Proposed Amendments to the German Financial Market Stabilization Program

Frankfurt
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On February 18, 2009, the German Federal Government presented a draft bill for the German Act on the Further Stabilization of the Financial Market (*Finanzmarktstabilisierungsergänzungsgesetz*) (the "**Draft Bill**"). The proposed legislation would temporarily allow the forced nationalization of financial institutions that are essential to the functioning of the financial market (*systemrelevant*) through expropriation. The Draft Bill also amends the German Act on the Implementation of Measures to Stabilize the Financial Market of October 2008 (*Finanzmarktstabilisierungsgesetz;* the "**Stabilization Act**")[1] to improve the effectiveness of stabilization measures and further facilitate their implementation. While the German Federal Government anticipates legislative action on the Draft Bill to be completed by April 3, 2009, the authorization to expropriate shareholders has already drawn criticism from the public, market participants and shareholder representatives. It thus appears likely that the proposed legislation will be challenged, as has already been the case with the Stabilization Act.[2] This memorandum summarizes key aspects of the proposed legislation that should be of interest to financial institutions and other market participants.

1. *Nationalization of Financial Institutions*

a) *Scope and Prerequisites for an Expropriation*

In order to prevent the collapse of an important financial institution, the Draft Bill proposes to authorize the German Federal Government to transfer to the Financial Market Stabilization Fund (*Finanzmarktstabilisierungsfonds*; "**SoFFin**"), or certain other public law entities defined in the Draft Bill, by way of expropriation:

[1] *See* our Alert Memorandum "The German Financial Market Stabilization Program" of October 21, 2008, available on our website www.clearygottlieb.com.

[2] A shareholder of a German bank has initiated legal proceedings against the Stabilization Act, in particular with regard to the statutory authorization to issue shares or silent participations to the Financial Market Stabilization Fund without shareholders' approval; *see* "Banken-Rettungsfonds SoFFin kommt vor das Verfassungsgericht", published on http://de.reuters.com on February 19, 2009. The German Federal Constitutional Court (*Bundesverfassungsgericht*) expects to adopt a ruling on the action (docket number: 1 BvR 119/09) in the course of this year.

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- all or part of the outstanding shares or other financial instruments qualifying as own funds (*Eigenmittel*) of the financial institution or its subsidiaries; and

- claims and financial instruments of the financial institution or its subsidiaries, as well as certain liabilities that are closely related thereto (such as liabilities from derivatives or repo transactions).

Pursuant to the official annotation (*Begründung*) to the Draft Bill, an expropriation may be necessary, particularly in the context of a fundamental restructuring, to quickly implement far-reaching measures subject to shareholders' and/or the supervisory board's approval by ensuring that applicable supermajority requirements, rights of minority shareholders, reporting duties *etc.* shall not interfere with a successful implementation of these measures.[3] However, the authorization to nationalize a financial institution through expropriation shall only be a means of last resort for the German Federal Government. The envisaged expropriation must therefore be "necessary" to safeguard the stability of the financial market, and there must be no other means that would be "legally and economically reasonable" and "equally effective, but less restrictive" than the expropriation.[4] In particular, an expropriation may only be effected if:

- the financial institution is essential to the functioning of the financial market;

- other measures by the SoFFin pursuant to the Stabilization Act would be insufficient for a sustainable stabilization of the financial institution; and

- a voluntary transfer of the respective shares or financial instruments could not be achieved at reasonable terms and within a reasonable time frame.

Any expropriation would have to be based on a decision by the German Federal Government until June 30, 2009 and be implemented by way of a regulation (*Rechtsverordnung*) adopted no later than on October 31, 2009.

b) Compensation Principles

In order to meet the requirements for an expropriation set forth in Article 14 of the German Constitution (*Grundgesetz*), the Draft Bill provides that persons or entities whose property interests are affected by an expropriation shall receive adequate cash compensation reflecting the market value of the respective shares or financial instruments:[5]

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[3] *See* the official annotation to Article 3 § 1 of the Draft Bill.

[4] *See* Article 3 § 1(4) of the Draft Bill. It is unclear in what circumstances an expropriation of claims and financial instruments (other than shares or silent partnership participations) of a financial institution would ever meet this test.

[5] *See* Article 3 § 4 of the Draft Bill.

- ***Weighted Average Domestic Exchange Price:*** If the expropriated instruments are traded on a domestic exchange, the compensation shall equal the lower of the weighted average price on the exchange during (i) the two weeks, or (ii) the three days prior to the date of the expropriation decision (or an earlier date on which the "intention" to take an expropriation decision became "known", provided that an effect on the average exchange price cannot be excluded).

