Germany’s Response to the Current Global Financial Crisis

On October 20, 2008, the German government adopted the *Finanzmarktstabilisierungsgesetz*† (the “German Stabilization Act”), a €500 billion rescue package to provide financial assistance to German financial institutions, pension funds and insurance companies and certain other entities (“Financial Sector Institutions”) in response to the current global financial crisis. On October 22, 2008, the Stabilization Fund created by the German Stabilization Act became operational. On October 28, 2008, the European Commission cleared the German Stabilization Act after determining that it does not violate European Union state aid rules. Such approval clears any uncertainty regarding any discrimination of foreign banks and distortion in competition, and paves the way for the legislation to address the current crisis in the German financial sector.

How does the German Stabilization Act provide relief to Financial Sector Institutions?

A central element of the German Stabilization Act is the creation of a financial market Stabilization Fund (the “Stabilization Fund”) for the purpose of overcoming liquidity shortfalls and strengthening the capital resources of stressed Financial Sector Institutions.

How does the Stabilization Fund work?

The Stabilization Fund can offer financial assistance to stressed Financial Sector Institutions through:

- granting financial guarantees (with a maximum duration of the end of 2012);
- refinancing such entities, particularly through the acquisition of equity stakes in such entities against capital contributions; and
- acquiring risky financial instruments and other assets, particularly receivables, securities, derivatives, and rights and commitments from stand-by credit facilities.

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† The German Stabilization Act consists of two individual laws: the *Finanzmarktstabilisierungsfondsgesetz* (the “FMSIFG”) and the *Finanzmarktstabilisierungsfonds* (the “FMS”).
The Stabilization Fund will be administered by a newly created governmental body, the Finanzmarktstabilierungsanstalt (the “FMSA”).

What financial restrictions are associated with the Stabilization Fund?
The German Stabilization Act authorizes the federal government to adopt specific rules to regulate, *inter alia*, (i) the form of guarantees to be provided by the Stabilization Fund, as well as the particular risks they may cover, (ii) the capital requirements Financial Sector Institutions must meet in order to obtain such guarantees, (iii) the calculation and application of the amount of guarantees, (iv) the consideration to be paid and conditions to be met by the Financial Sector Institutions for obtaining such guarantees, (v) the maximum amount for guarantees and (vi) other conditions necessary to ensure the effectiveness of the measures introduced by the German Stabilization Act. In response, the federal government has adopted rules that limit (i) the annual salaries of individual bank managers to a maximum of €500,000, which may, under certain circumstances, be exceeded, (ii) the aggregate financial assistance available to a single Financial Sector Institution to €10 billion and (iii) the acquisition by the Stabilization Fund of risky financial instruments and other assets from a single Financial Sector Institution to €5 billion. Furthermore, Financial Sector Institutions receiving relief under the German Stabilization Act may neither distribute dividends nor other profit unless they are contractually obliged to do so. Finally, such Financial Sector Institutions may not award severance payments, bonuses and discretionary compensation unless legally required to do so.

What criteria must Financial Sector Institutions meet in order to obtain financial assistance?
Financial Sector Institutions seeking assistance from the Stabilization Fund must submit their business plans to the FMSA for its review of the stability and prudence of such business plans. In addition, the federal government may enact regulations which set specific criteria (along with time limits and form requirements for such criteria) for Financial Sector Institutions receiving assistance from the Stabilization Fund. Such criteria include, in particular, limitations on corporate strategies, the use of financial assistance granted, compensation of employees and the payment of dividends and capital requirements, as well as measures to avoid distortions in competition. In addition, the specific criteria the federal government may adopt can be different depending on the form and recipient of the financial assistance.

The Bundesministerium der Finanzen (the “Finance Ministry”) ultimately determines whether to grant such financial assistance based on the condition of the applicant’s financial situation, the applicant’s overall significance for financial market stability, and considerations regarding the prudent and effective use of public funds.
How is the Stabilization Fund financed?
Under the German Stabilization Act, the federal government is directly liable for the Stabilization Fund and is responsible for funding the administrative costs of the FMSA. The German Stabilization Act authorizes the Finance Ministry to grant guarantees of up to €400 billion in favor of the Stabilization Fund to stimulate liquidity and promote refinancing in the finance markets. Furthermore, the Finance Ministry may borrow up to €70 billion in favor of the Stabilization Fund, which can be increased under certain circumstances by an additional €10 billion. In the event the Stabilization Fund pays under any guarantee issued, the German Stabilization Act further authorizes the Finance Ministry to borrow an additional €20 billion in favor of the Stabilization Fund. Therefore, the potential financial resources of the Stabilization Fund amount to an aggregate of €100 billion in cash, in addition to the €400 billion in the form of guarantees.

