CLEARY GOTTLIEB

ALERT MEMORANDUM

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INCREASED TRANSPARENCY REQUIREMENTS AND RESTRICTIONS – PRIVATE EQUITY INVESTMENTS UNDER THE NEW GERMAN KAGB

On July 22, 2013, the German Capital Investment Act (*Kapitalanlagegesetzbuch)* ("KAGB") entered into force. This act transposes the European Directive on Alternative Investment Fund Managers ("AIFMD") into German law. The KAGB, *inter alia*, imposes certain obligations on Private Equity fund managers who, by statutory definition, are regarded as "Alternative Investment Fund Managers" ("AIFMs") in connection with their M&A activities when their AIFs fall under the scope of the act (see I., below). Subject to a transformation period until mid-2014, the act most notably imposes obligations to disclose the acquisition of voting rights in non-listed companies (see II., below) and restricts certain capital distributions and other asset stripping measures (see III., below). In addition, a depositary is now mandatorily charged with reviewing whether an AIF has validly acquired legal title to its assets (see IV., below).

I. Fund Managers Covered; Transition Period

The restrictions discussed in this Memorandum apply to all AIFMs with a statutory seat and head office in Germany. If an AIFM is located outside of Germany but in an EEA Member State, it must comply with the new rules only with regard to its German AIFs. If an AIFM is located outside the EEA, it must comply only for AIFs marketed to investors in Germany.

A transition period until July 21, 2014 will apply to German AIFMs and to German AIFs of EEA-AIFMs if such AIF had been administered by the EEA-AIFM prior to July 22, 2013. In such cases, during the transition period the AIFMs need only comply with the KAGB rules on a best efforts basis. Non-EEA AIFMs marketing AIFs in Germany will be required to comply with the KAGB rules as of the date on which the AIFMs receive a marketing license. A marketing license will be required for a non-EEA AIFM intending to market an AIF in Germany after July 21, 2014.

II. Voting Rights Notifications for any Target Company

When an AIF acquires, disposes of or holds shares in a non-listed company and the percentage of voting rights held by it reaches, exceeds, or falls short of the thresholds of 10, 20, 30, 50 or 75 percent, its AIFM now must notify the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) ("BaFin") irrespective of the legal form of such entity.

Under the KAGB, an AIFM must comply with additional disclosure obligations, when it, either individually or jointly with another AIF, acquires control of a non-listed company. "Control" in this context means holding more than 50 percent of the voting rights, whereby voting rights in the

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target company held by undertakings controlled by the AIF or by persons acting on behalf of the AIF are attributed to the AIF. In this case, the AIFM must provide BaFin and the investors in the respective AIF with information pertaining to the financing of the acquisition. In addition, it must (i) notify the target company, its shareholders and BaFin of the acquisition of control, (ii) provide the target company, its shareholders and BaFin with information about the AIFM, the conflict management policy of the AIFM and the AIFM's policy for external and internal communication relating to the target company, in particular in connection with the target company's employees, (iii) inform the target company and its shareholders of the AIFM's intentions regarding the target company's future business development and of the likely repercussions on employees, including any material change in the conditions of employment, (iv) ensure that either the target company's or the AIF's annual report contains a fair review of the development of the target company's business during the fiscal year and addresses the target company's likely future development and (v) ask the target company's board of directors to make all such information available to the target company's employee representatives without undue delay, and use its best efforts to ensure that the board does so.

Some of these disclosure obligations already apply pursuant to German Takeover Law for listed targets. The KAGB, however, very significantly expands their scope of application and adds new obligations with the aim to protect investors in the AIF and stakeholders in the target company, especially employees, as well as to safeguard the stability of the financial system and thus leads to severely increased transparency and pertinent compliance effort on the side of the AIFM going forward. As practice develops, the specific content of the disclosure obligations will likely be further refined.

III. No "Asset Stripping" within 24 Months after an Acquisition

When an AIF, either individually or jointly with another AIF, acquires control of a non-listed company, the KAGB prohibits the AIFM, in certain circumstances and for a period of 24 months after the acquisition, from allowing, facilitating, supporting or instructing (i) distributions, (ii) share redemptions, (iii) acquisitions of own shares, or (iv) capital reductions. The KAGB also requires the AIFM to use its best efforts to prevent the target company from carrying out any such measures.

