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# Insolvency-proof Transfer of Credit and Collateral Portfolios in Cross-border Transactions: The German Refinance Register

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## 1. BACKGROUND

Legally valid and enforceable asset and portfolio transfers are essential building blocks of:

- syndicated bank lending;
- securitisation;
- repo and other asset-based funding transactions; and
- pooling of funding needs.

The clearing up in the aftermath of the credit crisis<sup>1</sup> has demonstrated that many legal issues related to asset transfers have not been tackled at all or, seemingly solved, have not been tested in respect of certain constellations. The transferor's insolvency would be the litmus test, in particular in the case of cross-border transactions. Under the principles of International Insolvency Law, related rules are established as national mandatory law, not disposable by contractual choice of law. Basically, the *lex fori concursus* is applicable, depending on the debtor's ties with the respective jurisdiction. In certain cases, the *lex rei sitae* has to be considered as conflicting law, as well as partial insolvency in certain jurisdictions. Partial insolvency can cause specific problems when financial institutions with branch networks are involved. This is why the resolution of bank groups with headquarters domiciled in the USA will involve significantly different issues as compared with their European counterparts, because they are typically structured as holding companies with subsidiaries, as opposed to the cross-border branch networks frequently used by European banking institutions.

Securitisation practitioners have tried to minimise related problems by ringfencing insolvency-remote special purpose companies ("SPVs") holding legal titles for the benefit of a second tier of transferees. However, this does not exclude claw back risks in respect of the initial asset transfer transactions from the originators to the SPVs — in particular in case of cross-border transactions which automatically involve several jurisdictions due to the *lex fori concursus* of the initial transferor and/or the *lex rei sitae* of the respective assets. This is why a thorough analysis of the specific national environments concerned regarding a transfer of

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<sup>1</sup> Erik Krusch, "Opinion Letters: When a Sale is not a Sale" (26 March 2010) Westlaw Business Currents; Christopher Elias, "The Tale of the Grim Repo: Lehman's Link to True Sales" (19 March 2010) Westlaw Business Currents.

assets/portfolios is essential. In this regard, two basic legal types have to be distinguished:<sup>2</sup>

- Common law traditions, normally relying on common law trusts and true sale Legal Opinions analysing re-classification risks;<sup>3</sup> and
- explicit legislation, as introduced by several civil law jurisdictions in order to enhance securitisation and syndicated lending (*e.g.*, in Italy, France, and Germany), providing for insular solutions.

## 2. THE GERMAN REFINANCE REGISTER — INTRODUCTION AND EVOLUTION

The German Refinance Register<sup>4</sup> (“Refinanzierungsregister”) was introduced to enhance legally valid and enforceable asset and portfolio transfers (including mortgage and loan portfolios) as a basis for syndicated bank lending, asset-based funding transactions (including ABS), and pooled funding.<sup>5</sup> The legislative move was widely welcomed by practitioners due to the fact that the common law trust is not established in the German civil law jurisdiction.<sup>6</sup> Although according to the prevailing view of German practitioners beneficial ownership is insolvency-remote, affirmative case law is restricted to constellations where the beneficiary had been the holder of legal title prior to establishing the trust. The Refinance Register provides for the clear allocation of ownership in the case of the transferor’s insolvency whilst avoiding the sometimes time-consuming and costly procedures for the transfer of legal title.

The basic legislation was implemented in two waves<sup>7</sup> — 2005/6 with the basics,<sup>8</sup> and 2009 with a focus on syndication and cross-border considerations.<sup>9</sup>

The legal foundation is scattered among several laws:

- the *German Banking Act* (“Kreditwesengesetz” — KWG) — §1(24) to (26), and §§22a to 22o;
- the Refinance Register Decree;<sup>10</sup> and

<sup>2</sup> For a comparison see McMillen and DeLorenzo, “Trust Laws and Islamic Finance” in Islamic Financial Services Board, ed., *Islamic Finance: Surveys and Global Legal Issues and Challenges* (Kuala Lumpur: Islamic Financial Services Board, 2008) at 141.

<sup>3</sup> Which, as has turned out, might not have been tested for all constellations.

<sup>4</sup> Equally referred to as “Funding Register”.