- ***Enterprise Valuation:*** The compensation shall be calculated on the basis of an enterprise valuation by the Federal Ministry of Finance (*Bundesministerium der Finanzen*; "**BMF**") if (i) the expropriated instruments are not traded on a domestic exchange, or (ii) there is an "indication" that the result of an enterprise valuation would significantly deviate from the weighted average share price.

The German Federal Constitutional Court (*Bundesverfassungsgericht*) has repeatedly held that the adequate compensation of shareholders for loss of their property rights must generally take into account existing exchange prices as a floor. The determination of the applicable reference date or period was left to the civil courts with the proviso that such determination shall prevent an abuse by, or to the detriment of, the compensated shareholders.[6] While the Draft Bill seeks to reconcile the flexibility required on the part of the German Federal Government with the compensation principles established by the German Federal Constitutional Court, a number of issues remain, including:

- ***Reference Period for Weighted Average Exchange Price:*** It is not free from doubt that a reference period of just two weeks (or even three days) actually prevents an abuse to the detriment of the expropriated shareholders, in particular since the *lower* average shall always determine which of the two reference periods applies. In addition, it is not entirely clear which circumstances would constitute "knowledge" of an "intended" expropriation decision with effect on the beginning of the reference period. It remains to be seen how the German Federal Government will construe the respective terms of the Draft Bill, should expropriation proceedings be initiated.[7]

- ***Deviation from the Weighted Average Exchange Price:*** The Draft Bill does not specify the circumstances in which the BMF would be obliged to conduct an enterprise valuation.

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[6] *See* the decisions of April 27, 1999 (1 BvR 1613/94 – DAT/Altana) and of November 29, 2006 (1 BvR 704/03). The German Highest Court in Civil Matters (*Bundesgerichtshof*) takes into account the weighted average share price during a three-month period prior to a certain reference date when calculating the minimum compensation to be granted to shareholders in accordance with the principles established by the German Federal Constitutional Court.

[7] This could be particularly relevant with regard to Hypo Real Estate Holding AG ("**HRE**"): After the German Federal Government announced that, if necessary, it would make use of the authorization set forth in the Draft Bill to nationalize HRE, HRE's share price rose by more than 40 percent; *see* Barkin, "Germany eyes bank nationalization as sector reels", published on http://uk.reuters.com on February 18, 2009.

- ***Enterprise Valuation:*** In addition, the valuation principles to be applied by the BMF when conducting an enterprise valuation remain vague. Given the size and complexity of balance sheets of financial institutions that are essential to the functioning of the financial market, an adequate valuation of the financial institution is likely to be very difficult (if not impossible) and time-consuming. In this context, it is unclear whether the financial institution shall be valued as an ongoing business (taking into account its nationalization) or at liquidation values (*i.e.*, a scenario without nationalization), by using multiples or discounted cash flows or earnings, and whether the relevant accounting standards for an enterprise valuation (such as IDW S1) shall apply. Depending on the chosen approach, the calculated enterprise value may vary significantly.

- ***Valuation of Assets for Which There is No Active Market:*** It is also unclear how the BMF would value complex assets of a financial institution (such as CDOs or CLOs), should they be expropriated and there be no active market for these instruments.

c) Effects on Conversion and Option Rights

The Draft Bill provides that conversion or option rights relating to shares or other financial instruments shall terminate by operation of law if the underlying instruments have been expropriated.[8] Pursuant to the official annotation to the Draft Bill, the "creation of new membership rights" shall thus be prevented[9], which suggests that conversion or option rights granted by the issuer or its affiliates shall terminate, even if the underlying shares or financial instruments have not yet been created (and therefore cannot be expropriated). By contrast, derivatives or futures transactions between third parties relating to expropriated shares would not create new membership rights. Such transactions should therefore remain in full force and effect, unless their respective terms provide otherwise. The holders of terminated conversion and option rights shall be entitled to compensation in accordance with the principles outlined under 1. b) above.

d) Remedies and Reprivatization

The holders of rights affected by an expropriation may bring an action against the expropriation regulation to the German Federal Administrative Court (*Bundesverwaltungsgericht*) within two weeks after publication of the regulation.[10] If the German Federal Administrative Court rules that the regulation infringes higher-ranking law, it shall declare the regulation void. The ruling, however, shall only apply *ex nunc*, so that any resolution passed by the SoFFin at a shareholders' meeting with the votes attached to expropriated shares would remain in full force and effect, unless a subsequent shareholders' meeting resolves to cancel one or more previous resolutions. Assets subject to

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8 *See* Article 3 § 2(2) of the Draft Bill.

