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NEWS LETTER

FINANCIAL MARKETS

Measures by the German Government to Stabilize the Financial Markets

As a reaction to the developments in the financial markets, the German Government adopted on 13 October 2008 a package of measures coordinated at the European and international levels. The German Parliament [*Bundestag*] and the Chamber of German States [*Bundesrat*] approved the draft statute on 17 October 2008 so that the statute was ready to take effect on 18 October 2008 (German Financial Market Stabilization Act [*Finanzmarktstabilisierungsgesetz, "FMStG"*] of 17 October 2008, Federal Law Gazette [*Bundesgesetzblatt, "BGBl."*] 2008 I, pp. 1982 et seq.). At the center of the

measures lies the creation of a Fund with a volume of up to 100 billion Euros. Of this amount, up to 80 billion Euros can be used to assume risk positions and to provide equity funds; 20 billion Euros are intended to cover guarantees in a total amount of up to 400 billion Euros. Companies in the financial sector which draw benefits from the Fund are subject to special regulations relating to corporate law, capital markets law, commercial law and civil law. After the German Government established further details in a regulation on 20 October 2008, the moneys in the Fund are immediately available.

I. Background

European financial institutions have also been affected by the subprime crisis in the US American real estate market that spreads since the middle of last year. This has caused many nations to take bail out actions in the amount of many billions in order to protect the financial system against systemic shocks which were expected in the case of the collapse of individual institutions. The United States of America and Great Britain adopted packages of measures at the beginning of October 2008 which went beyond individual bail outs. These packages provided in part (as was the case in Great Britain) for extensive liquidity facilities and state participations in financial institutions and in part (as was the case in the United States of America) the acquisition of troubled asset by a state fund. Despite the measures taken by the individual countries, the institutions began to face refinancing problem as national and international interbank lending

stalled. In the week from 6 to 10 October 2008, the stock markets also suffered dramatic losses worldwide. Just in this period of time, according to press reports, the German stock index DAX fell by 21.6%, whereby the daily losses in stock market capitalization amounted to an average of around 26 billion Euros. Under the impression of these dramatic developments, the finance ministers of the G7 countries met in Washington D.C. on 10 October 2008 and agreed on the coordinated adoption of measures to support the financial markets. On 12 October 2008, the heads of state and government of the Member States of the Euro zone resolved to provide state guarantees to support refinancing on the interbank market and to provide equity capital for troubled institutions. Each Member State is responsible under these resolutions to take measures which it considers appropriate.

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II. Overview

The package of measures of the German government provides primarily for three instruments (so-called "**Stabilization Measures**"):

- the granting of state guarantees for newly established refinancing liabilities with terms of up to three years,
- the participation of the German government in enterprises in the financial sector ("**Recapitalization**"),
- the assumption of risk positions by the German government.

According to the concept of the German Government, these instruments are supposed to be applied in the following order: primarily, the provision of guarantees, then the acquisition of shares to strengthen the equity capital base, and finally the assumption of risk positions. All measures can be combined with each other. The terms, type and scope of the specific measures shall take into account the duration of the crisis in the financial market.

The mentioned instruments are designed to stabilize the financial market by (i) overcoming liquidity shortfalls and (ii) strengthening the equity capital base of credit institutions and financial services institutions. The instruments will be implemented by the Financial Market Stabilization Fund (the "**Fund**"), a newly created governmental entity in the form of a fund lacking a separate legal personality.

The legal foundations for the measures have been established by the German Financial Market Stabilization Act ("**FMStG**" or also the "**Act**"), the core elements of which consist of the "Act on the Establishment of a Financial Market Stabilization Fund" [*Gesetz zur Errichtung eines Finanzmarktstabilisierungsfonds*, "**FMStFG**"] and the "Act on the Acceleration and Simplification of the Acquisition of Shares in and Risk Positions of enterprises in the financial sector by the Financial Market Stabilization Fund" (hereinafter referred to as the "**Acceleration Act**"). Furthermore, the Act limits the liability of special trustees

[*Sonderbeauftragte*] appointed under the Banking Act [*Kreditwesengesetz* "**KWG**"] and the Insurance Supervision Act [*Versicherungsaufsichtsgesetz*, "**VAG**"], and it modifies the concept of "over-indebtedness" [*Überschuldung*] in insolvency law.

The FMStG establishes only the basic principles for the legal foundations of the Fund and the measures to be taken by it. The details are contained in a separate regulation adopted by the German Government on 20 October 2008, the "Regulation on Implementation of the Financial Market Stabilization Fund Act" (*Finanzmarktstabilisierungsfonds-Verordnung*, "**FMStFV**"). The FMStFV took effect upon announcement in the electronic Federal Gazette on the morning of 20 October 2008.

Stabilization measures can only be drawn by eligible enterprises in the financial sector if such enterprises submit to certain terms and conditions, in particular with respect to their business and dividend policies as well as the compensation schemes and amounts applicable to their senior management.

The measures under the FMStG are accompanied at the international and European levels by changes in provisions on accounting for financial instruments in order to permit the enterprises to refrain from further write-offs that would otherwise be required.

III. Details

1. Financial Sector Enterprises

The Stabilization Measures of the Fund can only be allocated to enterprises which qualify as "enterprises in the financial sector" within the meaning of the FMStFG ("Financial Sector Enterprises"). These enterprises include domestic

- credit institutions and financial services institutions as defined in the KWG,
- insurance companies (including re-insurance companies) as defined by the VAG,
- pension funds,
- investment companies, and
- operators of securities and option exchanges.

