

LEGAL ANALYSIS

LEGISLATIVE DEVELOPMENTS & CASE REVIEWS

Reform of the German Bond Act and its Impact on the German Debt-Capital Market

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Introduction

On August 4, 2009 the Act to Reform Collective Bond Offerings and Enforcement of Investors' Rights¹ was published in the *Federal Gazette* and became effective the following day. The Reform Act implements three objectives of the German legislation: first, to adjust German capital-markets law to recent developments in international bond offerings, particularly with respect to entitling the bondholders to a more active participation in debt restructurings during a crisis of the bond issuer. Secondly, to improve the rights of bondholders by imposing certain transparency requirements on the terms and conditions of the bond offering. Thirdly, to improve the rights of individual investors in securities if such securities have been purchased upon investment advice. While the first and second objective of the Reform Act set forth above—the establishment of a new framework

1. *Gesetz zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung* (Bundesgesetzblatt, 2009), pp.2512 et seq. (the "Reform Act").

for German bond offerings—has been the result of several years of deliberation, finally resulting in a complete replacement of the former legal regime for German bonds,² the third objective—improvement of investor protection—has been included in the Reform Act only a few months before its enactment.³ Consequently, this article will focus on the major objectives of the Reform Act and outline the essential features of the new legal framework for German bond offerings, which, among other things, expands the possibilities for bondholders to vote on certain issues by majority vote, thus facilitating changes to the terms and conditions of a bond offering.

The former legal regime for bonds

Background

Article 1 of the Reform Act replaced the Act on Joint Rights of Bondholders of December 4, 1899 (the "Old Bond Act")⁴ with the New Bond Act. The Old Bond Act did not achieve significant practical relevance for the reasons set forth below and was widely seen as obstacle to attract more domestic as well as international bond activity in the German debt-capital market.

Shortcomings of the Old Bond Act

According to the German legislation, there were three main shortcomings of the Old Bond Act⁵: first, it only applied to German-law bond offerings by issuers with its principal corporate seat registered in Germany and thus excluded German-law bond offerings by foreign issuers. In other words, as soon as a bond offering involved at least one foreign entity as issuing entity,

2. See art.1 of the Reform Act (the "New Bond Act").

3. See art.2 of the Reform Act; in particular the Reform Act improves the enforceability of claims in the event of mis-selling by increasing obligations to document investment advice provided and by extending the period of limitations for claims for damages in the event of misleading wrong advice; for further details, see Podewils, *Das Gesetz zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung* (DStR, 2009), pp.1914 et seq.; Leuring and Zetzsche, "Die Reform des Schuldverschreibungs- und Anlageberatungsrechts—(Mehr) Verbraucherschutz im Finanzmarktrecht?" (2009) NJW 2856.

4. *Gesetz betreffend die gemeinsamen Rechte der Besitzer von Schuldverschreibungen* (Reichsgesetzblatt, 1899), pp.691 et seq. (the "Old Bond Act").

5. For a discussion of the Old Bond Act, see Podewils, *Das Gesetz zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung*, 2009; Horn, *Das neue Schuldverschreibungsgesetz und der Anleihemarkt* (BKR, 2009), pp.446 et seq.; Hutter, "Anleihen" in Habersack, Mülbart and Schlitt, *Unternehmensfinanzierung am Kapitalmarkt*, pp.418, 450 et seq.

the bondholders of such offering or tranche could not invoke the Old Bond Act for their collective restructuring initiatives.

