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Project Finance

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Law and Practice

Contributed by SZA Schilling, Zutt & Anschütz

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SZA Schilling, Zutt & Anschütz advises domestic and international clients in all areas of corporate and commercial law. It provides legal counsel to leading industrial and trade enterprises, banks, insurance companies and financial services providers, as well as large family-owned businesses and wealthy private clients. The finance team is based mainly in Frankfurt am Main, and currently consists of three partners, one counsel and five associates. It has experience in a broad array of projects, both domestic and cross-border, and advises lenders, borrowers or sponsors on project finance transactions.

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1. Project Finance Panorama

1.1 Recent History and Expected Developments

Project finance represents an important sector of the German finance market, not only for domestic projects and transactions but also for cross-border transactions which either physically cross the German border or which are located outside of Germany but contain a German element. Among those projects which are located within the German territory or the German exclusive economic zone ("EEZ"), renewable energy projects, including on-shore and off-shore wind farms and photovoltaic energy, or federal highway financing play a predominant role.

Furthermore, the financing of international joint ventures within Germany may take the form of project finance if the sponsors aim to keep the financing off-balance-sheet. This applies accordingly to infrastructure projects that involve the territory of multiple jurisdictions, EEZs and the High Sea (ie, international waters). One representative example is the financing of the NordStream 1 pipeline between Vyborg and Greifswald.

Another important type of project where project finance becomes the preferred finance option are cross-border projects, either in the private sector or in the form of public-private partnerships ("PPPs"), where the project may be physically located in any part of the world but involves strong German elements such as German sponsors, German exports or German lenders taking a leading position.

In case of large-scale projects project finance may be combined with export finance, untied loans (*ungebundene Finanzkredite* – UFKs) or finance schemes eligible for other

forms of government support such as, but not limited to, investment guarantees for equity-like loans.

Except for purely domestic projects, all of these transactions usually involve the laws of many different jurisdictions. Depending on the composition of the sponsors group and the syndicate of lenders, German law and English law represent the most common choices for the governing law of the facility agreement, while the governing law of security agreements is heavily dependent on the type and location of the relevant security.

Although the share of project finance transactions in the German domestic market is limited, project finance remains as an indispensable option for eligible projects. However, the limited number of transactions in this area of finance supports a concentration of the relevant market on a number of specialised key players, bearing in mind that project finance is complex and not every institution can afford the costs of building up and maintaining the required expertise in-house. Furthermore, low interest rates and redundant liquidity in the market continue to affect the demand for project finance, and existing sanctions have an impact on the project finance market for sponsors, exporters and lenders.

As project finance, because of its complexity, involves higher transaction costs than other forms of finance, it remains a predominant form of finance for large-scale and mega-projects, but is not necessarily suitable for smaller transactions. In this context, project finance plays a particularly strong role during the structuring and construction phase of projects as well as during the first years of the operation phase of complex projects. After a project has been successfully implemented and proven its sustainability during the initial part of the operation phase, the sponsors may consider refinancing the then-existing project finance wholly or in part through project bonds or other less complex forms of finance that reflect the different risk profile of an ongoing successful project. For this reason many project finance arrangements are repaid before their final maturity date.

Project finance will hence continue to play a key role for complex large and mega-projects, while the statistics will remain volatile because – due to the number of transactions and the volume of individual mega-deals – single transactions or a change of their timing tend to have a tangible impact on the relevant figures.

1.2 Institutions Typically Acting as Sponsors and Lenders

In a typical scenario for medium-sized projects it is usually one sponsor or a small group of sponsors including at least one knowledge investor from the relevant area of industry. This key sponsor may form a syndicate with other sponsors that are equally involved in the implementation of the project, such as the EPC contractor or other parties. In case of large and mega-projects the sponsors group consists normally of a group of joint venture partners originating from the relevant industry, but including also finance investors such as equity or pension funds. In this context the risk profile, as reflected in sponsors undertakings such as the commitment to provide additional equity or mandatory holding periods agreed with the lenders, may also have an impact on the eligibility of the project for pure finance investors. In general, it can be observed that the participation of finance investors tends to increase once a project successfully enters the operation phase.

In medium-sized transactions we see projects financed by one single German financial institution as lender, but for large transactions and mega-transactions it is usually a syndicate of lenders that provides the senior lending. In case of complex mega-deals it is also common to have different facilities such as an ECA facility, an untied loan facility and a commercial facility, each of which is granted by different syndicates and interlinked by means of an intercreditor agreement. Here a number of German financial institutions with rich experience in the area of project finance frequently takes the lead as arranger or agent, but there are also a considerable number of foreign banks with a strong presence in Germany which are equally active and successful in project finance in Germany. In particular, the role of the agent for facilities covered by guarantees issued by the German government (export guarantees, untied loans or investment guarantees for equity-like loans) is normally taken by German financial institutions or experienced foreign banks with a strong presence in Germany.

In case of development projects abroad with a strong German element, German development finance institutions, sometimes in a syndicate with foreign development finance institutions, play a leading role.

1.3 Public-private Partnership Transactions

In Europe, financing agreements for 42 PPP projects totalling EUR14.4 billion were concluded in 2017. Thereby, 13 of these 42 completed PPP transactions were funded by institutional investors (insurance companies, pension funds, etc), compared to 17 out of 68 projects in the previous year. As a whole, the number of projects in 2017 declined by 38% compared to the previous year; however, the market volume of PPP projects grew by 22% compared to 2016. Within Europe, Germany ranks fifth (together with Turkey) in terms of the number of tendered projects, and it ranks fourth in terms of aggregate projects value.

