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Asset-Backed Financing in Germany: Legal Concepts Affecting the Securitization of German Receivables

Alexander H. Stopp

Stopp & Stopp

Asset-backed financing is still in its infancy as an alternative to traditional banking instruments in Germany. One of the reasons is deemed to be uncertainty regarding the legal structure, validity, and enforceability of the many transactions involved in a securitization program. The Bundesaufsichtsamt für das Kreditwesen, the German Supervisory Authority for the Banking and Capital Markets Industry has recently passed a rule which gives securitizations their official blessing and will contribute to the acceptance of securitization as an effective commercial law financing instrument under German law. My view is that it is not so much the complexity of the law—commercial transactions law—that is to blame for this uncertainty but rather a scarcity of publicized and well-described transactions. An in-depth debate on the commercial law issues, including international aspects would go a long way to mitigate major concerns regarding the feasibility of German securitizations. Another reason for German reluctance to enter into securitization transactions, a trade tax issue, is currently being eliminated by the legislature.

I. INTRODUCTION

The lion's share of the capital raised in the asset-backed financing transactions commonly referred to as securitizations is raised through the sale of commercial paper in the United States. This is true as well for asset-backed financing programs that rely on foreign assets. Since the legal concepts that shape securitization as a capital raising approach are based on U.S. law, it should come as no surprise that the contractual arrangements for a securitization are often governed by New York state law. Typically, all contracts in a securitization program include a choice of law clause stipulating New York state law.

Such choice of law clauses are operative, even when there is litigation in a foreign jurisdiction. There are some aspects concerning securitization of foreign receivables, however, that are not exclusively governed by New York

state law. Ultimately, when the assets securing the issue of securities in the U.S. capital markets deteriorate in value or become completely worthless, foreign commercial law is relevant. The legal idiosyncracies of foreign jurisdictions may shape securitization transactions in foreign countries differently, and ultimately lead to alternative ways of risk management. The history of the unification of substantive laws on the assignment of trade receivables suggests that divergent national laws will continue to play an important role for some time to come.[1]

The core questions of commercial and bankruptcy laws in this context are: Which creditor is secured? Who "wins" in bankruptcy? Who finally has access to the commercial value of assets in which multiple security interests are perfected? These questions will often be decided before foreign courts and be subject to foreign laws.

This article endeavors to outline some of the issues arising under German law when transferring receivables originating from a German entity as a seller of receivables. As the pertinent provisions of German conflicts of laws are derived from the 1980 Rome Convention on the Law Applicable to Contractual Obligations, a multicountry convention, some aspects of the analysis will also be useful for the legal analysis of transactions in which receivables originate in other European jurisdictions. Simplifying the structure of securitizations of receivables somewhat, we will describe the sale of receivables (by virtue of a "Receivables Purchase Agreement") by a German originating party (assignor or "the seller") to a bankruptcy-remote vehicle (assignee or "the purchaser"),[2] which in turn is the issuer of commercial paper in the United States. The third-party debtors under the receivables are called "the debtors." The third-party creditors of the seller will be classified as money creditors ("third-party banks") or suppliers of materials (the "suppliers").

In a hypothetical transaction, the *Volkswagen* dealers, for example, could be sellers of purchase price receivables (the receivables) against their customers, who buy cars on credit from the dealers. Such receivables will in total amount to several hundred millions of deutsche marks. A special purpose vehicle incorporated in The Netherlands would typically be the purchaser of the receivables, and transfer them to a U.S. entity issuing commercial paper. From the proceeds of the commercial paper sold in the U.S. capital markets, the purchaser pays for the receivables.

Volkswagen AG would be the supplier (of the cars) and retain a security interest in the cars delivered to the dealers. *Volkswagen AG*, however, agrees for the dealers to sell the cars if the receivables, which represent the value of the cars, are assigned to *Volkswagen AG* beforehand. The consumer will not obtain ownership of a car until the purchase price is fully paid; nor will dealers obtain full title until they have paid the car manufacturer in full.

Because of the time delay between the payments due to the supplier and the funds received from the debtor, there is a need for financing. A bank (third-party bank) would therefore finance the dealers' business. The third-party bank will have to grant a loan to the dealers, as the dealers have to pay *Volkswagen AG* much sooner (typically 90 days) than the dealers receive monies from customers purchasing the cars on credit (typically a car loan runs for more than three years).

