

October 3, 2011

Euro Rescue Package Backed by German Federal Constitutional Court – German Parliament Approves Plan to Boost the Lending Capacity of the Eurozone Bailout Fund (EFSF)

In a widely expected decision of 7 September 2011 Germany's Federal Constitutional Court upheld the bailout for Greece and subsequent euro rescue measures and rejected various constitutional complaints directed against German and European legal instruments. The court also underpinned the participation rights of the German parliament and ruled that any future euro stabilization measure requires the prior approval of the parliament or its competent committees. In addition, German lawmakers on 29 September 2011 overwhelmingly voted in favor to expand the powers of the eurozone bailout fund. The constitutional verdict and the parliamentary vote eliminate a major hurdle to the European sovereign debt crisis response that's been closely watched by financial markets.

I. Background

1. Aid to Greece

In May 2010, the member states of the European Monetary Union (the “**Euro Member States**”) decided to provide substantial financial aid to Greece in connection with a three-year program of the International Monetary Fund and committed a loan facility in an aggregate amount of EUR 80 billion to be disbursed within an intergovernmental framework via pooled bilateral loans (“**Aid to Greece**”). The German parliament (*Bundestag*) adopted the Monetary Union Financial Stabilization Act (*Währungsunion-Finanzstabilisierungsgesetz*) of 7 May 2010 (“**WFStG**”) in order to establish a national legal basis for the Aid to Greece. The WFStG authorizes the German government to issue guarantees of up to EUR 22.4 billion which secure loans granted by the German Reconstruction Bank (*Kreditanstalt für Wiederaufbau*) to Greece.

2. Euro Rescue Package and European Stabilization Mechanism

Also in May 2010, the European Economic and Financial Affairs Council (ECOFIN) adopted a temporary and provisional stabilization mechanism to safeguard the financial stability of the European Monetary Union. It is based on (i) “*European Council regulation (EU) No. 407/2010 of 11 May 2010 establishing a European financial stabilization mechanism*”) and

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(ii) the European Financial Stability Facility S.A. (“**EFSF**”), a Luxembourg special purpose vehicle founded by the Euro Member States on 7 May 2010 and operating under the EFSF framework agreement dated 7 June 2010 (the “**EFSF Framework Agreement**”) between the Euro Member States and the EFSF (these measures together the “**Euro Rescue Package**”). The current stabilization mechanism expires on 30 June 2013 and authorizes the EFSF to grant loans and credit facilities to Euro Member States in an amount of up to EUR 440 billion. The Euro Rescue Package was backed by the European Central Bank authorizing the national central banks to purchase public debt instruments issued by Euro Member States under certain circumstances.

The *Bundestag* established the legal basis for the Euro Rescue Package by adopting the Act Concerning the Granting of Guarantees within the Framework of a European Stabilization Mechanism (*Gesetz zur Übernahme von Gewährleistungen im Rahmen eines europäischen Stabilisierungsmechanismus*) of 21 May 2010 (“**StabMechG**”). The StabMechG originally authorized the German government to issue guarantees in an amount of up to EUR 123 billion with respect to loans granted by the EFSF.

Since the financing conditions for Greece and certain other Euro Member States have further deteriorated, the Euro Member States have agreed to ensure that the EFSF can provide its full lending capacity in a maximum amount of EUR 440 billion until 30 June 2013. To secure the refinancing of such amount, Germany will be obliged to increase the total guarantee limit with respect to the guaranteeing of debt instruments issued by the EFSF from EUR 123 billion to approximately EUR 211 billion. It has also been agreed that the EFSF shall be authorized to take preventive measures (e.g. granting bilateral credit facilities to Euro Member States), recapitalize financial institutions or purchase government bonds issued by Euro Member States in the primary or secondary markets. These decisions required, *inter alia*, changes to the EFSF Framework Agreement which have been transformed into German law by amending the StabMechG (the “**StabMechG Amendment Bill**”) on 29 September 2011.

As of 1 July 2013, the tasks currently fulfilled by the EFSF shall be assumed by a permanent European stabilization mechanism which will be constituted by the “*Treaty establishing the European Stabilization Mechanism (ESM)*” signed by the Euro Member States on 11 July 2011 and be implemented by no later than 31 December 2012 (the “**European Stabilization Mechanism**” or “**ESM**”). The initial maximum lending volume of the ESM will be EUR 500 billion and the ESM shall receive a broader range of competences. The legislation process for the implementation of the ESM shall commence within the first quarter of 2012.

II. The Decision of the German Federal Constitutional Court

On 7 September 2011, the German Federal Constitutional Court (*Bundesverfassungsgericht*, “**BVG**”) rejected three constitutional complaints filed by a group of individuals against the WfstG and the StabMechG as well as certain European legal instruments in connection with the Euro Rescue Package the latter on which the BVG had no competence to decide on (see below).

1. Competences of the BVG

The BVG is the highest German judicial body to ensure that all public authorities in Germany, i.e. legislative, executive and judicial authorities comply with German constitutional law set forth in the German Constitution (*Grundgesetz*). Accordingly, it rules on the constitutionality of German federal legislation with the Constitution. Individual persons can only appeal to the BVG if a law or any other public act actually infringes their fundamental rights (*Grundrechte*) or other constitutional rights assigned by the Constitution. An abstract review of legislation and its compliance with the Constitution can only be initiated by the federal government, a state government or one fourth of the members of the *Bundestag*.