Domestic parent companies of the above mentioned enterprises are also included to the extent that they qualify as (pure or mixed) financial holding companies or supervised financial conglomerate enterprises within the meaning of the KWG. This requires, *inter alia*, that the subsidiaries of these parent companies are primarily or exclusively enterprises in the banking and investment services sector or enterprises in the banking, investment services and insurance sector. Finally, enterprises in the financial sector are also deemed to include entities under private law which have been granted authority as a "parent" of state banks [*Landesbanken*] organized under public law, even if these entities do not qualify as financial holding companies. This applies, for example, to the BayernLB Holding AG.

However, financial enterprises such as leasing companies and insurance holding companies are not covered unless, in the case of the latter, they also qualify as supervised financial conglomerate enterprises. Companies outside the financial sector are also not eligible for stabilization measures under the FMStG. Enterprises with seat in foreign countries are not eligible either, but their German subsidiaries are, provided that they meet the above mentioned requirements for a Financial Sector

Enterprise. The FMStFG does not make clear, whether investment companies are eligible to benefit from stabilization measures exclusively for themselves or, additionally, for the funds they manage.

2. Prerequisites for the grant of benefits

The FMStFG does not provide the Financial Sector Enterprises with specific entitlements vis-à-vis the Fund. However, the Fund shall exert its dutiful discretion when adjudicating on applications by Financial Sector Enterprises. In essence, such discretion extends to (i) the specification of such prerequisites that the Act and the FMStFV have defined in broad terms only, (ii) the details of the benefits to be granted (discretion in concept) as well as (iii) the allocation of the funds, which under the Act are available to a limited extent only (discretion in allocation). In general, an eligible institution will have a claim vis-à-vis the Fund that the Fund is obliged to take a decision and to base such decision exclusively on objective criteria. Therefore, benefits shall in general be granted to the extent that the criteria are fulfilled and, based on a careful prognosis, money is available. In general, the discretion with regard to concept and allocation must be exerted by taking into consideration the statutory goals of financial market stability, the neutrality with regard to competition, the needs of urgency as well as the principle of the most effective and economic use of the money in the Fund.

The Fund's decision on the granting of benefits, including at least the fundamental terms and conditions, is governed by public law. In contrast to this, specific benefits will be granted on the basis of private law contracts in each individual case. Remedies against the fundamental determination of the terms and conditions can be sought before the German Supreme Administrative Court [*Bundesverwaltungsgericht*]. If the German Supreme Administrative Court objects to decisions of the Agency, for example, with regard to specific terms and conditions, the principle of

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constitutionality [*Rechtsstaatsprinzip*] and the principles governing fundamental changes in the foundations of transactions [*Geschäftsgrundlagenlehre*] will most likely put the Fund in an obligation to adjust the terms of the private law agreements to the court's decision upon request of the benefited enterprise.

3. Basic legal features of the Fund

The Fund is being established as a separate estate [*Sondervermögen*] of the Federal Republic [*Bund*]. The Fund does not constitute a legal entity, but it can nevertheless act in its own name and file complaints as complaints can be filed against it. The Federal Republic is directly liable for the liabilities and obligations of the Fund, but the Fund is not liable for other obligations and liabilities of the Federal Republic.

As a general rule, the measures under the FMStG and the administration of the Fund fall within the responsibility of the Federal Ministry of Finance. However, by operation of the FMStFV the administration of the Fund was assigned to a newly created public law agency: the Financial Market Stabilization Agency or the "Agency". The Agency is established at the German Federal Bank [*Bundesbank*], but its organization is separated from the Bundesbank. The Agency is managed by a committee consisting of three members appointed by the Federal Ministry of Finance with the consent of the *Bundesbank*. The Agency is subject to legal and substantive supervision by the Federal Ministry of Finance. The Fund bears the costs of the Agency. As the Agency acts on behalf of the Fund, when the following text speaks of measures of the Fund such measures are those of the Agency or the Federal Ministry of Finance (if the latter decides to take over the initiative).

The German Supreme Administrative Court [*Bundesverwaltungsgericht*] has jurisdiction in the first and final instance over disputes under administrative law based on the FMStG. The German Supreme Civil Court [*Bundesgerichtshof*] has jurisdiction in the first and final instance over legal disputes that fall within the jurisdiction of the ordinary courts.

In order to enable the Fund to perform the tasks assigned to it, the German government is authorized under the FMStG to take out loans in a total amount of up to 100 billion Euros. The Fund can acquire participations in Financial Sector Enterprises or risk positions from such enterprises up to an amount of 80 billion Euros. 20 billion Euros are intended for the coverage of guarantees which the Fund can issue in a total amount of up to 400 billion Euros.

The Fund itself is neither subject to corporate income tax nor to trade tax. Furthermore, the Fund does not qualify as an enterprise within the meaning of VAT law. Therefore, goods delivered or services rendered by the Fund (for example, to the supported enterprises) are not subject to VAT, but on the other hand the Fund is not entitled to deduct input VAT in respect of goods or services supplied to the Fund. The exemption of the Fund from VAT is for the benefit of the entitled Financial Sector Enterprises as they are generally not entitled to deduct input VAT. On the other hand, to the extent they render tax exempt services to the Fund, they lose the possibility of opting for VAT.

Acquisitions by the Fund are also exempt from real estate transfer tax. However, there is no exception on subsequent sales by the Fund, meaning that such resale transaction may result in real estate transfer tax.

An important technical and administrative simplification lies in the fact that the benefited enterprises do not have to withhold and to pay to the tax authorities withholding tax on capital income including dividends and interest to be paid to the Fund. To the extent Financial Sector Enterprises are, on the other hand, creditors of capital income owed by the Fund, they will receive earnings without deduction of withholding tax. For purposes of double taxation treaties, the Fund shall be deemed to qualify as a domestic entity is entitled to the benefits of the respective treaty. This is supposed to limit the deduction of withholding tax in treaty states.

