

## Impact of the Draft German Bill on Issuer-Bondholder Relationships on Convertible and Exchangeable Bond Offerings

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In June 2008, the Federal Ministry of Justice (“FMJ”), published a Draft Bill of a Law on Legal Relationships Regarding Bonds and Amendments to the Statute of Limitations in the Area of Capital Markets Law (*Referentenentwurf eines Gesetzes zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Anleihen und zur Anpassung kapitalmarktrechtlicher Verjährungsvorschriften*, the “Draft Bill”). The Draft Bill sets out proposals for the long-awaited reform of the German Act on the Joint Rights of Bondholders of 1899 (*Gesetz betreffend die gemeinsamen Rechte der Besitzer von Schuldverschreibungen*, the “Bondholders Act”). In particular, the Draft Bill proposes a comprehensive set of rules for so-called collective action of bondholders. As a general rule, any amendment to the terms and conditions of a certain issuance of bonds needs to be agreed between the issuer and each and any holder of such bonds. Reaching such agreements is hardly practicable, irrespective of the form of the bonds, but virtually impossible in the case of bearer bonds where the issuer will not be able to identify each bondholder. Collective action clauses or rules facilitate such agreement by means of authorizing a certain majority of bondholders to agree to amendments to the terms and conditions of bonds that together form a single issuance with legally binding effect for and against all holders of such bonds, including those bondholders who voted against the amendment.<sup>1</sup>

The Draft Bill explicitly provides that it shall be applicable to any type of (German-law governed) bonds, except for German covered bonds (*Pfandbriefe*).<sup>2</sup> Since convertible bonds (and largely also exchangeable bonds, where the underlying consists of German shares) of German stock corporations are, as a practical matter, mostly governed by German law, these instruments will become subject to the new law, once

<sup>1</sup> By contrast, the U.S. Trust Indenture Act of 1939 („TIA“), which applies to SEC registered corporate bonds to a large extent prohibits collective action clauses. Section 316(b) TIA explicitly prohibits the impairment of the right of any bondholder to receive payment of the principal of and interest on such security without the consent of such holder. Pursuant to Section 316(a)(2) TIA an indenture may only contain provisions authorizing the holders of not less than 75% in principal amount of the bonds to consent on behalf of the holders of all such securities to the postponement of any interest payment for a period not exceeding three years from its due date.

<sup>2</sup> Although not entirely clear, we think that profit participation certificates (*Genussscheine*) should not fall under the proposed new law.

implemented.<sup>3</sup> This Memorandum summarizes some important features of the Draft Bill and their impact on convertible and exchangeable bond offerings.

#### 1. Tentative Schedule for the Implementation of the Draft Bill

The FMJ has solicited comments on the Draft Bill from market participants, which will be discussed at a hearing on September 22, 2008. As a next step, the Draft Bill is scheduled to be submitted to the Federal Parliament as early as this November. The new law may then come into force early next year, but in any event prior to the end of the current legislative period, which ends in September 2009.

#### 2. Current Law

As of today, collective action rules are set forth in the Bondholders Act. The Bondholders Act provides for a very limited scope of application of collective action of bondholders and, thus, bondholder collective action is currently of very limited practical relevance. Under the Bondholders Act, among other things, bondholder collective action may be taken only to avoid an imminent insolvency of a German issuer. Unless these requirements are met, amendments to the terms and conditions of bonds can only be effected by means of individual agreement between the issuer of the bonds and the individual bondholder.

#### 3. Important Features of the Draft Bill

The scope of application of the new law will no longer be limited to bond offerings by German issuers. Rather, the new law will also govern bond issuances of non-German issuers, including foreign subsidiaries of German companies. This means that convertible bonds issued by an, *e.g.*, Dutch or U.S. finance subsidiary of a German stock corporation would be subject to the new law, provided, however, that the bonds are governed by German law.

