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German Bank Restructuring Act

Impact on Investors in Debt, Hybrid and Equity Securities Issued by German Banks

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Since the beginning of 2011, creditors of and investors in German banks have faced a radically changed restructuring regime, whose impact on investor recoveries in a crisis may be significant. While at first glance the new framework seems to introduce proceedings similar to a U.S. Chapter 11 reorganization or English Scheme of Arrangement that look somewhat familiar and predictable to foreign investors, the most important and dangerous change to investors are the largely extended powers of the German banking and capital markets supervisory authority (BaFin) to cause overnight transfers of banks to bridge bank entities with potentially disastrous results to bank investors. This paper summarizes the most important aspects of the new regime and points to some of the risks that investors may face in the future.

A. New German Rules Governing Bank Restructurings in Germany

On January 1, 2011, the German Act on the Orderly Restructuring and Liquidation of Banks ("Bank Reorganization Act"), the German Act on the Establishment of a Bank Restructuring Fund, and the German Act for the Extension of Time Limitations Barring Management Liability (collectively, the "Bank Restructuring Act") came into effect. The Bank Restructuring Act comprises both the newly introduced Bank Reorganization Act and the Act on the Establishment of a Bank Restructuring Fund, as well as amendments to various other German laws, including the Banking Act, the Financial Market Stabilization Fund Act and the Stock Corporation Act.

The Bank Restructuring Act effects a German government-approved white paper dated March 31, 2010, on the pillars of financial market reform allowing for an orderly restructuring and wind-down of banks, providing regulatory instruments so as to prevent systemic risks for the financial system, requiring German banks to participate in the costs of future financial crises, and extending the personal liability of bank managements. Given the German government's recent experience with the necessity of ad hoc rescues of German banks (IKB, Hypo Real Estate, Commerzbank, Landesbanks) and the legal shortcomings faced thereby under prevailing German law governing these rescues at the time (keyword: asserted "expropriation" of shareholders in the Hypo Real Estate case), the Bank Restructuring Act seeks to remedy many of these perceived shortcomings and allow for an accelerated and predictable restructuring process for banks.

Investors in bank securities, however, should be aware that we consider it rather unlikely that any of the voluntary processes contained in the Bank Restructuring Act will have any significant relevance in practice. We lean towards the viewpoint that a moratorium and subsequent insolvency for banks with no systemic relevance, and a transfer order with subsequent liquidation of the remaining "bad bank assets" for systemically relevant banks, will be the prevailing bank restructuring tools in the future. Investors may want to take this into account when attributing (restructuring) values to bank securities.

B. Overview of Restructuring Mechanisms

Under the old rules, German banks were subject to ordinary insolvency laws, provided that only BaFin was entitled to file for insolvency, and that any such insolvency proceeding was normally preceded by a moratorium on the bank imposed by BaFin (e.g., in the case of Lehman Brothers Bankhaus AG). These rules remain in place, and we tend to believe that they will remain relevant especially for smaller banks with a large retail customer basis.

The Bank Restructuring Act adds three additional restructuring procedures that may be utilized either alone or in combination in work-outs of troubled banks. The Bank Reorganisation Act introduces two voluntary proceedings that may be initiated and managed by the troubled bank's management, i.e.,

- A Stabilization Proceeding (*Sanierungsverfahren*); and
- A Reorganization Proceeding (*Reorganisationsverfahren*).

These proceedings may be viewed as "civil law" solutions that may be adopted when consent of the various constituencies seems assured. We do not believe that they will have significant relevance.

On the other hand, and we believe by far more importantly, changes to the Banking Act contained in the Bank Restructuring Act permit BaFin under certain circumstances to issue a Transfer Order (*Übertragungsanordnung*) thereby transferring the viable part of a troubled bank to a NewCo, leaving behind all risks and excess liabilities in a bad bank in which many security holders would remain invested and which then would be liquidated (with potentially disastrous recovery to investors). Given the time sensitivity of bank restructurings due to daily refinancing requirements and the imminent risk of bank runs during a crisis of a bank, we believe that such a Transfer Order is the most likely restructuring tool for large, systemically relevant German banks. Therefore, understanding the potential implications of such an order seems to be vital for investors in German bank securities.