The Fund is entitled to take Stabilization Measures until 31 December 2009. After that date, the Fund is to be unwound and dissolved. The sale of acquired shares,

participations and rights by the Fund shall be conducted in a manner that avoids substantial impacts on the market [*marktschonend*].

4. Assumption of guarantees

The Fund may guarantee newly created refinancing liabilities of Financial Sector Enterprises in order to cure liquidity shortfalls and to support refinancing in the capital market. The granting of guarantees is the Stabilization Measure which is supposed to have priority. When considering the taking of Stabilization Measures in an individual case, the Fund is expected to determine whether the granting of a guarantee is sufficient to archive the goal of stabilization. Besides, the granting of guarantees is dependent on rather weak conditions as compared to Recapitalization measures and the assumption of risk positions. The guarantee will generally be provided in form of a first demand guarantee in accordance with standard banking practices. The guarantee covers not only the principal amount and interest, but also any other claim which the creditor of the guaranteed liability may have. As a general rule, guarantees are to be issued in Euro; if a guarantee is issued in another currency, the Fund must hedge the currency exchange risk and charge the benefited enterprise with the costs for the hedge transaction. Instead of guarantees, the Fund may also provide "other coverage in any appropriate form".

The guarantees can be issued with respect to debt securities issued by, and other refinancing liabilities of Financial Sector Enterprises. Although it is the intent of the legislature to enable the refinancing of German financial institutions, the wording of the statute does not preclude the possibility that the Fund issues guarantees relating to deposits of private persons and non-financial enterprises. However, these deposits are primarily protected by the current deposit insurance systems as having been supplemented by the political assurance of the German Chancellor dated 5 October 2008 with respect to deposits of private persons.

Guarantees can also be issued for liabilities of single purpose entities which have assumed risk positions

from a Financial Sector Enterprise (see point 6 below for details). According to the wording of the Act, this includes both domestic as well as foreign single purpose entities. The issuance of guarantees with respect to liabilities of such single purpose entities generally requires that the Financial Sector Enterprise requesting the guarantee is still substantially exposed to risks of loss or to liquidity risks associated with the risk positions transferred to the single purpose entity. Furthermore, the risks of the special purpose entity must be transparent and accessible to objective analysis. If the Fund guarantees liabilities of such single purpose entities for the benefit of a Financial Sector Enterprise, the benefiting enterprise shall be made subject to recourse claims, such that it will participate to a "reasonable" degree in the risk of a calling of the guarantee.

Debt securities and other liabilities can be guaranteed only if established in the period between 18 October 2008 and 31 December 2009 and if they have a maximum term of 36 months. This shall also apply for the guarantee of liabilities of single purpose entities having assumed risk positions from Financial Sector Enterprises. As a consequence, it will still be permissible in the future to transfer risk positions to single purpose entities; guarantees of the Fund, however, will only be available in compliance with the above-mentioned prerequisites. However, it is not clear whether the Act assumes a cut-off date for such risk positions as provided for in the event of a direct assumption of a risk position by the Fund (13 October 2008).

The benefited enterprise must pay a consideration for the guarantee in an amount considered "reasonable". Contrary to the legislative history, which provided for a consideration in an amount of at least 2 percent of the guaranteed sum, the FMStFV provides that the consideration shall be at fair market rate and shall be denominated in a specific percentage of the guaranteed sum and a margin.

Guarantees by the Fund can only be used if the Financial Sector Enterprise requesting the guarantee of its debt securities or other refinancing liabilities satisfies certain minimum requirements with regard to the level of its own funds. The FMStFV specifies in this respect that

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the enterprise must have "reasonable own funds". The wording indicates that this refers to the regulatory capital requirements. In consequence, the own fund requirements would have to be calculated in accordance with the pertinent regulation, such as, in the case of credit institutions and investment firms (within the meaning of the KWG), the Solvability Ordinance [*Solvabilitätsverordnung*]. If an enterprise does not have sufficient own funds, it might consider to improve its equity base by means of a Recapitalization measure.

According to the FMStFV, the maximum amounts for the grant of guarantees are also determined according to the own funds base of the requesting enterprise and its affiliates. However, it is open how to derive the maximum amount from the amount of available own funds.

5. Recapitalization

Recapitalization measures are directed towards the improvement of the equity base of Financial Sector Enterprises. The participation of the Fund in recapitalization measures can take any suitable form, including the acquisition of shares or silent partnerships or "other elements of the own funds". The use of the term "own funds" [*Eigenmittel*] as defined in the KWG indicates that this includes not only core capital but also supplementary capital as well as other funds eligible for own funds status [*Drittrangmittel*] (as defined in the KWG). In line with this, the Acceleration Act provides for the acquisition of participation rights [*Genussrechte*], which do not qualify as core capital. In this respect the Fund could also subscribe to subordinated debt, provided that the corresponding requirements for the qualification as supplementary capital or as *Drittrangmittel* are met. However, the FMStFV provides that recapitalizations shall primarily strengthen the core capital base as defined in the KWG or, in the case of insurance companies and pension funds, own funds as defined in the VAG.

The Fund shall receive fair market consideration for participating in the recapitalization measure. Generally such consideration shall take the form of a preferred dividend or of interest.

The participation of the Fund in recapitalization measures is only permitted if there is an important interest of the State and if the objective of the measure cannot be achieved better and more economically in another manner. This would, in particular, be the case if (i) a Financial Sector Enterprise is not eligible for the granting of a guarantee, as may be the case if its own funds base is insufficient, or if (ii) the granting of a guarantee would not suffice to stabilize the enterprise. The participation of the Fund in a Recapitalization can be made dependent on contributions by the shareholders of the supported enterprise. Since shareholders' preemptive rights are excluded or can be excluded under simplified conditions (see below), such contributions will most likely take the form of contributions to the capital reserves.

