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GUEST AUTHOR ANALYSIS: THE GERMAN FUNDING REGISTER'S INSOLVENCY-PROOF TRANSFER OF CROSS-BORDER PORTFOLIOS

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TOPICS: Regulatory: Disclosure, Region: EU and UK, Industry: Other

1. Background

The clearing up in the aftermath of the credit crisis¹ is the opening of a Pandora's box of legal issues which have not been tackled at all or, seemingly solved, have not been tested in respect of certain constellations. Legally valid and enforceable asset and portfolio transfers are essential building blocks of

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

The transferor's insolvency would be the litmus test. 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.²

Practitioners have tried to minimise related problems by ringfencing insolvency-remote special purpose vehicles (SPVs) holding legal titles for the benefit of a second tier of transferees, but this does not exclude claw back risks in respect of the initial transfers from the originators – 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 assets/portfolios is essential. In this regard, two basic traditional types have to be distinguished:

1. Common law traditions, normally relying on common law trusts and true sale Legal Opinions re. re-classification risks³; or
2. 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 Funding Register

The German Funding Register („Refinanzierungsregister“) is attributed to the second type. It was introduced with the aim of creating a solid legal basis for speedy and insolvency-proof asset transfers avoiding the sometimes time-consuming and costly procedures of the transfer of legal titles. 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.⁴ It provides for clear allocation of ownership in case of the transferor's insolvency. Construed as an exception to the general principles of German insolvency law, practitioners should be careful with analogous application and expansive interpretation.

The legal basis is scattered among several laws: the German Banking Act (KWG) - § 1 (24) to (26), and §§ 22a to 22o -, the Funding Register Decree, and the Pfandbrief Act and the Cover Register Decree (as far as the German type of statutory covered bonds - „Pfandbriefe“ - is concerned). Basically, the German initiative was originally driven by the fact that securitisations were being structured under foreign jurisdictions, or drafted as synthetic rather than true sale transactions. Due to this ad-hoc background⁵, 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 respectively the legal intent can be avoided.

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2.1 Scope of Application

Eligible transferors: „Funding enterprises“, i.e. any legal persons including entities under public law – KWG § 1 (24). Although not stipulated explicitly, eligible transferors should have their residence in Germany to be on the safe side, because related legislation is construed as an exception to national German insolvency law.⁶

Eligible beneficiaries / transferees:

- Credit institutions (established with a banking licence) with residence in the EU/EEA - KWG § 1(24) -,
- Special Purpose Vehicle Companies, not restricted re. residence – KWG § 1(26),
- Funding Intermediaries such as warehousing entities – only credit institutions, but not restricted re. residence – KWG §1(25),
- certain other entities, in particular EU/EEA central banks (with a view to repo funding), and the German KfW.

Eligible subject-matter of transfer: Assets and claims, real estate liens, registered liens in respect of aircraft, and ship mortgages, including tranches thereof⁷ – KWG §§ 1(24) and 22a. Based on § 22d(2) and (3) of the KWG and on the considerations of the legislative initiative re. § 22d, determinability of the subject-matter of transfer is required, i.e. the entry into the Funding Register must define the criteria respectively the documents by which the subject-matter can be determined. Statutory or contractual⁸ prohibitions of disposal exclude eligibility, whereas oral or implicit preclusions of assignment are overridden.

Eligible transfer transaction: Under § 1 (24)-(26) of the KWG, the disposal resp. acquisition of eligible assets or of claims on the transfer of such assets in return for equivalent value is required. However, the transferor may retain the economic risk and/or economic benefit of the related assets. This has been clarified by an amendment to the above-mentioned paragraphs of the KWG. The wording might not be quite perfect, but according to the explicit considerations of the 2009 legislative initiative, 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.⁹ Nevertheless, one has to be aware that under the principles of German insolvency law, assets encumbered with a mere security interest would be part of the transferor's insolvency estate. Therefore, it seems advisable to observe the demarcation lines vis-à-vis to a mere pledge or security interest, in order to avoid legal uncertainties. This is why the transfer transaction should aim at the final transfer of ownership / legal title at least in case of the transferor's insolvency.

The transfer contract and/or the transferred claim to be entered into the Funding 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 jurisdictions¹⁰. Such re-classification might be an obstacle to enforcement regardless of entry into the Funding Register.