In the following paragraphs this paper summarizes the three new proceedings as well as their potential implications on investors in bank securities.

C. Stabilization Proceeding (Sanierungsverfahren)

1. Key Features

A Stabilization Proceeding may be voluntarily initiated by the management of a troubled bank at a relatively early stage of a crisis. The proceeding may be opened once the bank's management has notified BaFin that it deems a financial restructuring necessary (*Sanierungsbedürftigkeit*). Such necessity for a financial restructuring is presumed if the development of the bank's asset base, financing or income indicates that specific regulatory minimum capital or liquidity requirements can no longer be met on a sustainable basis. A statutory presumption supports such indication if specific solvability or liquidity coefficients are decreasing and — due to such trend — a breach of certain minimum regulatory capital/liquidity requirements within a certain period of time can be anticipated. Therefore, a bank's management may initiate a Stabilization Proceeding well before an actual breach of regulatory capital requirements has materialized, at which stage BaFin would be in a position of taking more severe actions according to Sec. 45 para 2 of the Banking Act (*Kreditwesengesetz*) ("KWG").

The notification to BaFin must include a restructuring plan (*Sanierungsplan*; "Restructuring Plan"), which may include all measures appropriate for a restructuring of the bank. BaFin reviews the Restructuring Plan and, if deemed appropriate and sensible, forwards the Restructuring Plan to the competent Higher Regional Court ("Court"), which will open the Stabilization Proceeding if the Restructuring Plan is not obviously inappropriate or illegal.

As a general principle of the Stabilization Proceeding (and the Restructuring Plan), measures implemented under the Restructuring Plan may not impair any rights of any creditor without its prior consent. However, the Restructuring Plan may prime existing unsecured creditors by providing for new liquidity via a super-senior loan facility — the so-called restructuring loan ("Restructuring Loan") — which ranks ahead of any other unsecured claims of the bank's creditors (*Insolvenzgläubiger*) in an insolvency of the bank opened within three years. The nominal amount of the Restructuring Loan may not exceed 10% of the bank's own funds (*Eigenmittel*), and may only be drawn upon the implementation of the Restructuring Plan.

The Restructuring Plan must include a proposal for a so-called restructuring advisor (*Sanierungsberater*; "Restructuring Advisor"), who is in charge of the implementation of the Restructuring Plan. The bank has to designate a candidate. If BaFin considers the candidate unsuitable, the Court may replace it on application by BaFin. If the proposed candidate is an employee of the bank or member of the bank's management, the replacement requires no specific cause.

In the course of a Restructuring Proceeding, the Court may render further orders upon BaFin's application if such orders seem required for a successful restructuring and there was otherwise a risk that the bank would be unable to satisfy its creditors in full. In this respect, the Court may in particular:

- interdict or restrict the exercise of management functions by members of the existing management;
- appoint the Restructuring Advisor as a director (*Geschäftsleiter*);
- interdict or restrict the distribution of dividends to shareholders;
- review the payment and bonus schemes of the management in terms of adequacy and incentive and, if required, make adjustments for the future and interdict the payment of remuneration legally not owed;
- replace any approvals of the bank's supervisory board.

The Stabilization Proceeding may be applied for by all bank institutions within the meaning of Sec. 1 para 1 of the German Banking Act with a registered office in Germany.[1]

2. Impact on Investors' Positions

At first glance, the impact of a Stabilization Proceeding on the positions of investors in securities seems limited given the maximum size of the injection is equal to 10% of the bank's own funds (for example, at Commerzbank with an asset base of approximately €850 billion, the possible super-senior loan may equal about €5 billion at most[2]).