The maximum limit for Recapitalization measures in a single Financial Sector Enterprise and its affiliates is 10 billion Euros. In a specific case, this maximum limit can be exceeded if a governmental Steering Committee (representing several Ministries of the Federal Government) so resolves.

6. Special rules under corporate law, capital markets law, tax law and commercial law in the case of a Recapitalization

In order to facilitate and accelerate participations of the Fund by way of a Recapitalization, the Acceleration Act provides for a set of rules designed to ease requirements under corporate law, capital markets law and commercial law. In addition, special tax provisions apply for the relevant Financial Sector Enterprises.

a) Stock corporations law

If the Fund takes part in the Recapitalization of a Financial Sector Enterprise organized as a stock corporation (*Aktiengesellschaft*), the enterprise can create the necessary capital in a simplified manner. Firstly, the enterprise can make use of an authorized capital created by statute to which the Fund can exclusively subscribe, whereas no resolution of the general shareholders meeting is required with respect to the creation or

the exercise of such authorized capital. Secondly, the company can make use of relaxed requirements when calling and preparing the general shareholders meeting in the context of regular capital increases involving the participation of the general shareholders meeting. In the first situation, the preemptive rights of the shareholders are completely excluded at the time of the capital increase and its implementation, and in the second situation an exclusion of the preemptive right (to be resolved by the general shareholders meeting) is "in any event, permissible and reasonable". This reduces the risk that shareholders can successfully challenge the resolution on the capital increase. There is no obvious reason why the legislature excludes the preemptive right in the case of the capital authorized by statute without any exception and, thus, prevents private shareholders from contributing fresh capital to the relevant enterprise together with the Fund. If the management board has both measures available at hand, it might be required to opt for the simplified process for a regular capital increase instead of using the capital authorized by statute in order to enable the existing shareholders to participate in the capital increase.

- **Capital authorized by statute**

For a limited period up to 31 December 2009, the Act creates in any Financial Sector Enterprises organized in the legal form of a stock corporation [*Aktiengesellschaft*] an authorized capital in the amount of up to 50% of the share capital existing at the time the Act took effect. The management board, upon obtaining the consent of the supervisory board, is authorized to use this capital by issuing new shares to the Fund in exchange for contributions. The supervisory board is entitled to adapt the articles of association to the situation resulting from the creation and use of the authorized capital.

It is unclear whether – as the language of the Act appears to indicate – the legislature believes that a Financial Sector Enterprise can use the possibility of increasing the capital by using the capital authorized by statute only once. Contrary to § 202 German Stock Corporations Act [*Aktiengesetz*, "**AktG**"], the 50% limit does not relate to the share capital at the time of the authorization, but to the share capital at the time the FMStG takes

effect. The capital authorized by statute comes into existence regardless of whether or not the corporation has already created authorized capital. However, the use of the capital authorized by statute reduces any other authorized capital. An excessive dilution of the shareholding of the existing shareholders shall thereby be prevented. However, it is not clear how this reduction is calculated in case a corporation has created more than one type of authorized capital (as is the case with virtually every large stock corporation). In particular it is not clear, how this affects the authorization to exclude shareholders' preemptive rights for the various types of authorized capital.

The capital authorized by statute is available to all Financial Sector Enterprises in the legal form of a stock corporation, a limited partnerships on the basis of shares [*Kommanditgesellschaft auf Aktien*] and a Societas Europaea [SE], but not to companies which have the legal form of a limited liability company [*Gesellschaft mit beschränkter Haftung*], although the German Act on Limited Liability Companies [*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*] will provide for the creation of authorized capital once the German Act on the Modernization of GmbH Law and on Combating Abuses [*Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Mißbräuchen*] will have entered into force, which is expected to occur on 1 November 2008.

- **Loosened requirements for calling and preparing general shareholders meetings ("fast track")**

The share capital can also be increased by way of a regular capital increase with the participation of the general shareholders meeting. In this event, loosened requirements apply for calling and holding the general shareholders meetings according to the template provided by the German Securities Acquisition and Takeover Act [*Wertpapiererwerbs- und Übernahmegesetz*]. The corporation is free in selecting the location of the meeting; shortened notification periods apply and it is not necessary to send out notifications if the timely receipt by the shareholders is not ensured. In addition, the minimum period for calling a meeting has been reduced to one day.

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- **Reporting to the regular general shareholders meeting following the capital measure**

The management board must report about the capital measure in the regular general shareholders meeting following the capital measure by explaining in particular the scope of the capital increase, the issue price and the structure of the issued shares with regard to both legal and economic aspects.

- **Preemptive rights of shareholders in a subsequent sale**

The general exclusion of shareholders' preemptive rights at the time of the use of the capital authorized by statute and its simplified exclusion in the case of a regular capital increase is supposed to be offset by the fact that the Fund must grant the shareholders a "preemptive right" in the case of a subsequent sale of acquired shares, participations and rights. This raises a number of issues; for example, whether the "preemptive right" is not in substance a right of first refusal or a put obligation as is indicated by the reasoning for the Act. It is also open whether this "preemptive right" is supposed to benefit everyone who was a shareholder at the time of the subsequent sale or, instead, only those shareholders whose preemptive rights were excluded when the Fund subscribed to the participation (as indicated by the reasoning of the Act). If the preemptive right at the time of the subsequent sale is supposed to compensate for the exclusion of the preemptive right at the time of the Fund's subscription to the capital increase, it is not easy to explain why the same rule should not also apply with respect to the sale of silent partnerships and other rights for which the preemptive rights of existing shareholders were excluded. It is likely that the courts will eventually decide whether the grant of the "preemptive right" in the case of the subsequent sale is sufficient to eliminate any doubts about the constitutionality of the general or at least far reaching exclusion of the preemptive right.