9 *See* the official annotation to Article 3 §2(2) of the Draft Bill.

10 *See* Article 3 § 5(1) and (2) of the Draft Bill.

an expropriation shall only be retransferred if the expropriated persons or entities file a corresponding application within one month after the ruling of the German Federal Administrative Court was published.[11]

A nationalized financial institution shall be reprivatized upon its sustainable stabilization, *e.g.*, by disposing of expropriated shares or by way of a capital increase.[12] Persons and entities whose ownership interests were affected by the expropriation shall be given a right of first refusal regarding the disposal of existing or the issuance of new shares.

2. Amendments to the Stabilization Act

The most important amendments to the Stabilization Act contemplated by the Draft Bill may be summarized as follows:

a) Extension of Time Frame for Stabilization Measures

Currently, the SoFFin may only take stabilization measures until December 31, 2009. The Draft Bill proposes the following extensions:

- ***Credit Guarantees:*** The SoFFin may issue credit guarantees with maturities of up to 60 months, up from the current maximum of 36 months. In line with the European Commission's approval of the German rescue scheme for financial institutions, guarantees exceeding the 36-month threshold may cover not more than one third of the total amount of SoFFin guarantees for a financial institution and its subsidiaries.[13]

- ***Capital Participations:*** The SoFFin may acquire participations in financial institutions after December 31, 2009 if (i) the SoFFin already holds a capital participation in the respective financial institutions, and (ii) the additional participation would be necessary to maintain the SoFFin's capital share or to safeguard stabilization measures already granted by the SoFFin.[14]

b) Facilitation of Recapitalization Measures

The Stabilization Act contains various provisions that aim to ensure the quick execution of a recapitalization agreed with the SoFFin. In particular, it introduced the new concept of a statutory authorized capital (*gesetzliches genehmigtes Kapital*) to facilitate

[11] *See* Article 3 § 5(4) of the Draft Bill.

[12] *See* Article 3 § 6 of the Draft Bill.

[13] *See* Article 1 no. 4 a) of the Draft Bill and Section (24) of the EU Commission decision K(2008) 8629 dated December 12, 2008 (state aid case N 625/2008).

[14] *See* Article 1 no. 6 of the Draft Bill. So far, the SoFFin has only acquired equity participations pursuant to the provisions of the Stabilization Act in Commerzbank AG (silent participations and shares) as well as in Aareal Bank AG (silent participations).

capital contributions to distressed financial institutions in the form of stock corporations. The existing shareholders' preemptive rights to shares issued from the statutory authorized capital are excluded by the Stabilization Act. It has been noted that this concept is not in line with the Second Company Law Directive 77/91/EEC, which requires that any capital increase and any restriction of the shareholders' preemptive rights must generally be resolved or authorized by the shareholders' meeting.[15] Since the European Court of Justice has already rejected a derogation of these requirements for reasons of public interest, most notably including the continuing stability of a national banking system[16], it appears unlikely that the use of the statutory authorized capital will be practicable. The Draft Bill implicitly acknowledges this conclusion by introducing certain new provisions that expressly aim to facilitate capital measures in accordance with European law.[17]

In addition, certain statutory limitations on capital measures resolved or authorized by the shareholders' meeting are seen as potential obstacles to the SoFFin's intended acquisition of a majority participation in a financial institution. The Draft Bill therefore amends certain principles of the German stock corporation and takeover law, as far as a recapitalization pursuant to the Stabilization Act is concerned:

- ***Notice Period for Convening a Shareholders' Meeting:*** If a shareholders' meeting is convened, the Draft Bill provides that the applicable notice period may be reduced to one day, even if (i) persons other than the SoFFin may participate in a capital increase to be resolved, and (ii) additional items have been placed on the agenda. As from August 3, 2009, however, the applicable notice period shall be not less than 21 days, reflecting the provisions of the Shareholder Rights Directive 2007/36/EC to be transposed by that date.[18]

- ***Majority Requirements for Capital Measures:*** Capital measures generally require a resolution of the shareholders' meeting to be taken with a qualified majority of at least three quarters of the share capital represented at the resolution, subject to certain modifications by the company's articles of association. For purposes of a recapitalization under the Stabilization Act, the Draft Bill provides that a resolution of the shareholders' meeting on capital measures may always be adopted with a simple majority of the votes cast.