However, given its limited reach it seems highly unlikely that a Stabilization Proceeding will ever be employed in any severe crisis on a stand-alone basis. In such a case, it may serve as a short-term stabilization in the course of a large-scale restructuring or an imminent Transfer Order, i.e., it may be combined with substantial write downs or even a substantially higher number of (senior) debt left behind in a bad bank. This view is supported by specific carve-outs that the Bank Restructuring Act provides: Based on a statutory provision, actions provided for in a Restructuring Plan are irrefutably deemed not to be consummated with the intention to discriminate against other creditors (*Gläubigerbenachteiligungsabsicht*), i.e., no such action can subsequently be avoided by an insolvency administrator for willful disadvantaging of creditors under Sec. 133 of the German Insolvency Code. Thus, investors should be prepared that:

- A Restructuring Plan may prime senior unsecured creditors even if *pari passu* clauses in the most senior bonds seem to suggest otherwise, as the Restructuring Loan is likely to be viewed as an obligation preferred by operation of law (which is normally a carve-out in the indenture) once approved by the Court.
- The enumeration of potential court orders set out above is not conclusive; holders of profit-linked instruments may face an order as to the suspension on payments on such instruments along the lines of a dividend suspension.
- Chances are high that the Restructuring Plan may only be a start of a more severe restructuring or Transfer Order as the Restructuring Plan as such will hardly be sufficient to cure the bank's capital deficiencies that caused its crisis (and refinancing of the bank with a super-senior Restructuring Loan on top of the capital structure may prove to be particularly burdensome).
- Legal recourse for existing stakeholders is virtually non-existent. Only after the opening of an insolvency over the bank, may a primed creditor file an individual lawsuit against a super-senior lender so as to set aside the super-seniority on the basis of legal deficiencies of the Stabilization Proceeding or the Restructuring Credit.

The other alternative in which a Stabilization Proceeding may be employed is an early-stage recapitalization of a bank. When the management initiates the proceeding at a pre-crisis stage, the Stabilization Proceeding may be used to facilitate equity injections either by the public or the Bank Restructuring Fund so as to stabilize the capital base of the bank. Given the negative publicity of any such proceeding and its likely consequences on customer and counterparty relationships, we doubt that bank managements will favor such a route.

D. Reorganization Proceeding (*Reorgnisationsverfahren*)

The Reorganization Proceeding is essentially a refinement of existing insolvency plan proceedings in Germany in that the Reorganization Proceeding, while similar, is very much accelerated, and the plan may provide for spin-outs of “good banks” with limited liability to all-bank creditors, and incorporate corporate actions such as forfeiture of shares or issuance of new shares to creditors with only a simple majority (or two-thirds in certain cases) of the votes cast in a shareholder meeting. It is similar to an English Scheme of Arrangement as the plan requires court approval, which may or may not comprise a cram-down of dissenting groups, including shareholders.

While the Reorganization Proceeding addresses many issues hindering bank restructurings in the past, most notably the integration of shareholders in and the substantial abbreviation of the process, consummation of such a proceeding may still take many months. In past rescues, in order to calm the markets, the banks had to be stabilized by billions of Euro in government equity injections and guaranties before a formal restructuring process was even commenced. Given the daily refinancing requirements of a bank, the anxiety that such a proceeding may inspire in customers and counterparties, the rating effects, and the uncertainty as to how relationships of the bank not governed by German law may be affected by the commencement of such a proceeding, we are very skeptical as to whether or not a lengthy Reorganization Proceeding is at all feasible in reality in order to work out a troubled bank.

1. Key Features

In case the Stabilization Proceeding seems insufficient for a bank’s restructuring, or the Stabilization Proceeding cannot successfully be consummated, the bank’s management may combine the notification to BaFin of a need for a financial restructuring (see above, C. 1.) with an application for the opening of a Reorganization Proceeding (or switch over to such proceeding subsequently, as the case may be). Such application has to include a reorganization plan proposal (“Reorganization Plan”) and the proposal for a reorganization advisor (“Reorganization Advisor”). After the filing of such application, BaFin may file for the opening of a Reorganization Proceeding with the Court if:

- the existence of the bank is jeopardized, in particular if:
  - the bank’s own funds, core capital (*Kernkapital*), modified available own resources (*modifizierte verfügbare Eigenmittel*) or liquidity has fallen below 90% of the required thresholds; or
  - there are reasons to believe that failure to comply with such thresholds is imminent, and
- a collapse of the bank would endanger the stability of the financial system, taking into account the following considerations:
  - the nature and amount of the bank’s liabilities towards other financial institutions;
  - the amount of the deposits with the bank;
  - the nature, amount and composition of risks assumed by the bank, taking into consideration the specific conditions of relevant markets at that time;
  - the entanglement of the bank with other market participants;
  - the condition of the financial markets and the anticipated consequences of a collapse of the bank for other financial institutions, the financial market, and the confidence of depositors and other market participants in the stability of the financial markets.