<sup>5</sup> Otmar M. Stoecker, *The Funding Register, Los Patrimonios Fiduciarios y el Trust*, III Congreso de Derecho Civil Catalán (ed.: Sergio Nasarre Aznar/Martin Garrido Melero), Madrid/Barcelona 2006 at 399.

<sup>6</sup> Germany is not a party to the Hague Trusts Convention.

<sup>7</sup> Klaus Peter Follak, “The German Funding Register’s Insolvency-proof Transfer of Cross-border Portfolios” (16 April 2010) Westlaw Business Currents.

<sup>8</sup> BTDr. (German Parliament, official legal materials) 15/5852.

<sup>9</sup> BGBl (German Federal Gazette) 2009 I at 607.

<sup>10</sup> Statutory Order on the Form of the Funding Register pursuant to the *German Banking Act* (KWG) and on the Type and Manner of Recording on the basis of §22d para. 1 sent. 2 KWG — last amendment BGBl 2005 I at 3187.

- the *Pfandbrief Act* (“Pfandbriefgesetz”)<sup>11</sup> and the Cover Register Decree (“Deckungsregisterverordnung”),<sup>12</sup> as far as the German type of statutory covered bonds (“Pfandbriefe”) is concerned.

The first wave of the initiative was originally driven by the fact that, because of the above-mentioned legal uncertainties, German securitisations were being structured under foreign jurisdictions, or drafted as synthetic rather than true sale transactions. Due to this ad-hoc background, certain deficiencies in respect of formal requirements (design and details of register entries) still exist, and might have to be adapted by practitioners, as far as violations of substance regarding the legal intent are avoided. Given the fact that the Refinance Register has been construed as an exception to the general principles of German insolvency law, analogous application, interpretation or expansion of the Refinance Register principles requires a great deal of care.

In the context of agencies under the *German Financial Market Stabilisation Funds Act*,<sup>13</sup> which was set up to acquire and manage non-strategic or non-performing assets of banks, eligibility of transferors and transferees under the Refinance Register have been further clarified in discussions between banks, regulators, the German Ministry of Finance, and legal practitioners.<sup>14</sup>

Therefore, enhancements by way of explicit legislation have to be welcomed by legal practitioners and regulators likewise. The latest improvements in respect of eligible transferees and transactions have been introduced in the course of the transformation of the EU CRD IV<sup>15</sup> into German law.<sup>16</sup>

### 3. ELIGIBLE TRANSFERORS

Eligible transferors must qualify as “Refinancing Enterprises” (“Refinanzierungsunternehmen”) as defined by KWG §1(24): “Refinancing enterprises are enterprises which, for self-refinancing or transferee refinancing purposes, sell assets or claims thereto from their business operations to, or administer said assets or claims on a fiduciary basis for, the following enterprises . . .”

There is broad agreement that such “enterprises” encompass any legal persons (including credit institutions, the German KfW, entities under public law, and special funds under public law, as explicitly mentioned in the considerations of the act

<sup>11</sup> Last amendment BGBl 2013 I at 3395.

<sup>12</sup> Last amendment BGBl 2005 I at 1698.

<sup>13</sup> FMStFG (German Act on the Establishment of a Financial Market Stabilisation Funds — “Finanzmarktstabilisierungsfondsgesetz”).

<sup>14</sup> Klaus Peter Follak, “The German Funding Register’s Insolvency-proof Transfer of Cross-border Portfolios: Eligible Parties” (8 February 2011) Westlaw Business Currents.

<sup>15</sup> Capital Requirements Directive package: Directive 2013/36/EU and Regulation (EU) No 575/2013.

<sup>16</sup> Gesetz zur Umsetzung der Richtlinie 2013/36/EU und zur Anpassung des Aufsichtsrechts an die Verordnung (EU) Nr. 575/2013 (CRD IV-Umsetzungsgesetz), BGBl 2013 I, No 53, at 3395 (3397, 3420).

introducing the Refinance Register<sup>17</sup>), be they profit-oriented or not. This is, among other things, derived from the wording of KWG §22a(1), according to which “refinancing enterprises” include, but are obviously not restricted to, credit institutions or an entity referred to in KWG §2 par. 1 nos.1 to 3a.