- ***Exclusion of Shareholders' Preemptive Rights:*** To the extent that the shareholders' preemptive rights are excluded in connection with a recapitalization, the Draft Bill proposes to lower the applicable majority requirement to the minimum threshold required by European law, *i.e.*, not less than two-thirds of the votes cast

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15 *See* Article 25(1) and (2) and Article 29(4) of the Directive 77/91/EEC.

16 *See* decisions of May 30, 1991 – Cases C-19/90 and C-20/90 (*Karellas*), March 12, 1996 – Case C-441/93 (*Pafitis*) and May 12, 1998 – Case C-367/96 (*Kefalas*).

17 *See*, for example, the official annotation to Article 2 no. 4 of the Draft Bill, which explicitly refers to the European law requirements for an exclusion of the shareholders' preemptive rights.

18 *See* Article 5(4)(a) of the Directive 2007/36/EC.

or the share capital represented, unless half of the share capital is represented, in which case a simple majority shall be sufficient.[19]

- ***No Statutory Ceilings for Authorized and Conditional Capital:*** The statutory ceilings regarding the amount of authorized and conditional capital to be created by the shareholders' meeting shall not apply if such authorized or conditional capital is created in order to issue new shares to the SoFFin.[20] The shareholders' meeting may resolve to create conditional capital for the purpose of granting conversion or option rights to new shares (equity kicker) to the SoFFin in its capacity as holder of silent participations. The majority requirements for such resolution shall be the same as for the exclusion of the shareholders' preemptive rights described above.

- ***Accelerated Registration with the Commercial Register:*** In order to prevent shareholders from blocking a recapitalization from being registered with the commercial register (and thus becoming effective), the Draft Bill provides that capital measures resolved by the shareholders' meeting, or implemented by the management board, in connection with a recapitalization pursuant to the Stabilization Act shall be recorded in the commercial register irrespective of any legal actions brought against such measures, unless they are apparently void.

- ***Damages for Obstruction of a Recapitalization:*** Shareholders blocking a recapitalization of a financial institution that is necessary for its future existence, in particular by voting against the recapitalization at a shareholders' meeting or by bringing legal action against the recapitalization that is without merits, shall be liable to the company for any damages arising from their actions.[21]

- ***Modification of Takeover Law:*** In addition, the Draft Bill modifies certain requirements of the German Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz*) for takeover and mandatory tender offers by the Federal Republic of Germany in connection with a recapitalization under the Stabilization Act.

  In particular, the Draft Bill modifies the provisions of the German Bid Regulation (*WpÜG-Angebotsverordnung*) regarding the minimum offer price, which shall generally be based on the weighted average price on a domestic exchange during the two weeks prior to the publication, or the date on which the intention to

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[19] *See* Article 40 of the Directive 77/91/EEC.

[20] *See* §§ 202(3) clause 1, 192(3) clause 1of the German Stock Corporation Act (*Aktiengesetz*) and Article 2 no. 4 of the Draft Bill regarding §§ 7a(1), 7b(1) of the Stabilization Act.

[21] *See* Article 2 no. 4 of the Draft Bill regarding §§ 7(7) of the Stabilization Act. This provision relates to general principles of German stock corporation law as applied by the German Supreme Court, pursuant to which minority shareholders exercising a veto over a decision that determines the future existence of the stock corporation breach their fiduciary duty *vis-à-vis* the other shareholders; *see* BGHZ 129, 136 (*Girmes*).

submit a takeover offer became known.[22] If, however, the weighted average share price during the period from February 1 to 15, 2009 (*i.e.*, a reference period prior to publication of the Draft Bill) is lower than the weighted average share price so calculated, such lower price (which would be unaffected by speculation regarding a potential takeover bid envisaged by the Draft Bill) shall be relevant.

In addition, the provisions of the German Takeover Act regarding the mutual attribution of voting rights due to an "acting in concert" of shareholders shall not apply to persons acting in concert with the Federal Republic of Germany, the SoFFin or their respective subsidiaries, so that the mere acting in concert will not lead to the acquisition of a controlling share in the company (*i.e.*, at least 30 percent of the voting rights). This will facilitate the implementation of shareholders' agreements between the SoFFin and other significant shareholders that may be necessary or useful to ensure a successful stabilization of the troubled financial institution.

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[22] Under § 5(1) of the German Bid Regulation, a three-month period prior to publication of the takeover offer or the acquisition of a controlling share would be relevant.

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