Secondly, the Old Bond Act only permitted rights of bondholders to resolve changes to the terms and conditions of the bond offering “to avoid suspension of payments or insolvency proceedings” of the issuer. The changes to the terms were limited to reductions of interest and deferment of the principal payment for a maximum of three years. Such restrictions, however, proved to be impracticable since the implementation of a successful debt restructuring, will often require partial waivers of principal payment or even full waivers of principal payment (e.g. in case of a debt-for-equity swap); also, if insolvency is already imminent, it may be too late to carefully plan and negotiate a restructuring, particularly if the issuer either may or must file for insolvency according to ss.17, 18 and 19 of the German Insolvency Code.⁶

Thirdly, the procedural rules contained in the Old Bond Act were outdated and did not conform to international standards. For example, to convene a meeting of the bondholders, one had to rely on mailings and could not use modern communication technologies like email, internet, etc. Further, the requirement to deposit the bond certificates prior to a bondholders’ meeting does not reflect customary international market practice as nowadays bonds would usually be evidenced by global certificates kept by a custodian.

The new legal regime for bonds

Scope of application

While the Old Bond Act only applied to issuers with its principal corporate seat registered in Germany, the New Bond Act shall in principle be applicable to all bonds⁷ issued under German law on or after the day the New Bond Act became effective. However, covered bonds (*Pfandbriefe*)⁸ as well as bonds issued

6. Under the German Insolvency Code (*Insolvenzordnung* (“InsO”)), insolvency exists in the cases of: (i) illiquidity (s.17 InsO); (ii) impending illiquidity (s.18 InsO) or overindebtedness (s.19 InsO); management of debtor must file for insolvency within three weeks pursuant to s.15a InsO; s.18 InsO allows management of debtor to seek protection of the German Insolvency Code; creditors are also entitled to file under s.17 InsO or s.19 InsO. Pursuant to s.19 para.1 of the New Bond Act all resolutions of the creditors and bondholders are subject to the German Insolvency Code unless set forth otherwise in s.19 paras 2–5.

7. According to the published legislative reasoning, the New Bond Act shall apply to all types of debt securities, including so-called certificates (*Zertifikate*) and options. This means that it is also applicable to medium-term notes, commercial papers, convertible bonds as well as derivatives as long as they are securitised.

8. Covered bonds (*Pfandbriefe*) are regulated by the Covered Bond Act (*Pfandbriefgesetz*). Such Act provides for special statutory liquidation procedures; covered bonds do not accelerate automatically upon the issuer’s insolvency.

or guaranteed by the public sector are exempted from its applicability.

Transparency

The New Bond Act requires the terms and conditions of notes to be drafted in a manner which enables an investor who is knowledgeable about the relevant type of notes to determine the issuer’s obligations.⁹ According to the published legislative reasoning, such transparency requirement has been included in the New Bond Act in light of the financial crisis which demonstrated that the risks of highly complex products were not comprehensible for many investors since the terms and conditions of the relevant securities did not allow the investors to determine under what conditions and to what extent the issuer’s duty to perform would be limited.

Collective action clauses

In recent years, it has become customary practice in the international debt-capital markets, to modify the terms and conditions of a bond offering during the crisis of the issuer and to actively include the bondholders in any debt restructuring efforts. The respective provisions enabling the bondholders to change the terms and conditions of a bond offering with majority vote, to appoint a trustee for the bondholders and to conduct any other fundamental actions with respect to the bonds are called collective action clauses (CACs).

While previously it was questionable whether such CACs are in compliance with German law, the New Bond Act now specifically sets forth in s.4 that terms and conditions of a bond offering can either be changed through agreement with all bondholders or pursuant to ss.5 to 22 of the New Bond Act. In the implementation of such CACs, the issuer shall ensure equal treatment of all bondholders. The collective effect prohibits bilateral agreements between the issuer and an individual bondholder. This concept of collective effect is justified by the character of bonds as fungible securities. CACs are of particular relevance during the crisis of the issuer as long as an insolvency proceeding has not yet been commenced. In this scenario, the bondholders as creditors of the issuer have the opportunity to actively participate in any restructuring efforts and possibly prevent an insolvency of the issuer.¹⁰ Upon commencement of

Instead, they will be satisfied according to the conditions of the issue and they will be repaid at the time of their contractual maturity. Holders of covered bonds enjoy a preferential treatment insofar as the Covered Bond Act stipulates the separation of the cover assets on the one hand and the insolvency estate on the other hand.