- **Features of the shares and conditions for their issuance**

The rights represented by the shares and the conditions of their issuance are to be determined by the management board. In particular, the shares can provide for preferences and preferential rights which, however,

expire upon the transfer of the shares to third parties. Decisions by the management board require the consent of the supervisory board. According to the Act, an issue price at the level of the stock exchange price is, in any event, reasonable. In addition, the management board, acting with the consent of the supervisory board, may also decide to establish an issue price below the stock exchange price.

- **Loosened requirements for the raising of capital**

Capital increases for the purpose of the creation of a participation of the Fund can be implemented even if contributions for the existing share capital are still outstanding. An advance payment by the Fund can be credited against the obligation of the Fund to make its contributions. This permits the Fund to provide the money, in a case of emergency, even prior to the implementation of the measures required for the capital increase. Upon the execution of these measures, the advance payment will settle the duty to make the contribution even if the money is then no longer available for the management board. Hence, the decision about how the enterprise creates the necessary capital, i.e. whether it conducts a regular capital increase with the involvement of the general shareholders meeting or whether it chooses to use the capital authorized by statute (without involvement of the general shareholders meeting) does not necessarily have to be decided at the time of the advance payment of the capital.

- **Registration of the capital increase in the commercial register**

Under the Acceleration Act capital measures are only to a limited degree subject to examination by the courts. The implementation of a capital increase by the use of authorized capital created without the participation of the general shareholders meeting must be immediately registered in the commercial register. The Act expressly provides that an examination shall not take place. If the capital increase is resolved with the participation of the general shareholders meeting, the review by the courts is limited to instances of "obvious invalidity", which constitutes a very high threshold for any complaints by shareholders.

- **Issuance of participation rights (*Genussrechte*) and granting of silent partnership rights without participation of the general shareholders meeting**

Contrary to the applicable provisions under stock corporations law, a resolution of the general shareholders meeting is not required for the issuance of participation rights (*Genussrechte*) and the granting of silent partnership rights to the Fund. A silent partnership right established for the benefit of the Fund does not qualify as an enterprise agreement (*Unternehmensvertrag*) within the meaning of the AktG and, therefore, does not have to be registered in the commercial register in order to become valid. The Act remains silent on whether a different regime governs upon the transfer of the silent partnership right by the Fund to a third party. While the simplified issuance of participation rights is limited to the period until 31 December 2009, the Act does not contain any corresponding limitation for granting a silent partnership right for the benefit of the Fund. In the case of the issuance of participation rights, the preemptive right of the shareholders is excluded without any exception. In this respect the same applies as in the case of the use of the authorized capital created by statute. Also the "preemptive right" will most likely be available to shareholders in the event of subsequent sales.

- **Corporate Governance**

The management of the enterprise making use of a Stabilization Measure by the Fund must issue a public declaration stating that the enterprise is in compliance with the conditions for the participation in the Stabilization Measure with regard to, inter alia, the business policy, remuneration policy and dividend policy ("**Declaration of Undertaking**"; see point 7 below for details). Under the Acceleration Act the issuance of such declaration by the management board of a stock corporation is consistent with the management board's duty of care; in this respect the Acceleration Act specifies the duties imposed on the management board under general stock corporation law. The Declaration of Undertaking authorizes and requires the management vis-a-vis the company to comply with the declaration. Resolutions of the general shareholders meeting which contradict the Declaration of Undertaking can be

challenged for this reason. Shareholders may challenge it only if they reach or exceed a quorum of 5% of the share capital or a participation of EUR 500,000 in the share capital.

- b) **Special provisions for companies with other legal forms**

The provisions applicable to stock corporations apply *mutatis mutandis* to the *Societas Europaea* and the limited partnership based on shares [*Kommanditgesellschaft auf Aktien*]. However, the Acceleration Act does not contain any special provisions for Financial Sector Enterprises which are organized in the legal form of a limited liability company [*Gesellschaft mit beschränkter Haftung, GmbH*]. The legislature seems to assume in this respect that there is no need for any special regulation in light of the comparatively simple possibilities of increasing capital. The described regulations on the Declaration of Undertaking, however, also apply to the managing directors and the shareholders of a GmbH.

A resolution of the general membership meeting is required for amendments to the articles of association of cooperatives [*Genossenschaften*] which are directed towards having the Fund making contributions to the cooperative's capital. This resolution must be registered in the cooperative register unless it is "obviously void". The provisions on the involvement of the general shareholders meeting of stock corporations apply accordingly when granting participation rights by mutual insurance organizations [*Versicherungsverein auf Gegenseitigkeit*].

- c) **Capital markets law**

- **Dispension from the obligation to obtain a listing on the exchange**

The issuer of exchange-traded stock is generally required to have newly issued shares of the same class registered. The Acceleration Act releases the issuers from this obligation with respect to shares to which the Fund subscribes. However, the duty to register the shares is revived upon the transfer of the shares by the Fund to

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third parties. In such case, the one year deadline for the registration commences upon transfer to the third party.

