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German Bond Act 2009: key features, restructuring experiences and open questions

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On 5 August 2009, the new German Bond Act (*Gesetz über Schuldverschreibungen aus Gesamtemissionen – Schuldverschreibungsgesetz*) (*SchVG*) (2009 Act) came into force. It replaced the first German Bond Act of 1899 (*Schuldverschreibungsgesetz von 1899*) (1899 Act). The 2009 Act contains, in particular, detailed provisions on the:

- Joint representation of bondholders through a bondholder representative.
- Decision-making of bondholders.
- Protections for individual bondholders against unlawful majority decisions.

The 2009 Act primarily aims to align German bond law with international standards and to improve the ability to effect bond restructurings outside of insolvency proceedings. This is because the lack of flexibility in relation to bond restructurings was identified by legal practitioners and lawmakers as one of the 1899 Act's main flaws.

This article:

- Sets out some of the key features of the 2009 Act.
- Assesses the first practical experience of bond restructurings under the 2009 Act.
- Discusses some open questions under the 2009 Act.

SCOPE OF APPLICATION OF THE 2009 ACT

The 1899 Act had a very limited scope of application, because it only applied to bonds issued by persons or entities domiciled in Germany. For tax and other reasons, German businesses issued German law governed bonds almost invariably through non-German subsidiaries. Therefore, the 1899 Act had become virtually irrelevant.

In contrast, the 2009 Act applies to all bonds issued under German law on or after 5 August 2009, irrespective of:

- The issuer's domicile.
- The type of issuer (subject to certain exceptions (*see below*)).
- Whether the bonds take the form of bearer bonds or registered bonds.

The 2009 Act applies to both:

- Conventional debt bonds, where the issuer promises to the respective bondholder the repayment of principal and the payment of interest.
- Other types of securities, such as derivatives and warrants (*Genussscheine*).

The 2009 Act does not, however, apply to the following types of bonds:

- German covered bonds issued by mortgage lending banks (*Pfandbriefe*).
- Bonds issued by the Federal Republic of Germany, a German state, a German municipality or the German Federal Special Fund.
- Bonds for which either the Federal Republic of Germany, a German state or a German municipality is liable.
- Bonds issued under German law by a member state of the Eurozone. These are governed by certain provisions of the German Federal Debt Act (*Bundesschuldenwesengesetz*).

In addition, the frequently traded German certified loans (*Schuldscheindarlehen*) do not qualify as bonds under the 2009 Act.

AMENDMENTS TO BOND TERMS BY MAJORITY RESOLUTION

Additional flexibility for issuers and bondholders

Under the 1899 Act, the ability to amend bond terms by majority decision was limited. The only amendments that could be implemented by majority resolution were reductions of interest and extensions of the maturity date for a period of up to three years, where this was necessary to prevent the issuer's suspension of payments or insolvency. Amendments of the bond terms and further waivers of bondholders' rights, such as reductions of the principal amount and the implementation of more sophisticated restructuring tools (for example, debt to equity swaps), required the consent of each bondholder under general principles of contract law. The need to obtain individual consents from each bondholder constituted a major obstacle for bond restructurings outside of insolvency proceedings.

The 2009 Act provides issuers and bondholders with significantly increased flexibility. It allows the bond terms to provide

that those terms can, with the issuer's consent, be amended by way of a majority resolution of the bondholders, which is binding on all bondholders. Subject to certain restrictions under mandatory statutory law (*see below*), the issuer can choose in the bond terms if and to what extent it wishes to permit amendments of the bond terms by majority resolution. However, the issuer can also choose expressly to not permit amendments to the bond terms by majority resolution. In this case, amendments to the bond terms and restrictions on the bondholders' rights will still require unanimous consent.

The 2009 Act does not provide for aggregation clauses. This means that amendments by majority resolutions are only binding on the holders of bonds from the same bonds issue, governed by the same bond terms. Therefore, if an issuer has made several bond issues, amendments to the respective bond terms can only be made by separate bondholder resolutions relating to each bond issue. A provision in the bond terms under which, for example, amendments to the bond terms require both a qualified majority of all bonds issued by the issuer and a simple majority of the holders of bonds under an individual bonds issue, are void and unenforceable.