9. See s.3 of the New Bond Act.

10. Podewils, *Das Gesetz zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung*, 2009.

insolvency proceedings, according to s.19 para.1 of the New German Bond Act, all resolutions of the creditors and bondholders are subject to the German Insolvency Code unless set forth otherwise in s.19 paras 2 to 5 of the New German Bond Act.

With respect to debt-for-equity swaps, which are often used by distressed bond issuers to accomplish a restructuring, it must be noted though that the approval by the bondholders pursuant to a CAC itself is not sufficient. In addition, the shareholders of the bond issuer must also resolve such debt-for-equity swap, including the authorisation to issue equity to the bondholders.¹¹ Finally, an issue the New Bond Act did not address in its provision on CACs, is how these are affected by unilateral reservation clauses of the bond issuer to change the terms and conditions or make certain determinations. Such unilateral reservation clauses are customary in international bond offerings. If applying the concept of collective effect of the New Bond Act to such unilateral reservations by the bond issuer one could come to the conclusion that unilateral reservations are prohibited since they neither constitute an agreement with all bondholders nor a resolution pursuant to ss.5 to 22 of the New Bond Act. However, when reviewing the published legislative reasoning, no such interpretation can be found, as a matter of fact, the entire reasoning does not even mention the issue of unilateral reservations. Thus, one probably would have a stronger argument to conclude that unilateral reservations by the bond issuer are not prohibited by the New Bond Act.

Rights of bondholders

Resolutions

In contrast to the former regime, the provisions on bondholders' resolutions provided for in the New Bond Act¹² are only applicable if expressly specified in the terms and conditions of the relevant notes. If the provisions on bondholders' resolutions of the German Bond Act are applicable to the bonds at hand, holders of such bonds may modify their terms and conditions by majority vote. Thus, specific provisions on bondholders' resolutions of the German Bond Act provide a framework which can be further developed in the terms and conditions of the relevant bonds.

The terms and conditions may only deviate from ss.5 to 22 of the New Bond Act to the disadvantage of the bondholders as far as expressly provided in the New Bond Act. In any event, an obligation of

the bondholders to perform may not be imposed by way of majority resolution of the bondholders. A resolution passed with the required majority vote will be binding upon all bondholders and shall ensure an equal treatment of the bondholders of the relevant bonds; however, where a resolution does not provide for equal terms for all bondholders it shall not be effective unless the affected bondholders expressly approve such discrimination.

As a rule, bondholders may pass resolutions with simple majority of the votes casted. Resolutions which materially amend the terms and conditions require a majority of at least 75 per cent of the votes casted (a "qualified majority"). In particular, resolutions related to the following issues must be passed with a qualified majority: (i) the modification of the maturity of interest, the reduction or the exclusion of interests; (ii) the modification of the maturity of principal; (iii) the reduction of principal; (iv) the subordination of the claims under the bonds during insolvency proceedings of the issuer; (v) the conversion or exchange of the bonds in the company shares, other securities or other promises to perform; (vi) the replacement and release of collateral; (vii) the change of the currency of the bonds; (viii) the waiver or limitation of the bondholders' right of termination; (ix) the substitution of the issuer; and (x) the modification or repeal of ancillary provisions relating to the bonds as well as such other measures as specified in the relevant terms and conditions.

The abovementioned topics contained in s.5 para.3 of the New Bond Act may be limited by the terms and conditions of the bonds that may also expressly exclude some matters from the scope of bondholders resolutions, for example, in the case of bonds where the substitution of the issuer shall be permissible without the consent of the bondholders.¹³

The bondholders may pass resolutions either in a physical bondholders' meeting or by voting without meeting. The applicable voting procedure of the relevant bonds will either be specified in the relevant terms and conditions or will be determined on the basis of the convocation to the bondholders' meeting or of the vote request, in the event of voting without meeting.