#### 4. Matters to be Resolved by Bondholder Collective Action

The Draft Bill does no longer limit the type of bondholder decisions suitable for collective action. Thus, a group of bondholders meeting certain quorum and majority requirements (see below) may bring about the consent to almost any amendments to the terms and conditions of a certain issuance of convertible or exchangeable bonds proposed by the issuer. To be clear, an amendment to the terms and conditions of the bonds needs to be agreed between the issuer and the bondholders. A majority resolution of the bondholders will only substitute the individual consent of each bondholder, not, however, the agreement of the issuer. Therefore, the Draft Bill does not empower

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<sup>3</sup> For the only example of a foreign law-governed convertible bond issued by a finance subsidiary of a German stock corporation, see Qimonda Finance LLC \$217,647,000 6.75% Senior Unsecured Convertible Notes due 2013 of February 2008 which are governed by New York law. The prospectus supplement for this offering can be found under <http://www.sec.gov/Archives/edgar/data/1369377/000095012908000729/f01901e424b2.htm>.

bondholders to unilaterally amend the terms and conditions of the bonds without the consent of the issuer. However, the ability of the bondholders to call a bondholder meeting and have certain matters put on the agenda of a bondholder meeting (see below) may be used to put significant pressure on issuers to propose certain amendments to the terms and conditions of bonds.

Among other things, as a general rule, a majority of Bondholders may, with effect for and against all bondholders, consent to (i) a postponement or waiver of interest payments, (ii) a postponement of the repayment of principal, (iii) a partial waiver of the repayment of principal, (iv) a subordination of the bondholders' rights to payment under the bonds in the insolvency of the issuer, (v) the swap of the bond against shares, other securities or other rights, (vi) an exchange and release of collateral, (vii) a currency conversion, (viii) a waiver or limitation of the bondholders' right of termination and (ix) a substitution of the issuer. Please note, however, that a majority vote imposing on bondholders payment or other substantial obligations beyond those initially set forth in the terms and conditions of the bonds, will be invalid. Similarly, a majority vote resulting in unequal treatment of bondholders will be invalid, unless each bondholder who would receive less favorable treatment than any other bondholder explicitly consents to such unequal treatment.

In the case of convertible bonds, any amendments to the terms and conditions relating to the conversion feature or the underlying shares of the issuer must be in line with the applicable requirements of the German Stock Corporation Act (*Aktiengesetz*, the "AktG") and existing corporate authorizations. For example, should the issuer wish to force conversion of a convertible bond (that is in the money), the bondholders can consent to an early redemption option of the issuer by means of a bondholder vote. Obviously, under normal circumstances, bondholders will only vote in favor of such amendment if the resulting loss of optionality is compensated by a cash payment or otherwise. Also, under the Draft Bill, it should be permissible to submit an increase of the conversion price (again, likely against compensation for the loss of optionality) to bondholder vote. However, an increased conversion price would often raise issues with respect to the shareholder resolution authorizing the issuance of convertible bonds (the "Convertible Bond Authorization"). Therefore, an increase of the conversion price may not be a suitable subject for amendment by means of collective action. By contrast, should an issuer's Convertible Bond Authorization and conditional capital be declared void by a court and the issuer adopt a new Convertible Bond Authorization and conditional capital with an issue price higher than the conversion price set forth in the terms and conditions of the bonds, the bondholders should be able to consent to an increase of the conversion price that would bring the conversion price in line with the terms and conditions of the bonds by means of a vote with the required (super-)majority.

It is common market practice for terms and conditions of convertible and exchangeable bonds to grant the issuer certain unilateral adjustment rights regarding primarily the conversion price, the conversion ratio or both. These adjustment rights are meant to preserve the economic value of the conversion right in case of dividend

payments, rights offerings and other capital measures, stock splits, etc. For the avoidance of doubt, since these adjustments are not intended to change the economic value of the payments to be made or the assets to be delivered compared to the situation at the time of issuance of the bonds, in our view, these unilateral adjustment rights of the issuer would remain unaffected by the collective action rules set forth in the Draft Bill.

Certain other amendments that may be possible from a collective action point of view, such as a subordination of the bondholders' right to payment of principal may adversely affect the bondholders' conversion right. In particular, under the German AktG the issuance of shares by the issuer of the convertible bonds or its parent company in the case of the issuance of the convertible bonds by a finance subsidiary, upon conversion of unsubordinated bonds is deemed a capital increase against cash contribution. By contrast, in the case of the conversion of subordinated bonds the rules on contributions in kind may have to be complied with.

