

Liability Management Transactions in Germany

- German and U.S. Regulatory Framework and Selected Legal Issues -

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Part I

Liability Management - Basic Concepts, Standard Toolbox and Recent Trends

What is Liability Management?

- An umbrella term used to describe a variety of transactions that are used to “manage” the “liabilities” of an issuer.
 - “Liability” = contractual obligations contained in existing securities in the form of (i) payment obligations (financial liabilities) or (ii) affirmative or negative covenants (covenant liabilities).
 - “Management” = modification or elimination of liabilities.
- Liability management transactions typically relate to listed debt/hybrid securities (ranging from investment grade to junk), and can be an essential element of comprehensive debt restructurings.
- The objectives of liability management transactions may vary significantly, with examples including elimination of debt at a reasonable price, extension of maturities, easing of interest burden, waiver of restrictive covenants.

Standard Liability Management Toolbox

- Tender and exchange offers
- Open market purchases
- Consent solicitations

Recent Trends in Liability Management

- Opportunistic cash tender offers
 - Bond issuer is a weak credit, but not at the verge of bankruptcy.
 - May benefit from buying back debt at a significant discount to nominal.
- Consent solicitations in connection with M&A transactions
 - Bond issuer is the target of an M&A transaction; terms and conditions of outstanding bonds contain bondholder put rights in the event of a change of control (“CoC”).
 - Acquiror may make completion of M&A transaction contingent on waiver of CoC put rights of bondholders.

Recent Trends in Liability Management (cont'd)

- Rescue exchange offers
 - Bond issuer is at the verge of bankruptcy; debt load (bonds and bank debt) is unsustainable.
 - Survival of bond issuer dependent on acceptance of exchange offer of new bonds with extended maturities, reduced principal amount, less restrictive financial covenants and sometimes “upside protection” by a minimum percentage of bondholders.
- Need for solution to the “credit default swap dilemma”
 - Bondholders hedged through credit default swaps may have little incentive to consent to amendment to terms and conditions or to accept tender or exchange offer.
 - Issuer may have to devise incentives for hedged bondholders (possibly by triggering the CDS).

Part II

Principal Structuring Considerations – What Factors to Look At in the Outstanding Bonds and Other Debt, the Issuer and the Proposed Transaction

Important Characteristics of the Outstanding Bonds and Other Debt

- Types of bonds: stand-alone straight debt, MTNs, convertible bonds, hybrid bonds, high-yield bonds.
- Governing law of the bonds (and any guarantee(s)) – German law, English law, NY law.
- Principal market (admission to trading) of the bonds and home jurisdiction of the issuer (and any guarantor(s)) for purposes of the German Securities Prospectus Act (“WpPG”) and the German Securities Trading Act (“WpHG”).
- Applicable foreign stock exchange and other rules and regulations.
- Provisions in the terms and conditions of the outstanding bonds or other debt instruments that may affect a potential liability management transaction.
 - Explicit permission, explicit prohibition, limitation or silence with respect to buy-back (cash tender, market repurchase).
 - Clause permitting consent solicitation (so-called “collective action clause”).
 - Minimum thresholds for different changes to the financial terms or covenants.

Factual Circumstances of the Issuer

- Analyze economic and liquidity situation of the issuer of the bonds.
- Identify group entity best suited to carry out the liability management transaction.
- Analyze direct impact of transaction on financial condition of the issuer
 - Financing requirements.
 - Profit from retirement of debt at a discount.
- Analyze business plan and ability to offer bondholders an upside or other credible alternative to bankruptcy.

Goals and Impact of the Proposed Liability Management Transaction

■ Focus of transaction on

- Amendment of terms and conditions of outstanding bonds binding on all bondholders: consent solicitation.
- Retirement of certain debt: depending on volume, cash tender offer or market repurchase.
- Amendment of terms and conditions of outstanding bonds only of a certain percentage of bondholders: exchange offer (can be combined with consent solicitation).

Note: If the terms and conditions of outstanding bonds provide for 90% plus majority requirement for an extension of the term of the bonds, a reduction of the principal amount or changes to other fundamental terms (as is typically the case in English or NY law-governed bonds), such changes may require a combination of exchange offer and consent solicitation (so-called “exit exchange” or “exit consent”).