The KAGB prohibits distributions, the acquisition of own shares and arguably also share redemptions to shareholders if (i) the net assets of the target company, as set out in the target company's annual balance sheet account on the closing date of the last fiscal year, fall short of the stated capital plus undistributable reserves, or would fall short of such amount because of such distribution; or (ii) if the amount of such distribution would exceed the amount of the profits at the end of the last fiscal year plus any profits brought forward and sums drawn from reserves available for distribution, less any losses brought forward and sums placed to reserves in accordance with law or the statutes.

Capital reductions are only permissible in order to offset losses incurred, or to credit an amount to non-distributable company reserves (provided that such reserves thereafter do not exceed 10 percent of the reduced subscribed capital).

These provisions, however, only prohibit certain direct capital withdrawals from the target company. Commonly-used refinancing schemes, such as a debt push-down or the granting of security for loans taken out by the acquisition vehicle, do not appear to be restricted. In addition, the fact that the restrictions are based on certain balance sheet amounts should allow for a range of design and planning options.

IV. Safe Harbor for Small Targets

It should be noted that both the disclosure provisions and the prohibition of certain capital distributions are subject to a *de minimis* exemption, and do not apply when the target company employs fewer than 250 people and has annual net revenues of less than EUR 50 million, or has a balance sheet sum of less than EUR 43 million.

V. Depositary Due Diligence

An AIFM is required to install a depositary for each KAGB-covered AIF. The depositary must, *inter alia,* conduct certain due diligence to determine if the AIF has validly acquired legal title to its assets that are not financial instruments, *e.g.,* interests in limited liability companies (*GmbH)*, limited partnerships (*KG*) or partnerships (*OHG*), legal forms typically used for German portfolio companies.

In practice it is often impossible for the seller or purchaser to verify the legal ownership in a target company with absolute certainty. This is due to the fact that, at least for target companies that have been in existence for a significant period of time, the seller will not typically be able to provide a "chain of title" evidencing all share transfers since the foundation of the company. While German law now provides that title will pass if the acquisition of GmbH shares is *bona fide,* an acquisition will only be *bona fide* in certain narrow circumstances, in particular, if (i) the acquirer did not know or could not have reasonably known the fact that the seller was not the actual shareholder, and (ii) the seller was registered in the commercial register (*Handelsregister*) as a shareholder for at least three years prior to the acquisition, while for interests in KGs or OHGs similar *bona fide* protections do not exist in the first place, and may not exist, depending on applicable foreign law, for many foreign law entities.

It is unclear how depositaries will manage their task of verifying a shareholder's legal ownership. Pursuant to the KAGB, the depositary may generally rely on documentation provided by the AIFM and, when available, on external documents. However, the law requires the depositary to be independent from the AIFM as it is meant to protect investors' interests. Since the depositary is fully liable to investors if it either wilfully or negligently fails to carry out its prescribed functions under the KAGB, the depositary will need to perform appropriate investigations into the ownership of the target company in order to manage this risk.

We believe that, taking into account the particularities of German corporate law, it will be sufficient for the depositary to come to the conclusion that no reasonable doubt exists as to the valid transfer of ownership in the shares of the target company, since the KAGB does not require, in our view, a depositary to make such determination with absolute certainty. The depositary, in arriving at its conclusion, may use the due diligence reports commissioned by the AIFM in connection with the envisioned acquisition, but due to its independent status, it will also

need to carry out its own independent review. A depositary may need to obtain independent legal counsel to conduct due diligence to the extent that the due diligence report commissioned by the sponsor raises any concerns as to full ownership of the shares (or is based on insufficient underlying data). Given the practical obstacles, a pragmatic approach to the verification obligation of the depositary is warranted, however.

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If you have any questions, please feel free to contact Oliver Schröder (oschroeder@cgsh.com), Michael Kern (mkern@cgsh.com) or Alexander Rahn (arahn@cgsh.com) or any of your regular contacts at the firm. You may also contact our partners and counsel listed under "Germany", "Lawyers in this Practice", under the "Practices" section of our website at http://www.clearygottlieb.com.

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