The purchaser faces a conflict with regard to the interest in the receivables. *Volkswagen AG* will retain a security interest in the cars sold, but will allow sale of the cars on credit if the purchase price (the receivables) is assigned by the seller (the Volkswagen dealers) for security purposes. Without full ownership (since *Volkswagen AG* still has a security interest in the cars), the dealers are unable to give a bank security interests in the cars. Therefore, the third-party bank will require a general assignment of all the receivables originating from the dealers as a security. Thus, the same receivables (the amount of the purchase price for the cars) are assigned twice even before the purchaser enters the scenario: first, to *Volkswagen AG* and then to the third-party bank.

The credit extended to the dealers is a revolving credit. Any time money is received from customers, payments are made on the bank loan; any new customer, however, requires a new bank loan. Therefore, the overall volume of the loan may be relatively stable (assuming that the number of cars sold is stable). Only the underlying individual transactions (purchases by consumers and loans to the dealers) change. New loans are taken out as new cars are sold, but old loans are paid back by dealers as buyers make their payments to dealers.

We have to be careful about the terminology. Even though there are many transactions, for the purchaser of receivables only the volume of receivables at any particular time and the validity of the transfer of such receivables to the purchaser are the relevant point of reference in all securitization analysis.

How, then, can a purchaser of receivables hope to win over two prior assignments (the first one to the supplier —*Volkswagen AG*—and the second one to a third-party bank)? The answer is complex, but the purchaser stands before the supplier. For the third-party banks, the result turns on priority in time (the time the assignment is made).

Some European jurisdictions have adapted statutes dealing specifically with securitization transactions. Germany has not passed such a law, since the general view

is that securitization is permitted and covered by the existing laws. The legal analysis under German commercial law is commonly based by analogy on factoring, as factoring has in many respects a similar legal structure and commercial transaction patterns.[3]

There are no court decisions on securitization under German law, but the factoring model seems plausible. The basic vehicle of granting rights in accounts receivables in both factoring and securitization transactions is the assignment of receivables for the purpose of obtaining funds from a financing entity (such as the purchaser of the receivables) outside the seller's ordinary course of business. Some aspects of securitizations vary enough from factoring transactions that the courts will apply different reasoning. We address such differences in more detail later.

We first discuss the conflicts of laws issues in Section II and address some aspects of transferability under German substantive law before we focus on the most common commercial situation: potentially conflicting security interests in receivables in an asset sale setting, such as the conflict between the security interests of third-party banks and the suppliers' security interests. We summarize the accounting and tax issues that make securitization desirable under German law, including the true sale question, and deal with some of the intricate aspects of credit enhancement in securitization of German receivables.

II. CONFLICTS OF LAWS: THE ROME CONVENTION OF 1980

In order to determine which law will be applicable to certain assets, the assets have to be legally "localized". Land, whatever the legal concepts are that make it a legal commodity, is almost invariably localized "where it lies" (*lex rei sitae*), as is the case in many chattel cases. Claims, receivables, or general obligations (for money or for the performance of services or transfer of rights) are more difficult to "localize".

European law has unified the conflicts of laws rules in many European countries to a certain extent. The most unified area is currently the law of contractual obligations. Article 12 of the 1980 Rome Convention on the Law Applicable to Contractual Obligations reads: [4]

> ***Transfer of Claims.***
>
> (1) The obligations between assignor and assignee of a claim are governed by the law applicable to the contract between them according to this Convention.
>
> (2) The law applicable to the claim assigned governs the claim's transferability, the relationship between the assignee and the debtor, the circumstances under which the assignment can be invoked against the debtor, and the liberating effect of performance by the debtor on the claim.

The Rome Convention is not self-enforcing; the signatory countries implement its provisions. There is German legislation that implements the rules promulgated by the Rome Convention. The German law implementing Article 12 further provides that:

> If a third party is obligated to satisfy the obligation, the law applicable to the obligation determines whether recourse can be had to the debtor wholly or in part. The same applies if more than one party is obligated to satisfy on one obligation and the creditor has received satisfaction from one of such parties.