Goals and Impact of the Proposed Liability Management Transaction (cont'd)

- Transaction risks
 - Failure to reach required majority for bondholder resolution (consent solicitation).
 - Bondholder suits (consent solicitation).
 - Failure to reach minimum acceptance rate (cash tender offer, exchange offer).
 - Informal collective action by bondholders (consent solicitation exchange offer).
 - Timing issues (e.g., with respect to disclosure document).
 - Potential CDS dilemma.

Part III

A Closer Look into the Liability Management Toolbox – Cash Tender and Exchange Offers, Market Repurchases and Consent Solicitations

Issuer Self Tender Offers for Cash and Exchange Offers

- No special legal regime
 - Unlike in the United States (Williams Act), there is no special (comprehensive) legal regime governing issuer self-tender offers and exchange offers to the public in Germany; the German Securities Acquisition and Takeover Act (WpÜG) does not apply.
- Equal treatment
 - Issuers whose home state is Germany are subject to the equal treatment requirement under Section 30a(1) of the WpHG.
 - Section 30a(1) of the WpHG does, e.g., not apply to
 - Bonds of a (private or public) German company if such bonds are not admitted to trading on any regulated market in Germany or on any other organized market in the EU/EEA
 - Bonds of a Dutch finance subsidiary of a (private or public) German company if such bonds are not admitted to trading on any regulated market in Germany.
- Admission to trading outside Germany
 - Stock exchange rules and regulations may subject issuer self-tender and exchange offers to equal treatment and other regulatory requirements.

Issuer Self Tender Offers for Cash and Exchange Offers (cont'd)

■ Prospectus requirement

- Exchange offers (i.e. the offering of new debt/hybrid securities in exchange for the target securities) are subject to the German Securities Prospectus Act (WpPG) if the new securities are publicly offered in Germany and/or are to be admitted to trading on a regulated market of a German exchange.
- Limitation of exchange offers to professional investors only may not be possible.
- Issuers might be able to document exchange offers under existing MTN programs (on the basis of an approved base prospectus).
- Prospectus must be approved by competent authority (i.e., BaFin for issuers whose home state is Germany).
- No prospectus requirement for cash tender offer, but market practice to produce short tender offer memo including basic terms of offer.

Issuer Self Tender Offers for Cash and Exchange Offers (cont'd)

■ Insider trading

- Issuers (and dealer managers) will need to be mindful of applicable insider trading restrictions. German insider trading rules do not apply to material non-public information (“MNPI”) with respect to bonds of a (public) German company if the bonds are not admitted to, or included in, trading on the regulated market or OTC market (*Freiverkehr*) of any German exchange or any other organized market in the EU/EEA.
- The tender offer itself may be MNPI; exemption from ad-hoc publication requirement until launch should generally be available (if confidentiality can be maintained).
- Dealer managers may wish to get appropriate reps and warranties from the issuer on the absence of MNPI (including with respect to possible exemptions under Section 15(3) of the WpHG).
- Disclosure of insider information in the course of a pre-sounding of selected bondholders regarding their appetite to participate in cash tender/exchange offer may be lawful in certain limited circumstances (but note U.S. legal considerations).
- Results of the tender need to be published without undue delay (in view of its impact on the price of the bonds not tendered) by an ad-hoc announcement.

Issuer Self Tender Offers for Cash and Exchange Offers (cont'd)

- Market abuse
 - Tender offers and exchange offers should not raise particular concerns under market abuse provisions (given the prior announcement to the market).

U.S. Legal Considerations

- Self tenders are regulated by the Williams Act:
 - The Williams Act regime applies whenever tender offer activities are undertaken in the U.S.
 - General exemption if U.S. ownership of the securities is 10% or less (using counting rules that "look through" nominees)
 - Partial exemption at the 40% ownership level
 - Antifraud rules apply in any case
 - No material misstatements or omissions in tender documents.
 - 20 business day offer.
 - 10 business day extension if price or acceptance percentage changed in final 10 days of offer.
 - Prompt payment rule (3 days for debt).
 - No illusory offers or subjective conditions.
 - Several shortcuts allowed for non-convertible investment grade debt on length of offer, pricing, rolling settlement.
 - Some enhancements, such as 10 day/10 day offer (price expressed as spread over treasuries on day 10), are possible.
 - Modified Dutch auction permissible.