2. The Decision

The BVG ruled that neither the StabMechG nor the WFStG violated the individual persons' constitutional right under Art. 38 of the Constitution (in connection with the principle of democracy Art. 20 of the Constitution) which grants an individual person the right to elect the *Bundestag* and thereby set the legal and democratic fundament of the parliament to adopt laws. It further represents the legal basis for the *Bundestag* to adopt the budget and control its implementation by the government, i.e. any decision on revenues and expenditures of the public sector must remain with the parliament, as the budget autonomy of the parliament is considered by the BVG as one of *the* core principles of the German democratic constitutional state.

The BVG held that Art. 38 in conjunction with Art. 20 of the Constitution would only have been violated if the *Bundestag* had "divested" its budget right in a way that would prevent the parliament from exercising such right at its own discretion. The court established, however – based on the principle of interpreting the StabMechG in conformity with the German Constitution – that prior to issuing guarantees the German government shall not only be obliged to use its best endeavors to come to a mutual agreement with the budget committee (*Haushaltsausschuss*) of the *Bundestag* but rather obtain its *prior* approval. An exception to this rule shall only be permitted in urgent cases.

The BVG further made important statements regarding constitutional principles and boundaries which need to be obeyed by the government and the legislator with respect to future financial aid or stabilization measures for the benefit of other Euro Member States. The court stated that the *Bundestag* may not delegate its budget right to other institutions. In particular, Germany may not submit itself to an automatism that results in an indefinite, incalculable and uncontrollable liability caused by financial aid or stabilization measures for other Euro Member States. To the extent Germany enters into supra-national agreements which – due to the size of the obligations incurred thereunder – may have a structural impact on the parliament's budget right (e.g. where the granting of guarantees due to their size may endanger the federal budget autonomy or where the participation in such system may have such effect) such agreements as well as any individual dispositions of German funds require the prior approval of the parliament. Furthermore, it must be ensured that the parliament continues to have sufficient influence to control any financial aid or stabilization measure already in place.

In line with various other decisions the BVG stated further that the *Bundestag* in its capacity as legislator has a wide range of discretion with respect to the question if and when Germany's commitments may exceed Germany's budget capacity, i.e. which would lead to a loss of the parliament's budget autonomy. In particular, the *Bundestag* has the right to decide on the likelihood that guarantees would actually be drawn.

III. Significance

The verdict of the BVG is of major significance with respect to current and any proposed future euro stabilization measures as the court has set important boundaries for Germany's participation in such measures.

Although the court has generally approved Germany's involvement relating to the Aid to Greece and the Euro Rescue Package, it calls for a more influential role of the *Bundestag* or its competent committees. The *Bundestag* or a competent committee has to grant its prior approval with respect to any future euro stabilization measure. This also applies to any individual disposition even if such measure shall be carried out under an approved framework. Furthermore, any euro stabilization measure that leads to an indefinite, incalculable and uncontrollable liability for the German budget may be subject to a verdict of unconstitutionality. However, the *Bundestag* has a broad range of discretion with respect to the volume of any future commitment, i.e. only evident violations of constitutional law may be scrapped by the court in connection with a constitutional review.

The requirement of a stronger participation of the *Bundestag* is now also reflected in the StabMechG Amendment Bill as of 29 September 2011 which was backed by a broad majority across most political parties as well as the upper house of the German parliament (*Bundesrat*) on 30 September 2011, trade associations and unions. In the forefront of the new law, it has been the common understanding among lawmakers that the procedural requirements imposed by the BVG shall not impede a rapid reaction by the German government in any future financial crisis and expert opinions endorsed the idea to cater for flexible and rapid response instruments which, at the same time, respect the procedural supremacy of the *Bundestag*. It was recommended that the parliament's rights should be exercised on the budget committee level which could also involve the establishment of a special and competent "Stability Committee" with flexible procedural requirements such as co-ordination via telephone conference.

The StabMechG Amendment Bill partially adopted these recommendations by stipulating that any euro stabilization measure is generally subject to the prior approval of the *Bundestag* or the *Bundestag's* budget committee, respectively, depending on the severity and the significance of the measure. Furthermore, a sub-committee composed by the least possible number of members of the budget committee which represent the respective political majority circumstances shall exercise the budget committee's approval right in situations of urgency or confidential decisions to be made by the EFSF. This procedure applies to certain emergency measures such as preventive measures (e.g. the granting of bilateral loan facilities to Euro Member States by the EFSF), the recapitalization of financial institutions and the purchase of governmental bonds in the secondary markets where decisions must be made within days.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Winfried M. Carli, Partner
Munich
+49 89 23888 2607
wcarli@shearman.com

Hans Diekmann, Partner
Düsseldorf
+49 211 17888 818
Frankfurt
+49 69 9711 1000
hdiekmann@shearman.com

Alfred Kossmann, Partner
Düsseldorf
+49 211 17888 719
akossmann@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069 | WWW.SHEARMAN.COM

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