Article 33 of EGBGB (the German Law implementing Art. 12 of the Rome Convention), subsection (I), regulates the relationship between the seller and the purchaser according to the contract of assignment between them, often subject to New York state law. Article 33 of EGBGB, subsection (II), however, addresses whether a receivable is transferable; the relationship between the purchaser and the debtor; enforceability of assignment against the debtor; and how the debtor can fulfill within the law originally governing the contractual relationship between the seller and the debtor. As a result, both the contractual relationships between the assignee (the purchaser) and the debtor under the receivables (the debtor) the legal issues that arise in connection with the transfer of the receivables (such as form, specificity, priority, and other issues of transferability) are dictated by current law governing the receivables. The choice of law governing the contract between assignor (the seller) and assignee (the purchaser) does not affect these issues. That is, the law governing the original contractual basis of the receivables is interpreted to be "attached" to the receivables. In other words, the original law follows the receivables, no matter how often acts of assignment transfer the receivables to different owners (creditors or purchasers).

The result is that there could be an unexpected outcome if there is a chain of assignments, and the purchaser is ultimately an entity quite far from where the receivables originated. At second glance, however, this rule is a fair way of dealing with the debtor's legitimate expectation that the law under which the contract was originally entered into will not change.[5] This is crucial when it comes to determining the scope of the debtor's performance obligation which may well differ under different legal regimes.

It is the prevailing view that even in cases of assignment for security purposes only the legal prerequisites for assignment (transferability of the claim, specificity, and

so on) are subject to the law governing the receivables that are being assigned. The counter argument is that, in case of global assignments, which may predate the existence of the receivables it may not be possible to determine in advance which law will govern the receivables, as one knows neither debtors nor the details of the contractual stipulations, such as a choice of law clause. Therefore, some authors favor the law of the place where the seller has its domicile (see Kaiser, 1986, pp. 207, 222). One should note, however, that this view would typically lead to the same result in most securitization transactions, where the seller stipulates the application of its home country law.

A similar argument has been put forth by H. Stoll[6] in the case of *verlängerter Eigentumsvorbehalt* (suppliers' security interest in goods transferred into a security interest in the seller's receivables by assignment of the receivables for security purposes only). Stoll suggests subjecting such assignments to a different law (namely the seller's law) from the one governing the receivables. According to Stoll, in the *Volkswagen AG* hypothetical, *Volkswagen AG* (the supplier) will face questions regarding German, French, English, and U.S. law if the *Volkswagen* dealer (seller) sells cars to Germany, France, England, and the U.S., and if such sales, as consumer transactions, are subject to the consumer's home country law. Stoll believes that different laws governing the receivables in such a case could lead to different treatment of assignments (which may often be just one assignment), which raises a question about application of the law governing the receivables under Article 33 of EGBGB. In other words, assignments of the future receivables without notification to the debtors who are the actual consumers will be valid under German law. French law, however, may require debtor notification.

Stoll's conclusion is to choose the seller's law. This leaves the debtor and purchaser unprotected as they are not parties to the assignment. The debtor will find it has to deal with an assignment that is subject to a different law from the law that governs the receivables. Stoll, in advocating this view, tends to exempt basic principles regarding debtor protection from the rules of the law at the seller's legal seat and base such rules on the law governing the receivables[7].

The *Bundesgerichtshof* (German Supreme Court in Civil Matters) rejected this argument in 1991. The Court expresses clearly that there should be no distinction between standard assignments and assignments for security purposes. The opinion emphasizes that despite Stoll's view, transferability and debtor's protection are subject to the law governing the receivables, and this law will therefore continue to play an important role in the analysis. According to the Court, it remains unclear in Stoll's analysis what the scope of the seller's law should be.

In our hypothetical, Stoll would apply German law to the assignment, even though some or all of the receivables are not subject to German law. The question remaining, according to Stoll, is whether debtor notification under French law would be considered a mandatory debtor protection mechanism for the assignment. In our view, it is not surprising that the Court found Stoll's result too unclear.

Finally, the Court explicitly bases its opinion on the wording of Article 33 (II) of EGBGB, which it claims (It is the view of the German courts that this rule merely codifies what has been the legal rule.) As a result, it is firm principle that the law governing a claim will determine the details of the way the claim can be transferred. Contracts between the seller and the purchaser of the claim cannot interfere with this principle. Particularly when all contracts in a securitization program include a choice of law clause stipulating New York state law, this is a noteworthy result. The New York state law clause will not be enforced by many European courts when they determine the transferability of receivables under Article 12 of the Rome Convention.