- **No mandatory offer and limited notification duties under the German Securities Trading Act [Wertpapierhandelsgesetz, "WpHG"]**

The acquisition of a controlling majority by the Fund does not trigger any duty of the Fund to issue a mandatory offer for the outstanding shares. Nor does the acquisition of voting stock by the Fund trigger any duty to notify under § 27a WpHG. Under this provision a party acquiring 10 percent or more of the voting capital of a listed company must provide information about the goals of the participation and the financing of the acquisition. Other notification duties under the WpHG relating to several thresholds of voting rights stakes remain unaffected. The Act does not provide for any regulation on the duties to notify under banking supervisory law and insurance supervisory law with regard to the acquisition of participations in an amount of more than 10 percent of the capital ("material participations").

d) Tax law

From a practical perspective it seems of extreme importance that the Act provides that neither the acquisition of shares of Financial Sector Enterprises by the Fund in the context of a Recapitalization at a level higher than 25% of the nominal capital nor the "re-transfer" of such a participation result in the forfeiture of corporate income tax and/or trade tax loss carry forwards of those enterprises and their subsidiaries. Since the wording of the Act expressly addresses a "re-transfer" of the shares, it could be reasoned that the loss carry forwards only continue to exist when the transfer is to the original seller but not when the participation is sold to a third party. Based on the purpose of the law, however, the sale to a third party should also be privileged.

e) Exemption under antitrust law

According to the Acceleration Act, the provisions of German merger control law do not apply to the Fund and its measures. European antitrust law, of course, is not affected by this.

7. Assumption of risk positions

The Fund is authorized to assume risk positions from Financial Sector Enterprises which had been acquired prior to 13 October 2008. Risk positions which were acquired after 18 October 2008 cannot be assumed; however, such positions may be eligible for a guarantee by the Fund (see above). Risk positions which were acquired between 13 and 18 October 2008 do not fall under either of the measures.

The catalogue of risk positions includes, but is not limited to, receivables, securities, derivative financial instruments, rights and obligations under credit commitments, guarantees and participations, in each case together with the corresponding security. The Fund can also acquire risk positions from single purpose entities having acquired such positions from a Financial Sector Enterprise. The prerequisite for this is, in general, that the Financial Sector Enterprise is still substantially exposed to risks of loss and liquidity risks in connection with the transferred risk positions. Furthermore, the risks, to which the single purpose entity are exposed, must be transparent and accessible for objective analysis. If risk positions of such single purpose entities are assumed, the benefiting Financial Sector Enterprise shall participate in the risk in a "reasonable manner".

The assumption of risk positions can be conducted either by way of an acquisition or by way of other types of coverage. The acquisition can take place "in any appropriate form". Potential instruments for covering a risk position include, among others, credit derivatives by means of which the benefited Financial Sector Enterprise can transfer default risks associated with a loan or a debt security to the Fund.

If the assumption of risk is conducted by means of a purchase of the risk position by the Fund, the purchase price must not exceed the value at which the risk position was accounted for in the last interim financial report or the annual financial statements. In determining the purchase price the Fund shall ensure that it receives a reasonable return adequate in relation to the level of the assumed risk and which at least covers the Fund's refinancing costs.

The Fund can agree on a preemption right or a repurchase right for the benefit of the transferring enterprise, but it may also impose on the transferring enterprise a repurchase obligation. The transferring enterprise can also be obliged to participate in default risks associated with the transferred risk position and to compensate the Fund in the case of a default. Repurchase obligations and agreements on the participation in default losses have the effect that risks associated with the pertinent risk position remain with the "transferring" enterprise despite their "assumption" by the Fund. To the extent risks remain with the enterprise, such risks are not definitely "assumed" by the Fund, but only the time of their realization and the associated liquidity effects are postponed. In any case, the transaction shall be structured in such a manner that the enterprise does not have to reflect any risk associated with the transferred risk position in its balance sheet.

The Fund, subject to a preemption right of the benefited enterprise, is entitled at any time to dispose of the assumed risk positions. The sale of the respective positions shall be conducted in a manner that avoids substantial impacts on the market [*marktschonend*]. The benefited enterprise may re-acquire the risk positions from the Fund even if it has not been vested with a preemption right. In any event, when selling its positions the Fund shall achieve a reasonable return on the invested capital that covers its refinancing costs. The maximum limit for the assumption of risk is 5 billion Euros per Financial Sector Enterprise (and its affiliated enterprises), subject to a deviating decision by a governmental steering committee (representing several Federal Ministries).

In order to facilitate and accelerate the acquisition of risk positions as provided for in the FMStFG, the Acceleration

Act eliminates a number of hindrances under civil law and insolvency law which could otherwise impede or prevent the acquisition of a secured legal position by the Fund. Specifically:

- The transfer of risk positions and collaterals to the Fund cannot be set aside under insolvency law. This is supposed to prevent that legal positions acquired by the Fund are withdrawn in an insolvency proceeding of the Financial Sector Enterprise as a result of an avoidance of the acquisition by the bankruptcy trustee. If the Fund serves as an administrative trustee and if the trustor (the Act apparently speaks mistakenly about the trustee) becomes insolvent, the assets transferred to the fund are deemed to not be part of the insolvency estate, contrary to the law which otherwise applies.
- Hindrances on assignments and transfers under civil law (this may also include preemption rights, options or change of control clauses) do not prevent a transfer of legal positions to the Fund. This is supposed to apply not only for prohibitions on assignment, but also for agreements with third parties such as parties providing security. The corresponding agreements are invalid vis-a-vis the Fund.
- If a contract is transferred to the Fund, the counterparty (for example, a borrower) cannot terminate the underlying legal relationship for cause based on the transfer.
- The terms and conditions used by the Fund shall not be subject to the legal control of general terms and conditions. This is supposed to exclude subsequent disputes about the reasonableness of the terms and conditions used by the Fund. According to the legislative history, the assumption of risk positions and the guarantees granted by the Fund shall also to be excluded from the legal control of general terms and conditions.
- Since a transfer of a contract can be invalid if it leads to a violation of private secrets under § 203 German Criminal Code [*Strafgesetzbuch*], the Acceleration Act provides that § 203 German Criminal Code does not prevent any transfer of information in the context of transferring risk positions to the Fund.

