



## GERMAN NEWS FLASH

### EDITOR

Dr. Thomas Kaiser-Stockmann  
(Berlin) tks@msa.se

### EDITORIAL STAFF

Dr. Jan Ebersohl  
(Frankfurt) jne@msa.se

Dr. Rebekka Hye-Knudsen  
(Berlin) rhk@msa.se

## MANNHEIMER SWARTLING

### BERLIN OFFICE

Mauerstraße 83-84  
10117 Berlin  
Phone: +49 30 22 66 990  
Telefax: +49 30 22 66 9910

### FRANKFURT OFFICE

Bockenheimer Landstraße 51-53  
60325 Frankfurt am Main  
Phone: +49 69 974 01 20  
Telefax: +49 69 974 01 210

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## The German response to the financial crisis: An overview of the rescue package

After hitting the stock markets, the financial crisis has now made its way to the “real economy” and is deeply affecting one of Germany’s core businesses, the automobile industry. In fear of the recession, governments and parliaments have set up “rescue packages” in order to support the financial sector and to reanimate the market for short-term loans. As now more branches are calling for public help, the respective measures will become relevant also for business sectors other than the financial market. In the following, the measures passed in Germany to stabilise the financial markets will therefore be looked at more closely.

The German parliament enacted a 500 billion Euros rescue package on 17 October 2008. The new Financial Market Stabilisation Act (*Finanzmarktstabilisierungsgesetz, FMSA*) combined with a decree of the Ministry of Finance primarily aims at restoring confidence among market participants. Drafted in close cooperation with the European Commission, it launches a fund that is authorised to secure inter-bank loans by guarantees and to support endangered institutions by providing liquid funds. For this purpose, the FMSA has created the Financial Market Stabilisation Fund

(*Finanzmarktstabilisierungsfonds*), which is authorised to dispose of its funds upon the request of affected companies. The following measures are designed to countervail the crisis:

Until 31 December 2009, the government is entitled to grant guarantees of up to 400 billion Euros to secure the refinancing of German financial institutions. Guarantees are restricted to newly issued refinancing instruments whose duration may not exceed 36 months. In view of the Fund's budget, the German Government is making provision for defaults in the amount of five per cent of the amount of the guarantees. In addition, financial institutions have to pay consideration for secured loans that will be in line with market conditions.

Furthermore, the Fund can recapitalise financial institutions. 80 billion Euros have been set aside to this end. Recapitalisations will be implemented by the acquisition of participations, silent participations or similar equity-like participations. In this context, the financial institutions will increase their capital stocks. Conversely, the Fund will acquire the new shares.

Finally, the Fund can acquire risk positions such as receivables,

securities, derivative financial instruments and rights and obligations stemming from loan commitments or other warranties. Up to 80 billion Euros may be used for this measure, but not more than five billion for an individual financial institution. In order to reduce the financial risks of this measure, the Fund only acquires the respective risk positions at market rates, which will generally be below the nominal values.

As a return for each of these supporting measures, the requesting financial institutions have to accept restrictions in their business policies, which is supposed to reduce the risk of losses for investments of the Fund. Especially in case of recapitalisations and the acquirement of risk positions, financial institutions are subject to these restrictions. Apart from retained profits, the most discussed restriction is the intended cap of managing directors' remuneration.

Paving the way for the rescue package, some existing laws have been altered by the FMSA. Regulations regarding over-indebtedness in the Insolvency Code (*Insolvenzordnung - InsO*) and within the Stock Corporation Act (*Aktiengesetz*) are the main examples of these changes.



# Temporary relaxation of German insolvency law

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As outlined above, German law has witnessed considerable legislative activities in the context of the rescue package for the financial sector. These changes are not limited to financial institutions. Rather unnoticed, German insolvency law has also temporarily, i.e. until 2010, been changed in that the definition of over-indebtedness (*Überschuldung*), which constitutes a compulsory reason to file for insolvency, has been altered significantly.

Generally, over-indebtedness is present, if a company's liabilities exceed its assets. According to the law in place up until the financial crisis, if there was a reasonable chance that the company could be continued successfully (*positive Fortführungsprognose*), for the purpose of determining over-indebtedness, it was allowed to value the assets higher than their actual current value (*Fortführungswerte instead of Liquidationswerte*). However, under the current conditions even this approach may not be sufficient to prevent economically

senseless insolvencies, because it does not necessarily lead to a positive balance sheet. This may be the case in particular, if shares in other companies or real estate have temporarily depreciated and the going-concern value of the assets is therefore not sufficient to cover the liabilities. Thus, a company might be legally over-indebted, even though it has sufficient cash flow available to overcome a crisis.

