RESTRUCTURING OF CORPORATE BONDS
REQUIREMENTS OF THE NEW 2009 BOND ACT (SCHULDVERSCHREIBUNGSGESETZ)

INTRODUCTION

The new Bond Act came into force on 5 August 2009. In addition to the new Bond Act, the Bond Act dating from the year 1899 will also remain in effect. It is intended – in the case of issuing made after 5 August 2009 – to replace the "old" Bond Act and, at the same time, provides for the possibility of applying the "new" Bond Act to "old" corporate bonds through a resolution adopted by a majority of bondholders ("opt-in resolution").

The "old" Bond Act had only become important in practice in recent years. Its importance started with the debt-equity swap involved in the case of EM.TV Merchandising AG, which was followed by the Deutsche Nickel AG, Augusta Technologie AG and Rinol AG cases, as well as others. This was, however, of only limited importance in actual practice, since the previous Bond Act applied only to bonds issued by a company having its seat or a permanent establishment in Germany. The old Bond Act did not cover the frequently-occurring case of bonds of subsidiaries – usually located in the Netherlands – that were backed by a guarantee from the German parent company.

The essence, and at the same time weakness, of the old Bond Act can be described as follows:

No change to the principal/face value ("haircut") was possible, nor was any change permitted to be made to the security interest. The only possibility involved (limited) change in the interest rates due to the bondholders, which meant the effect achieved in terms of restructuring was only slight, and in many cases not sufficient for the envisaged restructuring.

Under previous law, actions against the validity of resolutions had no collective effect, i.e., the legal force of an (issued) judgment applied only to the relationship between the bondholder bringing the action and the company. The new Bond Act was also intended to eliminate this weakness.

MAJOR CHANGES

Under the 2009 Bond Act, the indenture may be modified by a majority resolution of creditors if and to the extent the indenture provides for such modification. Such legal basis is a prerequisite for any subsequent modification of indentures.
Impending insolvency – or even a reason for insolvency – is, on the other hand, not necessary for the application of the 2009 Bond Act.

The 2009 Bond Act lists examples of restructuring measures, which listing is not, however, exhaustive: the extension of the term of a corporate bond, modification of interest, a change in the principal amount and subordination are possible. In addition, conversion of bonds into shares in the company or an exchange for such shares (debt-equity swap) is possible if the bondholders adopt a resolution to that effect. This applies accordingly to the exchange and release of securities. It should also be pointed out that the right of bondholders to declare an event of default may be eliminated or abridged.

PREPARATION AND FORMULATION OF THE BONDHOLDER RESOLUTION

Resolutions must be adopted at a meeting of bondholders and – if major changes in the indenture are involved, in particular a modification of the rights of bondholders – by a majority of at least 75% of the votes cast.

A quorum is considered to be present at the meeting of bondholders if at a first meeting at least 50% of the voting rights (of bonded debt) are represented or if at a – subordinate – second meeting at least 25% of the voting rights (of bonded debt) are represented. Ultimately, it is therefore possible – with the right construction – to achieve modification of the major terms and conditions of an indenture with as little as 18.75% of all voting rights. In addition, the new Bond Act provides that the indenture may rule that circular resolutions are possible. What has not been clarified is what specific risks of successful avoidance actions can result from such a vote held without a meeting, in particular if and to the extent that the rights of each bondholder cannot be adequately exercised or taken into account.

REVIEW OF RESOLUTIONS / POSSIBILITY OF DELAY DUE TO ACTIONS TO SET THE RESOLUTION ASIDE

According to section 20 of the new Bond Act, a resolution adopted at a meeting of bondholders may be challenged due to a violation of the law or the terms of the indenture.

The authority to initiate an avoidance action, the period within which an action may be brought and the formalities for filing such an action are regulated by rules similar to the provisions regarding avoidance actions against resolutions of the stockholders' meeting.

