

THE FUTURE OF CROSS-BORDER LEASING IN GERMANY

State of the art. In Germany over the last seven years, around 150 cross-border leasing transactions were entered into between US investors and German municipal parties.

Some lessees are German transport service companies, public utility companies and other companies organised on a private law basis. Others are municipalities or organisations that benefit from the same credit rating as municipal enterprises like, for example, special-purpose associations.

Leased items are primarily rolling stock, waste incineration plants, clarification plants, trade fair exhibition halls, wastewater and freshwater systems or the urban rail network infrastructure.

The volume of transactions ranges from under US\$100m to almost US\$2bn. Lease terms are between 12 and 30 years, in the event that the German party decides to exercise the termination option.

Negotiation of the highly complex contractual documents takes place, in some cases, over the course of several years. A period of six to nine months can be considered quite good.

However, it has been frequently the case that the closing took place just a few weeks after the arranger has been appointed to implement the transaction. This arranger is the one who pushes for quick conclusion of the long-term contract. He works on the basis of a contingent fee and bears in many cases the entire risk of the costs in the event that the transaction does not ultimately go through as planned and no financial advantage flows to the German party.

From his point of view, every delay, every additional step in the procedure and the involvement of each additional party increase the risk that the transaction will fail for one reason or another at great expense to him.

German arrangers are normally major investment banks or Landesbanks or even leasing companies or financial service companies. In many cases, lessees were unable to rely on the support of their arrangers even while the contracts were still in operation.

Sometimes, the contact persons are no

longer available because the bank or leasing company has meanwhile pulled out of this business sector. Sometimes the team that organised the deal has changed employers and now occupies a new position, e.g. as exclusive consultant to the investors. It is not unusual to find this situation even with regard to the German or American law firm briefed by the lessee at that time.

The gain of the financial advantage from a cross-border leasing transaction was frequently portrayed in earlier years as being easy and problem-free. The transaction was portrayed in marketing as a sham based solely on US taxation and involving no real risks.

The success and advantageous nature of the transaction were said to be due solely to the sophisticated skills of the arranger and the naivety of American tax legislation.

In extreme cases, the municipality even complied with the instructions of the arranger, under no circumstances to reveal, during the rare meetings with the

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investor, and at the time of closing in particular, the (low) amount of the cash benefit or other terms of the transaction.

In many transactions, German lessees took no part whatsoever in the selection of the parties, negotiation of the contractual terms or evaluation of the advantages of the transaction. They were overawed by the reputation of the arranger, the self-presentation of the team of lawyers put together by the arranger that always acted as an integrated whole, and by the gap in expertise and experience between the global players on the one hand and the locally oriented municipalities on the other.

The terms and conditions that the banks proposed and the amount of the cash benefit disbursed were all accepted unquestioningly. No documentation of the stages of negotiation and recommendations was asked for.

This appeared to be a very convenient situation for the investor. Being a highly profitable entity whose tax position provides for a multitude of business transactions to be concluded smoothly, the initiation of a transaction with a German

municipal entity driven by an arranger to complete the transaction is at first glance simple and agreeable if no further inquiries are made and no own demands on quality are made.

Effects. However, it is human nature to overexploit the opportunities offered by such circumstances and to take excessive advantage of the resulting freedoms. This is true for the arranger contracts that make provision for the concealed skimming off of extra profits at the expense of the cash benefit for the municipal party.

This applies to the use of tax havens that encumber the municipal party with additional risks without additional compensation. This also applies to the assumption of market risks, as a result of the banks and financial instruments selected, that no municipality would normally accept outside of a leasing transaction. This also applies to the acceptance of structural risks and restriction of flexibility that, in the event of transparent and prudent negotiations, would never have been agreed to.

In this situation of badly negotiated

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contractual arrangements, the municipal party is not the only loser. Of course, the municipal party is at a disadvantage if millions are skimmed off from the net cash benefit accruing to it out of the transaction, so that it does not receive the full amount due. But, after all, it would have been in a worse position by not concluding the transaction in the first place, because it would not have received any funds at all.

The investors and banks which, as highly reputable companies, are tied to the transaction for a period of decades and which have lent their good name to the transaction as evidence of its propriety also suffer disadvantages.

Without doubt, many problems can arise for the investor if his business case is not reflected in the view of the German side and the arrangement sold to the lessee differs completely from that notified to his own tax authorities.

Even in the – hopefully hypothetical – case of a court dispute, there is no benefit to be gained by the investor if it should subsequently become apparent that the lessee was structurally at a disadvantage during conclusion of the transaction, received no impartial advice and had – and has – no knowledge of the risks associated with the transaction.

This applies all the more so if the municipal parties did not even have their own lawyers, because the lawyers involved in the negotiations are, in reality, acting solely on behalf of the arranging bank.

The lack of transparency and knowledge of the municipal parties has, in many cases, become public knowledge, not least due to unfortunate press statements by city treasurers and municipal finance officers deserted by their deal team immediately after conclusion of the contract.

Relying blindly on the reputation of the bank instead of being properly aware of the contents of the contract and the risks is a matter that, quite rightly, finds no public approval.

For this reason, it is not surprising to see citizens' protests against transactions obviously concluded or at the negotiating stage based on the principles "profit before security" and "speed before caution".