Therefore, there is still a potential for hold-outs in restructurings which involve several bond issues. This can only be partly mitigated by making the effectiveness of the restructurings of the various bonds issues interdependent.

Passing bondholder resolutions

Bondholder resolutions can be passed in a physical meeting of bondholders or by way of a vote in a virtual meeting (*2009 Act*). The bond terms can provide that resolutions can only be passed by one of these procedures.

Quorum. If the resolution is passed in a:

- Physical bondholder meeting, a quorum is present if 50% of the nominal value of the outstanding bonds is present or represented.
- Virtual meeting, a quorum is present if votes have been cast which represent 50% of the nominal value of the outstanding bonds.

The bond terms may provide for a higher quorum. If there is no quorum in the first meeting, a second physical meeting with the same agenda can be called which does not require a quorum. However, if resolutions will be passed at the second meeting which require a qualified majority of 75%, there is only a quorum at the second meeting if 25% of the nominal value of the bonds is present or represented. As a rule, bonds are disregarded when determining whether there is a quorum if they are held by:

- The issuer or any of its affiliates.
- A third party for the account of the issuer or any of its affiliates, and which are therefore barred from voting.

Voting requirements. In principle, bondholder resolutions require a simple majority of the votes that participate in the voting. However, amendments relating to material bond terms require a majority of 75% of the participating votes, unless the bond terms provide for a larger majority requirement. The 2009 Act names the following amendments as material amendments that require a qualified majority of 75% of the participating votes:

- Changes to the due date of interest payments, interest rate reductions and the exclusion of interest.
- Changes to the maturity date.
- Reductions of the principal amount.
- Subordination of claims in insolvency proceedings over the issuer.
- Substitution and release of security.
- Changes to the currency of the bond.
- Substitution of the issuer by another debtor.
- Waiver of the bondholders' termination right and its limitation.
- Conversion or exchange of the bonds in shares, other securities or other payment obligations.

This list is non-exhaustive. Therefore, it is necessary to determine what other bond terms constitute material terms which can only be amended with a qualified majority of 75%. There is little guidance on this, but amendments to bond covenants, which typically result in a change of the default risk for bondholders, can only be amended with a qualified majority. This includes amendments to covenants which limit the issuer's ability to:

- Create security interests over its assets.
- Incur additional financial indebtedness.
- Change its business.
- Relocate its domicile

In addition, any amendments to the bonds' denomination, the governing law and the place of jurisdiction usually constitute amendments to material bond terms which require approval of a qualified majority of bondholders. Only the following amendments can usually be made with a simple majority of bondholders:

- Amendments relating to technical provisions, such as provisions on the handling of payments.
- Amendments to non-material information covenants.

General limitations on the ability to make amendments by majority decision

Under the 2009 Act, issuers have a very broad discretion as to what extent amendments to the bond terms can be effected by majority resolution. However, there are a number of amendments that require the consent of each individual bondholder:

- Amendments to the bond terms that require bondholders to make additional payments.
- Amendments that do not equally apply to all bondholders require the consent of each bondholder put at a disadvantage.

Further, most legal practitioners take the view that a complete waiver of the principal under the bonds is inadmissible.

A number of legal practitioners have suggested that resolutions passed with the requisite majority are not *per se* legitimate. They suggest that:

- To be lawful, these resolutions must be in the interest of the bondholders and be suitable and appropriate for the intended purpose.
- Resolutions that do not satisfy these criteria can be challenged by bondholders.

German courts have frequently judicially reviewed shareholder resolutions in relation to intrusions into shareholder rights. Whether courts will transfer these principles into the 2009 Act in relation to bondholder resolutions is unclear as there are no court decisions yet addressing the issue. However, there are valid arguments supporting the view that challenge of majority decisions should only be permitted in narrow circumstances, where evidence is provided that the majority bondholders are:

- Not acting in good faith.
- Abusing their majority rights to the disadvantage of the minority and pursuing self-serving objectives.