#### 5. Effectiveness of Amended Terms and Conditions

Amendments to the terms and conditions of the bonds will only become effective if the bondholder resolution reflecting the amendments (i) is not void and (ii) has not been challenged in court by a bondholder within the statutory period based on a violation of the law (*e.g.* a violation of formal requirements applicable to the vote) or the terms and conditions of the bonds, or (iii) in case it has been challenged in court by a bondholder within the statutory period, it has been cleared for implementation by the competent court pursuant to Section 246a AktG.<sup>4</sup> In addition, the bondholder resolution needs to be implemented. Implementation means that, in the case of bonds represented by a global bond deposited with a central securities depository, the amendment resolution needs to be reflected in the wording of the terms and conditions of the bonds and, presumably, also that the amended terms and conditions be published on the issuer's website or in any other suitable form.

#### 6. Draft Bill Largely Mandatory

For the most part the provisions of the new law will be mandatory. In particular, the terms and conditions of the bonds cannot limit the scope of application of the new law. That means that within the scope of application of bondholder collective action, the terms and conditions of the bonds cannot stipulate majority requirements different from those set forth in the new law. Also, a bond issuer cannot amend the terms and conditions of the bonds by means of bilateral agreements with individual bondholders.

#### 7. Bondholders' Consent with or without a Bondholder Meeting

Collective action resolutions can be adopted (i) either at a bondholder meeting or (ii) without such meeting. In the Draft Bill, rules on bondholder meetings have been fundamentally revised compared to the Bondholders Act so that the minority bondholder

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<sup>4</sup> See numbered paragraph 7 below, in particular footnotes five and six.

rights regarding bondholder meetings largely mirror those of minority shareholders regarding shareholder meetings of German stock corporations. For example, (i) a quorum of 5% of the holders of a certain issuance of bonds can request a bondholder meeting and (ii) bondholders have the right to challenge collective action resolutions. As a general rule, collective action resolutions that have been challenged by bondholders before a competent court cannot be implemented until the decision of the court is no longer subject to appeal.

The Draft Bill prohibits the „purchase“ or „sale“ of a bondholder’s voting rights. More specifically, *i.e.*, someone who offers, promises or grants any advantages as compensation for a bondholder abstaining from voting or voting for or against a certain proposal will commit an administrative offense, as will a bondholder who requests or accepts such advantages, and may have to pay an administrative fine of up to EUR 100,000. However, this prohibition is unlikely to prevent bondholders from filing nuisance bondholder suits that delay or may even ultimately hinder the implementation of bondholder resolutions for the sole purpose of making the issuer pay for an out-of-court settlement of the dispute or the withdrawal of the bondholder suit. At least that has been the experience under the AktG, which also prohibits the „sale“ or „purchase“ of a shareholder’s voting rights.<sup>5</sup>

Special clearance proceedings will be available to a bond issuer if the issuer wants to implement a collective action resolution pending a bondholder suit challenging the resolution.<sup>6</sup>

The Draft Bill enters new territory by allowing the adoption of a bondholder resolution without a physical bondholder meeting. Bondholders can cast their votes by e-mail or in writing, whatever is specified in the terms and conditions of the bonds, including at a virtual bondholder meeting.<sup>7</sup>

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<sup>5</sup> The German legislator is currently attempting to address this issue through amendments to the rules of the AktG on special proceedings regarding the clearance of the registration of shareholder resolutions pending a shareholder suit, the so-called *Freigabeverfahren* pursuant to section 246a of the AktG. In particular, the criteria for a clearance of the registration are proposed to be clarified and a weighing of interests shall no longer be required if the plaintiff shareholder’s interest in the company is below a certain *de minimis* threshold.

<sup>6</sup> According to the Draft Bill, the rules on the special proceedings for the clearance of shareholder resolutions for registration in the commercial register pending a shareholder suit shall apply *mutatis mutandis*. This means that the competent court will have to decide whether the issuer is allowed to implement the bondholder resolution pending a bondholder suit challenging such resolution. The court will only decide that the bondholder suit does not interfere with the implementation of the bondholder resolution if the bondholder suit is obviously not admissible or without merit or if the interests of the issuer in the implementation of the resolution clearly outweigh potential disadvantages for the bondholders resulting from such implementation. The competent court will be the district court (*Landgericht*) at the place where the issuer has its registered office or, in case of a non-German issuer, the district court in Frankfurt am Main.