III. ISSUES OF TRANSFERABILITY OF CLAIMS UNDER GERMAN LAW

A. Basic Legal Features of Contractual Assignments

An obligation is transferred under German law by a contract consisting of an offer by the transferor and an acceptance by the transferee. The assignor (transferor) is referred to as the seller and the assignee (transferee) is referred to as the purchaser. There is in German law a distinction between contracts that transfer assets or otherwise affect title and contracts that entail only an obligation to transfer. This formal differentiation rather complicates German commercial law. A sales contract is merely an obligation to transfer property; it is not the transfer itself. It may well be the case that a seller sells receivables without transferring title at that time.

On the other hand, it is legally possible, and not unusual for security purposes, to transfer receivables without the transferee being a buyer of the receivables. It is also possible under German law to transfer obligations even before they exist, provided that it can be ascertained which specific obligations will be transferred (assignment of future receivables). A transfer of future receivables becomes effective under the condition precedent that the claim or obligation arises. This may have significant ramifications if receivables have been assigned to different assignees, since, as a general rule, an earlier assignment prevails over a later assignment.

It is generally accepted commercial and banking practice to obtain an assignment for security purposes of all receivables, including future receivables, of a given debtor company (so-called *antizipierte Globalzession*). In the case of a true sale of receivables, it is accepted commercial practice for the assignee to obtain an assignment for security purposes of all receivables, including future receivables under the condition precedent that a sales contract about the receivables will be entered into by the parties later. No issue of overcollateralization arises in this context, as the security interest in the receivables becomes effective only at the time and to the extent a contract of sale is concluded between the purchaser and the seller.[8]

German law does not have a statute of fraud equivalent. Only in enumerated specific cases are there legal form requirements such as the ones for the transfer of land, gifts, and wills. For an assignment to become effective, the debtor need not be notified, nor is there a registration or any other filing requirement.

If the debtor makes payment to the original creditor (the seller), the obligation is fulfilled and the claim extinguished even if the debtor is not aware of the assignment. Thus, it may be in the interest of the transferee (the purchaser) to notify the debtor of the assignment.

Therefore, one should include a provision in the receivables purchase agreement between the seller and the purchaser that the purchaser is entitled to notify the debtors (and then receive payment directly from the debtor). It is a common bank practice to obtain blank assignment notifications from the original creditor (the seller). If the seller should appear financially weak, the purchaser can notify the debtors using the seller's notification form and ask them to pay the purchaser directly.

If the debtor pays the seller after the assignment has become effective, the purchaser has a direct, but unsecured, claim against the seller for the monies received under civil law rules of unjust enrichment. It is obvious that the lack of a publication requirement, the lack of a legal form requirement, and the transferability of future receivables will all tend to make assignments a form of asset sale of last resort for companies that are unable to get credit from lending institutions.

B. Ineffectiveness of Assignments of Certain Receivables

An assignment will be ineffective in some cases under German law. If there is a contractual stipulation between the seller and the debtor that the claim cannot be assigned, for example, an assignment will not be effective. The courts have ruled that statutory provisions such as laws assuring confidentiality between attorneys and clients and between banks and their customers may mandate that a claim cannot be transferred without the debtor's (client's) prior consent. Intricate issues regarding the transferability of claims may arise in connection with bank secrecy and other privacy laws such as, for example, data protection statutes.

These questions concern the nature of the claim itself. There are, however, also transferability issues arising from the relationship between the seller and other parties in multiparty settings.

C. Conflicting Assignments

In some cases, assignments will be ineffective as a result of third parties' rights. Often, a prior assignment will prevail over a later assignment regarding the same claim: *ne transfereat plus*, or, one cannot transfer more than one has. The basic rule provides that early assignments win over later assignments. A claim already assigned to Party A cannot be transferred again to Party B by the same assignor. Priority in time decides the conflict in many practical cases, as German law and commercial practice allow for "future" assignments, since there are no publication or form requirements.

Because priority in time turns out to be, under a legal system that does not use notification or publication methods, a rather arbitrary criterion for solving conflicting interests among commercial parties, the *Bundesgerichtshof* has introduced another concept to address possible conflicts between assignments. The Court holds that a bank asking for assignment of receivables that can normally be expected to be assigned to the customer's suppliers may violate principles of public policy. The reason for the violation of public policy is that the bank induces its customer to defraud the suppliers regarding the ownership of the receivables.