Furthermore, the Stabilization Fund shall finance, at least to some extent, its activities through the generation of income deriving from the resale of equity positions and assets acquired, as well as from interest on loans made to and fees charged for guarantees granted for the beneficiary Financial Sector Institutions.

What changes does the German Stabilization Act introduce with regard to legally authorized capital?
The German Stabilization Act authorizes executive boards of Financial Sector Institutions, with the approval of the supervisory board, to increase the share capital by up to 50% through issuing new shares to the Stabilization Fund up and until December 31, 2009. No shareholder consent is required, and shareholder subscription rights are excluded by law. The executive boards of Financial Sector Institutions are authorized to determine the content of stock rights, as well as terms and conditions of issuance, and the issuance of preference shares without either voting rights or payments in arrears is permitted. The German Stabilization Act provides that an issue price equivalent to the stock exchange price is reasonable, although it also specifically allows the executive board, with the supervisory board’s approval, to establish an issue price below the stock exchange price if such price is reasonable. An advanced payment of capital contributions by the Stabilization Fund to a Financial Sector Institution is construed to be the fulfillment of its capital contribution obligations deriving from a later subscription of new shares.

The executive board must inform the general shareholders’ meeting in writing of the capital increase and the issuance of new shares, and they must describe the legal and economic aspects of the capital increase and the issue value, as well as preference rights, particularly with regard to profit distribution (Gewinnvorrang) and/or liquidation proceeds (Liquidationsvorrang).
If the financial instruments acquired by the Stabilization Fund are resold, subscription rights must be granted to the existing shareholders or partners of the corresponding institutions. However, if non-voting preference shares were issued to the Stabilization Fund, the Stabilization Fund could, on any transfer to a third party, convert such non-voting preference shares into common stock with voting rights. In addition, the executive board of a stock company (Aktiengesellschaft) which is a Financial Sector Institution is authorized to grant special dividend rights to the Stabilization Fund. However, the authorization requires approval by the supervisory board, although shareholder approval is not required. Further, shareholder approval is not required if the Stabilization Fund acts as a silent partner. These same rules also apply mutatis mutandis to any Financial Sector Institution that is a partnership limited by shares (Kommanditgesellschaft auf Aktien) or a Societas Europaea.

**What impact does the German Stabilization Act have on Take-over rules?**
If the Stabilization Fund acquires the control (30% or more) of a stock exchange listed entity, the Federal Financial Supervisory Authority releases the Stabilization Fund from obligations to issue a mandatory take-over offer normally prescribed under German law.

**What happens if the Stabilization Fund acquires risk positions?**
The German Stabilization Act contains several provisions that allow the Stabilization Fund to acquire risk positions more easily. The transfer of risk positions and collateral to the Stabilization Fund, for example, cannot be challenged under insolvency law. Furthermore, any obstruction to the transfer and assignment as well third party approval do not affect the legal validity of the transfer of risk positions.

**What changes does the German Stabilization Act make with respect to insolvency law?**
The definition of over-indebtedness has been revised by the German Stabilization Act to make clear that an entity whose assets do not cover its liabilities will not be considered over-indebted in the future if there is a high degree of probability—based on the circumstances—that the entity can continue operations.

**Which Financial Sector Institutions might seek relief from the Stabilization Fund?**
BayernLB, the second largest state-owned Landesbank in terms of assets, was the first German bank to seek financial assistance from the Stabilization Fund with its request for €5.4 billion shortly after the legislation became effective. Two other Landesbanks, WestLB and HSH Nordbank, have followed BayernLB in requesting assistance. Early indications suggest that many larger publicly-traded financial institutions may be more reluctant to seek assistance due to possible negative implications for their particular share value. Initially, a number of smaller
private banks appeared to be considering whether to act concurrently in requesting financial assistance in an attempt to minimize any possible reputational harm associated with requesting public financial assistance. Yesterday, Hypo Real Estate became Germany’s first publicly-listed bank to request financial assistance from the Stabilization Fund, seeking short-term cash and possibly a recapitalization. Hypo Real Estate’s request may act as a signal for other publicly-traded banks to follow its lead in seeking assistance. However, representatives of the insurance sector have suggested that insurance companies are currently unlikely to seek financial assistance under the German Stabilization Act.

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