There is a further requirement that the assets transferred should stem from the transferor’s “business operations” in that related assets should not have been originated exclusively for resale. This is to distinguish “refinancing enterprises” from “intermediaries” — KWG §1(25), such as warehousing entities. This means that agencies subject to the *German Financial Market Stabilisation Funds Act* established under German federal or state law<sup>18</sup> are eligible.

However, eligible transferors must also have their residence in Germany. This is not explicitly stipulated by law, but is derived from the fact that related legislation is construed as an exception to national German insolvency law.

#### 4. ELIGIBLE BENEFICIARIES / TRANSFEREES

So far, the following institutions have been eligible:

- Credit institutions (established with a banking licence) with residence in the EU / EEA — *German Banking Act* (KWG) §1(24).
- Special Purpose Vehicle Companies, not restricted as to residence — KWG §1(26).
- Funding Intermediaries such as warehousing entities — credit institutions only, but not restricted as to residence — KWG §1(25).
- Certain other entities, in particular EU / EEA central banks (with a view to repo funding).
- Agencies under the *German Financial Market Stabilisation Funds Act* (FMStFG) are explicitly not classified as banks,<sup>19</sup> nor can they be subsumed into another type of the above-mentioned eligible transferees. However, according to FMStFG §8a(5), 2nd sentence<sup>20</sup> the specific paragraphs of the *German Banking Act* governing the Refinance Register (KWG §§22a to 22o) are applicable accordingly to such agencies. These entities will, therefore, constitute “eligible transferees”. As they are strictly regulated by law, this is in accordance with the legal intent of creating a reliable basis for portfolio transactions.

From 01.01.2014, the following additional institutions are included:

- Insurance companies with residence in the EU/EEA, KWG §1(24) no. 4. The technical requirements applied to transactions of insurance companies domiciled in Germany have been specified in a Guidance Notice is-

<sup>17</sup> Beschlussempfehlung und Bericht des Finanzausschusses, Entwurf eines Gesetzes zur Neuorganisation der Bundesfinanzverwaltung, BTDr 15, 5852, at 17.

<sup>18</sup> Federal law agencies: see Finanzmarktstabilisierungsfondsgesetz (FMStFG, BGBl 2008 I at 1982) §8a(5) 2nd sentence; state law agencies see FMStFG §8b(2) 1st sentence.

<sup>19</sup> §8a(5), 1st sentence of the FMStFG, *supra*, n. 18.

<sup>20</sup> As for agencies under state laws, see §8b of the FMStFG, *supra*, n. 18, refers to §8a.

sued by the German insurance supervisors (“BaFin”) dated 1st January, 2014.

- The national German development bank KfW, KWG §1(24) no. 6.
- Pension funds or schemes within the meaning of the German Act to Improve Company Pensions (“Betriebsrentengesetz”, BetrAVG Art. 1b paragraph 3, 1st sentence in conjunction with Art. 112 and 118a of the German Act on the Supervision of Insurance Undertakings “VAG”).

### 5. ELIGIBLE SUBJECT-MATTER OF TRANSFER / ELIGIBLE ASSETS

Assets and claims, real estate liens, as well as registered liens in respect of aircraft and ship mortgages are eligible, including tranches thereof<sup>21</sup> — KWG §§1(24) and 22a. Based on §22d(2) and (3) of the KWG and on the considerations of the legislative initiative re. §22d,<sup>22</sup> determinability of the subject-matter of transfer is required, *i.e.*, the entry into the Refinance Register must define the criteria respectively the documents by which such subject-matter can be determined. Statutory or contractual<sup>23</sup> prohibitions of disposal exclude eligibility, whereas oral or implicit preclusions of assignment are overridden.

### 6. ELIGIBLE TRANSACTIONS

So far, under §1(24)–(26) KWG, the disposal resp. acquisition of eligible assets or of claims on the transfer of such assets in return for equivalent value was required. However, the transferor may retain the economic risk and/or economic benefit of the related assets, which has been clarified by the new wording of §1(24)–(26) KWG and §22j(4) KWG introduced by the 2013 amendments.<sup>24</sup> Under the new wording, this is the first alternative<sup>25</sup> of eligible transactions, applied to enterprises which “sell assets or claims . . . for self-refinancing or transferee refinancing purposes”. The previous wording might not have been quite perfect, but according to the considerations of the 2009 legislative initiative,<sup>26</sup> the legislator wanted to include transfers/sales where the payment of the purchase price is deferred, and the purchaser has to pay interest on the deferred purchase price as an equivalent. This structure allows, economically, for approximations to collateralised lending and repo-style transactions.<sup>27</sup>

The new wording introduces a second alternative, where transferors “administer said assets or claims on a fiduciary basis” for eligible transferees — KWG

<sup>21</sup> Tranches with a defined ranking are eligible.