Measures by the German Government to Stabilize the Financial Markets

8. Prerequisites for the use of Stabilization Measures

The granting of Stabilization Measures to Financial Sector Enterprises requires that the relevant enterprise warrants the "solidity and carefulness" of its business policies. The specific requirements resulting herefrom are specified in the FMStFV. They have a different degree of strictness depending on the kind of Stabilization Measure to be taken. The strictest conditions are connected to Recapitalization measures, while the assumption of guarantees is subject to comparably minor conditions. In any event, conditions must be compatible with the principle of proportionality. The conditions shall in each individual case take into account the type, the amount and the duration of the Stabilization Measure in question and the economic situation of the enterprise.

In order to avoid distortions of competition, additional conditions can be imposed on the business activity of an enterprise making use of Stabilization Measures.

As a general rule, the conditions shall be determined by way of an individual contract in each specific case. To the extent this is not possible or appropriate, in particular in the case of Recapitalization measures, conditions shall become binding by means of a Declaration of Undertaking which must be issued by all members of the management body authorized to represent the enterprise. The conditions, however, can also be imposed by way of a unilateral administrative decision.

To the extent that the terms and conditions are agreed in a contract, the legal consequences of violations of such conditions by the enterprise shall be regulated in the contract, whereby such legal consequence may include, among others, rights of termination, claims for damages and contractual penalties. Individual terms and conditions can subsequently be modified by means of an agreement between the Fund and the enterprise if this should become necessary due to a change in the circumstances.

The Fund is supposed to be able to demand from the benefiting enterprises to have their auditors check whether the enterprise has complied with the

conditions to the Stabilization Measure; corresponding determinations shall be included in the audit report. During the term of the Stabilization Measure, "reasonable" rights of information must be granted to the Fund. These rights of information are supposed to permit the Fund, *inter alia*, to evaluate Stabilization Measures six months after their implementation. The Federal Audit Agency [*Bundesrechnungshof*] must be granted audit rights.

a) Conditions for Recapitalization

The strictest and furthest reaching requirements are established in connection with Recapitalization measures. If an enterprise requests that the Fund takes a participation in the enterprise in line with a Recapitalization measure, the following conditions, among others, can be imposed on the enterprise:

- the reduction or complete elimination of certain types of risk (such as securitization risks) and activities in certain types of business or in certain markets;
- taking into account the needs of the non-financial industries, in particular small size and mid-size enterprises, when granting loans and investing capital. Whether such a condition can only be imposed if the benefited enterprise engages in the credit business at all remains open, but is indicated by the wording of the pertinent provision;
- the compensation systems of the enterprise as well as their incentive effects and reasonableness must be examined, and unreasonable compensation schemes must be terminated to the extent possible and permissible under civil law;
- the total compensation of members of corporate organs and managing directors shall be limited to a "reasonable level". The criteria to be applied when determining the reasonableness of the compensation include the areas of responsibility and the personal performance of the individual entitled to remuneration as well as the economic situation, the success and the future prospects of the enterprise (including the corporate group to which it belongs). Furthermore, when determining the reasonableness

of the compensation, it shall also be compared to the compensation granted in comparable enterprises. Monetary compensation of members of corporate organs and managing directors is, as a matter of principle [*"grundsätzlich"*], deemed to be unreasonable if it exceeds the amount of 500,000 Euros annually. The word "*grundsätzlich*" indicates that under certain circumstances, compensation may be accepted to be "reasonable" although it exceeds the 500,000 Euros limit.

The limits to the compensation of members of senior management and business managers primarily apply to the conclusion of new contracts. Additionally, it shall not be permissible to agree on benefits to be triggered by a change of control or by a premature termination of the employment. Beneficiaries under existing agreements shall not receive any benefits to which they are not legally entitled. Aside from this, compensation for members of senior management under existing contracts shall be reduced to a "reasonable level" to the extent possible and permissible under civil law. In particular, supervisory boards shall make use of the provisions laid down in § 87 para. 2 AktG, according to which the supervisory board is authorized to reduce the compensation of the members of the management board in case of a deterioration of the corporation's affairs. As a factual matter, the Fund could try to make the required changes in the service agreements a precondition for the participation in the requested Recapitalization measure, provided, however, that such approach is covered by the discretion the Fund has been vested with. This would confront the affected members of the senior management with the issue whether they are violating their duties owed to the company if they do not accept this precondition.

Bonuses or other elements of compensation placed in the discretion of the enterprise are not supposed to be paid during the term of a Stabilization Measure; however, they remain permissible to the extent the total compensation is reasonable, thus, especially if bonuses serve to compensate for a low fixed salary. Finally, performance targets, exercise prices for stock option programs and other parameters for success-linked compensation shall not be retroactively

modified to the detriment of the enterprise.

Finally, the Fund may require that the compensation of the business managers be disclosed on an individualized basis by differentiating between success-linked and success independent components as well as components with long-term incentive effects. Such disclosure shall be made in a compensation report to be published in the electronic Federal Gazette, provided that corresponding information is not already made in the notes to the annual financial statements.