The Reorganization Plan is comparable to an insolvency plan and includes a descriptive part (*darstellender Teil*), describing the bank’s financial status, restructuring needs, intended measures and proposed recoveries, and an operative part (*gestaltender Teil*), stipulating the individual restructuring actions to be adopted by the creditors. The

Reorganization Advisor will invite those creditors whose claims are likely to be impaired by the Reorganization Plan to file their claims. The Reorganization Advisor assesses the filed claims in order to determine each creditor's voting right based on the current amount of its claims. Unlike in ordinary insolvency plan proceedings, subordinated claims (such as T1 and T2 bonds) are not deemed to be waived by law and will participate in the voting. Creditor claims protected by any statutory or voluntary deposit insurance fund (*Einlagensicherungsfonds*)[3] cannot be impaired by the Reorganization Plan, and are, thus, not part of the proceeding. The same is true for employee compensation and pension claims, which are privileged.

To the extent the Reorganization Plan is impairing the rights of involved creditors, the plan has to provide for the formation of different classes of creditors. Creditors with similar legal positions are to be combined in one class (each a "Class of Creditors"). The Reorganization Plan must be approved by each Class of Creditors. The approval by a Class of Creditors requires that (i) a single majority of the voting creditors (majority of persons attending) of such Class of Creditors approves the plan and (ii) the sum of the claims of the approving creditors within such Class of Creditors exceeds 50% of the sum of the claims of all voting creditors within such Class of Creditors. The Bank Restructuring Act provides for a cram-down of a dissenting Class of Creditors by which the Court may replace an approval of a dissenting Class of Creditors if (i) the majority of all Classes of Creditors has approved the Reorganization Plan, (ii) the dissenting Class of Creditors is economically no worse off than without such plan and (iii) the dissenting Class of Creditors adequately participates in the economic values allocated under the Reorganization Plan.

Shareholders are to be included in the Reorganization Plan as a class if (i) the Reorganization Plan includes transactions generally requiring the consent of the bank's shareholders meeting, or (ii) the consent of the shareholders is explicitly required under the Bank Restructuring Act. In these cases, the Reorganization Plan has to be approved by a shareholder resolution with the single majority of the votes cast or — in case of a reduction of the share capital or an exclusion of subscription rights — a majority of two thirds of the votes cast or of the attending shareholders.[4] Any rejected consent by the shareholders can be replaced by the Court if (i) the majority of all Classes of Creditors has approved the Reorganization Plan, (ii) the measures proposed by the Reorganization Plan are capable of avoiding considerable negative effects on other enterprises in the financial sector arising out of the bank's potential collapse and the instability of the financial system caused thereby, and (iii), in addition, such measures are legally proportionate to the disadvantages suffered by the shareholders.

Once the Reorganization Plan has been approved by the Classes of Creditors and — if applicable — by the shareholders, the Court has to confirm the Reorganization Plan within three months. The measures under the Reorganization Plan become effective upon confirmation by the Court; corporate actions are then to be immediately filed with the competent commercial register and will become effective upon registration.