It also makes sense that powerful citizens' action groups formed and successful public actions occurred only in those towns that failed to obtain impartial advice independently of the arranger and his lawyer. These cities paid dearly for

believing that this compensatory element would have a disturbing and delaying effect, for misjudging public opinion and for giving the public the all-too-clear impression of mismanagement.

The Saxony Ruling. In light of this, it is not surprising that the free state of Saxony is the first federal German state to draw up a ruling ("*Verwaltungsvorschrift*") intended to lay down a minimum standard for the quality requirements to be ensured by a municipal party at the time of concluding the contracts.

After in-depth preparatory work, the Saxony Ruling was passed on August 26, 2003 and it applies without any transitional period. Although merely an internal regulation for Saxony, it is also appropriate to examine it and acknowledge it for transactions outside Saxony.

The Saxony Ruling has the legal nature of an internal administrative instruction. As a result, it is not a law or ordinance that changes the prevailing statutory or legal position.

Consequently, the Saxony Ruling merely describes the law as it currently already applies. It represents the governmental interpretation of the public-law framework conditions subject to which a German municipality can enter into a cross-border leasing transaction.

The rule signifies a general acceptance and approval of cross-border leasing transactions for the municipal party. This is definitely to be welcomed. The Saxony Ruling initially deals with the need for approval of the transaction. The statements made therein refer to the legal position in the free state of Saxony and are transferable only to a limited extent to other German federal states.

At the same time, however, it describes the general public-law requirements of the contractual structure, the arranger/lawyer team as well as the proper procedure to follow when negotiating and concluding the transaction. The legal consequence is the clear reference to the unlawfulness of the approving city council resolution and approval by the supervisory authority.

Deviations from the basic values underlying the approval accordingly render the legal transaction invalid. The municipality is just as much affected by the consequences of legal invalidity as the investor and the banks.

According to the Saxony Ruling, cross-border leasing transactions are not, in themselves, a municipal matter. Accordingly, they are only possible sub-

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ject to particular consideration of the principles of proper administration of both fixed assets and financial assets. This includes the proper maintenance and care of assets, generation of a reasonable income and safeguarding the availability of the assets.

Particular attention is given here to the principle "security before income". This principle is entrenched in all German municipal ordinances. The purpose of this provision is to protect public assets against losses from high-risk (speculative) transactions.

In considering the matter, the legislator has stated with effect for the whole of Germany that priority should be given to the protection of the taxpayer against the loss of public assets at the expense of profit. This does not require absolute security; however, there is a need to ensure that a loss of capital is highly unlikely.

When making the assessment, municipalities must, as public-law entities, always apply a higher degree of care and specialist knowledge than in the case of a private individual.

It is of decisive importance that the municipality and the approving authorities are adequately able to assess the matter, at the time of passing the resolution, with regard to the contractual structure, the risk profile, the flexibility of the con-

tracts, the scope of real securities and the economic viability of the transaction.

Particular requirements are made on the transparency of the transaction for the decision makers. Particular and specified demands are made on the issue of a description of a transaction. The Saxony Ruling nevertheless questions whether this alone is sufficient and refers to the uncertain nature of any future court decision.

In the light of this, the Saxony Ruling states that appointment of an independent transaction adviser should be considered. A report by such an adviser should reveal not only the legal risks but also the financial obligations and financial risks resulting from the same.

If there is a lack of any comprehensive and impartial information about the effects of the legal transaction, the Saxony Ruling indicates, by reference to the pertinent legal precedence, that there is a risk that the municipal council, on that ground alone, is unable to pass an unflawed resolution.

The Saxony Ruling does not explicitly state the requirements to be made on the impartiality of an impartial adviser. It obviously cannot be a company whose fee depends on performance or one which is legally or financially associated with the arranger or the firms of lawyers.

It is equally obvious that a "big-four

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group” that gives tax advice to the investors and/or the participating banks or that certifies their annual financial statements as auditor cannot be regarded as impartial for the purpose of this legal requirement.

The substantial conflict of interests in the event of being active in the same legal matter on behalf of both parties would not only weaken the negotiating position of the German lessee but also overshadow the entire transaction and all parties involved.

The endgame. Municipal leasing transactions are regarded as a success in Germany. This is demonstrated by the fact that many municipalities have already undertaken a large number of individual transactions in the course of the years and also encourage undecided neighbouring communities to do the same by their positive experiences.

The ongoing contractual duties are transparent and their liberal application limits neither the legal nor financial possibilities of municipalities.

As a result, Germany offers an attractive environment for additional and more challenging cross-border leasing transactions.

This view presupposes that conclusion of new agreements is not precluded finally and permanently by regulatory changes in the tax law framework of the US. In an endgame scenario of this kind, the idea of promoting new advantageous

financial transactions and gaining new cash benefits soon loses importance for the German side.

In this case, investors and banks expect that the contracts concluded will continue to be respected although the cash benefit realised from the same has already been completely used up.

The risk of contracts being declared invalid and non-binding due to breach of public law regulations that are not quite clear-cut is generally described as a national political risk. For Western industrial nations with a long legal tradition, it is nearly impossible for all cross-border leasing transactions to be declared null and void in their entirety.

However, the clear wording of the Saxony Ruling means that investors and banks would be well advised to take a glaring imbalance of negotiating power as a warning signal.

To this extent, the independent financial advice to the German lessee as required by municipal law offers an opportunity to avoid, even in later years, the built-in nullifying factors revealed by the Saxony Ruling. After all, this is in the interests – as generally understood – of all parties to the transaction.

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