With regard to the 2017 PPP projects in Germany, the transport sector dominated, followed by constructions related to healthcare and education.

With regard to transportation infrastructure, a EUR650 million project with a term of 30 years was closed on 15 February 2018 – ie, a project for the renewal of the motorway BAB A10/24 in Brandenburg between Neuruppin and

Pankow with BAM and HABAU as sponsors. The project debt is financed via long-term bonds, a structured finance facility provided by EIB and short-term loans provided by BayernLB, DekaBank, DZ Bank, Rabobank and Tecta.

Other motorway PPP projects presently in a tendering procedure include the motorway BAB A3 project between Interchange Biebelried and Interchange Fürth/Erlangen, motorway BAB A49 between Interchange Fritzlar and Merging Point Ohmtal, as well as two smaller projects on federal highway B247. In addition thereto at least seven further motorway expansion projects are presently in the project pipeline.

With regard to healthcare-related PPP projects, the University Hospital Schleswig-Holstein, the Particle Therapy Centre Kiel, the Hochtaunus-Kliniken (hospitals) and the West German Proton Therapy Centre in Essen represent landmark projects of a considerable size. The Proton Therapy Centre in Essen underwent a successful financial restructuring a few years ago. In addition thereto, many smaller projects have been implemented or are in the pipeline.

In addition thereto, there are a large number of PPPs in the education sector with Berufliche Schulen Hamburg (vocational schools of the City of Hamburg), the Fourth PPP Package of Schools in the City of Cologne, two schools PPPs of the City of Offenbach and a schools PPP of the City of Frankfurt am Main as outstanding landmark projects.

Germany has no PPP law or concessions law of general application, for which reason PPP projects generally are subject to general public procurement law, budget law, competition law, rules and regulations governing state subsidies and general contract law.

Important sectoral legislation includes the Hospital Finance Act (*Krankenhausfinanzierungsgesetz*), the Energy Industry Act (*Energiewirtschaftsgesetz*), the Act for the Promotion of Renewable Energies (*Gesetz zur Förderung Erneuerbarer Energien*), the Act for the Development and Promotion of Offshore Wind Energy (*Gesetz zur Entwicklung und Förderung der Windenergie auf See*) and the Federal Act Governing the Construction and Finance of Federal Highways through Private Entities (*Fernstraßenbauprivatfinanzierungsgesetz* or *FStrPrivFinG*). However, it should be noted that recent motorway projects do not include a toll component and hence were structured under the general legislation.

Other legislation of general application includes the Act against Restraints in Competition (*Gesetz gegen Wettbewerbsbeschränkungen*), the Regulation on the Award of Public Contracts (*Vergabeverordnung*), the Procurement Regulation for Public Works (*Vergabe- und Vertragsordnung für Bauleistungen* – VOB/A), the Procurement Regulation for Public Supplies and Services (*Vergabe- und Vertragsordnung für Leistungen* – VOL/A), the Procurement Regulation for Professional Services (*Vergabeordnung für freiberufliche Dienstleistungen* – VOF) or Article 106 of the Treaty on the Functioning of the European Union, together with other national and EU regulations regarding procurement, and the Capital Requirements Regulation (CRR).

1.4 Main Issues Considered When Structuring the Deal

Project companies in Germany will normally take the form of a special purpose vehicle ("SPV"). This special purpose vehicle is usually organised as a limited liability company (GmbH) or as a limited partnership with a limited liability company acting as general partner (GmbH & Co KG). Limited liability companies are particularly adequate as SPVs as this legal form allows a limitation of liability and, at the same time, enables its shareholder(s) – ie, the sponsor(s) – to issue binding instructions to the management. Further details of the structure will normally depend on the question of whether there is only one single sponsor and shareholder, or whether there is a group of sponsors and shareholders that uses the SPV as an incorporated joint venture company ("JVC"). In case of multiple sponsors the statute of the SPV, which is publicly available, will normally be short and concise and focus only on those issues which under applicable law must be regulated by the statute itself, while all other issues relating to the relationship between the sponsors/shareholders and between the shareholders and the SPV, according to common practice, will be regulated in a separate shareholders' agreement, which is not open to the public.

This does not mean that other legal forms are not available, but other legal forms are quite unusual for project finance because they either (i) give rise to a direct liability of the sponsors, which is in conflict with the concept of limited or non-recourse finance, or (ii) grant, from a sponsors' view, too much independence to the management of the SPV. In exceptional cases, in particular where multi-layered structures are involved, more complex structures may be chosen, whereas such structures normally also provide for a limitation of liability. In case of structures that involve multiple sponsors the sponsors may, in exceptional cases, prefer to have an independent management of the SPV and consequently opt for the legal form of a stock corporation.

In addition, tax considerations also play an important role for the details of the ultimate structure.

In case of cross-border projects, the relevant project SPV may also be domiciled in other jurisdictions. By way of example, in case of physical cross-border projects such as the NordStream pipeline the relevant project company is domiciled in Switzerland. In case of other cross-border projects where the physical project is located outside of Germany, the legal structure must be determined in accordance with the legal requirements of the host state of the investment and will normally, but not necessarily, involve a local SPV. In addition, tax considerations as well as investment protection

issues (eg, the existence or absence of a bilateral investment treaty) may have an important impact on the structuring of the project. While tax considerations may in particular cases support holding structures, most bilateral investment treaties protect only direct investments, with limited exceptions.

