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"Abandon hope all ye who enter here?" – First Practical Experiences with the New German Bond Restructuring Act

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In response to a need for a modern bond restructuring law permitting extensive financial restructurings outside formal insolvency law proceedings, the German legislator introduced a new German Bond Restructuring Act (*Schuldverschreibungsgesetz*, the "**2009 Act**") which became effective in August 2009. The 2009 Act replaced the German Bond Restructuring Act of 1899 (the "**1899 Act**") which was in need of overhaul and did not adequately deal with current international best practices for bond restructurings. Recently, several German courts were called upon to decide on some precedent restructuring cases handled under the new law. To the surprise of many practitioners, the relevant courts construed the 2009 Act rather narrowly, creating a hurdle that will be difficult to overcome in many future bond restructuring cases. This newsletter will summarize the effects of these widely recognized precedent cases (Pfleiderer, Q-Cells and Boetzelen/Deikon) and their key consequences for the general bonds restructuring practice.

Summary Conclusions – Key Consequences

- The decisions of the Frankfurt courts not to allow a restructuring of bonds issued prior to 2009 by a 75%-majority bondholder resolution (so called opt-in resolution) and the decision of the Cologne court to grant bondholders a right to demand early repayment of bonds in a typical close-to-insolvency situation can be considered a slap in the face of the German legislator whose clear intention it was to facilitate bond restructurings by introducing the 2009 Act. According to recent press reports, the German government is now working on a proposal for a reform of the 2009 Act to extend the applicability of the opt-in resolution and to further facilitate bond restructurings.
- For the time being, it will be difficult to capitalize on the 2009 Act when restructuring bonds that were issued by foreign issuers prior to 2009. Restructuring practitioners may still need to resort to the unwieldy old 1899 Act which, in the past, has proven to be largely inefficient.
- Bond investors now face a typical prisoner's dilemma: There could be a significant upside in terminating their bonds in case a qualified majority of bondholders accept the haircut helping the company to ultimately recover. There could, however, also be a considerable downside if the proposed bond restructuring fails and the company is forced into a potentially value-destroying insolvency because too many bondholders demanded early repayment of their bonds.

Pfleiderer

The first court decision deals with the application of the 2009 Act to bonds issued before the 2009 Act came into effect. To allow a restructuring of bonds issued prior to 2009, the 2009 Act explicitly provides that holders of such bonds can pass a 75%-majority resolution to make the bond subject to the new 2009 Act (a so-called 'opt-in resolution'). The 2009 Act provides that the law only applies to those bonds which are governed by German law.

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As part of an out-of-court restructuring package, the bondholders of Pfleiderer passed with 75%-majority such opt-in resolution for a bond issued by its Dutch subsidiary prior to 2009. Except for the subordination clause, which was governed by Dutch law, the Pfleiderer bond was solely governed by German law. Most German law governed bonds are issued by Dutch subsidiaries for tax reasons.

Some dissenting bondholders filed litigation before the Frankfurt District Court challenging the validity of Pfleiderer's opt-in-resolution, on grounds that such opt-in resolution would not be possible because the bond is not 100% governed by German law. The Frankfurt District Court held that an opt-in resolution under the 2009 Act requires a 100% German law governed bond. As a result, it held the opt-in resolution to be invalid and, at the same time, it dismissed Pfleiderer's summary proceedings motion to approve and endorse the implementation of the opt-in resolution which had been blocked as a result of the dissenting bondholders' litigation. The Frankfurt Court of Appeals later confirmed the Frankfurt District Court's dismissal of Pfleiderer's summary proceedings motion. A few days later, Pfleiderer had no choice but to file for the opening of insolvency proceedings.

Q-Cells

The second court decision also deals with the application of the 2009 Act to bonds issued before the new law came into effect. The Q-Cells bond was also issued by a Dutch subsidiary prior to 2009 but unlike the Pfleiderer bond, the Q-Cells bond was 100% governed by German law.

After the Q-Cell bondholders passed an opt-in resolution with the required 75% majority, dissenting bondholders filed litigation before the Frankfurt District Court challenging the validity of opt-in resolution. This time the Frankfurt District Court found another fly in the ointment: it held that an opt-in resolution for a bond issued by a foreign issuer either requires a unanimous opt-in resolution of all bondholders (which is only possible in theory) or the terms and conditions of the bond need to contain a provision which principally provides for majority decisions of the bondholders. The legal position of the Frankfurt District Court was a surprise to many restructuring practitioners because the language of the 2009 Act does not contain such requirement for an opt-in resolution.

Since the Q-Cell bond terms and conditions did not provide for a majority decision the Frankfurt District Court also dismissed Q-Cell's summary proceedings motion to approve and endorse the implementation of the opt-in resolution. As a result, Q-Cells also recently filed for insolvency proceedings.

Boetzelen/Deikon

In 2005 and 2006 the real estate holding Boetzelen (now Deikon) issued three bonds secured with second ranking mortgages. In the following years, the financial situation of Deikon deteriorated. As a result, in mid 2010, the bond issuer stopped paying interest and presented a restructuring plan proposing to the bondholders (i) an interest rate reduction for three years as well as an elimination of early termination rights and (ii) a 60% haircut. Deikon *inter alia* stated that without the proposed interest rate reduction it would become illiquid and, as a result of that, would have to file for insolvency. Prior to the bondholder meetings in which the interest rate reduction was approved, a retail investor unilaterally terminated and accelerated his bonds for cause on grounds of the upcoming potential insolvency filing of the bond issuer. The bondholder claimed repayment of the entire principal amount. As the bond issuer refused such right for early repayment, the bondholder brought a lawsuit before the local court of Cologne.

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The Cologne District Court upheld the early termination of the bonds for cause. The court took the position that adherence to the original terms and conditions of the bonds was unreasonable for the bondholder because (i) by its own admission, the bond issuer was facing insolvency, irrespective of the early termination of the bonds; and (ii) due to the structural subordination of the bonds, the claims under the bonds were not adequately secured with collateral. In its decision the court explicitly referred to the fact that the bondholder was a retail investor and not a commercial lender and that the amount invested by him was therefore significant. As a consequence, it would be unreasonable to expect the bondholder to further leave the funds with the bond issuer. The decision has been appealed and the case is currently pending before the Cologne Appeal Court.

It is worthy of note that the judgment was rendered in favor of retail bondholders only. It remains to be seen whether the investor-friendly jurisprudence will extend to commercial lenders.

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