In other words, if it is the commercial practice that car dealers buy vehicles on credit from the manufacturer, and the manufacturer obtains an assignment of the purchase price owed by the consumer (receivables) as a security, a bank asking for an assignment of just those receivables induces the car dealer to lie to the car manufacturer. The manufacturer will not relinquish possession of the cars without obtaining rights to the receivables, but if the bank had obtained the assignment before the car manufacturer had contacted the car dealer, the car manufacturer would, according to the priority in time rule, lose. The Court's opinion has therefore been labeled the breach of contract theory.

The most relevant application is in the case of a third-

party bank that is aware that the seller will normally assign the receivables arising from the resale of goods to the seller's suppliers. The courts have even invalidated assignment contracts for the benefit of third-party banks, if there were a clause in the assignment contract stipulating that the third-party banks were to re-assign any receivables assigned previously to suppliers. The reason for such a far-reaching invalidation is that a reassignment clause would shift the onus to the suppliers to invoke their rights as against the third-party banks in legal proceedings. Only an assignment contract exempting from assignment *ab initio* all claims assigned to suppliers will pass muster under the Court's rulings. Even a stipulation that the loan granted by the third-party banks is to be used for payment of the suppliers' claims first does not legitimize a global assignment for the benefit of the third-party banks.

IV. THIRD PARTY BANKS VS. SUPPLIERS IN FACTORING SITUATIONS

The *Bundesgerichtshof* has held that non-recourse factoring agreements are comparable to a cash transaction in which the receivables are paid in full by the debtor upon delivery, because (1) the seller receives full value for the receivables, and (2) the seller does not have to return the purchase price for the receivables. This is the so-called cash analogy. Therefore, the strong policy against third-party banks, which results in the breach of contract theory, is not applicable. The central element of a true sale from this point of view is the absence of a recourse provision and the similarity of the transaction to a cash transaction. The Court holds that only such a "true sale" is covered by the general authorization given by the seller's suppliers for the seller to dispose of goods in the ordinary course of business.

It should be noted that the authorization is based on an implied consent given by the supplier. Such authorization is largely fictional in nature, as the *Bundesgerichtshof* has held in various cases that it would be against public policy for the supplier to prevent the resale of goods in the seller's ordinary course of business. As a consequence, the purchaser obtains full title to the receivables in a non-recourse ("full") sale, even if the receivables have been assigned to a third party prior to the sale and assignment to the purchaser. The conflict rules related to priority in time or breach of contract therefore do not apply.

In securitization transactions, a party not privy to the sale of the receivables will normally "enhance" the value of the assets transferred by entering into an obligation to return the purchase price, or even the nominal amount of the receivables, to the purchaser in certain defined cases of default under the receivables. Credit enhancement cannot, however, come directly from the seller. The reason for this is that the *Bundesgerichtshof* has exempted such cases from a non-recourse factoring analysis.

It would seem that, were the third party identical with the seller, the *Bundesgerichtshof* would (conflict between the purchaser and suppliers of the seller) apply the principles announced in its opinion dated October 14, 1981. In this opinion, the court explicitly holds that the suppliers' authorization to resell the goods and dispose of the receivables in the ordinary course of business does not cover recourse factoring. The reasons provided for its decision are that recourse factoring is qualified as a loan by the German courts; therefore it would be treated like an assignment of all receivables for securing a bank loan.

In other words, the cash analogy would not be drawn when the seller submits to recourse subjecting the seller to the risk that it may not be able to keep the economic benefit of the purchase price for the receivables. In such cases, the supplier prevails over the bank as a secured creditor. Any and all receivables sold to the purchaser, but also assigned to the suppliers, would vest not in the purchaser, but in the supplier. Even if all receivables were all subsequently paid, the suppliers could still claim the sums tendered directly from the purchaser or the third-party banks.

The law is not entirely settled with regard to a conflict of assignment to the purchaser with assignment of all receivables (so-called *Globalzession*) to the benefit of money creditors (third-party banks). There have been suggestions that, in the case of a true sale, transfer of title to the purchaser should always prevail over an assignment of all receivables, including future receivables, for the benefit of a creditor bank. The *Bundesgerichtshof,* in two opinions, however, has not been unambiguous in its holdings.[9]

In the first case, the official ruling was "The authorization granted by the secured creditor to the borrower in cases of assignment of all receivables, including future receivables to enforce the receivables assigned, does not entitle the borrower to assign the receivables a second time and sell to a factor by way of non-recourse factoring." In the more recent opinion, the Court officially held without overruling the prior case that "The authorization granted by the secured creditor to the borrower in cases of an assignment of all receivables, including future receivables, to enforce the receivables assigned entitles the borrower to assign the receivables again insofar as the borrower obtains non-refundable (final) consideration for the receivables in the amount of the full value of the receivables at the time of the assignment."

