Stabilus Group: A Case Study of Issues that Arise in Complex Financial Restructurings

INTRODUCTION

There is no such thing as a 'typical' financial restructuring. The precise circumstances of the company or group that is facing financial difficulty, including the nature of its business and its capital structure, will heavily influence the process. Much will also depend on external factors such as the prevailing market conditions and the various formal and informal procedures that may be available in the relevant jurisdictions. However, there are a number of factors that will play a significant role in almost all complex restructurings whether implemented as a result of a consensual agreement between stakeholders, enforcement action taken by one or more creditors or the commencement of a formal procedure. These include the duties of the directors, the dynamics within the creditor group and the value of the business. The restructuring of a group of companies known as the Stabilus Group provides a good example of the way in which these issues may shape the restructuring process.

BACKGROUND

The Stabilus Group is a leading manufacturer of parts which are used in the automobile industry and other industries. Early in 2008 it was acquired by a private equity fund pursuant to a deal in which companies in the group took on substantial indebtedness to various lenders under English law-governed senior and mezzanine facilities agreements and provided guarantees and security. The lenders entered into an intercreditor agreement that was also governed by English law and, as is commonly the case in such leveraged deals, this had the effect of postponing and subordinating the claims of the mezzanine lenders to the claims of the senior lenders. Later the same year, the group started to experience severe financial difficulties and in April 2010, on the instructions of 100 per cent of the senior lenders, JP Morgan Europe Limited, in its capacity as senior facility agent, issued an enforcement notice to itself in its capacity as security trustee to accept an offer to transfer the operating subsidiaries of the group to two entities that were affiliated with one of the senior lenders (they were part of the same investment fund ("Triton")). The security trustee also transferred all of the mezzanine debt and a proportion of the senior debt to one of the purchasers and those liabilities were then released. The senior lenders injected some new money and converted some of their debt into equity; the remaining senior debt was converted into super-senior, senior and mezzanine debt. The senior lenders were also allocated senior and mezzanine profit participating loans.

This enforcement-led restructuring was recently considered by the English High Court in Saltri III Ltd v MD Mezzanine SA Sicar & Ors [2012] EWHC 3025 (Comm). Generally, litigation in this context is initiated by dissentient creditors who wish to challenge the restructuring but in this case the Triton senior lender took the unusual step of seeking a declaration that the restructuring was valid. The case is also unusual because generally, in the English market, security trustees refrain from entering into transfer arrangements themselves, preferring instead to appoint an administrator. In other respects the judgment tells a familiar story of a company in financial distress whose path to restructuring was heavily shaped by the directors’ concerns about incurring personal liability, the
difficulty in achieving a consensus among a diverse and ever-changing group of lenders and numerous attempts to
gauge the value of the Stabilus Group.

The position of the directors: how much influence do they have?
In most developed jurisdictions company directors are subject to duties, and may incur liabilities, in relation to
their management of the company. Usually this includes the possibility that they may be held accountable if the
company becomes insolvent and its creditors are not paid in full. The precise nature of these duties and liabilities
varies between jurisdictions (which can cause problems where group companies involved are subject to the laws
of different jurisdictions) but in any event this is likely to be at the forefront of directors’ minds when the company
is facing financial difficulties. Well-advised directors will continually assess the financial position of the company
and consult financial advisers and lawyers to ascertain what action they should take, and when, to comply with
their duties and reduce the risk of incurring personal liability. There will be a lot of difficult decisions to make,
such as whether further credit can (and should) be obtained or whether a more fundamental change is required
to the business plan or the capital structure. The directors will retain their management powers (at least until an
insolvency office-holder is appointed) but their influence will diminish as the company’s position worsens to the
point where key creditors take control, for example, when there is an event of default under the finance documents
that entitles them to accelerate their debt (and enforce security where this has been provided). The directors will
still need to comply with their duties and the key question in that regard will be whether, and if so when, they
should place the company into a formal insolvency process (if it is within their power to do so). This will not always
be a straightforward decision as they must balance the risks of continuing to trade (and potentially incurring
liability for doing so) against the possibility that entry into a formal process might prove to be premature and
cause greater loss to the creditors. There will probably be other stakeholders who are able to commence formal
proceedings but it will often not be in their interests to do so unless they are fully secured, given the destructive
effect on the value of the business. Therefore the directors will retain some influence over the restructuring process.

