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ARTICLE

Revision of German Bond Act: New Restructuring Options for German Bonds

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On 5 August 2009 a major reform relating to German bond restructurings took place in Germany: the new German Bond Act (*Gesetz über Schuldverschreibungen aus Gesamtemissionen*) came into force. This new act replaces a legal regime, the German Act Concerning the Joint Rights of Bondholders (*Gesetz betreffend die gemeinsamen Rechte der Besitzer von Schuldverschreibungen*), which has broadly remained unchanged since its introduction on 4 December 1899.

1. The old German Bond Act

The old act was designed for bond restructurings, but never acquired practical relevance[2] and has long been considered as highly inflexible. This was mainly due to the following reasons:

(1) Firstly, the scope of the old act was regarded as too narrow; it covered only bonds where the issuer and the place of the issuance were located in Germany. However, nowadays it is common practice that a non-German vehicle acts as the issuer of the bond.

(2) Secondly, amendments regarding the bond were possible only to prevent an illiquidity of the issuer or insolvency proceedings over the estate of the issuer. The aforementioned triggering events were too late for a successful restructuring of the issuer.

(3) Thirdly, the restructuring options which were provided for in the old act were very limited; in particular the old act provided only for the possibility to reduce interest claims and to defer principal claims for a limited period of three years. Haircuts regarding the principal claims of the bondholders, debt-for-equity swaps or other standard restructuring tools were not provided for. Furthermore, it was unclear if – on an international level – the widespread 'Collective Action Clauses', i.e. clauses granting a majority of bondholders usually the opportunity to amend the terms and conditions by mere majority vote, could be validly agreed on.

(4) Finally, the procedural rules were regarded as technically flawed, in particular with respect to the convening of bondholders' meetings.[3]

2. The new German Bond Act

The new act is designed to correct the aforementioned downsides and to align the German bond law with common practice in international financial markets.

2.1. Scope of application

In contrast to the old act, the new act now applies to all issuers of bonds which are governed by German law, regardless of the place of business of the issuer. Moreover, the new German Bond Act does not apply only to conventional bonds with fixed interest payments but also to other forms of debt securities such as derivatives.[4] The only exceptions to the scope of application concern *Pfandbriefe* (German covered securities regulated by the German *Pfandbrief* Act), and, broadly speaking, government bonds.

Time-wise, the new act applies to all bonds issued after the coming into force of the new act on 5 August 2009. Bonds issued prior to that date remain subject to the old act. However, creditors who hold bonds which have been issued prior to the effective date may – together with the issuer – opt for the application of the new act.

Notes

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2 D. Leuering, 'Das neue Schuldverschreibungsgesetz', (2009) *NZI* 638, 639.

3 D. Leuering and D. Zetzsche, 'Die Reform des Schuldverschreibungs- und Anlageberatungsrechts – Verbraucherschutz im Finanzmarktrecht?', (2009) *NJW* 2856, 2857.

4 A variety of other forms is described by Horn, 'Die Stellung der Anleihegläubiger nach neuem Schuldverschreibungsgesetz und allgemeinem Privatrecht im Licht aktueller Marktentwicklungen', (2009) 173 *ZHR* 12, 18 *et seq*.

Unlike the old act, the new act is not limited in preventing an illiquidity and/or insolvency of the issuer. Thus, bond restructuring measures may already be taken when the first signs of financial difficulties appear.

2.2. Mandatory provisions

The new act contains only a few mandatory provisions, in particular sections 1 to 4. The most important of these is section 4 which refers to the 'collective binding' (*kollektive Bindung*) of the bondholders. According to such regulation the provisions of the bond may be amended only by a uniform agreement for all bondholders which has been signed by all bondholders[5], unless a majority decision according to the principles outlined in para 2 of the German Bond Act (see below under voluntary provisions) has been agreed. This regulation is flanked with an obligation of the issuer to treat the bondholders equally.

2.3. Voluntary provisions

The core element of the new act, para. 2 (sections 5 to 22) of the act, is of a voluntary nature. The issuer may opt for such possibilities, but is under no obligation.

(a) Indenture trustee[6]

The new act modernises the institution of the indenture trustee. The terms of a bond may provide for an indenture trustee of the bondholders and vest him or her with certain rights, subject to certain protection mechanisms with respect to the bondholders' rights. If the position of an indenture trustee is not directly provided for in the terms of the bond, the terms may provide for the possibility of a simple majority vote of the bondholder meeting to appoint such agent. The indenture trustee must not necessarily be independent from the issuer of the bond.[7] However, certain persons with close relations to the issuer may not be appointed directly by the terms of the bond but only by a majority decision of a bondholders' meeting. In any case, a close relationship with the issuer has to be revealed. The indenture trustee has to follow the instructions of the bondholders and may be withdrawn from his or her position without cause by the bondholders. Costs and expenses of the indenture trustee have to be borne by the issuer.