One cannot, however, rely on the second opinion, as it

dealt with unusual factual circumstances. Hence, the conflict is, according to the prevailing view among German legal scholars, decided by priority in time. This means that if a purchaser obtains an assignment of all receivables, including future receivables, earlier than a third party, title to the receivables will vest with the purchaser. In the reverse situation, if another party obtains an assignment of all receivables, including future receivables, earlier than the purchaser, title to the receivables will vest with the third party.

This principle of priority in time also applies if the transfer of the receivables is not a "true sale," but is qualified as a loan. Therefore, as a general rule, the purchaser should attempt to obtain an assignment of all receivables, including future receivables, under the condition precedent that a sales contract is concluded regarding the receivables.

V. STRUCTURING SECURITIZATIONS OF GERMAN RECEIVABLES

A. Tax and Accounting Issues

1. Elimination of Accounts Receivable from the Seller's Books

One of the incentives for a seller to enter into securitizing receivables is that the receivables will be exchanged for cash. This may have a very welcome effect on the balance sheet. The incentive for changing from traditional bank financing to securitization, in our *Volkswagen* hypothetical, is that even though securitization serves a traditional financing function, the sale of the receivables does not show up as a loan on the seller's books. This result can be achieved only if securitizations are treated like non-recourse factoring. For this purpose we must differentiate factoring transactions without recourse and with recourse.

In non-recourse factoring agreements, the unwillingness or inability of the debtors to pay, which is the credit risk, is borne by the factor (the purchaser). In recourse factoring agreements, this credit risk is assumed by the client (the seller).

Receivables must be capitalized on the balance sheet of the "economic owner." The economic owner of receivables is the entity that bears the credit risk. In the case of non-recourse factoring, the receivables must therefore be capitalized by the factor (the purchaser). In the case of recourse factoring, the German Supreme Tax Court (*Bundesfinanzhof*) treats the client (the seller) as the economic owner, and characterizes the consideration tendered by the purchaser as a loan. The *Bundesgerichtshof* follows the same qualification (see Betriebsberater, 1982, p. 9).

Some legal scholars disagree, however. They suggest capitalizing the receivables on the balance sheet of the factor (the purchaser) and entering an accrual on the balance sheet of the client (the seller) in case of bad debt losses.

2. Income Tax and Trade Tax Aspects

Factoring can increase the German trade tax burden, when applicable. The trade tax has two components: the trade tax on income, and the trade tax on capital. Recent legislation has eliminated the trade tax on capital, so its tax effect is not an issue for structuring future securitizations in Germany.

The trade tax on income is calculated on the accounting profit. Most of the rules for income determination apply also to the trade tax. An important adjustment is that half of the interest expense on long-term debt is not deductible. In practice, most important is the so-called long-term loan.

Long-term loans are relevant for the trade tax on income as well as for the trade tax on capital. Debt connected with the establishment of a business or its improvement as well as loans providing the long-term capital base of the business are usually considered long-term debts; this may include mortgages, long-term bank loans, and corporate bonds. "Long-term" is defined as a term of more than one year. Debt assumed in an exchange transaction like loans to finance or delivery contracts or wages is not considered long-term for trade tax purposes.

Recourse factoring is interpreted by both civil courts and tax courts in Germany as a loan. Therefore, the receivables will be capitalized on the seller's books on the commercial balance sheet as well as the tax balance sheet. For income tax purposes, the seller can deduct the interest or other fees paid to the purchaser as tax-deductible expenses. For trade tax purposes, half of the interest for long-term loans must be added to income, thereby forming the tax base for the trade tax under the condition that the payments the seller receives from the purchaser are not used for ongoing business operations, but serve as a reinforcement of the long-term capital base of the company (see § 8, No. 1, German Trade Tax Act). In addition, 50% of the principal of the long-term loan in excess of an amount of 50,000 DM must be added to the assessed value forming the tax basis for the capital trade tax.

In the leading case decided on recourse factoring, in December 1986 the Court ruled against a seller of receivables under a recourse factoring agreement stating that the seller had used the short-term loans given by the purchasers in the seller's company to finance a long-term

contract essential for its business. Non-recourse factoring, on the other hand, is interpreted by the civil courts as a purchase of receivables and not as a loan. The German tax law, in principle, follows the reasoning of the civil law.