In view of the above, proper drafting of the transfer transaction is crucial, and requires specific legal experience.

Eligible Keepers of the Funding Register: In case of credit institutions, normally the transferor; additionally the German central bank and the KfW, as well as certain public entities including German central and regional governments („Bundesländer“)- § 22a(1) KWG. Subject to consent by the German banking supervisors (BaFin), the German KfW or a credit institution having its residence in Germany may keep registers on behalf of third parties - § 22b(1) KWG.

2.2 Legal Effects of a Valid Entry into the Funding Register

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/rights validly entered into the Refinance Register. The result is separation from the transferor's insolvency estate. In addition, claims of third-party general creditors of the transferor are not enforceable in respect of entered assets, 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).¹¹

Restrictions: The above-mentioned ringfencing is restricted to existing and enforceable claims under a legally valid and enforceable transfer contract. The entry into the Funding 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 Funding Register Administrator in the case of insolvency proceedings - § 22n(3) KWG. In practice, this problem might be solved by perfection of assignments after entry, or by assignment of related rights of disposal.

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 claim or right which is not enforceable.

Nullity/Void Entries

Entries which are not eligible according to the principles mentioned above under 2.1 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 that even banks with a residence in the EU would be subject to home-country (and not German) insolvency law.

2.3 Enforcement of the Entry in the Funding Register

If insolvency proceedings are opened in respect of the transferor's assets, the right of disposal in respect of the entered assets is transferred to a Funding Register Administrator - §§ 22i - 22o KWG. This is possible as soon as insolvency becomes imminent.

2.4 Further Details and Procedural Topics

-Subject to the above-mentioned (supra, 2.1) principle of determinability, entry of tranches / portions of rights is permitted, including agreed ranking between transferred respectively retained tranches.

-Any deletion of entries is subject to the beneficiary's consent - § 22d(5) KWG.

-The Funding Register may be kept in electronic form.

-For each institution keeping a Funding Register, a Funding 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 entered items, nor the correctness of the register - §§ 22e to 22i KWG.

2.5 Funding Register and Covered Bonds („Pfandbriefe“)

Apart from considerations in respect of securitisation and syndication, the legislation on the Funding Register has been 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.

Such enforceability is provided for by the Funding 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, 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 Funding 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.

2.6 Funding 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 Funding Register provides an explicit solution for insolvency-proof syndications.

2.7 Funding 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 any reliable structure of insolvency-remote transfer prior to perfection of the transfer 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 subject to certain rating triggers related to the originator, in order to be on the safe side. Following the introduction of the Funding Register, final perfection of legal transfers can be construed insolvency-proof. However, two issues have to be considered and provided for:

-the costs of the final legal transfers;

-the risk of disposal by a transferor breaching his fiduciary obligations.

2.8 Funding 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 Funding 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 as beneficiaries should have their residence in the EU/EEA.

-The benefits of the Funding 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 having residence in the EU (EU Directives 2001/24/EG and 2001/17/EG) - 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 Funding Register by a German non-bank 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.

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

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¹Krusch, Opinion Letters: When a Sale is not a Sale, Westlaw Business Currents 26th March 2020; Elias, The Tale of the Grim Repo: Lehman's Link to True Sales, Westlaw Business Currents March 19th, 2010.

²In certain cases, the *lex rei sitae* has to be considered as conflicting law, as well as partial insolvency in certain jurisdictions.

³Which, as is turning out, might not have been tested for all constellations.

⁴Germany is not a party to the Hague Trusts Convention. 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.

⁵Related legislation was implemented in 2 waves – 2005/6 (basics), and 2009 (with a focus on syndication and cross-border considerations).

⁶Due to the lack of case law re. the exact demarcation lines of the *lex fori concursus* in respect of the Funding Register.

⁷Tranches with a defined ranking are eligible.

⁸However, § 354a of the German Commercial Code is applicable.

⁹Under 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/transferee.

¹⁰See Krusch, *supra* FN 1 and, in particular in respect of the UK, the decisions in *Re George Inglefield* (1933) Ch.1 and *Welsh Development Agency v Export Finance Co. Ltd.* (1992) BCLC 148.

¹¹However, problems in respect of commingling have to be taken care of - § 48, 2nd sentence of the German Insolvency Act (InsO).

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