Furthermore, in case of cross-border projects involving export credit agencies (ECAs) or multilateral lenders, the requirements of such ECAs or lenders may also have an impact on the final project structure.

Another important consideration for the structuring of the project is the question of whether the project SPV is going to operate the project by itself, or whether operation shall be contracted out to a separate operation SPV and, in the latter case, whether such operation SPV is fully controlled by the project SPV or whether this must be an independent third party, either because the project per se does not include operation or because public procurement laws, competition law or other legal requirements dictate a separation of the operator function.

2. Guarantees and Security

2.1 Assets Typically Available as Collateral to Lenders

The security package in project finance transactions is typically based on ring-fencing. This concept serves not only the purpose of creating a comprehensive security package. An equally important function is to prevent third parties from acquiring prior ranking security rights. Borrowers in case of project finance are mostly organised as SPVs. In the event that these SPVs have any subsidiaries, such subsidiaries are usually included into the ring-fencing.

Most project finance arrangements are based on limited recourse or (less frequently) non-recourse concepts. In case of limited recourse, security and/or quasi-security granted by the sponsors is frequently limited to the construction period and sometimes the first year(s) of the start-up period and may take many forms from hard guarantees on first demand to comfort letters or restrictions on the repayment of structurally subordinated funds like shareholder loans or mezzanine capital.

Typical collateral in a project finance transaction includes a pledge of shares in the project company, a pledge of project accounts as well as a pledge or, more commonly, security assignment of receivables under contracts which relate to the project (eg, engineering, construction, operation, maintenance and insurance contracts). Further, ownership in movable assets such as machinery will usually be transferred as security. If the project company owns real estate on which the project is being built or operated, such real estate will typically be encumbered by a land charge. Finally, the security package will often include corporate or bank guarantees to secure, for example, equity contribution commitments or to mitigate the risk of cost overrun or payment delays. Completion guarantees with regard to the finalisation of the project are also a common means of security.

A pledge of shares in a limited liability company (GmbH) requires notarisation under German law. A land charge over real estate has to be granted in notarial form and registered in the land register in order to become valid. For all other security mentioned above, no specific form requirements apply. However, written form is standardly used. A pledge of accounts (or other receivables) needs to be notified to the third party debtor (in case of an account, the account holding bank). Such notification is a validity requirement. In contrast, in case of a security assignment the obligor generally does not need to be notified to create a valid assignment.

Furthermore, particularly in case of large projects or mega-projects, it is not uncommon that the overall finance structure includes one or more facilities that are supported by government guarantees. These may be export credit guarantees issued by one or more ECAs, or (in case of Germany) untied loan guarantees or investment guarantees for so-called equity-like loans. Less common in the German environment, but not insignificant, is private risk insurance. In addition thereto, the lenders might take security over investment guarantees issued to the sponsors.

2.2 Charge or Interest over All Present and Future Assets of a Company

German law does not recognise the concept of floating charges. However, it is generally possible to also extend security interests to future-acquired assets. In this context, it is important that the asset to be encumbered or transferred for security purposes (eg, a future claim or revolving inventory) can be identified at the time of the conclusion of the security agreement in a manner that ensures its determinability when acquired.

2.3 Costs Associated with Registering Collateral Security Interests

For the registration of a land charge in the land register, a registration fee has to be paid. The amount of such registration fee depends on the amount of the land charge to be created. Moreover, where notarisation is required in order to create security – eg, pledge of shares in a limited liability company (GmbH) or creation of a land charge – notary fees are incurred. The amount of the notary fees depends on the value of the encumbered assets and is calculated according to a statutory fee schedule. However, please note that German law does not acknowledge the concept of stamp duty.

2.4 Granting a Valid Security Interest

German law generally requires that each item of collateral is individually identified in the security document or that it is, at least, identifiable, in order to grant a valid security interest in that item. A general description of the types of

collateral covered is generally not sufficient. This requirement results from the so-called "in rem principle of legal certainty" (*sachenrechtlicher Bestimmheitesgrundsatz*). Hence, any general description used needs to be of a nature that procures individual identifiability.

The precise and identifiable description of the assets is, in particular, a challenge in connection with the security transfer of inventory. In such case, the agreement will frequently be either all-inclusive, refer to a certain area on the business premises and state that title to all assets located therein will be transferred, or list individual inventory in an explicit way.

2.5 Restrictions on the Grant of Security or Guarantees

Capital maintenance rules may limit a company's ability to grant security or guarantees. In the case of a limited liability company no assets may be paid out to shareholders that are required for the maintenance of the statutory share capital. In the case of a stock corporation any repayment of shareholders' contributions is prohibited. These restrictions do not only apply to direct payments, but also to the grant of security or guarantees. Exemptions apply under domination and profit transfer agreements, if a valid reimbursement claim exists against the shareholder or where a shareholder loan or comparable loan is repaid.

In case of public entities acting as security grantors the applicable restrictions under procurement law, budget law, and state subsidy law need to be strictly observed.