Therefore, in the case of non-recourse factoring, the transaction is classified as a purchase and interest, meaning that the discount between the nominal amount of the receivables and the purchase price, cannot be added for trade tax purposes. Since the receivables are not on the seller's books, nor is there any other obligation owed to the purchaser because the purchase of the receivables has been consummated, no "long-term debt" issue can arise. In the case of non-recourse factoring, it would be inconsistent with the qualification as a purchase ("true sale") to render an invoice for services such as administration of the receivables, if the purchaser were the true "economic owner" of the receivables.

B. "True Sale" Issues

Following the factoring analogy, for a transaction to qualify as a "true sale" for commercial law as well as tax law accounting purposes, the basic tenet is as follows. There is a general presumption that the purchaser indeed assumes the risks ordinarily associated with the ownership of the claims as long as the purchaser has no recourse against the seller in case the receivables are not paid because of the debtors' inability or unwillingness to pay. There is some indication, in factoring cases decided by the *Bundesgerichtshof*, that there is an additional requirement that the purchaser pays full value for the receivables. German regulations stipulate that for an issuer to be able to remove the securitized assets from its balance sheet, recourse back to the seller must be limited to less than 10% of the value of the receivables sold and the receivables can not be transferred back to the seller unless the seller pays the current value of the receivables. If the purchase price is deeply discounted in a manner that in no way reflects economic reality, it will be assumed that the seller did not "truly sell" the receivables.

Under commercial law, it will remain an open issue in such circumstances whether the analogy drawn by the *Bundesgerichtshof* between a cash payment by the debtor and a sale to the seller will stand.

C. Credit Enhancement by Third Parties

It is not uncommon in securitization programs for the purchaser to enhance the value of the assets by additional instruments. A classic instrument providing additional security for the owner of a receivables pool is a bank's letter of credit or guarantee due in case of a defined default ratio of the receivables. The bank will, upon the drawing of the letter of credit or the exercise of the guarantee, purchase all or part of the defaulted receivables pool. Of course, if a number of banks secure a pool of receivables, it would have to be decided, according to German law principles of specificity of assignment, which receivable will be transferred to which bank. This may be a legal aspect overlooked by banks and their legal counsel if the transactions involved are of an international nature. The German Supervisory Authority for the Banking and Capital Markets Industry emphasizes the specificity requirement in its Ruling[10].

Often, as German law has strict requirements to be met for qualification as a "true sale," credit enhancement is supplied by non-banks. A traditional tool for providing credit enhancement is credit insurance, which for various reasons may turn out to be costly and therefore inefficient.

Sometimes, affiliates of the seller or the seller's parent company may secure the performance of the receivables pool to some extent, which may be the most efficient way to allocate the credit risk. The seller will often have long-term business relationships with the debtor or will at least be knowledgeable about industry practices, including the debtors' payment history. For "sister" companies providing credit enhancement, no serious problems arise regarding true sales and thus, the validity of the assignment as against the suppliers.

This remains true even though often the acts of one legal entity are attributed to the other under German corporate law concerning industrial conglomerates, if two companies are owned and controlled by the same parent company. The German Supervisory Authority will consider the "factual backing" of the assets by the Seller if the Seller is a bank and the Single Purpose Vehicle (the Purchaser) is part of the same conglomerate, has an identical or similar firm name and if there is no explicit remark in the prospectus that the investors can only claim against the Purchaser but not the Seller. The regulatory focus on "factual backing" may make certain securitization structures problematic. Increasingly, the fact of common ownership is taken by the German courts as a reason to treat different legal entities as one for liability purposes. The cases decided, however, do not involve facts similar to securitization transactions. I also do not necessarily think that German legal rules about industrial conglomerates would be applicable to all relevant international sets of facts.

Still, it is not inconceivable that the German courts might decline to treat some transactions as true sales because of the security provided to the purchaser by the seller's sister company, if the purchaser is motivated to participate in the particular transaction because of this

additional security. I would submit that in a securitization setting the courts will most likely base analysis of the bankruptcy issue on whether the entity rendering the credit enhancement is "downstream" or "upstream" in the corporate structure from the seller. An upstream legal entity that directly or indirectly owns the seller would not normally be included in the bankruptcy estate, while a downstream entity would be.