U.S. Legal Considerations (cont'd)

■ Exchange Offers

- Also subject to the Williams Act, as in the case of tender offers.
- Securities Act of 1933 also applies to offer of new bonds.
- New offering may be exempt under SEC Rule 802 if 10% or less of the class held by U.S. holders.
- New offering may also be exempt under Securities Act Section 3(a)(9) if securities are of the same issuer, holders surrender nothing but their securities and no simultaneous cash sale of new bonds.
- New offering must otherwise either be registered with the SEC or made as a private placement (e.g., only to qualified institutional buyers (QIBs)).

■ All offers subject to disclosure issues

- Avoid selective disclosure of MNPI.
- Sign NDAs if necessary in one-on-one repurchases or market soundings.

Issuer Self Tender Offers for Cash and Exchange Offers (cont'd)

■ German Tax Considerations: Issuer

- Cash offer may result in taxable cancellation of indebtedness (COD) income if nominal value of bonds exceeds offer price and, following their acquisition, bonds are cancelled. (Bonds are not automatically cancelled if they are acquired by the debtor.)
- Exchange offer may result in taxable COD income if nominal value of existing bonds is higher than nominal value of new bonds.
- Application for so-called rehabilitation exemption may be possible.
- Additional tax considerations may be relevant if, for example, certain types of financial instruments are acquired (e.g., convertibles or exchangeables) or if certain financing structures are used (e.g., use of non-German issuing vehicles in connection with parent guarantees). In certain cases, it may be advisable to have an affiliate of the issuer acquire the bonds.

Issuer Self Tender Offers for Cash and Exchange Offers (cont'd)

- German Tax Considerations: Tendering Bondholders
 - Acceptance of cash or exchange offer will generally result in disposal of bonds.
 - Tax consequences of disposal depend on the bondholder's jurisdiction of residence and type of the financial instrument (cf. tax disclosure of the relevant offering memorandum).
 - Frequently, tendering bondholder's will incur a loss which may be recognized for tax purposes.
 - Certain tendering bondholders (e.g., bondholders who elected for mark-to-market treatment) might derive a taxable gain.
 - Additional tax consequences may result from accrued (but untaxed) interest and the termination of hedging agreements.

Issuer Self Tender Offers for Cash and Exchange Offers (cont'd)

■ IFRS Accounting Considerations

- IAS 39.40: If in an exchange offer the target bonds are exchanged for debt instruments with “substantially different terms”, the issuer shall treat the target bonds as extinguished, remove them from its balance sheet and recognize the debt instruments offered in exchange therefor as new financial liability.
- IAS 39.40 applies also to a substantial modification of the terms of an existing financial liability.
- IAS 39/AG62: Terms are “substantially different” if the discounted present value of the cash flows under the new terms is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability (taking into account net fees paid or received discounted at the original effective interest rate).
- IAS 39.41: The difference between the carrying amount of a financial liability (treated as) extinguished and the consideration paid will have to be recognized in profit or loss.

Issuer Self Tender Offers for Cash and Exchange Offers (cont'd)

- Key terms of issuer self-tender and exchange offer (not subject to Williams Act, see U.S. legal considerations)
 - Significant leeway for issuers (with acceptability to bondholders as a limiting factor).
 - Invitation to tender versus offer to purchase.
 - Offer period: no legal minimum or maximum.
 - Partial tender offers generally permissible.
 - No prohibition to purchase outside the tender offer (at or below the tender offer price).
 - No limitation on pricing mechanisms (e.g., fixed spread, continuous or “on the fly” pricing based on formula, rolling settlement, single point pricing; Dutch auction).
 - Conditions permissible, although for legal reasons typically not necessary (if structured as an invitation to tender).
 - Changes to the terms / withdrawal rights.

Open Market Purchases

- Typically executed by a financial institution on behalf of the (undisclosed) issuer; typically no pre-announcement to the market.
- Price and timing flexibility; no or at least less visibility than tender and exchange offers; amount that can be repurchased is generally limited, no covenant relief.
- Market Abuse
 - No specific safe harbor for open market purchases of bonds by the issuer; the safe harbor for share buy-backs under EU Regulation 2273/2003 does not apply.
 - Subject to a case-by-case analysis, if the volume of the open market repurchases does not significantly exceed 10% of the issue, the repurchase is executed in an orderly fashion and the liquidity (following the repurchase) is not materially reduced, open market repurchases for bona fide commercial purposes should generally not raise market abuse concerns.