If insolvency proceedings are instituted over the assets of the issuer, the appointed indenture trustee acts as the exclusive agent of the bondholders. If no indenture trustee has been appointed at the time of the opening of insolvency proceedings, the insolvency court convenes a bondholder meeting to nominate an indenture trustee. However, the bondholders are not obliged to appoint an indenture trustee in such case; instead they may also pursue their rights on an individual basis.

The appointment of an indenture trustee paves the way for a uniform and quick representation of the bondholders, in particular against the background that bondholders usually are a heterogeneous group which is hard to deal with on an individual basis. Moreover, it is often not possible to contact each individual bondholder, simply because they are unknown to the issuer. In restructuring scenarios, the appointment of an indenture trustee further opens up the possibility to employ professionals experienced in turnaround situations.

(b) Amendment of terms and conditions of the bond

The major change to the former legal framework is the possibility of the bondholder meeting to amend any terms of the bond (with the exception of the creation of further liabilities of the bondholders). The bondholder meeting may in particular – but is not limited to – agree on the following measures:

(1) the amendment of the maturity date or a (partial) haircut with respect to the principal payment or interest;

(2) the subordination of the repayment claim in potential insolvency proceedings;

(3) the swap of the repayment claim into equity (debt to equity swap);[8] and

Notes

5 N. Horn, 'Das neue Schuldverschreibungsgesetz und der Anleihemarkt', (2009) *BKR* 446, 448 discusses if such concepts apply even after the expiration of the bond.

6 For an analysis of the indenture trustee see K. U. Schmolke, 'Der gemeinsame Vertreter im Referentenentwurf eines Gesetzes zur Neuregelung des Schuldverschreibungsgesetzes – Bestellung, Befugnisse, Haftung', (2009) *ZBB* 8 *et seq*.

7 Cranshaw, 'Internationalisierung und Modernisierung – Bemerkungen zum geltenden und zum Referentenentwurf eines neuen Schuldverschreibungsgesetzes', (2008) *BKR* 504, 509; Podewils, 'Neuerungen im Schuldverschreibungs- und Anlegerschutzrecht – Das Gesetz zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung', (2009) *DStR* 1914, 1918.

8 According to German law, certain further aspects with respect to debt to equity swaps have to be borne in mind. In particular the shareholders of the issuer would have to agree. Other variations such as debt to asset swaps are also possible. See also Podewils, 'Neuerungen im Schuldverschreibungs- und Anlegerschutzrecht – Das Gesetz zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung', (2009) *DStR* 1914, 1915.

(4) the swap or the release of collateral. In any case, the principle of an equal treatment of all bondholders has to be observed with respect to the aforementioned measures.

This array of potential decisions of a bondholders' meeting strongly increases the attractiveness of the new act.

Interestingly, the terms of the bond may not directly vest the indenture trustee with the right to waive certain rights of the bondholders. In particular the indenture trustee may not be vested with the right to agree on the aforementioned measures. This requires a formal resolution of the bondholders' meeting. Thus, confidential out of court restructurings of bonds with an indenture trustee will not be possible.[9] Restructuring practitioners who aim for a 'silent solution' will thus – as under the previous law – have to account for a full repayment of the bondholders' claims and most likely not inform the indenture trustee of the restructuring (which would possibly trigger his or her obligation to accelerate the bond claims).

(c) Procedure regarding passing of resolutions in bondholders' meetings

The procedural rules of the bondholders' meeting have been aligned with the general provisions of the German Stock Corporation Act.

The issuer of the bond and the indenture trustee are entitled to convene a bondholder meeting. The act further provides for a mandatory bondholder meeting if at least five percent of the bondholders request one (and if certain further requirements are met, e.g. if they have a particular interest in the meeting). This latter provision is particularly important if the meeting of the bondholders is not in the interest of the issuer.

The bondholders' meeting has the quorum if a minimum of 50% of the voting rights – on a value basis – of the bondholders is present. If such requirement is not met, the chairman may convene a second meeting where the requirement of 50% of the voting rights of the bondholders is no longer necessary. However, even in such case 25% of the voting rights of the bondholders have to be present if decisions have to be taken which require a qualified majority.

Usually, the bondholders decide by majority vote of the present voting rights of the bondholders. Such majority decisions bind all bondholders. However, if a decision results in an 'essential change' to the terms of the bond, a qualified 75%-vote of the participating bondholders is necessary. This is usually the case with respect to the decisions outlined under 2.3 (b) above.

In any case, it is always possible that the terms of the bond provide for higher thresholds.

