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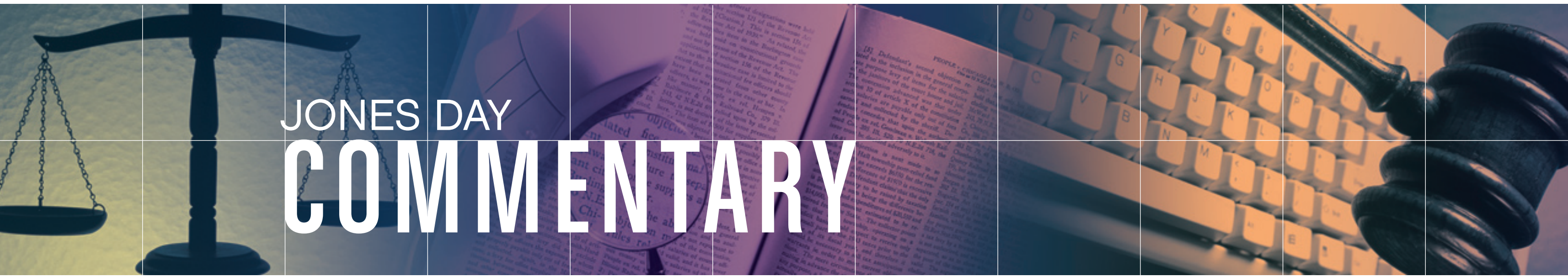

GERMANY ADOPTS ITS OWN RESCUE PACKAGE FOR FINANCIAL INSTITUTIONS

With unprecedented speed, on October 17, 2008, the German parliament enacted a €500 billion package of measures intended to shore up the country's financial sector and restore confidence among market participants. The new financial market stabilization law (*Finanzmarktstabilisierungsgesetz*, the "Stabilization Law"), which was agreed in close cooperation with members of the European Union and the G7, establishes a fund authorized to secure the refinancing of financial institutions in Germany. On October 20, 2008, the German government adopted implementing regulations (*Finanzmarktstabilisierungsfonds-Verordnung*, the "Decree") detailing the powers of the fund as well as the obligations to be imposed on companies that apply for support under the rescue package. Requesting state support is voluntary, but the stabilization measures will be available only until December 31, 2009.

THE FINANCIAL-MARKET STABILIZATION FUND

The Stabilization Law gives the German government broad powers to use the special financial-market stabilization fund, set up under the jurisdiction of the Federal Ministry of Finance and managed by a newly founded authority established by the German Central Bank, to adopt measures as it sees fit to revive frozen inter-bank lending and provide fresh capital to struggling financial institutions.

Under the Stabilization Law and the Decree, there are three types of support mechanisms that may be provided by the fund: Up to €400 billion will be available for credit guarantees, and as much as €70 billion will be available for direct capital injections and, if necessary, for purchases of risky assets by the fund. An additional €10 billion may be used by the fund for recapitalizations and purchases of risky assets with the approval of the German parliament. For budgeting purposes, the government is also setting aside €20 billion, or 5 percent of the total amount of guarantees that may be issued, to cover potential defaults.

While not expressly embodied in the Stabilization Law and the Decree, the government has indicated that first priority in stabilizing the financial sector will be given to the issuance of credit guarantees and then, where needed, capital injections. Only companies that have obtained credit guarantees and received extra capital but are still unable to operate normally will be allowed to sell troubled assets to the fund.

Eligibility. Alongside German financial institutions, German subsidiaries of foreign institutions will also have access to the fund. While there is no entitlement to state support and it is up to the financial institutions themselves to request help from the fund, the Decree includes a precondition that only solvent companies will be allowed to draw credit guarantees. This provision may create strong incentives for insufficiently capitalized institutions that may be nearing insolvency to seek extra capital from the fund, thereby introducing a degree of indirect compulsion for shaky banks to participate in the rescue scheme.

Guarantees. As the primary measure, the fund may issue guarantees on behalf of a requesting financial institution with respect to inter-bank borrowings and to support refinancing efforts. The amount of guarantees that may be issued on behalf of a company will depend on the capital requirements of the requesting institution.

The form of and conditions for each guarantee will be determined by the fund in agreement with the requesting company on a case-by-case basis, but the term of any guarantee may not exceed 36 months. At the latest, all guarantees will expire on December 31, 2012.

In return for providing the guarantees, the fund will charge an appropriate market-based fee, taking into consideration the level of default risk, plus an unspecified margin.

Recapitalization. The fund may recapitalize financial institutions using various instruments in line with the legal form of the entities, which may include nonvoting preferred shares and hybrid capital such as participation certificates, with the primary purpose of strengthening core capital. Such acquired capital interests may be transferred or resold by the fund, provided that any such disposition is carried out in a manner that avoids market disruptions.