Any further judicial review of the content of bondholder decisions causes legal uncertainty and does not duly take into account the fact that bondholders do not owe the same fiduciary duties to each other as shareholders (which are, by statutory definition, pursuing the same objectives).

RESTRICTION OF INDIVIDUAL TERMINATION RIGHTS IN THE BOND TERMS

Bond terms must not generally exclude the right of individual bondholders to terminate their bonds. However, bond terms can define events which give rise to a termination right (*2009 Act*). In addition, bond terms can provide that:

- Termination rights must be exercised in a uniform manner.
- A termination by individual bondholders can only take effect if termination rights are exercised that represent a certain minimum percentage (not exceeding 25%) of the nominal amount of outstanding bonds.

If bonds are terminated by the requisite number of bondholders so that the individual terminations take effect, bondholders can resolve that the terminations are revoked and are ineffective. The resolution must take place within three months from the terminations taking effect. An explicit provision in the bond terms allowing this resolution is not required. The majority requirements for this resolution are not clear. The wording of the 2009 Act suggests that the resolution:

- Requires a simple majority of all outstanding votes (irrespective of whether these votes participate in the vote).
- Must be approved by a number of bondholders (in contrast to the number of voting rights of these bondholders) exceeding the number of bondholders that have exercised their voting rights.

However, most legal practitioners argue that, in accordance with the general voting principles under the 2009 Act, the revocation resolution requires both:

- A simple majority of all voting rights that participate in the vote.
- That the nominal value of the bonds approving the revocation be greater than the nominal value of the bonds that have been terminated.

There is no support for this view in legislative records and it overstretches the wording of the relevant provisions. Therefore, this view is questionable.

The ability to limit the individual bondholders' termination rights in the bond terms and revoke terminations raises a number of questions that the 2009 Act does not address and which are not clarified:

- The requirement that termination rights must be exercised in a "uniform manner" is unclear. However, the most reasonable interpretation appears to be that any bondholder that wishes to exercise termination rights must exercise that right with respect to all bonds it holds.
- The 2009 Act does not clarify whether the issuer can defer payments to bondholders that have exercised their termination right until either the three-month period has expired or a resolution revoking the terminations has been passed. The legislative records suggest that issuers can retain payments, but there is doubt that this approach is correct. Bond terms that provide for a termination threshold should therefore include rules on whether the issuer can retain payments and interest payable during the retention period. The provision of a retention right in the bond terms should be permitted under the 2009 Act.
- Another more significant question is whether a termination by the relevant majority of bonds will affect all bonds under the relevant bonds issue rather than the bonds that have actually been terminated. Some practitioners suggest that a termination by the requisite number of bondholders will terminate all bonds. However, our view, which seems to be supported by the majority view expressed by legal practitioners, is that a termination of a minority of bondholders would not have this effect. However, the lack of clarity of the wording of the 2009 Act creates uncertainty.

DEBT-TO-EQUITY SWAPS BY MAJORITY RESOLUTION

It is expressly permitted that the bond terms can allow the conversion or exchange of bonds into shares, other securities or other payment obligations, by a resolution of bondholders (*2009 Act*). The resolution requires a majority of 75% of the votes cast or a higher majority provided in the bond terms.

Some commentators question whether a debt-to-equity swap by majority resolution violates the constitutionally guaranteed principle of the freedom of association. In relation to insolvency plan proceedings, the legislator has refrained from introducing a debt-to-equity swap without individual consent of the relevant creditor. It notes that this would violate the constitutionally guaranteed principle of free association. It remains to be seen whether German courts will share these concerns. However, if the bond terms explicitly permit a debt-to-equity swap, these concerns should be unfounded. An exchange of bonds against

a general partnership interest, resulting in personal liability of a bondholder, will not be permitted. This is because the 2009 Act explicitly prohibits the imposition of additional obligations on bondholders without their individual consent.

The 2009 Act does not affect restrictions on the issue of equity interests applicable to the issuer. This means, for example, that the issue of shares in a German stock corporation to bondholders in exchange for the bondholders' claims under the bonds is subject to a valuation of the claims under the bonds. This also requires a shareholder resolution authorising the issue of new shares to the bondholders, whereby the subscription rights of the existing shareholders are excluded in relation to the new share issue.