<sup>22</sup> BTDr 15/5852, *supra*, n. 17 at 20.

<sup>23</sup> However, §354a of the *German Commercial Code* (“HGB”) is applicable.

<sup>24</sup> See *supra*, n. 16.

<sup>25</sup> For the interpretation of the 1st alternative see Brogl, Reischauer/Kleinhaus, KWG, §1 KWG RZ 420; Kokemoor, Beck/Samm/Kokemoor, KWG, §22a KWG, RN 15; Tollmann, Boos/Fischer/Schulte-Mattler, KWG, 4th ed., §1 KWG, RN 256.

<sup>26</sup> Official legislative materials, BTDr 17/10974 at 83.

<sup>27</sup> Under German GAAP and European IFRS, the result would normally imply balance sheet disclosure as a lending transaction rather than disposal of balance sheet items, until final allocation to the beneficiary and/or transferee.

§1(24) sent.1. In this case, the purpose of “self refinancing or transferee refinancing” is subject to an extended interpretation not requiring any disposal (sale) resp. acquisition of assets nor any related flow of funds between the transferor and the transferee. This amendment clarifies that, inter alia, primary syndications (“club deals”) where the transferor acts as a mere security agent for the benefit of the transferee are eligible transactions.<sup>28</sup>

The transfer contract and/or the transferred claim to be entered into the Refinance Register may be construed under a foreign (*i.e.*, non-German) jurisdiction. Nevertheless, it seems advisable to construe the transfer contract under German law in order to avoid re-classification risks under foreign, in particular common law jurisdictions.<sup>29</sup> Such re-classification might be an obstacle to enforcement regardless of entry into the Refinance Register.<sup>30</sup>

Caveat: the above-mentioned structures allow, economically, for approximations to collateralised lending and repo-style transactions between the transferor and the transferee. However, one has to be aware that under the general principles of German insolvency law, assets encumbered with a mere security interest for the transferee would be part of the transferor’s insolvency estate. *I.e.*, such assets would be separated for prioritised settlement of the transferee’s claim, but would not be finally taken out of the order and disposition of the liquidator. As the German Refinance Register aims at the clear allocation of ownership of assets in the case of the transferor’s insolvency, it seems doubtful whether a mere security interest of the transferee vis-à-vis to the transferor would be enforceable under the specific rules and procedures of the Refinance Register, regardless of registration.<sup>31</sup> Therefore, it is advisable to observe the demarcation lines to a mere pledge or security interest, in order to avoid legal uncertainties and possible re-classification. This is why the underlying transaction should aim at the final transfer of ownership or legal title of the asset (which could also be a mortgage held by the transferor for the transferee’s benefit) in case of the transferor’s insolvency. In view of the above, proper drafting of the transaction is crucial, and requires specific legal experience.

## 7. ELIGIBLE KEEPERS OF THE REFINANCE REGISTER

If the refinancing enterprise is a credit institution, the transferor would normally keep the Refinance Register himself. Additionally, the German central bank and the KfW are eligible, as well as certain public entities including German central and regional governments (“Bundesländer”) — KWG §22a(1). Subject to consent by the German banking supervisors (“BaFin”), a credit institution having its residence in Germany or the KfW may keep registers on behalf of third parties —

<sup>28</sup> Under the previous wording, such extended interpretation had been challenged, see *e.g.*, Tollmann, *supra*, n. 25 at §1 KWG, RN 256.

<sup>29</sup> See Krusch, *supra*, n. 1 and, in particular in respect of the UK, the decisions in *Inglefield Ltd., Re*, [1933] Ch. 1 (Eng. C.A.) and *Welsh Development Agency v. Export Finance Co.*, [1992] B.C.L.C. 148 (Eng. C.A.).

