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INTERNATIONAL FINANCIAL LAW REVIEW

Middle East goes west

Five tips for buying in Europe/US

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Turn small investments into club deals

Credit crunch fallout

The impact on acquisition finance

Private equity and venture capital review



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Dr Frank Thiäner and Jens Hörmann of Pöllath + Partners analyse Germany's new private equity laws

New but not improved

Dr Frank Thiäner and Jens Hörmann of Pöllath + Partners analyse Germany's new private equity laws

When they entered into coalition on November 11 2005, the Christian Democratic Union (CDU), Christian Social Union (CSU) and Social Democratic Party (SPD) planned to create a comprehensive legal and tax framework for private equity funds. It was on their agenda to amend and expand the Act Governing Participations in Enterprises (*Gesetz über Unternehmensbeteiligungsgesellschaften*, UBGG) and to provide a reliable legal and tax framework for private equity in Germany. Two years later, these plans have been much reduced. Instead of creating a single comprehensive private equity law, the German government has taken three steps to regulate the activities of private equity funds.

On August 15 2007, the government presented its draft of the Act for the Modernisation of the General Conditions for Capital Investments (*Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen*, MoRaKG). The legislation includes an Act for the Promotion of Venture Capital Investments (*Gesetz zur Förderung von Wagniskapitalbeteiligungen*, WKBG) and an Act for the Amendment of the UBGG. On October 24 2007, the government also presented its draft of the Act for the Limitation of Risks Associated with Financial Investments (*Risikobegrenzungs-gesetz*).

“The Risk Limitation Act introduces a number of steps to prevent undesirable developments in private equity”

The WKBG introduces venture capital companies (*Wagniskapitalbeteiligungsgesellschaften*) as a separate class that can benefit from tax exemptions, to promote venture capital investment. The Act on the amendment of the UBGG expands the scope of permitted investments for certain private equity funds. The Act for the Limitation of Risks Associated with Financial Investments introduces a number of steps to prevent undesirable developments in private equity. The new regulations should come into effect early in 2008.

A class of their own

The Act for the Promotion of Venture Capital Investments creates a legal and tax framework for the activities of venture capital companies (*Wagniskapitalbeteiligungsgesellschaften*) investing in small, young enterprises that need funds to develop and expand their businesses. The WKBG grants qualified venture capital companies certain tax exemptions to promote venture capital investments. A partnership or corporation qualifies as a venture capital company if it has been approved by the Federal Financial Supervisory Authority (*BaFin*), has a minimum capital of €1 million (\$1.467 million), restricts its activities to the acquisition, holding, administration and disposal of equity investments in qualified target companies, and has its registered office and business administration in Germany.

To qualify for tax exemption, the venture capital companies have to invest at least 70% of the funds under management in qualified target companies – that is, companies that are not more than 10 years old at the time of acquisition and do not operate any business that is older than 10 years. At the time of the acquisition they must have equity (*Eigenkapital*) of not more than €20 million (\$29.538 million), and should not be listed on a securities exchange. Target companies lose their qualification if they acquire a business older than themselves, if their shares are held by the venture capital company for more than 15 years, or if their shares have been admitted for trading on any securities exchange for three years.

If a venture capital company is operated as a partnership and complies with WKBG requirements, its activities are considered asset management activities for income tax purposes. The company's income is only taxed at the level of its shareholders and it is exempt from trade tax (*Gewerbesteuer*). A venture capital company loses its tax privilege if it engages in commercial activities. These include the acquisition and short term disposal of participations in qualified target companies or other enterprises, the acquisition of securities, bank deposits or other capital market instruments, and the rendering of advisory services to (or the granting of loans or guarantees in favour of) target companies; the taking of loans or issuing of debentures and the exploitation of a market by using professional experience also fall into this category. However, a 100% subsidiary of the venture capital company may carry out these and other commercial activities.

The new ruling in section 8c of the Corporate Income Tax Act (KStG) contains an exception in favour of venture capital companies: tax loss carry-forwards of a target company may be preserved in acquisitions by a venture capital company and, if the shares are held for at least four years, also in disposals by the venture capital company. But preservation is limited to loss carry-forwards that are attributable to reserves of the target company's taxable domestic assets.

More opportunity?

The second reform for private equity funds concerns the Act Governing Participations in Enterprises (UBGG). This Act governs the activities of certain private equity funds that acquire minority interests in other enterprises and are exempt from trade tax (*Gewerbesteuer*). The Act amending the UBGG extends the investment opportunities of such private equity funds to include participations in unlimited partnerships and foreign companies. Shareholder loans from private equity funds are also exempt from mandatory subordination of shareholder loans to other creditors (*Eigenkapitalersatz*).

However, the limited amendments of the UBGG and the introduction of the new WKBG for venture capital companies have led to a split in private equity legislation and have missed out on the chance to regulate other important aspects of private equity investments, such as tax transparency of all private equity funds. Further reforms should look back to the initial goal: to consolidate the legal and tax framework for private equity investments in a single act. This would avoid the need for coordi-

“The limited amendments of the UBGG and the introduction of the new WKBG for venture capital companies have led to a split in private equity legislation”

nation. It would also eliminate gaps and additional administrative burdens, such as the federal *BaFin*'s role in approving and supervising venture capital companies, and the state authority's in private equity funds subject to the UBGG.

Risk limitation

The Risk Limitation Act aims to impede undesirable activities by increasing investment transparency. In particular, the proposed amendments on the notification obligations under the Securities Trading Act (*Wertpapierhandelsgesetz*) are important. Voting rights attached to shares and comparable rights attached to other securities (such as stock options) will be added up when determining whether the notification thresholds have been exceeded. Sanctions following the violation of notification obli-

gations will be tightened. The violation of notification obligations will result in a six month suspension of voting rights, to prevent anyone from sneaking into a shareholders' meeting.

Following French and US examples, the holder of material participations (10% or more of the voting rights) will have to disclose details of the objective with which they pursue their investment, and the source of the funds used for the acquisition of the shares, when the company requests it.

The provisions of the Securities Trading Act (*Wertpapierhandelsgesetz*) and the Securities Acquisition and Takeover Act (*Wertpapierübernahmegesetz*) are extended by a specification of the definition of “acting in concert”. According to the draft, the requirements of acting in concert are ful-

filled if investors interact in a way that is conducive to permanently or considerably influencing the issuer's strategic focus.

To ease the identification of the owner of registered shares, amendments to the German Stock Companies Act (*Aktiengesetz*) are intended. The draft provides for the restriction of registration of attorneys-in-fact, who are entitled to exercise voting rights instead of the shareowners. Upon request, the registered persons shall be obliged to inform the company whether or not they actually own the shares, or in whose name the shares are held.

Lastly, the draft introduces an obligation to inform the Economic Committee (*Wirtschaftsausschuss*) of the Workers' Council or, if there is no Economic Committee, the Workers' Council, about details of a takeover, as long as it does not threaten to compromise the company's business or trade secrets.

The Federal Council of Germany (*Bundesrat*) issued a statement about the draft on November 30 2007. Critics raised the question whether the Risk Limitation Act is actually required in the interest of the German financial community, and made specific suggestions for its improvement. The impact of the statement on the draft remains to be seen.

“Neither London nor Hong Kong will succeed as an Islamic finance hub until they convince local Muslim investors”

IFLR journalist Rachel Evans profiles Mohaimin Chowdhury, *IFLR* February 2008

“Islamic bonds could be the solution to the US credit crunch”

Read Neeta Thakur of Clifford Chance, *IFLR* December 2007

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