Voting rights

The voting rights of a bondholder shall be determined on the basis of the nominal amount or, as the case may be, proportionally by reference to the outstanding bonds. The right to vote is suspended as long as the bonds appertain to the issuer or companies connected with it or are considered to be held for account of the issuer or a company connected with it.

11. Depending on the type of legal entity of the bond issuer—stock corporation (*Aktiengesellschaft* (AG)) or closely held corporation (*Gesellschaft mit beschränkter Haftung* (GmbH)), the procedures for shareholder action resolving a debt-for-equity swap and the issuance of equity as fundamental corporate changes are set forth in the German Stock Corporation Act (*Aktiengesetz*) and the German GmbH Code (*GmbH-Gesetz*) respectively.

12. New Bond Act ss.5–22.

13. The majority requirements set out in the New Bond Act only provide for minimum requirements. The terms and conditions may set forth that certain or all amendments to the terms and conditions require a greater majority, but in no case a lesser majority.

Convening of bondholders' meetings

A bondholders' meeting may be convened by the issuer or by the common representative of the bondholders. Under certain circumstances further specified in the New Bond Act or, as the case may be, as provided in the relevant terms and conditions, a bondholders' meeting has to be convoked if this is requested by bondholders representing 5 per cent of the outstanding bonds and that are able to prove a particular interest for example the appointment or the dismissal of a common representative.¹⁴ The bondholders' meeting shall be convoked at least fourteen days before the date of the meeting.¹⁵

Entitlement to vote

Only such persons (or proxies) that at the time of the voting can claim the rights under the bonds shall be entitled to vote. The entitlement to participate in the consultation and voting procedure shall be evidenced pursuant to the requirements set out in the terms and conditions of the bonds. According to the published legislative reasoning however, these must be limited to requirements which are essential to determine the identity and the entitlement of the individual bondholder. With regard to bonds represented by a global bond certificate, a written certificate issued by the bank or financial institution documenting that the bondholder maintains a securities account in respect of the bonds will be sufficient evidence of the entitlement unless otherwise provided by the terms and conditions.

Venue of meeting

Pursuant to the New Bond Act¹⁶ for such issuers having their registered office in Germany the bondholders' meeting shall take place at the place where the issuer has its registered office or if the relevant bonds are admitted to trading on an exchange within the meaning of s.1 para.3e of the German Banking Act (*Kreditwesengesetz*) based in a member state of the European Union or in another state of the European Economic Area, the bondholders' meeting may also be held at the place where such exchange has its registered office.

Notice of meeting

The notice of a bondholders' meeting must indicate the name, the registered office of the issuer, the time

and place of the bondholders' meeting as well as the conditions for participation to the meeting and exercise of the voting rights. The notice must be published in the *German Electronic Federal Gazette (Elektronischer Bundesanzeiger)*. The terms and conditions may specify other means of publication. In any event, the convocation as well as the conditions for attendance to the meeting and exercise of the voting rights must be made available to the bondholders of the relevant notes by the issuer via publication on its website or, on such other website specified in the terms and conditions, from the day of the convocation until the day of the meeting. The costs for the publication are borne by the issuer.

The meeting agenda

The agenda of the meeting shall be published together with the notice, including a proposed resolution for each item subject. No decisions shall be made with respect to items of the agenda that have not been published as set forth above. Bondholders representing 5 per cent of the outstanding bonds may demand that new matters for decision-making shall be made publicly available. Such new matters must be published on the third day before the date of the meeting at the latest. Counter-motions announced by any bondholder prior to the meeting must be made available to the bondholders by the issuer without undue delay until the day of the meeting on its website or on such other website specified in the terms and conditions.

Appointment of proxies

The notice shall make reference to the possibility of each bondholder to be represented in the bondholders' meeting by proxy, also indicating the requirements for a valid representation by proxy. The proxy shall be presented in writing.