<sup>30</sup> See below, chapter 8b.

<sup>31</sup> In favour: Fleckner, WM 2006 at699; denied by Tollmann, *supra*, n. 25 at §22j KWG, RN 17.



KWG §22b(1). The keeper must be domiciled in Germany in order to secure supervision by the German banking supervisors.

## 8. LEGAL EFFECTS OF A VALID ENTRY INTO THE REFINANCE REGISTER

*a) Basic effects:* §22j of the KWG establishes a ringfence of the beneficiary's claims on assignment resp. transfer of legal title of the assets, claims and rights validly entered into the Refinance Register. The result is total separation from the transferor's insolvency estate in that such assets and claims would be finally taken out of the order and disposition of the liquidator. In addition, the beneficiary may object to disposals by way of execution or execution of attachment initiated by third-party claimants/creditors, even prior to insolvency. This means the beneficiary would be able to deliver a related third-party notice under §771 of the *German Enforcement Act* ("ZPO"). Further, any right of set-off or retention of the transferor against the beneficiary is excluded. These effects are extended to any accessory security rights in respect of the entered items, as well as to any substitutes thereof (in particular payments on principal and interest).<sup>32</sup>

*b) Restrictions:* The above-mentioned ring-fencing is restricted to existing and enforceable claims under a legally valid and enforceable transfer contract. The entry into the Refinance Register does not create any claim in its own right, nor any public faith or legal fiction. Further, it does not restrict the transferor's legal authority to dispose of entered assets prior to the appointment of a Refinance Register Administrator in the course of insolvency proceedings — KWG §22n(3). In practice, this problem might be solved by perfection of assignments after entry, or by assignment of related rights of disposal.

As mentioned above (chapter 6), the entry of claims construed under a foreign jurisdiction is possible. However, the validity and enforceability of such claims would be governed by the respective jurisdiction, even if the transfer contract itself is drafted under German law. The result might well be the valid transfer of a non-enforceable claim or right.

*c) Nullity/Void Entries:* Entries which are not eligible according to the principles mentioned above (chapters 3 to 7) would be void. This applies, e.g., normally to transfers by enterprises with residence outside Germany, such as German branches of foreign banks. The logic behind this result is that even banks with a residence in the EU would be subject to home country (and not German) insolvency law.

*d) Enforcement:* If insolvency proceedings are opened in respect of the transferor's assets, the right of disposal in respect of the registered assets is transferred to a Refinance Register Administrator — KWG §§22l to 22o. This is possible as soon as insolvency becomes imminent.

<sup>32</sup> However, problems in respect of commingling have to be taken care of: see, §48, 2nd sentence of the *German Insolvency Act* ("InsO").

## 9. FURTHER DETAILS AND PROCEDURAL TOPICS

*a) Tranches/portions of rights:* Subject to the above-mentioned (in chapter 5) principle of determinability, entry of tranches or portions of rights is permitted, including agreed ranking between transferred respectively retained tranches.

*b) Deletion of entries:* Any deletion of entries is subject to the beneficiary's consent — KWG §22d(5).

*c) Form of the Refinance Register:* The Refinance Register may be kept in paper form or as electronic register.

*d) Refinance Register Monitor:* For each institution keeping a Refinance Register, a Refinance Register Monitor has to be appointed by the German banking supervisory authority ("BaFin"). However, his duties and liabilities are restricted to the formal correctness of keeping the register. This means he is not obliged to investigate the existence and enforceability of items to be registered, nor the correctness of the register — KWG §§22e to 22i.

*e) Excerpts of the Refinance Register:* As from 1st January 2014, a new paragraph 6 has been added to §22d KWG stating that "the transferee may request from the administrator at any time an excerpt concerning the entries in the refinance register . . ."