2.6 Absence of Other Liens

Only land charges and mortgages are registered in a public register (land register). A creditor who is able to explain a legitimate interest to the land register will be entitled to inspect the entries in the land register in order to verify if any liens with higher priority are registered. With regard to other liens, no registers or records are available. A creditor will usually demand respective guarantees from the debtor with regard to the ranking of its collateral. However, the recovery achievable under such guarantees might be of limited benefit.

2.7 Releasing Typical Forms of Security

German law differentiates between "accessory" security interests – sureties (*Bürgschaften*), pledges – that depend on the existence of the underlying secured claim, and "non-accessory" security interests that may exist irrespective of a secured claim. Accessory security interests are automatically terminated/released by operation of law upon satisfaction of the secured claim. With regard to other security interests, a separate contractual release (eg, in the form of a reassignment of claims or retransfer of assets) is necessary. In case of a land charge, a creditor's consent to the deletion thereof (*Löschungsbewilligun g*) as well as deregistration from the land register are necessary.

3. Enforcement

3.1 Secured Lender Enforcing its Collateral

Enforcement of collateral requires that the secured claim is unpaid despite being due. Pledged security is generally sold in a public auction which is a formal proceeding and requires prior notification of the owner of the pledged security at least one month before the public auction takes place. If the asset has a market price, pledged security can be enforced by way of a private sale at the choice of the pledgee. Banks prefer private sales as they usually lead to better results and are less formalistic.

Land charges and mortgages are enforced by way of a public auction (*Zwangsversteigerung*) or forced administration (*Zwangsverwaltung*) in formal proceedings organised and conducted by the court (*Vollstreckungsgericht*). However, the parties may agree on alternative forms of enforcement (eg, private sale) in order to realise better results.

Assigned receivables against third parties are generally realised by collecting them from the debtor, which does not entail specific formalities.

The realisation of a guarantee depends on its agreed content. In case of a guarantee on first request (*auf erstes Anfordern*), the beneficiary may require payment from the guarantor – generally without having to demonstrate any further conditions for payment, but subject to possible ex-post challenges and further subject to safeguards imposed by relevant jurisprudence to avoid abuse.

3.2 Upholding Foreign Law

According to Article 3 paragraph 1 of regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I), which is applicable in Germany, a contract will be governed by the law chosen by the parties. A specific link to a foreign jurisdiction is generally not required in order for the choice of law to be valid. However, in case the only link to a foreign jurisdiction is the law chosen by the parties, mandatory provisions of the jurisdiction to which the case is linked will apply irrespective of the chosen law. Further, the application of provisions of the law chosen by the parties may be refused if such application is manifestly incompatible with the public policy (*ordre public*) in Germany. Finally, the freedom of choice of law may be limited with regard to collateral and the underlying agreements. For example, in rem security is mandatorily governed by the law of the location of the property (lex rei sitae). Apart from the aforementioned limitations German courts will recognise foreign law chosen by the parties for the contract and enforce the respective provisions.

German law will also generally recognise the submission to a foreign jurisdiction (see Article 25 of regulation (EU) No 1215/2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters).

3.3 Judgment Without Retrial

With regard to courts of EU Member States, the recognition of judgments is governed by regulation (EU) No 1215/2012 on jurisdiction and recognition and enforcement of judgments in civil and commercial matters. According to Article 36 of such regulation, a judgment given in a Member State shall be recognised in the other Member State without any special procedure being required. However, the party who wishes to invoke a judgment given in one Member State in another Member State needs to produce a copy of the judgment which satisfies the conditions necessary to establish its authenticity as well as a certificate to be issued pursuant to Article 53 of the regulation containing certain information with regard to the court proceedings. In addition, the court may require the party to provide a translation of the certificate or the judgment. On application of a party, the recognition of a judgment may be denied in certain cases – eg, in case of an evident breach of the German *ordre public* (see Article 45 of the regulation).

With regard to courts of a non-EU Member State, the recognition of judgments would be governed by the provisions of the German Code of Civil Procedure (ZPO). Such judgments will generally be recognised, subject to limited exceptions – eg, if the foreign judgment violates the German *ordre public* (see Section 328 of the ZPO) and further subject to international treaties which are in place with regard to certain matters or with specific countries.

According to Section 1061 of the ZPO, the recognition and enforcement of foreign arbitral awards in Germany is governed by the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, dated 10 June 1958. On that basis, foreign arbitral awards will generally be recognised and enforced without re-examination of the merits of the case. Certain exceptions apply, as set out in the New York Convention.

3.4 Other Matters Impacting a Foreign Lender's Ability

As set out above in **3.2 Upholding Foreign Law**, provisions of the German *ordre public* might limit a foreign lender's ability to enforce its rights under a loan or security agreement in Germany. In addition thereto, sanctions laws may have an impact on the enforcement of rights.

4. Foreign Investment

4.1 Restrictions on Foreign Lenders Granting Loans

Generally, there are no restrictions for foreign lenders with regard to granting loans. However, the extension of loans in a commercial manner, or to an extent requiring a commercial organised business, requires a German (or an EEA Member State) banking licence according to the German Banking Act (*Kreditwesengesetz,* KWG). No distinction is made between foreign and domestic lenders, nor between banks and non-banks, if the loans are granted in Germany and in the aforementioned manner. Noncompliance with these licensing requirements is a criminal offence under German law and may, in addition, be sanctioned by fines. Furthermore, foreign equity investments may be subject to restrictions under the German Foreign Trade and Payments Ordinance (*Außenwirtschaftsverordnung*, AWV), depending on the target company's field of activities.

