is assumed if the financial investor both shares in the financial risk of the business (*'Mitunternehmerisiko'*) and has significant influence on its conduct (*'Mitunternehmerinfluenz'*). Consequently differentiation between typical and atypical silent partnership shall, for the purposes of this article, be made with respect to the tax implications.

### TYPICAL SILENT PARTNERSHIP

- (1) Typical silent partnerships are unsuitable for improving the credit rating of a business. The silent partner is not obliged to make additional capital contributions in case of a crisis, neither is he obliged to repay profits he has once received. On divestiture of the silent partnership he is entitled to repayment of his capital contribution.
- (2) It follows from this that a typical silent partnership has to be treated as debt capital in the balance sheet according to all examined accounting principals (IUGB, IFRS, US-GAAP).
- (3) The compensation for the investor can, in general, be agreed upon in a flexible way, provided that such compensation includes a profit-related element. With regard to public companies the same limitations as described for subordinated loans apply.
- (4) In the absence of specific contractual arrangements to the contrary, only limited information and control rights are available to the investor by law. When increasing the investor's influence and control rights one has to bear in mind that it is predominantly such improved position which quickly renders him a joint-venturer and thereby an atypical silent partner.
- (5) Taxation of a typical silent partnership is similar to taxation of a subordinated loan, i.e. the financed business can deduct compensation paid to the investor from taxes whereas the investor is liable to taxes on investment of capital/trade earnings and withholding taxes on capital.

### ATYPICAL SILENT PARTNERSHIP

- (1) Given that in the context of mezzanine financings the atypical silent partnership is a conscious decision for a joint venture for tax purposes, there are various opportunities for improving the credit rating of a business by exposing the investor to the

risks associated with the business. In particular, it can be agreed that the capital contribution is subordinated to claims of other creditors.

- (2) As with participation rights an atypical silent partnership can be treated as equity when accounting in accordance with the accounting principles of the German Commercial Code. In order to qualify as equity the capital contribution has to be subordinated and must be granted for a period of five years or longer. Furthermore, the investor needs to participate in profits and losses. Compensation unrelated to the profits of the company may not be agreed upon. IFRS and US-GAAP again do not allow for its treatment as equity if the investor has a right to reclaim the capital.
- (3) Apart from the fact that the previously described conditions have to be met in order for the capital contribution to qualify as equity, the compensation of the investor can, in general, be agreed upon freely. With regard to atypical silent partnerships with public companies the same restrictions apply as those which apply to subordinated loans and typical silent partnerships.
- (4) As a complement to the unattractive fiscal qualification as a joint venture atypical silent partnerships offer the probably greatest liberty with regard to influence and control rights of the investor. Such liberty is only limited by general corporate law principles. Hence this type of mezzanine financing is mainly employed under circumstances in which influence and control seems to be of greater importance than tax-efficiency.
- (5) As indicated before, financing costs may not be deducted from taxes by the financed business whereas the investor will generate taxable income from trade earnings.

### CONCLUSION

The German market experiences an increasing need for mezzanine finance. Various instruments are available and supported by a stable and well-established legal framework. Intelligent and appropriate application of these instruments will be essential for improving the financing situation of many successful companies in Germany and offer attractive chances to both domestic and foreign investors.