Other than the Restructuring Plan and an insolvency plan under the current German Insolvency Law, the Reorganization Plan can directly impair the rights of creditors as well as the rights of shareholders of the bank and may include the following measures:

- <u>Impairment of creditors' claims:</u>
  The Reorganization Plan may include a variety of amendments to the debt, including a reduction of principal claims against the bank. The plan has to specify:
  - the respective reduction of the principal claim expressed as a percentage;
  - in case of a term-out: the extension period; and
  - the collateral securing the specific claims.
- <u>Debt-to-equity swap:</u>
  The Reorganization Plan may also provide for a debt-to-equity swap of certain classes of debt. The implementation of a debt-to-equity swap, however, requires the consent of all affected creditors, i.e., may not be imposed by majority resolution (it is unclear, however, whether or not a debt-to-equity swap could be

crammed down on dissenting creditor classes). The Reorganization Plan would then include the necessary steps for a debt-to-equity swap, e.g., a capital reduction followed by a capital increase for contribution in kind with no pre-emption rights of existing shareholders. Shareholders may in such instance have the right to receive an adequate compensation to be determined by court-appointed appraisers (*sachverständiger Prüfer*).

- Restructuring loan:
  The Reorganization Plan may include a super-senior Restructuring Loan with the terms set out above.
- Spin-off:
  The Reorganization Plan may also include a spin-off of certain or all assets and some liabilities of the bank to an existing or a newly incorporated bank entity. In turn, the bank will receive all shares in the new bank entity. Other than under existing spin-off rules, the joint and several liability of the transferring and assuming entities is limited in bank restructurings. Creditors are limited to the quota stipulated in the Reorganization Plan and may in no event claim more than what they would have received without the spin-off.
- Corporate restructuring and disposal of assets:
  The Reorganization Plan may include any other corporate reorganization measures which support the restructuring of the bank, in particular amendments of the bank's statutes and a disposal of some or all of the bank's assets or subsidiaries. To the extent the shareholders are suffering a loss by any specific measure, they are entitled to receive an adequate compensation.
- Liquidation:
  The Reorganization Plan may propose the liquidation of the bank.

In order to prevent an immediate termination of agreements entered into between the bank and its main creditors and counterparties, the termination of any agreements (except those with creditors whose claims are subject to protection by the depository insurance fund) is prohibited by law until the end of the first banking day following the day of the bank's application for the opening of a Reorganization Proceeding. The Reorganization Proceeding will not affect any collateral, and general rules as to financial security and derivatives contract's netting contained in the German Insolvency Code will remain applicable.

2. Impact on Investors' Positions

The direct implications of the potential plan stipulations on security holders and creditors are comparable to any Chapter 11 plan of reorganization or English Scheme of Arrangement. A cram-down of creditors is only possible when the principles of seniority of claims and equal treatment within classes have been complied with (i.e., when no junior class or the bank or its shareholders have received value prior to the senior claims being satisfied in full, and no creditor is preferred over an equally ranking creditor) so that the plan will have to follow these principles. However, some peculiarities and uncertainties should be noted:

- Profit-linked instruments (such as Tier 1 notes or silent participations) may economically lose their appreciation rights. While a spin-off technically maintains a 100% participation in NewCo, profit-linked instruments are generally linked to the stand-alone profit of the bank, not its consolidated results. Moreover, any recapitalization of NewCo may significantly reduce the participation or even lead to a squeeze-out of the bank from NewCo by the Bank Restructuring Fund at minimal compensation.
- It is unclear whether or not the principle of priority could be circumvented by spinning off equity instruments to NewCo, while leaving unsecured debt behind. This is especially important in light of government silent participations in some of the banks, most notably Commerzbank.
- Shareholders in banks may be subjected to severe dilution, and may essentially lose all their shareholder rights in respect of the operating business if and when it is spun off to NewCo. Under German law, no shareholder pre-emption rights exist for rights issues by a subsidiary. The valuations to be employed in conjunction with debt-to-equity swaps will not provide significant protection. Given their dividend-based model and the significant capitalization needs of the bank's operating business, it is likely that such valuations would come out at very low levels.

- Creditors should be aware of the short filing notices for their claims and their limited recourse should their claim be rejected. The Bank Restructuring Act to some extent "incentivizes" rejection of claims by creditors considered "critical" by the Reorganization Advisor as a rejected creditor — in order to claim a compensation over and beyond what has been awarded by the plan — would subsequently have to evidence in court a better recovery for his claim in the restructuring had his claim been admitted. This is almost impossible so that the bank may be tempted to exclude any claims that may interfere with its restructuring proposal.