4.2 Restrictions on Foreign Lenders on Granting of Security or Guarantees

Generally, there are no restrictions regarding the granting of security or guarantees to foreign lenders. However, the requirement for a banking licence under the German Banking Act, set out above in **4.1 Restrictions on Foreign Lenders Granting Loans**, applies in the same way to the assumption of guarantees if this is done in a commercial manner or to an extent requiring a commercial organised business.

Furthermore, sanctions laws may restrict transactions with certain foreign lenders.

4.3 Foreign Investment Regime

Pursuant to the German Foreign Trade and Payments Act (*Außenwirtschaftsgesetz,* AWG) and the German Foreign Trade and Payments Ordinance (*Außenwirtschaftsverordnung*, AWV), foreign acquisitions of a controlling share (ie, 25% or more) of the voting rights in a German company may be examined and prohibited by the competent German authorities – the Federal Ministry of Economics and Technology (BMWi). The option to examine and prohibit certain acquisitions is not limited to specific sectors. The individual transaction must not negatively affect the public policy or the public security of the Federal Republic of Germany. Therefore, in order to guarantee transaction security, it is not uncommon for foreign investors to apply for and obtain a clearance certificate (*Unbedenklichkeitsbescheinigung*) from the BMWi with regard to AWG and AWV prior to the closing of the envisaged acquisition.

4.4 Restrictions on Payments Abroad or Repatriation of Capital by Foreign Investors

Generally, there are no restrictions on payments abroad or repatriation of capital by foreign investors. However, certain cross-border transfers of funds must be notified under the AWV. Furthermore, sanctions to the extent recognised by, and applicable in, Germany may apply to some payments, cross-border or domestic.

4.5 Maintenance of Offshore Foreign Currency Accounts

While it is permissible for a project company to maintain offshore foreign currency accounts, it is uncommon as (i) the euro is an anchor currency and convertible in almost all jurisdictions, and (ii) offshore accounts are usually viewed

with scepticism as they are often brought in connection with tax evasion practices.

5. Structuring and Documentation Considerations

5.1 Registering or Filing Financing or Project Agreements

In general, under German law, financing or project agreements do not need to be registered or filed with any government authority. However, depending on the type of the financing/security agreement, there are certain formal requirements to be observed. For example, a pledge of shares in a German limited liability company and the creation of a land charge or mortgage require notarisation. Security encumbering real property needs to be registered in the land register.

5.2 Licence Required for Owning Land or Natural Resources

Ownership of land as such does not require a licence. However, certain activities typically connected with the ownership of land – eg, activities in the area of property development – may require a licence under the German industrial code (*Gewerbeordnung*). Foreign entities may operate in Germany, either directly or by establishing a subsidiary or a branch, and hold a respective licence. The exploitation of certain natural resources may also require a licence. Thus, the exploitation of minerals, for example, requires a government licence under the Federal Mining Act (*Bundesberggesetz*). The same applies to cables and pipelines on the continental shelf. The right to exploit natural resources is not necessarily tied to title in land and depends on the nature of the relevant resource. Foreign entities may hold exploitation licences even if they are not owner of the relevant land.

5.3 Recognition of Agent and Trust Concepts

Agent concepts are recognised in Germany. It is common practice that an entity acting as security agent holds security on behalf of the whole group of lenders participating in the financing.

In case of accessory security which is legally inseparable from the secured claim (eg, a pledge), parallel debt structures are frequently used in order to facilitate the transferability of the security and to enable changes in the consortium of lenders/security holders. In such case, in addition to the secured claim a second claim is created as abstract acknowledgement of debt entitling the security agent to an amount corresponding to the amount of the secured claim. The claim secured by the accessory security and the claim under the abstract acknowledgement of debt will only be fulfilled once – ie, if the secured claim has been fulfilled, the security agent may not realise its claim under the abstract acknowledgement of debt. German courts have not yet confirmed the validity of parallel debt structures, as these have never been questions in court proceedings.

5.4 Rules Governing the Priority of Competing Security Interests

The rules governing the priority of competing security interests depend on the type of security. The order of priority of security encumbering real property (eg, a land charge) is determined on the basis of the sequence of entries or, if the entries are made in different sections of the land register, the date of the entries. The parties are free to agree on a different ranking, however. This requires the consent of the person taking lower priority. In an insolvency of the security provider, the priority remains unaffected. Under certain conditions, the insolvency administrator may have a right to challenge the agreement regarding the priority.

The ranking of contractual security (eg, a pledge) depends on the date of the creation of the security. However, the parties may contractually agree to treat each other in a way deviating from the priority established by law.

Debtor and creditor may agree on a subordination of the creditor's claim for payment which will then also be recognised in possible insolvency proceedings. This is frequently done with regard to claims for repayment of shareholder loans in order to avoid the over-indebtedness of the debtor which would otherwise constitute a compelling reason for the opening of insolvency proceedings.

Furthermore, the allocation of proceeds from the realisation of security among different lenders groups is frequently governed and modified by intercreditor agreements.

5.5 Requirements of Local Law

German law does not require that the project company is organised under the laws of Germany. However, if a foreign company outside the European Union transfers its administrative office to Germany without transferring the registered seat, the company may face difficulties in being recognised as a foreign company in Germany.