For the implementation of debt-to-equity swaps to be successful, the requisite shareholder and bondholder resolution must be closely attuned.

JOINT BONDHOLDER REPRESENTATIVES

Joint bondholder representatives (joint representatives) can be appointed in one of two ways (*2009 Act*):

- By the issuer in the bond terms (contractual joint representative (*Vertragsvertreter*)).
- The bond terms can allow the appointment through a resolution of bondholders (appointed joint representative (*Wahlvertreter*)).

In the absence of provisions in the bond terms regarding the appointment of a joint representative, bondholders can only appoint a joint representative if insolvency proceedings are opened in relation to the issuer. In this case, the insolvency court must call a bondholders' meeting, to allow bondholders to resolve on whether a joint representative will be appointed.

Rights of joint representatives

A joint representative's rights are limited to a number of procedural rights, including the right to:

- Call bondholder meetings.
- Manage the passing of resolutions outside of physical bondholder meetings.
- Obtain information from the issuer to the extent that it requires the information to perform its obligations as bondholder representative.
- Assert the claims of bondholders in the issuer's insolvency.

However, the joint representative can be granted additional rights, such as the right to:

- Agree on the amendment of the terms of the bond.
- Enforce the bondholders' rights.
- Exercise the bondholders' termination rights.
- Receive notices on behalf of the bondholders.

Joint representatives are granted additional rights by a bondholders' resolution. In the case of a contractual joint representative, the bond terms must set out the joint representative's rights, but can also provide that rights can be granted to the joint representative by bondholder resolution.

Bondholders are no longer entitled to exercise any rights that are granted to a joint representative (unless a bondholders' resolution provides otherwise). Before making an investment decision, potential investors should therefore closely examine the powers that have been delegated to a bondholder representative under the bond agreement or subsequent bondholder resolutions. This is because it is important to understand the extent to which individual bondholder rights are limited as a result of a delegation of rights to a joint representative.

Bondholders' right to issue instructions

Bondholders can issue instructions to their joint representative, even if rights and powers have been delegated to their joint representative. Instructions can only be made by a bondholder resolution and not by individual bondholders. Therefore, a bondholders' meeting must be called. In certain circumstances, the 2009 Act provides minority bondholders with the right to call such a meeting. If the joint representative is to receive an instruction to agree on an amendment to the bond terms which would usually require a bondholder resolution by qualified majority, the resolution instructing the joint representative requires a qualified majority. However, whether an instruction to the joint representative to dismiss such an amendment also requires a qualified majority or can be made with a simple majority is unclear.

Appointment and dismissal of joint representatives by bondholder resolution

In principle, the appointment of a bondholder representative by resolution requires a simple majority of the votes cast. However, if a joint representative is being granted the power to agree to the amendment of material bond terms (which requires a majority of 75% of the votes cast), a qualified majority of 75% of the votes cast is required. The bond terms can provide for a higher majority for the appointment of a bondholder representative. In addition, if the bond terms provide a higher majority requirement for certain significant amendments to the bond terms (such as waivers of the principal claim), the appointment of a bondholder representative, whose powers comprise the right to agree on such amendments, is subject to the same majority requirement.

Both contractual and appointed joint representatives can be dismissed by a bondholder resolution at any time without a reason and without appointing a new joint representative. According to the legislative records relating to the 2009 Act, a resolution dismissing a joint representative who has been appointed by a bondholders' resolution requires the same majority as the appointment. This means that a qualified majority of 75% of the votes cast is required for a dismissal, if the joint representative was granted the power to agree to the amendment of material bond terms. Whether a qualified majority requirement can be justified by the interests of minority bondholders is questionable and it remains to be seen whether a simple majority of the votes will generally be sufficient to dismiss a joint representative appointed by bondholder resolution.

In any event, it should be possible to dismiss a joint representative who has been appointed in the bond terms with a simple majority of the votes cast.