The actions taken by directors of the Stabilus Group companies were not challenged in the English proceedings
but the judgment describes a lengthy restructuring process in which the lenders were regularly informed of the
directors’ concerns, particularly about their increasingly imminent need to commence insolvency proceedings in
Germany (where the operating companies were based). These concerns were largely due to the potential for the
directors to incur liability under German insolvency law where a company is ‘over-indebted’ or ‘illiquid’. From
2008 there were clear indications of financial distress: some of the group’s customers (such as General Motors
and Chrysler) entered insolvency processes, credit insurers withdrew cover and some suppliers began to demand
payment on delivery. As would be expected in these circumstances, the directors sought specialist restructuring
advice. However, by early 2009 it was clear that the support of lenders would be needed as the group would soon
breach certain financial covenants, and become unable to meet interest payments, under the facility agreements.
The senior and mezzanine lenders agreed to defer interest payments and not to accelerate the outstanding
liabilities or instruct the security trustee to enforce the security for a short period (the ‘suspension period’) in which
a restructuring could be agreed. In exchange, certain conditions were imposed including the production of a three-
year business plan to be presented to the lenders (Rothschild was engaged to assist with this) and the appointment
of a chief restructuring officer. PwC was also engaged by the Stabilus Group to carry out an independent business
review for supply to the lenders.

The financial position of the company worsened, trade credit was being withdrawn and key customers reduced or
ceased to place orders. The directors produced a business plan but it was rejected by the lenders and so a second
‘cash-optimised’ business plan was produced that was designed to improve medium-term cash flow. This could
only be achieved if new funding was provided. It became clear from the results of the independent business review
that a financial restructuring was needed if the business was to continue because it could not service its existing
debt burden. While the lenders were considering how to carry out the restructuring they were informed that,
without new funding and further extensions to the suspension period, the directors would be under a mandatory obligation to commence insolvency proceedings in Germany. A bridge facility was provided by the senior lenders and the suspension period was extended. A ‘real degree of urgency’ was created when the auditor refused to sign off on the going concern opinion in the accounts and, later, when the suspension period and the bridge facility had expired, matters reached a head and the senior lenders (who were controlling the process by then) were informed that if they did not have a commercial agreement by the end of the day the directors would have no option but to commence insolvency proceedings. No doubt this motivated the senior lenders to reach an agreement in principle that day. It took more than two months, a further extension of the suspension period and yet more pressure from the directors before the restructuring was finally implemented.

If the directors had not been concerned to avoid personal liability, then perhaps the restructuring process would have taken even longer than two years to complete. It is clear that certain steps were taken by the lenders (although perhaps not as quickly as the directors would have liked) because they were concerned that the directors’ predicament would lead them to commence insolvency proceedings. Directors will only be able to influence a restructuring process in this way where the lenders believe that some value remains and will be best preserved if insolvency proceedings can be avoided. Even where that is the case, the directors may find themselves in a very difficult position while negotiations are ongoing. This may be exacerbated by other stakeholders who are aware of the directors’ predicament and try to use the spectre of personal liability to exert pressure on them to follow a particular course of action where there are competing proposals.

Stakeholder dynamics: can a consensus be reached?

Eder J opened his judgment on the proceedings by stating that ‘at their heart [was] a battle between a group of senior lenders and a group of mezzanine lenders and, in the middle, a security trustee’. Given the number of stakeholders who may be involved in a restructuring it is not surprising that disagreements occur and competing proposals are put forward. In addition to the directors, the interests of employees, pension trustees and trade creditors may need to be considered and, depending on the method of implementation, the consent of shareholders may be required. Commercial lenders will usually play the most significant role but their interests may not be aligned. Different classes of lender will have more or less bargaining power depending on their relative positions in an enforcement or insolvency scenario, and this will need to be taken into account in order to achieve a deal that is perceived by all lenders to reflect their position in the capital structure. This is further complicated by the fact that lenders may have different interests even within the same class: they may own debt in another class as well or have purchased debt at par when the loan was first syndicated and so be less willing to accept a write-down than lenders who purchased the debt at a discount. Their motivations may also be different: so-called ‘distressed debt traders’ purchase debt with a view to playing an active role in the restructuring and often in the hope of obtaining an equity stake. On top of that, it may not even be possible to identify all lenders, let alone their individual interests and agendas, if the debt is being traded. Consequently, it can be very difficult to reach a consensus on how to restructure the company.