The legal forms most commonly used in Germany are the limited liability company (*Gesellschaft mit beschränkter Haftung*, GmbH) and the limited partnership (*Kommanditgesellschaft*, KG). A limited partnership consists of at least one general partner which is personally liable for the company's debt and at least one limited partner. Due to such personal liability of the general partner, a GmbH is often used as general partner; such KG would then be a "GmbH & Co. KG".

The decision on the legal form of a project company depends on various factors, including the degree of influence shareholders wish to exercise over the management, the protection against liabilities incurred by the project company or tax-related issues.

6. Bankruptcy and Insolvency

6.1 Availability and Practice of Company Reorganisation Procedures

A company may be reorganised outside of insolvency proceedings or in the context of insolvency proceedings. Outside of insolvency proceedings a company may be reorganised, for example, by selling it in an asset deal, share deal, or via instruments such as debt equity swaps. In the context of insolvency proceedings, the German insolvency code (InsO) provides for several options to reorganise a company.

There are different types of insolvency proceedings. In general, a distinction is made between insolvency proceedings taking place under the control of an insolvency administrator (*Fremdverwaltung*) and insolvency proceedings taking place under the debtor's own control (*Eigenverwaltung*). The insolvency administrator is generally appointed by the insolvency court with the participation of the preliminary creditors' committee and – as the case may be – the creditors' meeting. However, the debtor may, under certain conditions, request that the insolvency proceedings take place under the debtor's own control (*Eigenverwaltung*), supervised by a trustee (*Sachwalter*). This may also apply during the opening proceedings. Such insolvency proceedings under the debtor's own control are often advantageous for the debtor as the existing management can continue the business as conducted before, which often results in time and cost savings.

Additionally, so-called "protection proceedings" (*Schutzschirmverfahren*) are available to a debtor who is overindebted (*überschuldet*) or imminently insolvent (*drohend zahlungsunfähig*), but still able to pay its current debt, if a financial recovery of the debtor is not obviously without a chance of success. In such a case, the debtor may apply for proceedings under its own control and may be granted a period of up to three months for the preparation and submission of an insolvency plan. The insolvency court shall – upon the debtor's request – prohibit or provisionally stop individual enforcement measures against the debtor except for enforcement in immovable property and shall entitle the debtor to enter into obligations encumbering the insolvency estate (*Masseverbindlichkeiten*).

Irrespective of the type of insolvency proceedings, there are several options to restructure the insolvent company in the context of such proceedings. One commonly used option is a sale of the debtor's assets by way of an asset deal (*übertragende Sanierung*). Depending on the status of the insolvency proceedings, this may require the consent of certain parties involved – eg, the creditors' committee (*Gläubigerausschuss*). The creditors of the insolvent company participate in the proceeds resulting from such sale on a pro rata basis.

A further option – not only in the so-called "protection proceedings" (*Schutzschirmverfahren*) – is the submission of an insolvency plan. Issues such as the satisfaction of the insolvency creditors, the distribution of the insolvency estate, the insolvency procedure and debtor's liability may be covered by an insolvency plan and regulated deviating from statutory law. This gives the debtor the opportunity to achieve a kind of "settlement" with its creditors and other parties involved.

6.2 Commencement of Insolvency Processes Impacting Lender's Rights

The lender's rights to enforce its loan or any security or guarantee may be affected after the commencement of insolvency proceedings over the assets of the borrower or security provider, as individual enforcement measures are prohibited after the opening of insolvency proceedings and the insolvency creditors have to file their claims with the insolvency administrator. However, certain creditors of the insolvent company may have the right to preferential treatment (*Absonderungsrecht*) – eg, creditors whose claims are secured by a pledge in the debtor's assets.

6.3 Payment Order to Creditors on a Company's Insolvency

Under German insolvency law, owners of certain assets have a right to segregation (*Aussonderungsrechte*) and may claim that their assets are not part of the insolvency estate. Secured creditors, such as pledgees or holders of a land charge, will be satisfied with priority (*Absonderung*). Only after satisfaction of the secured creditors, the unsecured creditors will be satisfied on a pro rata basis from the remaining assets. In addition thereto, subordination agreements may lead to downward adjustments of creditors' rankings in the distribution waterfall. The debtor's shareholders will be satisfied last.

6.4 Risk Areas for Lenders

In an insolvency of the borrower, the borrower will most probably not be in a position to fully repay the loans to its lenders. The claims of insolvency creditors which have no preferential rights will be satisfied on a pro rata basis from the insolvency estate and creditors will generally only be able to recover a small part of their receivables.

Further, under German law, an insolvency administrator may contest (*anfechten*) certain legal transactions made within certain time periods prior to (the filing for) the opening of insolvency proceedings. Generally speaking, legal transactions which are detrimental to insolvency creditors may be contested – eg, transactions granting unjustified security or satisfaction to a certain creditor (and thereby harming other creditors) or transactions which are made with the intention to harm other insolvency creditors. The repayment of shareholder loans within the last year prior to the request for the opening of insolvency proceedings or thereafter may also be contested. The consequence of a contestation is that any assets transferred by the debtor in connection with the contested transaction must be returned by the creditor to the insolvency estate.

If security is granted by a third party and not the insolvent borrower, this security is – in general – not affected by the opening of insolvency proceedings over the assets of the borrower.