E. Transfer Order (*Übertragungsanordnung*)

In addition to the "civil law" Stabilization and Reorganization Proceedings, the Bank Restructuring Act has also amended key sections of the German Banking Act thereby significantly enlarging the power of BaFin to act in bank crises. Almost unnoticed, this portion of the legislation seems to us the most important part as we would believe for the above reasons that any restructuring of a systemically relevant bank would be carried out by BaFin exercising its public law authority to transfer viable assets and liabilities of a troubled bank into a good bank NewCo, while leaving excess liabilities and toxic assets behind in a bad bank, from which creditors then would have to seek recovery.

The powers of BaFin are extremely broad and de facto enable BaFin to separate a good bank out of a troubled bank overnight, on the basis of preliminary asset and liability allocations and preliminary valuations, even excluding the old bank and its constituents from a shareholding in the NewCo altogether or imposing an additional liability on the old bank. The impact on creditors and security holders left behind may be a total wipe-out of their positions. It seems, therefore, essential that investors in bank securities familiarize themselves with what we consider the most likely restructuring tool for future bank crises.

1. Key Features

Besides a whole bundle of new reporting duties and supervision rights of BaFin, the Bank Restructuring Act has given BaFin the power to render a Transfer Order to a systemically relevant bank in a crisis. According to the official reasoning, legislators intended to address situations where a Stabilization or Reorganization Proceeding might not be appropriate, where the necessary financing cannot be obtained, or where the proceeding failed or was stalled for a considerable time. The newly implemented restructuring mechanism authorizes BaFin to issue a Transfer Order, thereby forcing a bank to transfer its (systemic) assets and liabilities in whole or in part to an assuming entity (so-called "Bridge Bank"). The concept follows existing legal concepts applicable to insurance companies and mortgage-lending institutions (*Pfandbriefbanken*) in a crisis, which under certain circumstances permit the coercive transfer of liabilities and their asset cover (*Deckungsmasse*) to another entity. In general, the entity serving as the Bridge Bank will be held by the Bank Restructuring Fund (managed by the Authority for Stabilization of Financial Markets ("FSMA") and funded by German banks) and/or by other financial institutions willing to participate in the rescue of the distressed bank.

Given the severe impacts of a Transfer Order on the stakeholders of the troubled bank, the issuance of a Transfer Order is only permitted if the going concern of the troubled bank is jeopardized, a collapse of the bank would endanger the stability of the financial system[5] and no other (less severe) means to overcome the bank's crisis are available. Depending on the degree of distress, before rendering a Transfer Order, BaFin may allow the bank to deliver a recovery plan (*Wiederherstellungsplan*) presenting a credible alternative as to how (i) the bank's going concern may be ensured within a time period of no more than six weeks and (ii) an adequate regulatory capital and liquidity structure can be created on a sustainable basis.

If a Transfer Order is rendered, it may cover all or substantially all of the assets of the troubled bank, or only selected portions or business divisions. In the event that the Transfer Order relates to only portions of the bank's assets and liabilities, the Bank Restructuring Act provides certain criteria as to the composition of the assets/liabilities subjected to the order:

- Assets and liabilities secured by financial securities (*Finanzsicherheiten*) within the meaning of Sec. 1 para 17 KWG may only be transferred together with the respective financial security (and vice versa).
- Assets and liabilities which are included in a securities clearing system within the meaning of Sec. 1 para 16 KWG or a clearing system of a central bank may only be transferred together with the related securities (and vice versa).
- Assets and liabilities which are included in a master settlement agreement (such as the ISDA Master Agreement) may only be transferred together with the master settlement agreement and other assets and liabilities which are covered by such master settlement agreement (and vice versa).
- The selection of all other assets and liabilities has to be made in accordance with such assets' and liabilities' significance for an effective and cost-efficient mitigation of the systematic risks caused by the distressed bank's collapse. To the extent several liabilities have an identical profile in this respect, the selection has to respect the ranking of such liabilities in a deemed insolvency of the distressed bank. The Bank Restructuring Act (and the official reasoning from the legislator) remains unclear as to whether higher ranking or lower ranking liabilities shall remain with the distressed bank or will have to be transferred to the Bridge Bank. Following the principle that more junior creditors should "share the pain" first, it is likely that in such a scenario junior ranking liabilities would remain with the distressed bank and senior ranking liabilities would have to be transferred to the Bridge Bank.

