

New Debenture Act Enters into Force

On 5 August 2009, the new German Debenture Act (*Gesetz über Schuldverschreibungen aus Gesamtemissionen (Schuldverschreibungsgesetz – SchVG)*, the "Debenture Act") as part of several amendments to Germany's securities laws entered into force.

1. Summary

The main changes contained in the Debenture Act are the extension of the collective rights of bondholders and the adaption of these rights to internationally accepted standards. The Debenture Act also introduces a number of structural modifications, such as the possibility to appoint a common representative (*gemeinsamer Vertreter*) of the bondholders. The procedural requirements on the passing of bondholder resolutions are modernised, *inter alia*, by creating the possibility to convene virtual bondholder meetings. Moreover, a specific transparency requirement in respect of the terms and conditions of bonds is introduced. Apart from some few exemptions, the Debenture Act will apply to all bonds issued under German law, irrespective of the location of the issuer or the place of listing. The new rules now also provide for collective action clauses.

2. Background

So far, the legal basis for collective rights of bondholders has been the Debenture Act of 1899, the "1899 Act". However, many of the provisions of the 1899 Act were drafted too narrowly or became outdated over time due to new developments. In particular, its scope of application was limited to issuers domiciled in Germany, changes to the terms and conditions by way of a bondholder resolution were only possible in the case of an "eminent non-payment or insolvency of the issuer", and the bondholders' scope of decisions was limited to the waiver of bondholders' rights, in particular with regard to the reduction of the applicable interest rate and the deferral of payments. Hence, apart from some few cases, the 1899 Act was never of major practical relevance.

Discussions about a reform of the Debenture Act started as early as 1993. The first proposal of an amendment act had been published by the German Federal Government in 2003 but was not followed through in the legislative process. The first draft of the Debenture Act dated as of May 2008 and underwent a number of changes in the following consultative process and parliamentary hearings.

3. The Main Changes

3.1 Scope of application

The Debenture Act applies to all types of bonds governed by German law, irrespective of the seat of the issuer or the place of listing of the bonds. The only instruments that are excluded from the scope of application of the Debenture Act are German covered bonds (*Pfandbriefe*) issued under the *Pfandbrief* Act and German government bonds (i.e. bonds issued or guaranteed by the Federal Republic of Germany, a Federal State or a municipality).

Key Issues

1. Summary

2. Background

3. The Main Changes

4. Outlook

If you would like to know more about the subjects covered in this publication or our services, please contact:

[Sebastian Maerker](#) +49 69 7199 1510

[Dr. Marc Benzler](#) +49 69 7199 3304

[Peter Scherer](#) +49 69 7199 1294

[Dr. Oliver Kronat](#) +49 69 7199 4575

To email one of the above, please use
firstname.lastname@cliffordchance.com

Clifford Chance, Mainzer Landstraße 46,
60325 Frankfurt am Main, Germany
www.cliffordchance.com

The Debenture Act stipulates that its provisions apply to all bonds with identical terms and conditions that derive from the same issuance. Hence, in the case of a tranching with several classes of notes that convey different (i.e. senior and junior ranking) rights, such as in many securitisation or other structured finance transactions, each class of notes is treated as a separate bond for the purposes of the Debenture Act.

3.2 Terms and Conditions

The Debenture Act requires that the terms and conditions of a bond must be set out in the bond certificate itself unless the certificate is not intended for circulation, such as in the case of bonds that are in the form of a global note deposited with a central securities depository. In the latter case, the terms and conditions can also be set forth in a separate document outside the bond certificate.

Furthermore, the obligation of the issuer to perform as set out in the terms and conditions must meet certain transparency requirements. In particular, the Debenture Act requires that a bondholder who is familiar with such type of bonds must be able to conclusively determine the content of the issuer's obligations by virtue of the terms and conditions. However, the German legislator conceded in the official reasoning to the Debenture Act that even very complex terms and conditions may be admissible if they are clearly directed to a circle of investors who are familiar with such structured instruments.

The Debenture Act does not set out the legal consequences of a breach of said transparency requirement. According to the official reasoning, those would be determined by "the common provisions" (i.e. the rules under the German Civil Code and other applicable statutes) with respect to the circumstances of a single case and might include damage claims as well as the nullity of the terms and conditions.

3.3 Collective rights of bondholders

Changes to the terms and conditions of a bond are now either possible through uniform agreement between the issuer and all bondholders or, more importantly, through a change suggested by the issuer and approved by majority resolution of the bondholders, provided that the relevant terms and conditions foresee majority decisions by bondholders.