An action to set aside a resolution may be based on formal deficiencies, for example, on the violation of the right of bondholders to speak and ask questions modeled on the provisions of law governing stock corporations. The Bond Act does not prescribe the substantive prerequisites for the alteration of bondholders' rights. Whether and the extent to which judicial review will take place therefore remains to be seen for the time being.

According to the second half of sentence 3 section 20(3) of the 2009 Bond Act, initiation of an action to set aside a resolution triggers a suspension of the amendment process. The problem is made more serious by the fact that there is no limit as to the time during which bondholders can join the action, which creates significant potential for obstruction. The Bond Act makes no provision for the mandatory announcement of such actions (thereby limiting the possibility of joining the action to a specific period of time).

This suspension of the amendment process, which can therefore prove very inconvenient in certain circumstances, can be overcome only by means of what is referred to as a release order from the competent Regional Court (Landgericht).

The release procedure is modeled on the corresponding provisions of law governing actions to set aside resolutions, for example, in the case of capitalization and transformation measures. However, the revisions of the Act Implementing the Shareholders' Rights Directive (Gesetz zur Umsetzung der Aktionärsrechterichtlinie – ARUG) have up to now not been incorporated into the Bond Act. For example, the Regional Courts remain the courts of first instance in the proceedings regarding the release order.

A release order is issued if an action to set aside a resolution is inadmissible or obviously unjustified or if a company against which such an action is brought has an overriding interest in the adoption of the proposed measures. This can, for example, be the case when restructuring is necessary in order to rehabilitate a business.

APPROACH TO RESTRUCTURING CASES IN ACTUAL PRACTICE / REDUCTION OF RISK OF ACTIONS TO A MINIMUM

As a rule, the restructuring of a bond issue through the alteration of the rights of the bondholders will be carried out in connection with other rehabilitation measures. In this context, the following options are available for accelerating the process and avoiding the risk of actions to set aside resolutions:

VOTE WITHOUT MEETING (SECTION 18 OF THE BOND ACT)

The first possibility is to opt for a vote without a meeting as provided for by section 18 of the Bond Act. This procedure must, however, be provided for in the indenture or – by way of an opt-in resolution – included in the indenture at a later date. A vote without a meeting is not only more expedient, but also minimizes the grounds for challenging a resolution (e.g., ostensible breach of disclosure duties).

RESTRUCTURING CONCEPT

As well, a restructuring concept should also be prepared so that in the case of a dispute, it is possible to document and prove or convincingly argue that the modification of the rights of bondholders is necessary to rehabilitate the business of the issuer and that the burden imposed upon bondholders in connection with the rehabilitation is reasonable in and of itself and also when compared with that borne by other classes of creditors.

CONTACT WITH BONDHOLDERS / COMMUNICATION THROUGH A COMMON REPRESENTATIVE

Before a meeting is convened, the issuer should contact major bondholders in order to secure the necessary majority. Experience shows that it is also very helpful if the "big" bondholders express support for the restructuring concept of which the alteration of the rights of bondholders is a part.

A common bondholder representative will frequently be necessary. In that respect, it is necessary to approach potential candidates. The common representative is – depending upon the powers invested in the representative – authorized to issue statements for and against all bondholders such as, for example, (limited) waivers of the right to declare an event of default, etc.

FORMULATION OF OPT-IN RESOLUTION

The next step is to formulate what is referred to as the opt-in resolution pursuant to section 24 of the Bond Act if the bond in questions was issued prior to the 5 August 2009. The provisions of the new Bond Act already apply to opt-in resolutions. In this context, the provisions of the indenture must also be amended to permit certain changes in the rights of bondholders.

FORMULATION OF THE ACTUAL RESOLUTION

After the indenture has been amended accordingly, certain rights of the bondholders (haircut, reduction of interest, exclusion of possibility to terminate, extension of term, etc.) can then be altered through a second resolution. A debt-equity swap is also feasible, and experience also shows that bondholders prefer this solution, which gives them an opportunity to benefit from the possibility of a successful outcome to the process of rehabilitation of the business.

DR. OLIVER WILKEN / DR. KLAUS FELKE

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