In other words, a parent company's assets, under ordinary circumstances, are not subject to third-party creditors' claims. The result is that a financial loss taken by the parent company will not affect the third-party creditors' rights. It is simply none of the creditors' concern how much the parent company is worth.

On the other hand, financial losses taken by downstream entities may diminish the seller's value. Applying the *Bundesgerichtshof*'s cash analogy, monies received by the seller are not subject to the seller's final disposition if there is an obligation entered into by a downstream affiliate that could weaken the seller's position. In case of bankruptcy or attachment procedures, this could diminish the seller's asset values. Guarantees given by downstream affiliates will likely affect the true sale analysis, and the receivables will in such a case be subject not only to prior assignments for the benefit of third-party banks, but also to subsequent assignments for the benefit of suppliers.

VI. CONCLUSION

Securitizations of German receivables do involve many legal aspects. The issues under German law are complex and multifaceted, but they are traditionally well-defined. The courts have ruled on most of them. To sum up the result, securitizations will be treated in many respects like traditional bank financing or factoring.

The greatest commercial risk a purchaser in a securitization program faces is that there may be prior assignments of all receivables, including future receivables, for the benefit of third-party banks. Consider that any commercial bank has to control for the same risk when granting loans in Germany. Hence, there is no basis for a claim that legal insecurity should prevent securitizations from becoming an accepted financing practice in Germany.

With the trade tax issue now resolved by the legislature, we may expect to see more and more securitizations in Germany.

END NOTES

[1] See D. Wallace, Jr. and H. Burman, "Trade Financed by Accounts Receivable: Can International Rules Be Unified by the Year 2000?": *ABA International Law News*, vol. 26, no.1, winter 1997, p.1 .

[2] For the purposes of the discussion, it is not necessary to distinguish between Special Purpose Vehicles and other forms of purchasing vehicles, such as trusts.

[3] The German commentators normally avoid addressing this issue directly. See A. Früh, "Asset Backed Securities/*Securitization am Finanzplatz Deutschland*," in: *BetriebsBerater*; but see Chr. Goegher, 1996, *Securitisation*; compare also R. Preusche/I. Smolka/Chr. V. Dryander, 1992, "Securitization in Germany", in: H. Morissey (ed.), *International Securitization*; Th. Baums, 1984, *Asset Securitization in Europe*; Th. Baums, 1992, *Asset-Backed Finanzierungen*.

[4] The Rome Convention has been in force as between Belgium, Denmark, France, Italy, Luxembourg, the United Kingdom and Germany since April 1, 1991; it has later become effective for the Netherlands, Ireland and Greece. The text supplied here is a translation of the German version.

[5] This was the rule under German conflicts of laws even before implementation of the Rome Convention.

[6] IPrax (1991), p. 225; Staudinger-Stoll, IntSachenR RdNr. 291, 292.

[7] See Reithmann-Martiny, 1996, *Internationales Vertragsrecht*, 5th edition, RdNr. 311.

[8] German courts have adopted a rather strict doctrine of overcollateralization, according to which security interests whose market value exceeds the amount secured by a certain percentage will be held unenforceable.

[9] December 19, 1979, in *Bundesgerichtshof in Zivilsachen* vol. 75, p. 391, and November 11, 1981, in *Bundesgerichtshof in Zivilsachen* vol. 82, p. 283.

[10] The German Supervisory Authority for the Banking and Capital Markets Industry, the Bundesaufsichtsamt für das Kreditwesen, has recently passed a rule that securitizations do not require administrative approval, Rundschreiben 4/97 dated March 19, 1997 (file no. 13-21-3.95) issued by the Bundesaulsichtsamt für das Kreditwesen (Administrative Ruling by the German Supervisory Authority for the Banking and Capital Markets Industry hereinafter referred to as the "Ruling"). The Ruling covers the administrative aspects of securitizations, in which banks subject to the rules of the German Supervisory Authority for the Banking and Capital Markets are Sellers. Beyond this, it indirectly acknowledges that securitizations are a legitimate means of refinancing receivables.

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ALEXANDER H. STOPP is a partner in the Bad Homburg, Germany, law firm of Stopp & Stopp. He received his legal education in Augsburg, Germany, and earned a Master of Law degree at the University of Michigan, which he attended on a fellowship of the *Studienstiftung des deutschen Volkes*. He is a member of the bar both in Frankfurt am Main and in New York State. Mr. Stopp has been involved with several securitization programs for German receivables. Practice areas include banking, general corporate and commercial law, including international, and intellectual property law.