<sup>7</sup> Recently, the FMJ has taken a similar approach for shareholder meetings in its Draft Bill regarding the Implementation of the European Shareholder Rights Directive in Germany (*Referentenentwurf eines Gesetzes zur Umsetzung der Aktionärsrechterichtlinie (ARUG)*, the “ARUG”). Pursuant to the draft

## 8. Required Quorum and Majority

Collective action resolutions, whether adopted at a bondholder meeting or by consent without a meeting, require the following quorum and majorities.

Bondholders representing at least half of the outstanding principal amount of the bonds constitute a quorum. Generally, bondholder collective action resolutions require a majority vote of participating bondholders. The voting rights attributable to any bondholder are reflected by the principal amount of the bonds held by such bondholder compared to the aggregate principal amount of all bonds forming a single issuance together with such bondholder's bonds. Any changes of so-called "substantial terms and conditions"<sup>8</sup> will require a super-majority of 75% of participating bondholders.

The chairperson can call for a second meeting if a quorum cannot be established. Except for changes of essential terms and conditions no quorum will be required at this second meeting. Bondholders representing at least 25% of the outstanding principal amount of the bonds constitute a quorum for super-majority vote decisions at a second meeting.<sup>9</sup>

## 9. Other Important Features of the Draft Bill

The Draft bill also authorizes bondholders to appoint a common representative who can, among other things represent the bondholders in negotiations with the issuer and make information requests to the issuer. The common representative can be appointed by majority vote.

The terms and conditions of the bonds can provide for conclusive bondholder termination rights. If that is the case, bondholders will not have an additional right of termination for cause based on general principles of German contract law. The terms and conditions of the bonds can provide that the right of termination can only be exercised by bondholders together representing a certain minimum percentage of the principal amount of the bonds, such minimum not exceeding 25%.

Convertible bonds issued by a finance subsidiary are generally issued under a guarantee of the parent company. Unless the guarantee is an integral part of the terms and conditions of the bonds, the guarantee is not *per se* subject to amendment by collective action of the bondholders. However, if the terms and conditions of the bonds explicitly provide that the rules on collective action shall apply *mutatis mutandis* to the

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bill, shareholders will be able to participate in meetings and cast their vote online in the future. However, the ARUG will not eliminate altogether the obligation of a stock corporation to hold a physical meeting.

<sup>8</sup> The Draft Bill considers the terms and conditions dealing with the matters listed in numbered paragraph four of this Memorandum as being substantial. It does not provide for a conclusive list of substantial terms and conditions.

<sup>9</sup> Bondholders representing at least 18.75% of the outstanding principal amount of the bonds could, among other things, consent on behalf of all holders to the impairment of the right to receive payment of principal at maturity in a scenario like this.

guarantee, the bondholders can consent to amendments to the terms of the guarantee proposed by the guarantor by means of a bondholder resolution with the required majority.

10. Terms and Conditions as General Business Conditions?

At present, the scope of judicial review of the terms and conditions of bonds is still somewhat uncertain, depending on whether the terms and conditions of bonds qualify as general business conditions. For consumer protection purposes German courts closely scrutinize general business conditions. Although the legislative materials accompanying the Draft Bill show that the FMJ is aware of the open issue, the question has been left open intentionally. It would certainly be beneficial to issuers, underwriters and investors if the Draft Bill were to provide more legal certainty on this point. It remains to be seen whether this question will be addressed in the further course of the legislative proceedings.

11. Transitional Rules

As a general rule, the new law would only apply to bonds issued after the effective date of the new law. However, the holders of bonds issued prior to such date can resolve, by means of a super-majority vote and with the consent of the issuer of the bonds, to submit the bonds to the provisions of the new law.

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If you have any further questions on the Draft Bill or convertible bonds in general, please contact Gabriele Apfelbacher ([gapfelbacher@cgsh.com](mailto:gapfelbacher@cgsh.com)) or Jochen von Berghes ([jvonberghes@cgsh.com](mailto:jvonberghes@cgsh.com)) in our Frankfurt office at +49.69.97103.0.

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