Open Market Purchases (cont'd)

■ Insider trading

- “Trading windows” following the publication of annual or interim reports should be used.
- If the issuer possesses insider information unrelated to the proposed buy-back, open market purchases may not be executed.
- If the buy-back has a material effect on the financial condition of the issuer, such fact (if non-public) would constitute MNPI. An ad-hoc publication prior to the execution of the buy-back, however, should generally not be required.
- The issuer’s intention to repurchase bonds in the market may in itself constitute MNPI with respect to the bonds, but should generally not restrict the issuer from executing the purchase and generally does not trigger an ad-hoc disclosure obligation. The situation would be different if the issuer’s intention to repurchase bonds in the market was influenced by circumstances amounting to MNPI.
- Depending on the volume of repurchases (10% or more of the bonds outstanding), the issuer will need to consider making a subsequent announcement to the market.

Open Market Purchases (cont'd)

- Equal treatment
 - Open market purchases should generally not be an issue with respect to the equal treatment requirement under Section 30a WpHG; however, the issuer should be careful in soliciting select institutional investors to sell.
- “Creeping tender offer”
 - Take care that nature of purchases in the U.S. does not become intense enough that Williams Act (tender offer regulation) would apply.
 - Factors include active and widespread solicitation, size, premium, pressure, etc.

Consent Solicitations

- Goal: Modification of terms and conditions of one or more bond issues with binding effect for all holders of outstanding bonds concerned.
- Legal regime applicable to consent solicitation depends on law applicable to the bonds.
- Under German bondholder law as currently in effect, modification of terms and conditions of German law-governed bonds by means of majority decision permissible only in case of **imminent insolvency** of a **German issuer**.
- No such limitation for non-German law bonds, but the bonds themselves may have contractual limitations.

Consent Solicitations (cont'd)

- Draft bill (“Draft Bill”) of new German bondholder law (“New Law”) permits modification of terms and conditions of German law-governed bonds by (super-)majority vote (by nominal amount), if terms and conditions of bonds include collective action clause.
 - According to Draft Bill, collective action clause (and legal regime of New Law governing bondholder resolutions) can be included in terms and conditions of bonds already outstanding prior to the adoption of the New Law if bondholders so resolve with a qualified majority of 75% of the nominal amount of the bonds.
 - New Law expected to enter into effect prior to the summer recess of the German parliament, i.e., by July 2009.

Consent Solicitations (cont'd)

- Unless the terms and conditions of the bonds provide otherwise, bond provisions subject to amendment by (super-)majority vote (by nominal amount) of the bondholders are, e.g.:
 - Term
 - Interest coupon (amount and payment date)
 - Repayment claim (amount and payment date)
 - Ranking in insolvency
 - Type of the securities (conversion of bonds into equity or other debt instruments)
 - Currency
 - Restrictive covenants
 - Bondholder put rights
 - Substitution of the issuer

Consent Solicitations (cont'd)

- Unless the terms and conditions of the bonds provide for a greater majority, modifications resulting in a substantive change of the terms and conditions require a majority of 75%, other modifications a majority of 50%.
- International bond investors typically expect 90% plus majority requirement for changes to fundamental terms of the bonds; consistency with international market practice may call for inclusion of such super-majority requirement in the terms and conditions of German law-governed bonds.
- Modification resolutions may be adopted in or outside a bondholder meeting, whatever form of vote is specified in the terms and conditions of the bonds.
- Payment of “consent fee” to individual bondholders as consideration for voting in favor of a proposed amendment is prohibited; payment of incentive fee to all bondholders, e.g., in the form of a premium on the repayment of principal owed under the bonds, should be permissible.

Consent Solicitations (cont'd)

- Bondholder resolutions may be challenged in court by bondholders who participated in the vote and raised an objection against the vote.
 - A bondholder suit may be based on violations of the New Law or the terms and conditions of the bonds, as well as, in very limited circumstances, on incorrect or incomplete information provided by the issuer.
 - Bondholder suits must be brought against the issuer within one month from the resolution. Pending any bondholder suit, the challenged resolution must not be implemented, unless the issuer prevails in special proceedings confirming that the resolution may be implemented despite pending bondholder suits.
 - If the implementation of a challenged bondholder resolution is time-sensitive, the issuer may consider trying to reach a settlement with the claimant; the payment of the settlement amount must not violate the prohibition on payment of “consent fees”.

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