

THE REGULATORY TREATMENT OF MEZZANINE FINANCING IN GERMANY



INTRODUCTION

THE GRANTING of loans belongs to the activities regulated under the German Banking Act ("KWG"), irrespective of whether the lender also accepts deposits or not. Any person performing this activity for the purposes of profit requires a license and is considered a bank under KWG. Such isolated license requirement is, with only a few exceptions, unique within the EU. It raises difficulties for any unregulated non-bank debt provider wishing to operate in the German market, in particular mezzanine and other debt funds.

MEZZANINE INVESTMENTS

A typical mezzanine investment consists of a debt or debt-like instrument, paired with an equity component giving the mezzanine lender upside potential, while the debt component — which generates steady interest payments and ranks as senior to the company's common stock — provides a measure of downside risk protection. The most common instrument is a note which may provide both cash interest and pay-in-kind interest, paired with warrants to acquire stock of the borrower. Mezzanine investments can also be made using preferred stock in place of a debt instrument.

Like private equity investments, mezzanine investments are typically made in portfolio companies on a longer term basis. However, whereas a typical private equity fund entails no steady cash flow and returns on the fund's investments are only realized when the investments are sold, mezzanine funds contain debt or debt-like instruments. Hence, the portfolio companies in which the mezzanine provider is investing are compelled to make interest payments, therefore generating significant current income for investors. However, despite such differences and due to the similar investment approach and targets, in many EU countries mezzanine and private equity funds

fall under the same regulatory regime.

MEZZANINE INVESTMENTS = LENDING WITHIN THE MEANING OF KWG?

Not every type of loan or debt instrument triggers license requirements. Neither participations under corporate law - including silent ones - nor debt instruments participating in losses of the debtor in a way which is comparable to equity qualify as loans within the meaning of KWG. Participations are excluded for the underlying joint purpose between a corporation or partnership and its shareholders or partners, as opposed to loans where lender and borrower are said to each follow their own interests. In practice, the borders are blurred and it is therefore risky to rely solely on such differences. Loss participation comparable to equity requires the debt instrument to be subordinated in a way that it is not possible, under any circumstances, that calling the debt causes the debtor to become insolvent. Such so-called "qualified subordinated loans" are of little use in practice by the mezzanine lenders.

CROSS-BORDER MEZZANINE LENDING

If the mezzanine investment qualifies as loan but is rendered by a non-German lender from outside of Germany upon the initiative of the portfolio company or its shareholder (e.g. a private equity investor), such mezzanine investment should not be subject to licensing requirements in Germany based upon the so-called "passive freedom of services doctrine".

GRANTING VERSUS PURCHASING LOANS

Another option may be cooperation with a regulated entity licensed to provide lending services. The regulated activity under the KWG covers granting loans, which does not include acquiring them. Once a loan is granted by a



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credit institution, the claim against the debtor or the loan agreement as a whole may be taken over by anyone, including non-banks. However, in this scenario license requirements are triggered again if the claim or loan is remodeled by the non-bank entity following the purchase. Thus, the two crucial issues for non-bank debt providers are how to distinguish granting a loan from purchasing one and what is the equivalent of remodeling a loan in a way that triggers license requirements.

With regard to drawing the line between granting and purchasing loans, the relevant provision in the KWG (sec. 1, para. 1, sentence 2, no. 2) may suggest that the provision of monies is a core element of what is regulated and thus, only after the loan has been initially disbursed by a bank, does its purchase become an unregulated activity. However, BaFin seems to take the position that the conclusion of the loan agreement (and not merely the disbursement) triggers the license requirements. As long as it is the bank that is in charge of arranging the terms of the loan and that concludes the contract with the debtor in the first place, the fund may subsequently assume the rights and obligations of the agreement, including the obligation to actually pay out the credit monies to the borrower. Such transaction would still qualify as purchase of a loan provided that the fund, following its assumption of the loan agreement, does not alter the loan terms and conditions. Any modification of the terms would trigger licensing requirements, however not the mere provision of monies in an amount as previously agreed upon between the bank and the debtor. The question of whether actions under the loan agreement amount to modifications triggering the need to again involve a bank needs to be carefully assessed in each case. Write-offs should not have to be cleared with a bank; however, realizing collateral may be consid-

ered a term-changing event depending on the way it is provided for under the original agreement.

The partner bank or regulated entity that is cooperating for such purposes in complying with its capital requirements has to cover any risk position on its balance sheet with an adequate amount of equity positions. For pricing purposes, it would be of particular interest to any mezzanine or debt fund if it were possible to frame the involvement of the bank such that no additional capital requirements are triggered.

CONCLUSIONS

Although the regulatory landscape for mezzanine funds is not ideal, there may be ways to make investments in Germany. However, in practice, such methods often trigger additional costs. Hopefully, Germany will catch up with the standards of other EU member states on an ongoing basis and create a level playing field for mezzanine investments in German companies. At the end of the day, protection needs may be more relevant at the level of the investors in the fund (typically addressed by regulating the manager of the mezzanine fund) rather than at the level of the portfolio company receiving the loan. With respect to the latter, any protection needs could be addressed the same way as is currently being discussed for private equity funds: by providing for certain transparency requirements prior to making an investment. In any event, there is no reason why mezzanine funds should be subject to more regulatory requirements than private equity funds. ■

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