Qualifications of the joint representative

Both individuals and, more commonly, legal entities can be appointed as joint representative. If the bondholder representative is a legal entity, it must be "knowledgeable". It is not clear what type and range of expertise is required for a legal entity to

PFLEIDERER AND Q-CELLS DECISIONS

Pfleiderer

According to a ruling of the regional court of Frankfurt, the opt-in procedure cannot be applied to German law governed bonds which were issued by non-German entities before 5 August 2009 (*court order dated 15 November 2011*). In addition, the local court of Frankfurt emphasised that the 2009 Act only applies to bonds which are entirely governed by German law, making it clear that the 2009 Act does not apply to bonds which are partly governed by non-German law. The appellate court of Frankfurt approved this decision in a ruling dated 27 March 2012, on the basis that the opt-in procedure was not available. It did not address whether split jurisdiction clauses hinder the 2009 Act's application.

Q-Cells

The regional court of Frankfurt affirmed the Pfleiderer decision, ruling again that the opt-in procedure cannot be applied to German law governed bonds which were issued by non-German entities before 5 August 2009 (*court order dated 23 January 2012*). It argued that an application of the opt-in procedure would violate the constitutionally guaranteed right to rely on the existing law. Therefore, the consensual restructuring of Q-Cells failed and Q-Cells filed for insolvency.Pfleiderer and Q-Cells decisions

be knowledgeable, but it should be sufficient if the legal entity's business is centered on the provision of financial or legal services. Therefore, law firms, accounting firms and financial institutions are typically "knowledgeable".

Persons who have potential conflicts of interest, such as bondholders or persons who are affiliated with the issuer are not generally barred from being appointed as joint representative by bondholder resolution. The 2009 Act merely provides for a disclosure obligation of certain persons who may have a conflict of interest, such as:

- Board members and employees.
- Shareholders holding more than 20% of the issuer's share capital.
- Certain creditors of the issuer and their board members and employees.

Failure to properly disclose the relevant circumstances results in an administrative fine of up to EUR100,000. In addition, where a joint representative has not disclosed the relevant circumstances, the bondholder resolution effecting the appointment may be challengeable (*see below, Challenge of bondholder resolutions by individual bondholders*).

CHALLENGE OF BONDHOLDER RESOLUTIONS BY INDIVIDUAL BONDHOLDERS

Challenge of illegitimate bondholder resolutions

To protect bondholders against illegitimate limitations of their rights by majority decisions, the 2009 Act allows bondholders to challenge resolutions by taking action against the issuer (unless they have voted in favour of the resolution). These actions must be filed with the competent court within one month from the publication of the resolution in the applicable publication media.

The action can be based on:

- A breach of procedural rules under statutory law or the bond terms regarding the passing of bondholder resolutions.
- Illegitimate content of a resolution, such as a breach of the principle that resolutions must apply equally to all bondholders or be made in the interest of the bondholders (*see above, Amendments to bond terms by majority resolution, General limitations on the ability to make amendments by majority decision*).

The effect of a challenge to a resolution is significant, as it blocks the implementation of the resolution until the challenge has been dismissed by final court judgment or an implementation order has been issued (*see below*). This is irrespective of whether the action is well founded and irrespective of the gravity of the asserted breach. This means, in practical terms, that amendments of the bond terms will not take effect until a final judgment dismissing the challenge or an implementation order has been handed down.

Implementation orders

In restructurings, the blocking effect of a challenge to bondholder resolutions has a substantial hold-out value for minority bondholders. To limit an abuse of the blocking effect by minority bondholders, the 2009 Act attempts to counterbalance it by giving issuers the right to file a petition with the competent appellate court for an implementation order in an expedited procedure. The appellate court must issue an implementation order if either:

- The action is inadmissible or evidently unfounded.
- The plaintiff does not provide documentation evidencing that he holds bonds with a nominal value of at least EUR1,000 since the calling of the relevant bondholder meeting.
- In the absence of a grave violation of the law, the disadvantages resulting from the non-implementation of the resolution for the issuer and bondholders outweigh the disadvantages for the claimant if the resolution is implemented.

As a rule, the appellate court must hand down its decision within three months from the date on which the petition was filed. In urgent cases, a decision can be handed down without having an oral hearing. The decision of the appellate court is non-appealable.

