

Reform of the German Bondholder Act

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Part I

The current Legal Environment for German Bonds

Introduction

- On August 5, 2009, a comprehensive revision of the German Bondholder Act (*Schuldverschreibungsgesetz*), which the market had awaited for many years, has become effective.
- The revised version of the Bondholder Act (the “New Act”) results in fundamental changes to the legal régime applicable to German law-governed bonds. These changes will be relevant not only in connection with the issuance of new bonds, but also for future amendments of the terms and conditions (“T&Cs”) of existing bonds, particularly in a restructuring scenario.
- In the case of bonds issued prior to August 5, 2009, the application of the New Act will depend upon a corresponding resolution passed by a majority of at least 75% of the votes cast (“Opt-In”).
- This presentation summarizes the general legal régime applicable to issuers of German law-governed bonds, the main changes and improvements introduced by the New Act, as well as some of the remaining pitfalls that we see in connection with the New Act.

The current Legal Environment for German Bonds (1)

- As in many other legal systems, bonds issued under German law are considered to create contractual relationships among the issuer and each bondholder. On this basis, the consent of the issuer and all bondholders is required to validly agree on amendments to the T&Cs with binding effect for all bondholders, unless the T&Cs or statutory law provide otherwise.
- In the international bond markets, so-called “Collective Action Clauses” or “CACs” generally enable the issuer to amend the T&C’s with a specified majority of the bondholders.
- However, in the past, the validity of CACs was doubtful under German law:
 - It is not entirely clear to what extent German courts consider T&Cs as “general business terms” within the meaning of EC-Directive 93/13/EEC. Pursuant to such directive and German statutory law, “general business terms” are subject to particularly strict transparency and reasonableness requirements, and the application of these rules to T&C’s may create a risk of invalidity.
 - A possible violation of EC-Directive 93/13/EEC was particularly debated for CACs.

The current Legal Environment for German Bonds (2)

- The previous German Bondholder Act of 1899 (the “Old Act”) provided that T&C’s can be amended by mere majority resolutions (with binding effect for all bondholders) only in limited circumstances.
 - In particular, such resolutions (i) could only be passed in order to avoid an imminent insolvency of the issuer (which limited this tool to situations in which the issuer was already significantly distressed, the demonstration of which in a dispute was difficult) (ii) required a physical bondholder meeting and (iii) could only effect very limited amendments to the T&C’s, such as a temporary waiver of interest payments and an extension of the maturity of the bonds, but not, for example, a partial waiver of principal payments. The effect of any resolutions passed could only cover a period of time of up to three years, and any resolutions passed became obsolete in an insolvency of the issuer.
 - Furthermore, the Old Act applied only to issuers based in Germany.
 - Consequently, the scope of application of the Old Act was very narrow, and the Old Act was, in practice, rarely applied in the restructuring of existing bonds. (Examples include the restructuring of bonds issued by Südmilch AG and Rinol AG.)

The current Legal Environment for German Bonds (3)

- Under the Old Act, difficulties in restructurings of German law-governed bonds included the following:
 - Issuers could not use the Old Act to implement a comprehensive restructuring on the basis of a consent solicited from a majority of bondholders.
 - In most of the cases in which the Old Act was applied, it could only be used (i) to achieve a temporary relief for the issuer and/or to gain time in order to develop a restructuring concept and (ii) to make bonds “less attractive” (*i.e.*, to create an incentive for bondholders to participate in a consensual restructuring as described below).
 - Comprehensive restructurings (*e.g.*, by way of a debt-equity swap or a (partial) waiver of principal payments) were not structured on the basis of the Old Act, but rather
 - as exchange offer/liability management transactions with a high acceptance threshold, leaving the untendered bonds outstanding (*e.g.*, Augusta Technologie AG, EM.TV & Merchandising AG); or
 - by a cross-border merger of the issuer and a subsequent in-court restructuring under non-German insolvency laws (so-called “COMI migration”) (*e.g.*, Deutsche Nickel AG, Schefenacker AG).