Quorum

In the bondholders' meeting the chairperson will prepare a register of the bondholders that are present or represented by proxy.¹⁷ The register will be signed by the chairperson and made available to all bondholders without undue delay. The bondholders' meeting shall be quorate if the bondholders that are present in the meeting represent at least 50 per cent of the outstanding bonds. If the meeting does not have a quorum the chairperson may convene a second meeting. Such second meeting does not require a quorum. For resolutions requiring a qualified majority the bondholders that are present shall represent at least 25 per cent of the outstanding bonds. However, the terms and conditions of the bonds may include higher quorum requirements.

17. The convening party shall chair the bondholders' meeting unless the court has appointed another chairperson.

14. This requirement is similar to the one set forth in s.122 para.1 of the German Stock Corporation Act (*Aktiengesetz*) for convening a shareholder meeting.

15. The terms and conditions can prescribe that a registration is required in order to participate in a bondholders' meeting or to exercise any voting rights. In this case the notice period shall take into account the registration period. The registration has to be submitted on the third day prior to the bondholders' meeting at the latest and shall be sent to the address which has been provided in the notification of convocation of the bondholders' meeting.

16. New Bond Act s.11.

Information rights

Unless otherwise provided by the terms and conditions of the bonds, the relevant provisions of the German Stock Corporation Act (*Aktiengesetz*) for voting of the shareholders in the general meeting of shareholders (*Hauptversammlung*) shall be applicable mutatis mutandis to voting and the count of votes. In order to be valid, any resolution shall be recorded by a notary in the minutes of the meeting, a copy of which may be requested by each bondholder present or represented by proxy in the bondholders' meeting within one year of the date of the meeting.

Publication of resolutions

Resolutions passed by the bondholders shall be published by the issuer in the *Electronic Federal Gazette*. Any bondholders' resolutions amending the terms and conditions of the bonds must be published by the issuer on its website or on another website as specified in the terms and conditions of the bonds, together with the initial wording of the terms and conditions for a period of at least one month commencing on the day following the bondholders' meeting.

Voting without a physical meeting

The legislator has introduced the possibility to vote without conducting a physical meeting in order to prevent unnecessary burdens for the bondholders in certain circumstances. Unless provided otherwise in the New Bond Act, the provisions on the notice and procedure of an ordinary bondholders' meeting shall apply mutatis mutandis. The requirements of participation and voting may be stipulated in the terms and conditions of the notes or specified in the relevant vote request. Such vote request shall indicate the voting period that shall be no shorter than 72 hours.

Votes shall be casted in writing but the terms and conditions may also provide for other forms of voting.

The entitlement to participate in the consultation and voting procedure shall be evidenced in the same manner as in the case of an ordinary bondholders' meeting. A list of bondholders entitled to vote shall be prepared by the chairperson. If no quorum exists, an ordinary bondholders' meeting will be convened that shall be considered as a second bondholders' meeting with respect to a quorum. A minute in relation to each voting shall be prepared. Each bondholder who participated in the voting may request a copy within a period of one year after the voting period. After publication of the resolution each bondholder that participated in the voting may object to the result of the voting within a period of two weeks after the publication of the resolution.

Challenges of resolutions

A bondholders' resolution may be contested by an action for breach of applicable German law or the terms and conditions of the bonds at hand.¹⁸

18. Any action must be brought against the issuer within one month after the publication of the resolution. Where the

Furthermore, a bondholders' resolution may also be challenged based on incorrect or incomplete information or a refusal to divulge information. However such a challenge is only admissible, if an objectively judging bondholder would have considered the information as an essential condition for the voting.

A bondholder is entitled to challenge a resolution: (i) if he has taken part in the vote; and (ii) declared opposition against the resolution on time; and (iii) if he had bought the bond before the notice convening the meeting was published. Furthermore any bondholder who has not participated in the vote is entitled to challenge a resolution where: (i) he is wrongly refused to vote; or (ii) if the meeting was not duly convened; or (iii) the vote was not duly requested; or (iv) the subject of a resolution was not duly published.