Furthermore, the new act provides not only for physical bondholder meetings but also for the possibility to agree on bondholders' resolutions by, for example, virtual bondholder meetings where votes can be transmitted by email.

(d) Challenge of bondholders' resolutions[10]

Resolutions of bondholders may be challenged by individual bondholders, in particular due to violations of the Bond Act or the terms of the bond. Again, the regulation on a challenge has been aligned with the challenge provisions of the German Stock Corporation Act. Bondholders who are eligible to challenge a resolution usually must have attended the respective resolution-taking (and timely filed an objection), were not duly admitted to the bondholders' resolution-taking, or were affected by other formal mistakes. Usually, the challenge of a bondholder meeting resolution creates a stay of the implementation of such resolution.

The possibility to challenge a bondholders' resolution was meant to serve as a corrective measure to the far-reaching rights of the bondholders' meeting. However, a challenge can be time-consuming, cumbersome and may thus impede a fast and successful restructuring, in particular in the light of a restructuring scenario where liquidity problems require a quick solution. Moreover, it has long been common practice in Germany at shareholder meetings of corporations for certain shareholders to misuse formal flaws and take advantage of their nuisance value in order to receive considerable payments. Despite certain endeavours of the government to minimise such misuse of challenges it is obvious that there is considerable blackmail potential with respect to bondholders' resolutions as well.

2.4. Application of the statutory law on general terms and conditions[11]

The German legislator does not specifically regulate whether the German statutory law on general terms and conditions clauses (i.e. sections 305 *et seq*.

Notes

9 K. Kuder and M. Obermüller, 'Insolvenzrechtliche Aspekte des neuen Schuldverschreibungsgesetzes', (2009) *ZInsO* 2025, 2025.

10 A detailed review of the challenge possibilities with respect to bondholder resolutions provides T. Baums, 'Die gerichtliche Kontrolle von Beschlüssen der Gläubigerversammlung nach dem Referentenentwurf eines neuen Schuldverschreibungsgesetzes', (2009) *ZBB* 1 *et seq*.

11 A detailed discussion of this aspect provides P. Sester, 'Transparenzkontrolle von Anleihebedingungen nach Einführung des neuen Schuldverschreibungsrechts', (2009) *AcP* 628 *et seq*.

German Civil Code, *Bürgerliches Gesetzbuch*) applies to bonds. However, the *Bundesgerichshof*, the German Federal Court of Justice, has held on several occasions that terms and conditions of bonds are subject to the aforementioned provisions of the German Civil Code.[12]

The statutory law on general terms and conditions clauses provides for certain protection rules with respect to clauses which are not individually negotiated but are set up by the issuer for a multiplicity of contracts. However, such protection applies only if the respective clauses deviate from statutory law; thus, if the terms and conditions of a bond replicate the provisions of the new Bond Act, the protection mechanism is not applicable.[13] With respect to other clauses any issuer will have to bear in mind the requirements of the statutory law on general terms and conditions clauses, for example with respect to clauses which allow the issuer to unilaterally amend the terms and conditions of the bond.[14]

3. Conclusion

The new German Bond Act is a major improvement compared to its predecessor, since it makes the restructuring of bonds far easier. This is largely due to the expanded catalogue of restructuring measures which have a binding effect upon all bondholders. Accordingly, the bondholder meeting has the opportunity to restrict and overrule rights of individual bondholders. Furthermore, the technical procedures regarding bondholder meetings have been adapted to the needs of market participants and common practice in international financial markets. Finally, it serves the goal of a pragmatic and quick restructuring that the indenture trustee will speak with one voice for the bondholders.

Despite certain remaining downsides – such as the challenge risk – the new German Bond Act will make German bond law far more attractive in restructuring scenarios and lead to German law being used more frequently with respect to the issuance of bonds.[15]

Notes

12 BGH, decision, 30 June 2009 – XI ZR 364/08 (2009) *ZIP* 1558 *et seq.*; BGH, decision, 28 June 2005 – XI ZR 363/04 (2005) *ZIP* 1410 *et seq.*

13 N. Horn, 'Das neue Schuldverschreibungsgesetz und der Anleihemarkt', (2009) BKR 446, 453. discusses whether such concepts apply even after the expiration of the bond; D. Leuering and D. Zetzsche, 'Die Reform des Schuldverschreibungs- und Anlageberatungsrechts – Verbraucherschutz im Finanzmarktrecht?', (2009) *NJW* 2856, 2857.

14 For a very critical assessment BGH, decision, 30 June 2009 – XI ZR 364/08 (2009) *ZIP* 1558 *et seq.*

15 The application of the new German Bond Act to high yield bonds is outlined in K.F. Balz, 'High Yield Bonds zukünftig nach deutschem Recht?', (2009) *ZBB* 401 *et seq.*

International Corporate Rescue

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