The current Legal Environment for German Bonds (4)

- Due to the inflexibility of the Old Act, many corporate issuers did not issue bonds governed by German law, but chose English or New York law as the governing law.
- Following many years of discussion in the market and in light of the significantly increased need for restructurings in the context of the current financial crisis, the German legislator eventually recognized the need:
 - to clarify that clauses which are customary in international bond issuances (such as CACs) shall also be permitted under German law; and
 - to provide for a modern set of rules for issuers and bondholders that offers a practical alternative to English or New York law.
- The consensus reached in the New Act has brought the pertinent German law rules in line with international standards and will thereby help to facilitate restructurings of German bonds.
- At the same time, most of the new rules are only optional and need not be implemented where this would be inappropriate in light of the nature of the bond (e.g., majority decisions in the case of commercial paper)

Part II

Main Elements of the New Bondholder Act

Main Elements of the New Bondholder Act (1)

- The New Act applies to:
 - All German and non-German issuers
 - Including corporates, financial institutions, SPVs, non-German sovereign issuers
 - Only exception: Bonds issued or guaranteed by the German Federal Republic of Germany, a German Federal State or a German municipality, as well as the German Financial Market Stabilization Fund (*Finanzmarktstabilisierungsfonds* or *SoFFin*)

[The Old Act applied only to bonds issued by German issuers and not, for example, to bonds issued by their finance subsidiaries located abroad. This was one reason why the Old Act had only limited practical relevance.]

- Of bonds governed by German law
 - Including straight bonds (such as high-yield bonds), medium term notes, commercial paper, convertible bonds (*Wandelanleihen*), bonds with warrants attached (*Optionsanleihen*), but also certificates, options and other derivatives that are certificated in securities
 - Exceptions: German Covered Bonds (*Pfandbriefe*)

[The Old Act applied only to bonds having a “nominal amount” and, therefore, did not to apply to certain hybrid equity-type instruments.]

Main Elements of the New Bondholder Act (2)

- The New Act introduces a transparency requirement for T&Cs.
 - Investors who are generally familiar with bonds of the respective kind must be able to establish the scope of the issuer's obligations from the T&Cs.
- Position of bondholder representative (*Gemeinsamer Vertreter*) is strengthened.
 - German law-governed bonds generally do not provide for a trustee comparable to a trustee in English law- or New York law-governed bonds.
 - The New Act provides for the possibility to appoint a bondholder representative. Its position can be similar to that of a trustee.
 - The bondholder representative can be appointed either in the T&Cs or, subsequently, by the bondholders by way of a bondholder resolution.
 - The scope of the authorities of the bondholder representative is determined by the terms of its appointment (*i.e.*, in the T&Cs or the respective bondholder resolution).
 - Particularly far-reaching rights (such as the right to waive payments on behalf of the bondholders) cannot be granted to a bondholder representative in the T&Cs, but only to a bondholder representative appointed by way of a bondholder resolution.

[Both these changes result in helpful clarifications, since transparency issues and trustee provisions were subject to significant legal uncertainty under the Old Act.]

Main Elements of the New Bondholder Act (3)

■ Bondholder Resolutions (1)

- T&Cs can now provide that a majority of bondholders may in all respects (except as noted below) pass resolutions resulting in amendments to the T&Cs that are binding on all bondholders.
- The New Act contains a non-exclusive list with matters on which majority resolutions can be passed.
 - Extension of maturities
 - Reduction of interest and/or principal payments
 - Subordination of the bonds in the issuer's insolvency
 - Conversion or exchange of bonds for equity or debt instruments
 - Release of security interests
 - Change of bond currency
 - Waiver or restriction of acceleration rights of bondholders
 - Replacement of the issuer
 - Amendments to ancillary obligations (e.g., negative pledge)
- New bondholder obligations cannot be established by majority decisions.
- More fundamental changes to the T&Cs (including all of the above examples, except for mere amendments to ancillary obligations) can be resolved upon only by a super-majority (*i.e.*, 75%) of the votes cast, while less significant changes can be resolved upon by more than 50% of the votes cast. The T&Cs can provide for higher majority requirements.