Attempts were made to achieve a consensual restructuring of the Stabilus Group but the fact that the restructuring took two years to finalise, was implemented by enforcement rather than agreement, and was challenged in proceedings in several jurisdictions, clearly illustrates that this was not possible. Most lenders must have believed, at least in the early stages, that there was residual value in the group, as both the senior and the mezzanine lender groups agreed to defer interest payments and suspend their rights while a restructuring was negotiated. However, there was a fundamental difference in the views of the two classes of lender as to the precise value to be placed on the business. Perhaps inevitably, given the subordination of their rights to those of the senior lenders, the mezzanine lenders sought to persuade the senior lenders that the business was worth more than the value of the senior debt but the senior lenders disagreed. As time passed, the mezzanine lenders appear to have felt increasingly alienated and frustrated. They did not have access to the same amount of information as the senior lenders;
certain valuation reports were prepared without their knowledge (and were only obtained under compulsion in proceedings in Luxembourg after the restructuring had taken place) and only the senior lenders were informed of indicative bids sent to Rothschild, which was conducting a marketing exercise. Certain of the mezzanine lenders submitted their own bids and restructuring proposals but these were rejected by the senior lenders on the basis that they would have to write off too much of the senior debt.

The frustration felt by the mezzanine lenders and their desire to reach an agreement with the senior lenders is evident in their willingness to use certain tactics in an attempt to improve their negotiating position. They alleged that the senior lenders’ failure to agree a restructuring or to commence insolvency proceedings meant that they were causing damage to other creditors and were liable under German law ‘lender liability’ principles (liability may be incurred in circumstances where lenders continue to provide finance to a company at a time when it is known to be insolvent). It is hard to see why the mezzanine lenders would have wanted insolvency proceedings to commence (it seems highly unlikely that they would have received anything in that scenario) or to become embroiled in the ‘time and money consuming’ ‘destabilising’ litigation that they were threatening (and which they eventually commenced in Luxembourg, Germany and England). Presumably their aim was to put pressure on the senior lenders to accede to their demands for equity in the restructured company. These tactics were not wholly unsuccessful in that the senior lenders did recognise the mezzanine lenders’ ‘nuisance value’ and as a consequence offered to make a consent payment to smooth the way to a consensual restructuring. This was not accepted by the mezzanine lenders and no agreement could be reached.

The claims made by the mezzanine lenders in the English proceedings revealed tension not just between the creditor classes but within the senior lender group. The mezzanine lenders alleged that the restructuring was the result of a bargaining exercise between the senior lenders, following which various groups obtained larger or smaller slices of the cake as a result of the fact that certain lenders held a blocking minority of the senior debt and were thus able to impose a deal. There were certainly fractures within the senior group. When it became obvious that additional funding was required, at least two of the senior lenders thought that the directors should commence insolvency proceedings. It took time and intense negotiations for them to agree to provide a bridge facility (the consent of all of the senior lenders was required because the new money was intended to rank ahead of the existing senior liabilities). Later, when the facility needed to be extended, there was further dissent within the senior lender group as some lenders were increasingly worried about their potential liability under German law. When it came to agreeing the terms of the restructuring itself, the senior lenders who had purchased the debt at a substantial discount in the secondary market wanted equity returns and were prepared to accept a higher write-down of debt than the original lenders. Therefore it was difficult to reach a consensus. The challenge was made greater by the continually changing constitution of the senior group as a result of trading in the secondary market. Certain senior lenders, including those affiliated with Triton, built up their holdings. The Triton entities submitted a proposal that just failed to attract sufficient support (although a co-ordinating committee had been appointed it could not take decisions to bind the other lenders – decisions were taken by the group as a whole (or the relevant percentage required by the terms of the finance documents)). Triton commenced negotiations with Goldman Sachs and Anchorage, who together accounted for 18 per cent of those votes, and they came to hold a blocking minority of the votes so their support for any restructuring was essential. Eventually it was a proposal agreed by these three lenders that was accepted by the rest of the senior lender group but only after difficult and prolonged discussions.

The vexed question of valuation: who has an economic interest?