The Decree sets a ceiling of €10 billion on the amount that will be available to any single financial institution and its affiliates for recapitalization purposes. Capital injections by the fund may be conditioned on concurrent capital contributions by other shareholders of the recipient institutions. The use of proceeds from these recapitalizations will be subject to appropriate conditions and determined by the fund on a case-by-case basis.

A recapitalization will be subject to an appropriate market-based fee, the form of which is to be determined by the fund and which is to rank senior to the residual equity rights of other shareholders.

Purchase of Risky Assets. For institutions that require additional support, the fund may purchase up to a maximum of €5 billion of troubled assets and any related securities from any single company and its affiliates, thereby removing a persistent source of uncertainty from the balance sheet of such companies. Only assets and securities acquired prior to October 13, 2008, are eligible for purchase by the fund, and the form of any such purchase is to be determined by the fund on a case-by-case basis.

However, in line with the government's stated goal that asset purchases be used only as a final remedy, the conditions attached to such purchases may be unattractive to many companies. For example, the purchase price to be paid by the fund for the troubled assets will be based on their stated value in the latest annual or interim reports of the selling institution, but may be lower. At a minimum, the Decree requires that mandatory and appropriate interest payments cover any refinancing costs of the fund. Any assets purchased by the fund may be subject to put and call options and other forms of risk participation by the benefiting institution. The fund will be entitled to transfer or resell any acquired assets at any time, and the institutions selling assets to the fund may be obligated to compensate the fund for any losses it incurs as a result of such transfers or resales.

OBLIGATIONS AND CONDITIONS FOR ACCESSING STATE SUPPORT

The Decree imposes several obligations and conditions on institutions seeking support under the rescue package and requires them to accept some government interference in their business. With respect to German subsidiaries of foreign institutions that apply for and receive aid under the rescue package, it is expected that these obligations and conditions would be imposed only on the German subsidiaries themselves and not on their foreign parents. While the Stabilization Law and the Decree do not directly address this issue, this conclusion would seem to follow by analogy to Section 53 of the German Banking Act, which provides that banking regulations under the act are applicable to German subsidiaries of foreign institutions, but not the foreign parents of those German subsidiaries.

Any institution applying for any form of support must submit its business model to the fund for approval. The Decree does not specify the scope of this requirement, and no clear terms for the method of compliance are yet in place. More helpful guidance will likely take shape and emerge as individual support packages are negotiated. The purpose of this requirement is to allow the government to examine business policies and prevent institutions from engaging in high-risk activities, which the government believes is the root cause of the current turmoil. For this reason, the fund has been empowered to direct institutions receiving support to reduce their exposure to, or even cease engaging in, certain risky businesses, including risky activities outlined in European Union Directive 2006/48/EG pertaining to activities of credit institutions.

Institutions seeking recapitalization or that want to sell troubled assets to the fund must comply with further conditions, including the following:

- Management remunerations must be appropriate, with a rebuttable presumption that any annual remuneration exceeding €500,000 is inappropriate.
- All severance and bonus packages or other remuneration elements, which are not legally binding at the time an institution applies for support, must not be paid.
- No dividends or distributions other than to the fund may be made while the stabilization measures are in effect.
- In the case of recapitalizations, a commitment must be made to maintain lending to small and mid-sized companies in Germany under fair market conditions.

In securing compliance with the foregoing requirements, the fund may impose certain information obligations and audit rights as well as seek contractual remedies from institutions seeking support under the rescue package, including damages, penalties and, ultimately, termination of aid.

CONCLUSION

The Stabilization Law and the Decree mark an extraordinary undertaking by the German government to guarantee the financial system's stability and ability to function, creating what has been billed as the largest financial package of its kind in the country's history. Many of the measures are unprecedented in their scope and depart from general principles of lawmaking in Germany, particularly in the way they delegate wide-ranging authority to the Federal Ministry of Finance and the fund to adopt implementing rules. These measures already face legal challenges in the courts. In addition, there remain many ambiguities regarding the specific terms and conditions as well as the form of any guarantees, recapitalization, and asset purchases, with the fund and the Federal Ministry of Finance having great discretion in structuring individual support packages. For example, while the stabilization measures are set to expire at the end of 2009, it is unclear how long the fund may hold any acquired capital or purchased assets. Nevertheless, the decision to enact broad legislation but to leave room for negotiation of detailed terms and conditions on a case-by-case basis reflects the German government's desire to retain maximum flexibility in managing the rescue plan and making any adjustments swiftly, depending on market reactions.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Thomas C. Mahlich
49.89.20.60.42.209
tmahlich@jonesday.com

Martin Kock
49.89.20.60.42.274
mkock@jonesday.com

Volker Kammel
49.69.9726.3939
vkammel@jonesday.com