Main Elements of the New Bondholder Act (4)

■ Bondholder Resolutions (2)

- The T&Cs can provide that bonds can only be accelerated by bondholders representing specified percentages (up to 25%) of the outstanding bonds acting together. Under certain circumstances, an acceleration declared by a minority of bondholders can be revoked by way of a bondholder resolution.
- Resolutions can now be passed not only in physical bondholder meetings but also by votes cast outside of such meetings (e.g., by email).
- Resolutions in bondholder meetings can be passed only if bondholders representing at least 50% of the outstanding bonds are present. If this quorum is not achieved, a second meeting can be scheduled. No minimum quorum is required for such second meeting, unless certain fundamental types of resolutions are proposed to be passed. The T&Cs can provide for a higher quorum.

[Under the Old Act, a practical consequence of the quorum requirement was typically a need to schedule two consecutive physical meetings. Under the New Act, this burden will be reduced by passing resolutions outside of a physical meeting.]

- Bondholders must be treated equally and may not be offered any additional consideration for votes passed in bondholder resolutions.
- In addition, the New Act modernized and clarified procedural rules (which were subject to significant legal uncertainty under the Old Act) for bondholder meetings and resolutions.

Main Elements of the New Bondholder Act (5)

■ Bondholder Resolutions (3) – Debt-Equity Swap

- Under the New Act, T&Cs can provide that a 75% majority of the bondholders can resolve upon a conversion of all bonds into shares or other equity instruments.
- However, requirements under corporate law applicable to the entity in which shares are intended to be granted (*i.e.*, in practice the issuer or a guarantor) need to be observed as well:
 - In most cases (particularly in the case of German entities), a new shareholder resolution on a capital increase will be required to allow the creation of the new shares; and
 - In addition, for German entities, corporate law requires that shares not be issued below par. Therefore, the bonds to be converted into shares must have a certain minimum (market) value which may have to be confirmed in an expert opinion.
- These additional corporate law aspects are not addressed in the New Act. It remains to be seen to what extent future debt-equity swaps will be effected on the basis of bondholder resolutions.

Main Elements of the New Bondholder Act (6)

■ Challenges of resolutions

- The New Act provides that bondholder resolutions can be challenged in court by minority bondholders only if (subject to certain exceptions) such bondholders voted against the resolution passed.
- Such challenges can be based upon the alleged violation of the New Act or the T&Cs, or on inaccurate or incomplete information.
- The applicable procedural rules are comparable to those available to minority shareholders against shareholder resolutions passed at annual general meetings of stock corporations.
- As in a shareholder litigation, a bondholder resolution which is subject to litigation must not be implemented, unless the issuer has obtained temporary relief in a special proceeding. Therefore, bondholder litigation may create additional delay and thereby jeopardize a successful restructuring.

[The Old Act did not contain any provisions on the challenging rights of bondholder resolutions. Nevertheless, even under the Old Act, in recent years, professional shareholder plaintiffs have started to turn their attention towards bonds. It remains to be seen whether the changes introduced by the New Act will lead to the creation of an active scene of professional bondholder plaintiffs.]

Part III

Summary and Outlook

Summary and Outlook

- The New Act constitutes a major improvement of the legal régime applicable to German law-governed bonds. By abolishing significant uncertainties that existed under the Old Act and introducing procedural rules in line with international standards, the choice of German law has become more attractive for bond issuers. The New Act offers a large degree of flexibility for issuers to structure the T&Cs of their bonds according to their needs.
- For distressed issuers of bonds (including of bonds issued prior to August 5, 2009, provided that at a majority of at least 75% has opted for the application of the New Act) the New Act will significantly facilitate out-of-court restructurings. In particular, under the New Act, a majority of bondholders can resolve upon a debt-equity swap, although the cooperation by shareholders is typically also required in this context.
- The rules under the Old Act will continue to apply to bonds issued prior to August 5, 2009 in cases where the bondholders have not opted for the application of the New Act. In respect of restructurings, this should not be relevant since a restructuring typically requires the consent of a 75% majority of the bondholders in any event. However, the continued application of the unclear procedural rules under the Old Act may lead to problems for the issuers of such bonds.
- There is a continuing risk that the validity of T&Cs may be challenged on the basis of rules applicable to “general business terms”, given that the German legislator has decided not to clarify whether T&Cs constitute “general business terms”. However, the German legislator indicated that it intends to work on a resolution of this question on the European level.

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