The Debenture Act provides for a non-exhaustive list of issues that may be the subject of bondholder resolutions, including an exchange or release of collateral, substitution of the issuer, modifications of the interest and principal payments or the maturity date. However, the cases in which the bondholders may decide through a majority resolution may be

restricted and/or determined in more detail in the terms and conditions. Changes to the terms and conditions to the detriment of single investors are not permissible, save in cases of an explicit consent of these investors.

Generally, a bondholder resolution requires a simple majority (50 per cent) of the participating votes. In the case of proposed changes to material provisions of the terms and conditions (in particular those referred to in the Debenture Act), however, a majority of 75 per cent of the participating votes is mandatory. The terms and conditions of a bond may only provide for higher but not for lower majority requirements.

The Debenture Act also contains several procedural modifications. It introduces, *inter alia*, the possibility to bring about bondholder resolutions without the need to convene a physical bondholder meeting. In this case, bondholders can submit their votes by e-mail or other means of communication as provided for in the relevant terms and conditions.

Furthermore, the Debenture Act provides for the right to appeal against a bondholder resolution to the courts, provided that the claimant had acquired the bond before the notification of the summoning of the bondholder meeting in which the resolution has been passed. An appeal may, *inter alia*, be based on procedural error, lack of required majority, lack of necessary quorum or unequal treatment of bondholders. The bondholder resolution may not be executed until the court has decided on the appeal (save for temporary relief against such appeal applied for by the issuer).

3.4 Common Representative

The Debenture Act also introduces the concept of a common representative (*gemeinsamer Vertreter*) whose functions may largely be compared to those of a "note trustee" in bond issuances under English or US law. A common representative may be appointed either in advance in the terms and conditions or by a majority resolution of the bondholders. Natural persons as well as legal entities, provided they have adequate knowledge, may be appointed as representative.

The common representative's general duties are the representation of the bondholders' interests vis-à-vis the issuer and the convening of bondholder meetings. It can be commissioned with further specific tasks by virtue of a majority resolution of the bondholders and has to comply with their directions. If the common representative has been commissioned to enforce the bondholders' rights in general, single bondholders are not allowed to enforce their rights individually, unless otherwise permitted by a majority resolution. Furthermore, the common representative has comprehensive rights of information vis-à-vis the issuer insofar as necessary to comply with his assignment.

3.5 Transitional Provisions

The Debenture Act will apply to all German law bonds that are issued after the date of its entering into force. However, subject to the consent of the issuer, the bondholders of a then already existing issuance may decide with a majority of 75 per cent of the participating votes (by virtue of a change the terms and conditions) that the new rules also apply to their transaction.

4. Outlook

The intention of the German legislator to adjust the German law rules on the collective rights of bondholders to internationally common requirements should surely be welcomed. However, whether the Debenture Act can really achieve this result in practice remains to be seen.

Some of the proposals for improvement that have been made in the consultative process (such as the possibility to appoint a common representative in the terms and conditions) have been included in the final draft. On the other hand, there are still a number of potential shortcomings that make the Debenture Act (and thus the issuance of bonds under German law) not as attractive as it was intended and should be.

First of all, what seems a bit unfortunate is the very vaguely formulated transparency requirement in

respect of the terms and conditions of bonds. In fact, there are already much more detailed transparency requirements designed to protect the interests of investors, especially in the German prospectus rules and, above all, according to the conduct of business rules requiring investment firms to advise their customers adequately and correctly (as recently amended by the implementation of the MiFID). In this respect, the Debenture Act will likely create more doubts for issuers than it adds benefit for potential investors.

Moreover, the Debenture Act falls short in defining specific rules for tranching issuances of bonds, such as in the case of most securitisations or other structured finance transactions. Each class of notes is to be treated as a separate bond for the purposes of the Debenture Act, which in itself seems highly artificial. The Debenture Act does not provide that majority decisions by investors of a subordinated tranche cannot have detrimental consequences for the investors of a senior ranking tranche. Hence, it needs to be ensured in the terms and conditions of such tranching issuances that amendments are only possible by virtue of majority resolutions of the investors of each tranche. In any case, a majority resolution by the investors of a senior tranche cannot bring about amendments to the terms and conditions that are binding on the holders of subordinated tranches (unless they also consent).

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Prague ■ Riyadh* ■ Rome ■ São Paulo ■ Shanghai ■ Singapore ■ Tokyo ■ Warsaw ■ Washington, D.C.

* Clifford Chance has a co-operation agreement with Al-Jadaan & Partners Law Firm