In a restructuring, the value of the company is often key and will have a particularly significant role in determining which stakeholders have a place at the negotiating table and what interests they will have in the restructured company. However, there are many difficulties in placing a value on a company, not least because there are several methodologies that can be used and most will produce a valuation range within which the value falls rather than providing a single figure. The problem is complicated further when the company is in financial difficulties
because there are more variables to consider, such as the extent to which the company’s distressed situation should be taken into account and how its prospects of recovery are to be quantified. Different classes of creditors will seek to place a different value on the company to improve their bargaining position. Inevitably, this leads to disagreements, some of which have been played out in the courts of various jurisdictions.

When the Stabilus Group was acquired in 2008 the net consideration was approximately €519 million, €340 million was advanced under the senior facility agreement and €75 million under the mezzanine facility agreement. By 2010 (but probably much earlier) the senior lenders had concluded that the value of the group was well below the amount of the senior debt and so the mezzanine lenders had no economic interest in the group and there was no reason (other than their nuisance value, mentioned above) for them to be given a stake in the newly restructured group. In the English proceedings, the mezzanine lenders asserted that this was not the case. The focus was on whether the security trustee had breached its duties under the intercreditor agreement by implementing the restructuring. Under the intercreditor agreement the security trustee owed certain duties in relation to the method, type and timing of enforcement. It was accepted that those duties were equivalent to the duties owed by a mortgagee to a mortgagor and included, at the very least, a duty to take reasonable care to obtain the true market value of and/or the best price reasonably obtainable for the transaction security at the time of the sale or disposal. The judge analysed the evidence in considerable detail and found that, even assuming that the burden of proof was heavy and lay on the security trustee, there had been no breach of this duty.

When it appeared likely that the security trustee would need to enforce the security it decided that it should obtain four different types of valuation. The first three were desktop valuations and the fourth was to be a ‘market tested valuation’ but when it could not obtain the necessary confirmations to rely on Rothschild’s earlier marketing exercise, the security trustee took the decision, against Rothschild’s advice, not to carry out a fresh sales process. Central to the mezzanine lenders’ case was their contention that where a sale is to a connected or affiliated party, as the Triton purchasers were, a mortgagee is under an obligation to take, and to act upon, independent advice as to the method of sale. The judge found that there is no such absolute obligation under English law; all that could be said was that a mortgagee must take reasonable steps in the circumstances and would only be in breach of duty if he had acted as no mortgagee of reasonable competence acting with ordinary care and (where appropriate) acting on competent advice would act. Failure to run a sales and marketing process in parallel with the restructuring did not constitute a breach of its duty; in fact it would have been impracticable, if not impossible, and potentially damaging given the distressed state of the company.

The mezzanine lenders’ case was that if a sales and marketing process had been undertaken this would have resulted in bids worth in excess of the senior debt, i.e. it would have shown that they did have an economic interest in the Stabilus Group. The main problem with this contention was that a number of exercises were carried out for different parties, including certain mezzanine lenders, during the restructuring process that indicated (expressly or by implication) that the value broke well within the senior debt. In the proceedings the mezzanine lenders challenged the valuations in a number of ways (including those conducted on their behalf) but although the judge acknowledged that several of the exercises had their limitations, he rejected the challenges. Exercises carried out by PwC, Deloitte and Ernst & Young in 2009 and 2010 indicated that the value of the group was below €250 million. Particular weight was given to a report that the security trustee had commissioned from American Appraisal (UK) Limited, which concluded that the value of the group was between €220 and €230 million at a time when the senior liabilities were in excess of €400 million. The report was based on three separate (albeit desktop) valuation methodologies: a benchmark multiple analysis (adjusted to reflect current market environment); a discounted cash flow valuation; and a leveraged buy out valuation. The judge found the report to be a substantial and impressive document that had been carefully prepared (over 270 hours) on the basis of reliable information that had been provided by management. There was no reason why the security trustee should not be entitled to rely on it.
Trading in the secondary market also indicated that the value of the company was less than the senior liabilities. The deep discount at which the senior debt was trading throughout the restructuring process implied a valuation range of approximately €160 million to €280 million. The mezzanine lenders argued that the fact that a quoted company’s debt is trading below par does not mean that its stock is worthless and that, in this case, the debt trading was not connected to the group’s intrinsic value because it was influenced by the differing agendas of the lenders (discussed above). The judge was prepared to accept that there might not be a direct correlation between a company’s intrinsic value and the trading price of its debt but, in this case, because the discount was so substantial and continued consistently and continuously, he took the view that it was ‘a strong corroborative force for the conclusion that the mezzanine lenders were ‘under the water’ by a very large margin’.