According to the new regulation – which is to remain in effect until 31 December 2010 – over-indebtedness is not at hand, if the continuation of the company seems more likely than not, regardless of whether its liabilities exceed its assets (cf. section 19 para. 2 InsO). This may prove to be an advantage not only for the company, but also for its creditors, as they are more likely to recover their claims from a continued company than from one which is forced to file for insolvency even though it would have been able to continue its business.

# Commission adopts changes to mitigate consequences of financial turmoil

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To some extent, traditional accounting standards may intensify the financial crisis. According to traditional rules financial institutions have to value most financial products according to their actual market price. However, as there is virtually no market in respect to some financial products, these products would have to be exhibited in the balance sheets with a very low value or none at all. Thus, traditional accounting standards force the institutions affected to considerable depreciations, even though some of these products are likely to realise reasonable prices in the future.

To overcome these difficulties, the European Commission has adopted amendments to international accounting standards as suggested by the International Accounting Standards Board (IASB), an independent non-governmental accounting standard setter. These can already be applied for financial statements for the third quarter of 2008.

By changing the adopted IAS 39 Financial Instruments: Recognition and Measurement, the IASB has introduced the possibility to reclassify financial products for companies accounting in accordance with International Financial Reporting Standards (IFRS).

In this context, the European Commission has reverted to accounting models ("discounted cash flow" models) which – in exceptional circumstances – have already been admissible under US Generally Accepted Accounting Principles (GAAP). Applying these models, financial institutions would no longer have to reflect market fluctuation to such a dramatic extent in their financial statements.

The IFRS amendments refer to the financial crisis as such "exceptional circumstances". The US Securities and Exchange Commission (SEC) and the International Accounting Standards Board (IASB) have also stated that presently exceptional circumstances are at hand allowing the application of such cash flow models. However, the amendments to IFRS 7 Financial Instruments: Disclosures also introduce additional disclosure requirements linked to these reclassifications in order to ensure a certain standard of transparency. As a consequence, EU companies are granted the same flexibility as their American competitors to reclassify certain assets by other than the current values. Therefore, the new rules may help to avoid distortions in the competition between US and European banks due to different accounting rules.

# Responding to failed self-regulation of financial markets

Regarding legislative activities and developments in the foreseeable future, the German government and its international partners will regulate financial markets more strictly. Future legislative steps will serve the purpose of achieving financial markets that are less dominated by speculative activities, which bear the risk creating bubbles and crashes conversely. In particular, it is planned to strengthen the role of the International Monetary Fund as a watchdog for financial institutions. Also, advanced regulations for rating agencies are planned in order to establish more reliable assessments of businesses and financial products. Furthermore, requirements of higher equity capital for financial institutions and of more transparent investment products are planned in order to provide a more stable basis for the

financial markets. In this context, amendments to laws on financial-market oversight are planned to strengthen the competence of financial regulators for interventions in times of crisis. At a national level, the Federal Financial Supervisory Authority (BaFin) will act in closer coordination with the German Federal Bank (*Bundesbank*). In addition, the German government is planning to suggest reforms to European and international financial-market supervision. Finally, it has indicated that it will develop suggestions for the improvement of existing statutory deposit guarantees based on EU law in view of its explicit commitment that no private saver will lose saving deposits because of the financial crisis.

# Compensation of board members and bonuses

A flawed structure of incentives is widely perceived as one reason for short-sighted business plans that have contributed to the current crisis. Therefore, the use of public aid in the form of recapitalisation granted by the Stabilisation Fund is tied to a cap of the remuneration of board members and other senior officers. Notably, the decree has not introduced a maximum salary for managers of companies requesting support of the Fund in the form of recapitalisation. However, according to the provisions of the decree, the Fund must exercise its influence to reduce the compensation to an adequate amount of generally no more than 500,000 Euros annually. It is, however, unclear how this pre-condition for public aid can be met, especially in view of existing contractual agreements and taking into account that a forced reduction is a grave interference in the company's private autonomy. In the absence of a compelling legal framework, it seems more likely that any reductions will be based on a personal commitment of board members.



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