## 10. REFINANCE REGISTER AND COVERED BONDS ("PFANDBRIEFE")

Apart from considerations in respect of securitisation and syndication, the legislation on the Refinance Register has been and is drafted with a view to the security of the German type of Statutory Covered Bonds ("Pfandbriefe"). Under traditional German supervisory guidelines, apart from direct holding of legal titles by the Pfandbrief Bank only claims against suitable credit institutions on the transfer of assets which are enforceable in case of the transferor's insolvency are eligible for the cover pool under the *German Pfandbrief Act* ("Pfandbriefgesetz"). Such enforceability is provided for by the Refinance Register. Nevertheless, other structures which are insolvency-proof under non-German jurisdictions are (and have been) eligible as well, such as common law trusts, US agent banks, the French fiducie, the Austrian trust and structures under Japanese trust law. This has been confirmed by §1(2) of the *German Pfandbrief Act*. Specific provisions have been introduced to secure the priority rights of holders of "Pfandbriefe" in respect of assets which have been entered into both a Refinance Register and a cover pool under the *Pfandbrief Act*, including clarifications in cases where assets are split into tranches held by Pfandbrief Banks and other types of credit institutions.

## 11. REFINANCE REGISTER AND SYNDICATION

So far, beneficial interests (ownership)/equitable titles in contractual "trusts" under German jurisdiction have been investigated by the German supreme courts only in respect of a specific structure: they are definitely insolvency-proof, if the trustor/beneficiary himself has vested the respective asset to the trustee/agent. The Refinance Register provides an explicit solution for insolvency-proof syndications. Due to the latest amendments to the Refinance Register legislation which came into force on 1st January 2014, initial club deals and mere holdings of mortgages by a

bank security agent without any flow of funds between the agent bank (lead manager) and syndicate member banks are explicitly included.<sup>33</sup>

## 12. REFINANCE REGISTER AND SECURITISATION

In order to perform feasible securitisation transactions, cost and speed of the transfer of real estate security rights are crucial. Particularly in the case of granular retail transactions, securitisation is hardly feasible without a reliable structure of insolvency-remote transfers prior to perfection of the assignment of legal collateral titles. Before the Refinance Register was introduced, solutions under German jurisdiction normally involved the assignment of the claims incorporated in the loan contracts, whereas the real estate collateral was held in trust for an SPV. Due to the lack of established case law, perfection was agreed to be implemented as soon as certain rating triggers related to the originator were to materialise, in order to be on the safe side. Following the introduction of the Refinance Register, final perfection of legal transfers can be construed insolvency-proof, and hence can be postponed to the stage of insolvency. However, two issues have to be considered and provided for:

- the costs of the final legal transfers; and
- the risk of disposal by a transferor breaching his fiduciary obligations.

## 13. REFINANCE REGISTER AND CROSS-BORDER TRANSACTIONS

A few issues in respect of cross-border transactions deserve specific attention:

- Assets located outside Germany are eligible. However, validity and enforceability under the respective jurisdiction have to be investigated carefully. This is also true with regard to the jurisdiction of the transfer contract. It has to be remembered that the entry into the Refinance Register does not create any claim in its own right, nor any public faith or legal fiction.
- The transferor should have residence in Germany.
- Credit institutions and insurance companies as beneficiaries must have their residence in the EU or EEA.
- The benefits of the Refinance Register are restricted to the applicability of German insolvency law.
- The application of home country insolvency law is, even under EU jurisdictions, only certain for insolvency proceedings over credit institutions and insurance companies domiciled in the EU (EU Directives 2001/24/EG and 2001/17/EG<sup>34</sup>) — but not for other types of enterprises such as SPV companies. This means that the separation of assets located in a country outside Germany and entered into the Refinance Register by a German non-bank or non-insurance company might not be enforced by the forum *rei sitae* in the case of secondary insolvency proceedings because such forum might not apply German insolvency law.

<sup>33</sup> Under the previous wording, this had been denied by Tollmann, *supra*, n. 25.

<sup>34</sup> Now integrated into the so-called Solvency II Directive 2009/138/EU.

- Insolvency-proof structures construed under non-German jurisdictions and tested by case law continue to be applicable.

#### **14. CONCLUSIONS**

Securitisation and syndicated collateralised lending require insolvency-proof rights in rem, particularly in cross-border transactions. However, in case of real estate situated in Germany or certain other civil law jurisdictions, beneficial interests in real estate security construed as common law trusts under English or US law might not give a satisfactorily enforceable right in rem, because the local courts would most likely apply national principles of property law under the *lex rei sitae*. The German Refinance Register offers feasible solutions in these cases.