Contemporaneous evidence also showed that the mezzanine lenders had themselves concluded that they were out of the money and this was also implicit in the bids they submitted. It was clear that they did not believe there was any current value in their investment but that their expectation was that the Stabilus Group would recover in the future (albeit that this would require a significant reduction in the group’s indebtedness) and they wanted to persuade the senior lenders to give them an equity interest in the hope of a future return. The fundamental problem was that the mezzanine lenders did not demonstrate why the senior lenders were wrong in concluding that the mezzanine lenders had no economic interest. The evidence mentioned thus far clearly did not support the mezzanine lenders’ case. In addition, the judge was not persuaded by the expert who gave evidence on their behalf that the value of the group was more than double the valuation figure in the security trustee’s report and well in excess of the senior debt. This was largely because of a difference of opinion as to how quickly the Stabilus Group would recover from the downturn after 2008. The judge raised concerns that the expert’s conclusions were based on hindsight whereas the security trustee could only have based its decision on the information available at the time. Also, the expert had not had the benefit of contact with the management, which was understandable as he became involved after the restructuring was implemented, but it was regrettable that he had not been provided with the witness statements of the chief restructuring officer and interim chief financial officer.

Perhaps there were ways in which the mezzanine lenders could have bolstered their case. If they genuinely considered that the Stabilus Group’s value exceeded the amount of the senior debt, they could have exercised their rights under the intercreditor agreement to purchase the senior debt at par or purchased it in the market at a significant discount. Their failure to do so could not be held against them (the judge found that it couldn’t deprive them of any of their other rights or lessen the obligations of the security trustee under the intercreditor agreement). However, if they had purchased senior debt, this might have improved their position as it would have made their subsequent assertions about the value of the group more plausible; and holding senior debt would also have given them greater influence over the restructuring process. In addition, if they had been able to provide any evidence to support their claims that at the time of the restructuring they were prepared to make a bid in excess of the senior liabilities, that might have helped.

Ultimately the judge found that on the evidence available there was no realistic basis for thinking that if a sales process had been carried out it would have attracted any offers in excess of the amount owed to the senior lenders (or indeed any better than Triton’s offer). Therefore, although certain of the security trustee’s actions drew criticism from the judge (he was prepared to assume at the very least that it had acted inappropriately in failing to put in place Chinese walls and in sharing information with the senior lenders to the exclusion of the mezzanine lenders), the mezzanine lenders had not suffered any loss and so there was no actionable breach of duty by the security trustee.
CONCLUSION

The judge stated that ‘the overall effect of the restructuring was to place the Stabilus Group on a sustainable footing with a substantially reduced debt burden’. In that respect it is a success story in which a number of hurdles, including the spectre of personal liability for the directors and the senior lenders, the challenging dynamics within the lender group and the uncertainty as to the value of the business, were overcome. These issues, among others (such as whether the proposed restructuring can be achieved under the terms of the finance documents), will need to be addressed in any restructuring, whatever approach is adopted. Even in the context of formal procedures, directors will be faced with the difficult decision as to when to commence the procedure. It will often be advisable (and in the case of some procedures, necessary) to obtain the support of certain creditors and carrying out one or more valuation exercises will be key to determining whether the company has satisfied the threshold conditions for the opening of proceedings and whether the sale of the business or certain assets is vulnerable to challenge.

The story told from the perspective of the mezzanine lenders is ‘one of disappointment at a failed negotiation’. The judge found that there was no legal basis for their disappointment. Nonetheless, their disappointment was such that they pursued costly and time-consuming litigation in several jurisdictions. There have been a number of cases in recent years in which junior creditors have similarly felt sufficiently aggrieved to challenge restructurings. The prospect of such challenges, which can be damaging even where they are unsuccessful, exacerbates the need for directors to carefully consider their position, for attempts to be made to reach a consensual agreement among stakeholders and for great care to be taken when valuing the business. The inherent difficulties in doing so mean that this is a story that is likely to be repeated.

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