The Restructuring Act permits adjustments to the transferred assets and liabilities within four months from the effective date of the Transfer Order in order to allow an effective rescue of the distressed bank and stabilization of the financial system. During this period of time, BaFin may issue additional orders, including (i) a transfer of further assets and liabilities to the Bridge Bank or (ii) a re-transfer of assets or liabilities from the Bridge Bank to the distressed bank. The re-transfer of liabilities to the distressed bank is likely to follow the transfer scheme in reverse order, i.e., the most junior liabilities of the Bridge Bank that prove unsustainable will be subject to re-transfer to the distressed bank.

The Transfer Order must include a consideration to the distressed bank if and to the extent the sum of the transferred assets and liabilities reflects a positive value. In general, the consideration consists of shares in the Bridge Bank, unless the issuance of new shares is not acceptable to the Bridge Bank (e.g., because it is uncertain if the minimum nominal contributions for the issuance of new shares have been met) or endangers the implementation of the Transfer Order (e.g., if the distressed bank would become the parent of the Bridge Bank, causing a consolidation of both banks). In this case, the Transfer Order stipulates a cash consideration. The description of the calculation of the consideration and the determination of the value of the transferred assets and liabilities in the contained Restructuring Act is vague: the consideration has to be in "an adequate relation to the value of the transferred assets and liabilities" at the time of the issuance of the Transfer Order; stabilizing state aid will not be taken into account. The adequacy of the consideration has to be assessed by an expert appraiser, which will be appointed by the Court on application of the FSMA. It is highly likely that any such valuation would follow the valuation standard IDW S1 of the German Institute of Chartered Accountants. If a final valuation is not available at the time of the implementation of the Transfer Order, the transfer can be based on preliminary valuations that have to be concluded within four months.

In case the transferred assets and liabilities have a negative value, the Transfer Order can include a cash consideration to be paid by the distressed bank to the Bridge Bank (which is potentially recorded as a liability in its liquidation status). Maturity and ranking of such consideration will have to correspond to the maturity and ranking of the liabilities assumed by the Bridge Bank, which means a liability senior to any debt left behind at the distressed bank.

A Transfer Order does not require any separate spin-out plan (*Ausgliederungsvertrag*), report (*Ausgliederungsbericht*), or approving resolution of the distressed bank's and the Bridge Bank's shareholders (*Ausgliederungsbeschluss*). The transfer of agreements to the Bridge Bank on the basis of a Transfer Order will neither result in a cancellation of the affected agreements nor does it require the counterparties' consent; in addition, the Bank Restructuring Act stipulates that transferred agreements cannot be terminated by a party merely because of the transfer. Contractual provisions to the contrary are declared void by the Bank Restructuring Act; termination, however, for other reasons remains possible. Alternatively, BaFin may re-transfer to the distressed bank any agreement whose termination is asserted by a counterparty.

The joint and several liability of the distressed bank and the Bridge Bank to creditors has been modified. Remaining creditors of the distressed bank may seek satisfaction from the Bridge Bank only in an amount equal to the difference between its recovery from the distressed bank and the amount that the creditor would have received in an insolvency and liquidation of the entire bank had the Transfer Order not been rendered. Creditors of the Bridge Bank may only seek satisfaction from the distressed bank if and to the extent their claim has not been recovered from the Bridge Bank in full, subject, however, to the limitation that they may only claim up to the amount that the creditor would have received in an insolvency and liquidation of the entire bank had the Transfer Order not occurred. Any challenge or avoidance of the transfer of the assets based on the Transfer Order inside or outside the insolvency of the distressed bank or the Bridge Bank has statutorily been excluded.

The hive-down — i.e., the transfer of the relevant assets and liabilities — becomes effective and the claim for consideration becomes due with the issuance and publication of the Transfer Order.