Common representative

Pursuant to the New Bond Act the terms and conditions of the bonds may designate a common representative of the bondholders or allow the appointment of such common representative by the bondholders for the purpose of exercising their rights. The appointment of the common representative can also be made in the terms and conditions of the bonds. In this case, however, special requirements may apply.

Criteria for the eligibility the common representative

Any person having legal capacity or any knowledgeable legal entity¹⁹ can be appointed as a common representative. In order to prevent conflicts of interests, the appointment of persons belonging to the sphere of interest of the issuer is subject to specific disclosure requirements, namely it is required that the person discloses that he belongs to the following persons: (i) members of the board or employees of the issuer or of any of the issuer's affiliates; (ii) shareholders' holding at least 20 per cent in the share capital of the issuer or of any of the issuer's affiliates; (iii) financial creditors of the issuer or of any of the issuer's affiliates with claims of at least 20 per cent of the outstanding bonds issued as well as board members or staff of these financial creditors; and (iv) persons who are subject to the influence of such persons as a result of a special personal relationship.

Where the common representative is appointed in the terms and conditions certain limitations apply. The appointment of a member of the management board, of the supervisory board, administrative board or similar, of an employee of the issuer or of one of its affiliates shall be void.

action is brought against a domestic issuer, the regional court in the district where the issuer has its registered office shall have exclusive jurisdiction. Actions in respect of issuers that do not have a registered office in Germany will be heard by the regional court of Frankfurt am Main which shall have exclusive jurisdiction.

19. For example, law firms or audit firms.

Where such other persons belonging to the sphere of interest of the issuer as specified above are appointed in the terms and conditions the relevant circumstances shall be disclosed in the terms and conditions.

The common representative shall have the duties and capacities assigned to him by the New Bond Act (such as to convene a bondholders' meeting) or those assigned to him by the bondholders by majority vote or as specified in the terms and conditions. The common representative must follow the bondholders' instructions. However as far as the common representative has been empowered to assert rights of the bondholders, no bondholder shall have the right to assert these rights on his own unless the majority vote provides differently. The common representative has the right to demand from the issuer to be provided with all such information required for the performance of its duties.

The common representative shall be liable to the bondholders for the proper performance of his duties. He has to apply the diligence of a prudent and conscientious business manager. His liability may be limited by resolution of the bondholders or, to a certain extent, in the terms and conditions. The New Bond Act specifies that the terms and conditions of the bonds may limit the liability of the common representative of the bondholders to ten times of the amount of its annual remuneration except in case of willful misconduct (*Vorsatz*) or gross negligence (*grobe Fahrlässigkeit*) of the common representative.²⁰

Outlook

The New Bond Act has accomplished its primary goal to provide a legal framework for German-law

governed bond offerings that enables offerings reflecting customary international practice, particular with respect to collective action clauses. Such CACs are of particular relevance in the crisis of a bond issuer and significantly facilitate the participation of the bondholders in a debt restructuring preventing an insolvency of the bond issuer. Therefore, the New Bond Act should attract more bond offerings from companies in need for financing and increase the importance of the German debt-capital market, also with respect to its Anglo-American competitors. Further, the new transparency concept seems well-drafted, protecting investors on the one hand, and not unduly burdening issuers on the other hand.

In terms of critique, there are two observations. First, the omission of unilateral reservation clauses of the bond issuer in the concept of collective effect leaves some degree of legal uncertainty. Secondly, the establishment of a right of minority bondholders to contest resolutions of the majority of bondholders seems to ignore the difficulties of a comparable concept of the German Stock Corporation Act has caused. However, in practice the effect of both issues could likely be minimal and not outweigh the significant advantages of the New Bond Act for the following reasons: the issue of unilateral observations can practically only be resolved in such manner that they are still permitted by the New Bond Act. This analysis is supported by the fact the New Bond Act does not expressly prohibit unilateral reservations. The issue of minority bondholders will have to be dealt with by the courts which—like in the case of the German Stock Corporation Act—should be able to develop case law that appropriately limits the impact of minority bondholder action.

20. See s.8 para.3 of the New Bond Act.