- During the term of the Stabilization Measures, no dividend payments shall be made to shareholders other than the Fund. The Fund receives dividends, however, only in the case it has subscribed to shares in line with a Recapitalization.
- Other repayments to shareholders, for example, in the context of reductions of capital or in the case of a redemption of shares or other parts of the equity base, are not permitted.

b) Conditions for the assumption of guarantees

The grant of guarantees can be made subject to restrictions relating to the entering into certain types of risks and/or transactions (as described above for Recapitalization measures). Other than in the case of Recapitalizations, no restrictions apply with respect to the granting of loans, management compensation and dividend policy.

c) Conditions for the assumption of risk positions

The conditions for the assumption of risk positions generally follow the conditions for Recapitalization measures, except that no conditions can be imposed with regard to the policies relating to the granting of loans. Benefited enterprises, therefore, can be restricted with respect to entering into certain types of risks and/or transactions, management compensation as well as with regard to the dividend policy.

Measures by the German Government to Stabilize the Financial Markets

9. Limitation of the liability of Special Trustees under supervisory law

The Stabilization Measures are accompanied by a limitation of the liability of special trustees who, by virtue of supervisory law, temporarily assume the powers of removed members of corporate bodies of institutions within the meaning of the KWG or of insurance companies within the meaning of the VAG. The liability of such Special Trustees for negligent behavior is limited to one million Euros, and in the case of companies listed on the stock exchange, to four million Euros. This also applies to multiple violations of duties and independent of whether the special trustee assumes the powers of one or more corporate bodies. These supplements to the KWG and the VAG are not tied to any Stabilization Measures under the FMStG and accordingly apply to all companies covered by the KWG or the VAG, regardless of whether they use Stabilization Measures or not. This provision on the limitation of liability is applicable only until 31 December 2010.

10. Revision of the term "over-indebtedness" in insolvency law

For a period of a good two years (until 31 December 2010), the term of over-indebtedness under insolvency law in § 19 of the German Insolvency Code [*Insolvenzordnung*] is changed back to the wording which was valid until the Insolvency Code took effect. This is supposed to enable enterprises to avoid insolvency during these two years if there is a greater probability that the financial power of the enterprise will be sufficient in order for it to continue. The problems resulting under the previously applicable definition of over-indebtedness, which were considered to have been finally overcome when the German Insolvency Code was adopted, can, thus, again become a bone of contention. The temporary new rule in § 19 of the German Insolvency Code is not limited to Financial Sector Enterprises making use of benefits under the FMStG. Instead, the new regulation applies for all enterprises which are subject to German insolvency law.

11. Modifications in accounting rules for financial instruments

In order to protect actors in the financial markets from the ongoing need to write-off positions in financial instruments, modification of the accounting rules applicable to financial instruments are planned. The first step has already been taken by the International Accounting Standards Board ("IASB") on 13 October 2008 when it adopted modifications in IAS 39 and IFRS 7. According to these modifications, it is now possible under tight preconditions to re-qualify certain financial instruments that were accounted for at fair value in such a manner that they are accounted for at cost or at amortized costs. The European Commission has implemented these revisions at the European level by means of a regulation dated 15 October 2008.

12. European law on state aid

The European Commission stated in its notice of 13 October 2008 that national Stabilization Measures under Art. 87 (3) (b) EC Treaty can be approved "to remedy a serious disturbance in the economy of a Member State" if certain conditions are fulfilled. In particular,

- the supporting measures must be made available according to objective criteria which do not discriminate against enterprises from other EU Member States;
- the aid to be granted under the programs must be limited in time, whereby the maximum term is two years;
- the scope of the state support must be limited to the degree necessary for overcoming the present turbulence in the financial markets;
- it must be excluded that shareholders or supported enterprises obtain unjustified advantages from the aid at the expense of the tax payers;

- it must be ensured that the private sector makes a reasonable contribution for the grant of the aid; in particular, the supported institutions must pay reasonable compensation for granting guarantees and other security, and recapitalization must occur at fair market values;
- rules of conduct must be imposed on the recipients of support which preclude an abuse of the aid, for example, in the context of an expansion or an aggressive market strategy;
- structural measures for the financial sector or the benefited enterprises must be taken after the aid ends.

IV. Outlook

The German Government's package of measures is in many ways without precedent in recent economic history. This applies not only to the volume of the provided funds and the rapidity of the legislative process which allowed the package to take effect within one week. The character of the adopted measures and their impacts on the legal relationships of the involved enterprises, their management bodies and shareholders are equally unprecedented. The Act will most likely be a starting point for additional measures directed towards a comprehensive reform of the legal frameworks for financial markets.

Germany notified the Commission about the stabilization program on 14 October 2008. The approval of the national stabilization program has the consequence that individual aid under this program no longer has to be separately notified. In the case of recapitalization measures, the enterprise must, however, submit a restructuring plan to the Commission, if appropriate, at a later date. This applies, in any event, if the recapitalization measure is permanent. The same rule also applies for guarantees if the guaranteed event occurs. The Commission will examine these restructuring plans separately according to the rules for state aid. The Commission clearly states that it will differentiate between structurally sound enterprises which have only experienced difficulties as a result of the present tight liquidity and enterprises with structural problems for which the standard of examination will be stricter.

It remains to be seen whether Financial Sector Enterprises will accept the offered measures and submit to the far reaching conditions associated with the prerequisites for taking advantage of these measures, and the hope remains that the goal of stabilizing the financial markets intended by the legislature will be achieved so that the Fund can again withdraw from its participation in the enterprises as the Act provides for the period after 31 December 2009. Until that time, there will be countless issues for the Fund, the FMSA and the affected enterprises, their management boards, managing directors and shareholders when implementing and applying the new Act and the supplemental regulation issued on the basis of the Act.

Hengeler Mueller provides comprehensive advice in all important areas of private and public business law and has an experienced team of attorneys specializing in the fields of banking law, financings and capital markets law, including banking and insurance supervisory law.

In this Newsletter, we want to inform you about current topics. Our Newsletters do not fully cover all developments in legislation and case law or provide legal advice for specific situations.

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20. Oktober 2008

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