Following the consummation of the Transfer Order, the Restructuring Act provides BaFin with further means in order to conduct the restructuring of both the distressed bank as well as the Bridge Bank:

- BaFin may render instructions to the distressed bank regarding the exercise of its voting rights in the shareholders' meeting of the Bridge Bank. BaFin may also withdraw the banking license of the distressed bank. In addition, the distressed bank may only transfer its shares in the Bridge Bank to a third party upon the prior approval of BaFin.
- With respect to the Bridge Bank, BaFin has the authority to closely monitor the restructuring of the transferred banking business. In addition, the Bank Restructuring Act enables simplified implementations of capital measures and other corporate restructurings at the Bridge Bank.

2. Impact on Investors' Positions

The direct impact of a Transfer Order on investors depends on the specific circumstances, in particular, on the composition of the transferred assets and liabilities. However, it is not unlikely that a Transfer Order may lead to an almost complete wipe-out of all investor positions remaining with the distressed bank. In any event, investors should take into account that the main goal of a Transfer Order is the protection of the stability of the financial markets, and that the optimized or even fair recovery by individual investors is not the primary objective of these provisions.

- The Transfer Order per se does not provide for any amendment or rescheduling of the transferred debt, i.e., it may only lead to a debtor change. If and to what extent this either could be structured as a conditional transfer including a haircut (e.g., only bonds are subject to the transfer to the Bridge Bank whose holders have accepted a 30% haircut, while bonds of dissenting holders remain at the distressed bank) or a conditional re-transfer (e.g., transfer of the bonds to the Bridge Bank, proposed bondholders resolution under the Bond Restructuring Act and re-transfer to the distressed bank if not approved by sufficient majority) is unclear.
- Hybrid instruments without voting rights such as profit participation rights (*Genussrechte*), silent participations (*stille Gesellschaft*) or convertible bonds (*Wandelschuldverschreibungen*) are "in doubt," to be continued by the Bridge Bank but facing an "adaptation to the new circumstances." In the best case that may mean that these instruments are amended as to the Bridge Bank's new business and forthwith relate to the profits and shares of this entity. In the worst case, however, any loss attribution to such instruments that may have occurred prior to or simultaneously with the crisis may be carried forward by the Bridge Bank so that the loss of principal is set in stone.
- Investors should also be aware that their instruments may continue to be impaired following the transfer to the

Bridge Bank. If the Bridge Bank received financial aid from the state and such state aid has not been refinanced:

- dividend payments to shareholders of the Bridge Bank (including the distressed bank if it has received shares in the Bridge Bank) would not be permitted;
- payments to holders of hybrid instruments would not be permitted if — according to the terms of such instrument — such payments would not be owed unless specific criteria are met and, in case of the Bridge Bank, these criteria are only met because the Bridge Bank received financial support from the state; and
- payments on subordinated debt instruments of the Bridge Bank would not be permitted if the subordinated debt could not be satisfied if any state aid received by the Bridge Bank would have been repaid first.

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ENDNOTES

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[1] This includes IKB and the German Federal State Banks (Landesbanken; e.g., Helaba, LBBW, BayernLB, HSH, NordLB and WestLB) but not KfW, the German Federal Bank (“Bundesbank”) and further bank institutions exempt under Sec. 2 para 1 of the German Banking Act.

[2] Numbers were calculated on the basis of the Interim Report dated September 30, 2010.

[3] These generally include all liabilities which are required to be shown in the balance sheet as “liabilities to customers,” including demand deposits (*Sichteinlagen*), term deposits (*Termineinlagen*) and savings deposits (*Spareinlagen*) as well as registered savings certificates (*Namens-Sparbriefe*), but excluding liabilities to other banks and claims in respect of which the bank has issued bearer instruments (*Inhaberpapiere*), e.g., bearer bonds (*Inhaberschuldverschreibungen*) and bearer certificates of deposit (*Inhabereinlagenzertifikate*).

[4] In the latter case a single majority is sufficient if the shareholders attending the general assembly represent at least 50% of the share capital.

[5] See above par. D. 1.