6.5 Entities Excluded from Bankruptcy Proceedings

In general, individuals and legal persons, but also entities without legal personality, may be subject to insolvency proceedings under German law. However, insolvency proceedings may not be opened over the assets of certain legal entities governed by public law (eg, the federal states and municipalities). Entities operating in certain economic sectors may be subject to specific provisions (eg, financial institutions).

7. Insurance

7.1 Restrictions, Controls, Fees and/or Taxes on Insurance Policies

Generally, there are no restrictions on insurance policies over project assets located in Germany. However, insurance companies require a licence issued by the German Federal Financial Supervisory Authority (BaFin) in order to offer insurance for projects located in Germany. This also applies to foreign (non-EU) insurance companies offering insurances in Germany. EU and EEA-based and licensed insurance companies do not require a separate German licence; they must undergo, however, a notification procedure with the BaFin in order to operate in Germany.

An Insurance Premium Tax of 19% applies to insurance premiums collected in Germany. This Insurance Premium Tax is also applicable if the insurer is located outside of Germany but within the EU or European Economic Area and the insurance agreement concerns, for example, immovable assets (especially buildings and plants) located in Germany, or is entered into with a client located in Germany. The same applies to an insurer who is located outside of the EU or European Economic Area and has an insurance agreement with clients located in Germany. However, an agreement under which an insurer is only obliged to issue a guarantee or other security does not qualify as an insurance agreement and is therefore not subject to the Insurance Premium Tax.

For the avoidance of doubt, guarantees issued by the Federal Government of Germany covering exports, untied loans or investments do not qualify as insurance in terms of the Insurance Premium Tax Act or otherwise, although the same are sometimes loosely referred to as "insurance".

7.2 Payable Insurance Policies over Project Assets to Foreign Creditors

Generally, insurance policies over project assets are payable to foreign creditors. However, certain cross-border transfers of funds must be notified under the German Foreign Trade and Payments Ordinance (*Außenwirtschaftsverordnung*, AWV). Furthermore, sanctions to the extent recognised by, and applicable in, Germany may apply to some payments, cross-border or domestic.

8. Tax

8.1 Payments to Lenders Subject to Withholding Tax

Generally, there is no requirement under German tax law to deduct or withhold tax from (i) payments of principal, (ii) interest payable on loans, or (iii) payments made out of the proceeds of a claim under a guarantee or of the enforcement of security, provided the loan has no profit-link feature and is not securitised as fungible debt instrument.

However, interest payments to a foreign lender may be considered German-sourced income, provided the loan is directly or indirectly secured by real estate located in Germany, comparable rights or ships registered in Germany. In such case, the foreign lender might be under an obligation to file a tax return (at least, where an applicable double taxation agreement also permits Germany to tax such income) and German tax authorities have the discretion to require the obligor to withhold tax. The tax rate for a corporate taxpayer is 15.825%. Any tax withheld might be credited or refunded upon tax assessment on the foreign lender. Domestic lenders are subject to regular taxation.

8.2 Taxes, Duties, Charges or Tax Considerations Relevant to Lenders

Except for (potential) income taxation (see above, **8.1 Payments to Lenders Subject to Withholding Tax**) there are no specific taxes, duties or other charges which would apply to lenders making loans to entities incorporated in Germany. The granting of a loan is subject to VAT at a rate of 19%, but is generally exempt from VAT. German law does not acknowledge the concept of stamp duties. With regard to notary and registration fees, which may apply in connection with the creation of certain security (eg, pledge of shares, land charge), see **2.3 Costs Associated with Registering Collateral Security Interests**, above.

8.3 Usury Laws or Other Rules Limiting the Amount of Interest Charged

Generally, parties to a loan agreement are free to agree on the amount of interest to be charged for the loan. However, very high interest payments would be considered as violating "good morals" and are prohibited in Germany according to general civil law principles. Furthermore, compound interest is not permitted under German law.

9. Applicable Law

9.1 Law Typically Governing Project Agreements

According to Article 3 paragraph 1 of regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I), which is applicable in Germany, a contract will be governed by the law chosen by the parties. In case of a project situated in Germany, the parties will generally choose German law as the law governing the project agreement. This might be different with regard to projects situated abroad or involving foreign parties.

9.2 Law Typically Governing Financing Agreements

See **9.1 Law Typically Governing Project Agreements**, above. If the financing is provided by German banks, the financing agreements will generally be governed by German law. In case of international projects (eg, a banking consortium with a majority of non-German banks, foreign sponsors and/or a project situated abroad) the financing agreements are often governed by English law.

9.3 Matters Typically Governed by Domestic Law

Despite a choice of law made by the parties of an agreement, mandatory rules of the jurisdiction where a contractual obligation has to be performed will apply according to the Rome I regulation. Further, the security documentation regarding assets located in Germany has to be governed by German law (lex rei sitae). A pledge of shares will be governed by the law applicable as company statute of the respective company – ie, by German law in case of a German limited liability company.

10. Islamic Finance

10.1 Development of Islamic Finance

As far as Islamic finance is concerned, Germany was the first western country to bring a Shari'a-compliant bond to market. The German state of Saxony-Anhalt issued a five-year, EUR141 million asset-backed sukuk in 2004.