Whether the ability of minority bondholders to block the implementation of bondholder resolutions will compromise successful restructurings of issuers largely depends on the appellate courts':

- Interpretation of their power to issue implementation orders based on the interests of the issuer and the bondholders outweighing the interests of the claimant.
- Ability to issue implementation orders in a short time, given the potential obligations of the issuer's directors to file for insolvency within 21 days of their corporation's illiquidity or over-indebtedness.

It is not possible to evaluate the situation, due to the limited number of court decisions available. For comparison, in relation to implementation orders in connection with shareholders resolutions (where the same mechanism applies), courts appear to be reluctant to issue implementation orders based on the issuer's outweighing interests and the average duration of implementation order proceedings is about 90 days.

Given a director's obligation to file for insolvency, the 90-day duration of implementation order proceedings may be problematic. However, whether this justifies the calls for a comprehensive abolition of the possibility to challenge bondholder resolutions is doubtful. If practical experience shows that the 90-day duration is problematic, a legal reform should aim at making the rules on the implementation order more effective, in particular by:

- Widening the courts' discretion to issue implementation orders.
- Adjusting the procedural rules for implementation orders.

Consequences of successful challenges

A successful challenge of a bondholder resolution renders that resolution void, so that it does not retroactively have any legal effect. However, if the resolution was implemented on the basis of an implementation order (for example, if the bond terms have been amended), a successful challenge does not affect the implemented actions. However, the issuer must compensate bondholders who have successfully challenged the resolution for any losses that have been caused by the implementation of the illegitimate resolution. These losses include the claimants' legal expenses and any other pecuniary loss that the illegitimate resolution caused. For example, if a resolution was passed to reduce the principal amount of the bonds, the issuer must compensate for the amount of the reduction and any consequential losses, such as loss of interest. Bondholders who have not challenged the relevant resolution are not entitled to damages.

INCLUSION OF "OLD BONDS" UNDER THE 2009 ACT

The 2009 Act applies to all bonds that are governed by German law and which were issued on or after 5 August 2009 (*see above, The scope of application of the 2009 Act*). German law governed bonds issued before 5 August 2009 by a German issuer remain subject to the 1899 Act. However, bondholders can, with the issuer's consent, opt for the 2009 Act to apply to these bonds, to benefit from the restructuring options available under the 2009 Act. An opt-in requires a bondholder resolution with a majority of 75% of the participating votes.

Nearly all German law governed bonds issued before 5 August 2009 were issued by non-German entities and were therefore not governed by the 1899 Act. Therefore, the lack of clarity of the 2009 Act's opt-in provisions has triggered extensive discussions as to whether the opt-in procedure is also available to the holders and issuers of these bonds. German courts addressed this question in the restructurings of the Q-Cells group and the Pfleiderer group. Both groups issued bonds through their respective Maltese and Dutch subsidiaries before 5 August 2009 and were seeking to restructure these bonds by relying on the opt-in procedure under the 2009 Act. The requisite majority of bondholders approved the companies' opt-in proposals and subsequent changes to the bond terms. However, a few bondholders filed complaints against the bondholders' resolutions, arguing that the opt-in procedure could not be applied to bonds issued by non-German issuers before 5 August 2009. In both situations, an otherwise consensual restructuring was blocked, which resulted in insolvency filings (*see box, Pfleiderer and Q-Cells decisions*).

These decisions appear to be a significant step back for out-of-court bond restructurings in Germany, in particular for bonds issued by non-German issuers. It is unclear whether the legislator will take action in relation to this.

Under the 2009 Act, the regional court of Frankfurt is the competent court for all actions relating to the challenge of bondholder resolutions relating to bonds issued by non-German issuers. Therefore, the Frankfurt court of appeal is the competent court for all implementation orders relating to these bonds, including bonds issued before 5 August 2009. It is therefore unlikely that the position regarding opt-in for old bonds by non-German issuers will change in the short term. The situation is slightly different for bonds with split jurisdiction clauses, as the Frankfurt court of appeal has left this question open.

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