The largest recent development on the German market with regard to Islamic financing was the opening of KT Bank AG (Kuveyt Türk) in July 2015. KT Bank AG was the first fully-fledged Islamic bank in the country. Other current institutional players involved in Islamic financing in Germany include major German financial institutions such as Commerzbank and Deutsche Bank, which have also launched Shari'a-compliant products.

There are no specific legal rules governing Islamic financing in Germany. The German Federal Financial Supervisory Authority (BaFin) therefore treats all forms of Islamic financing and Islamic banking the same as all other types of financial and banking services provided on the German market. Whether a financial institution or another form of lender requires permission to offer Islamic financing products on the German market consequently depends on the general rules and regulations pursuant to the German Banking Act (*Kreditwesengesetz*, KWG); see also **4.1 Restrictions on Foreign Lenders Granting Loans**, above, and **10.2 Regulatory and Tax Framework**, below.

10.2 Regulatory and Tax Framework

Generally, there is no specific regulatory and tax framework for the provision of Islamic financing in Germany – the general rules with regard to financing in Germany apply. Islamic banks and other credit and financial institutions are subject to general regulatory establishment and doing-business rules under the German Banking Act (*Kreditwesengesetz*, KWG). Thereby, German supervisory law enumerates types of financial contracts, the offering of which requires a banking licence under certain circumstances. Islamic finance products are not expressly listed in the relevant definitions. In relation to some of these products it could therefore be argued that a company only marketing such products does not require a licence in Germany. However, it is a controversial discussion in Germany as to whether a functional view of these products makes them so similar to conventional financial products that a banking licence would be necessary from a supervisory law standpoint. Furthermore, should an Islamic bank offer a variety of financial products and services, including deposit banking and the issuing of credit cards, it would be required to hold a licence in Germany, as such services are clearly included in the list in Section 1 of the German Banking Act (KWG). Finally, acquiring a licence in Germany may also seem prudent for an Islamic bank seeking to market its products in Germany, as reasonable customers would be unlikely to trust a financial services provider without such a licence.

With regard to sukuk or other Islamic banking products, their relevance is gradually increasing on the German financing market. Even though the Saxony-Anhalt sukuk was the first Shari'a-compliant bond issued in an OECD state and the Islamic financial system has made a positive impression on German financial institutions, Islamic finance in Germany still plays a minor role compared to that in some other European countries. However, the efforts of certain banks and the BaFin to promote Islamic finance have recently led to an increase in Islamic financial services in Germany.

With regard to takaful insurance products, the market in Germany is still relatively untapped, although German insurers such as Allianz pursue this business actively via foreign subsidiaries such as Allianz Takaful B.S.C. or PT Asuransi Allianz Life Indonesia. In any event, even though the insurance market in Germany is heavily regulated, there are no legal obstacles specific to Shari'a-compliant insurances preventing the marketing of such products in Germany.

The future of Islamic banking in Germany and the European Union is favourable. The success of a Shari'a-compliant

Islamic bank or other financial institution will depend on its operating model. However, it is expected that the growth of Islamic banking and finance in Germany will be slow and gradual.

10.3 Business Requirements for Islamic Banks to be Authorised/Admitted

As described above, there are no special requirements for the authorisation of Islamic banks in Germany. An Islamic bank or another Islamic credit and financing institution which wants to acquire a licence under the German Banking Act (*Kreditwesengesetz,* KWG), must fulfil certain general criteria and apply for such a licence with the competent German authority, the BaFin. In the same way, insurers offering Islamic insurance products are subject to the same supervisory regime as insurers in general.

The requirements to be met by an Islamic bank or other financial institution applying for licensing in Germany include:

- thresholds for minimum stated share capital;
- liquidity requirements and participation in deposit protection schemes;
- requirements with regard to the institution's management, in particular its independence and ultimate responsibility for all corporate actions; and
- a verified and transparent ownership (UBO) and holding structure.

Such requirements may be difficult to fulfil for Shari'a-compliant institutions – for example, certain refinancing models and deposit protection schemes may be viewed as "haram" by Islamic scholars. Furthermore, the independence of an Islamic institution's management from its Shariah Supervisory Board may also be difficult to facilitate in a Shari'a-compliant way. Nevertheless, the licensing of KT Bank AG in Germany proves that Shari'a-compatibility can be achieved within the German regulatory framework for conventional banking and financing institutions, and the requirements verified by the BaFin can be met by an Islamic bank seeking to establish itself and do business in Germany.

An alternative is to apply for a so-called "European Passport for Credit Institutions". An Islamic bank or other credit institution which is already licensed in another EU/EEA member state only needs to undergo a notification procedure with the BaFin in order to be allowed to provide banking services on the German market; a separate authorisation procedure in Germany is not necessary. However such Islamic financing institutions must have undergone the appropriate licensing proceedings in their EU/EEA country of origin and must be compliant with that country's regulatory requirements in order to acquire the "European Passport".

Finally, Islamic finance products can be offered by an existing and licensed conventional credit institution, which has introduced Islamic finance products into its portfolio. This practice is the most common one with banks in Germany in order for them to cater to the demand of their Muslim customers. Here again, the same licensing requirements apply as for the business of the relevant institution in general.

10.4 Framework for Ensuring Shari'a-compliant Products

There is no framework under German law for ensuring Shari'a-compliant products and transactions and there are no German supervisory bodies in this regard. Thus, compliance with Islamic finance principles with regard to financing products marketed in Germany can only be certified by recognised foreign authorities offering such certificates.

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