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ARTICLE

Schefenacker plc: A Successful Debt-for-Equity Swap

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Executive summary

This article discusses the way in which the CVA, a highly flexible UK insolvency procedure, was used to implement a complex cross-border restructuring without damaging the operations of a global Tier One automotive supplier.

Background

Schefenacker is the ultimate holding company of a global Tier One automotive products manufacturer. The group supplies some 28% of global production of wing and rear-view mirrors, and its main customers are five of the largest global auto manufacturers. The mirrors businesses are primarily located in the UK, USA, Korea, Hungary, Australia and Germany; with operations in a further six countries. At the time of the restructuring it was also the ultimate parent of a smaller lighting business which was operationally based in Germany, the USA and Slovenia.

Prior to the restructuring, the ultimate holding company was Schefenacker AG, a German registered company. The group had originated in Schwaikheim, in South-West Germany, and was still wholly owned by the founding family. However, it had grown from being a German company to a global group, and by the time of the restructuring its spread of operations was such that the group's business could not be regarded as only, or even primarily, German.

The principal value of the group's financial debt was as follows:

– Senior secured RCF facility: EUR 50 million
– Second lien term loan: EUR 155 million
– Unsecured guaranteed bond issue: EUR 200 million

In addition the group had some bilateral facilities and other operational creditors.

In mid-2006 the group became concerned about its operational performance and began a major restructuring programme, advised by Allen & Overy and assisted by Alix Partners and latterly Alvarez and Marsal. It also embarked on a review of the sustainability of its financial indebtedness. Following these actions, the secured lenders to the group consented to an overall restructuring plan involving four interconnected restructuring elements:

– balance sheet restructuring;
– refinancing;
– corporate restructuring; and
– operational restructuring.

The refinancing, corporate restructuring and operational restructuring proposals were supported by the senior lenders and the key customers and shareholders, subject to an acceptable balance sheet restructuring to reduce the group's financial debt to a level that it considered sustainable in the long-term.

This article will discuss the balance sheet restructuring.

The method chosen to implement the balance sheet restructuring was a Company Voluntary Arrangement ('CVA') under the UK Insolvency Act 1986 (as amended) ('IA86'). A CVA was used in preference to a S425 Scheme of Arrangement for a number of reasons, including that a CVA is one of the insolvency procedures recognised under the EC Insolvency Regulation 2000. If the CVA were approved by the creditors, therefore, it would be recognised as a main proceeding throughout the EU (except Denmark).

The restructuring took the form of a debt-for-equity swap to remove some EUR 300 million from the balance sheet, EUR 200 million of bond debt and approximately EUR 100 million of shareholder and related loans, together with the release of guarantees of the bond debt from the majority of the operating companies and certain other subsidiaries. The CVA was to be proposed by

Notes

1 KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 148 countries and have 113,000 people working in member firms around the work. The views and opinions expressed herein are those of the authors and do not necessarily represent the views and opinions of KPMG international or KPMG member firms.

Nominees from KPMG, who would become Supervisors of the CVA if it were approved by the creditors.

The key issues

The key issues to implement the balance sheet restructuring were:

- migration – the location of the holding company needed to be in the UK;
- the creditors – a proposal had to be approved by the unsecured creditors, the key group of which was the bondholders;
- rescue – the operations of the group had to be preserved without damage, to allow the ongoing group to prosper.

Migration

The location of the holding company, Schefenacker AG, was migrated via a well-understood, but little-used, German legal process, with the consent of the bondholders, to the UK. In the process Schefenacker AG was transformed into Schefenacker plc, a UK registered and UK based company. The reasons for this were:

- to allow a debt-for-equity swap. It is likely that as a matter of German law this would have required unanimous approval from bondholders and therefore would have been practically unachievable;
- to allow guarantees to be released. Guarantees of the bond debt had been given by companies elsewhere in the group, and without the CVA these could not have been released or compromised without insolvency proceedings against the guarantors, which were the principal operating companies of the group;
- to be able to achieve both of the above in one process over only one company. This allowed the operating companies to remain largely unaffected and in particular meant that a light touch approach was possible. The operating companies did not enter any insolvency/restructuring proceedings so they were able to continue business in the ordinary course throughout the restructuring and did not require the CVA Supervisors to be involved in their management. This reduced complexity (of which there would otherwise have been a surfeit) and costs (which otherwise could have been prohibitive) and without it there was no alternative but to go through a difficult process of security enforcement which would have significantly reduced value for stakeholders and prejudiced the long term viability of the group; and
- speed. Once the deal was agreed, implementation via a CVA requires only that the creditors were given 14 to 28 days' notice of the meetings; that the meetings are held and the result reported to the court and that there is then a 28 day challenge period. Once that has expired (assuming no challenge is made under section 6 IA) implementation of the debt-for-equity swap and distribution of the consideration can take place immediately.

Key elements allowing migration

Schefenacker is not a mandate for every non-UK company to switch to England to achieve a restructuring that might not be as easy in their homeland. Schefenacker AG had certain key elements which made it possible:

- although the company had its origins in Germany, the group had become global with operations in twelve countries in Europe, the US, Mexico, and Asia.
- it was a pure holding company, having as assets cash, investments in its subsidiaries and intercompany debts;
- it was privately owned;
- it had no employees in Germany;
- its universal successor was incorporated in the UK, had offices and employees in England and had no connection with Germany;
- its direct creditors were the financial creditors and professional advisers: there were no direct trading creditors;
- the migration had been approved by the secured lenders, a majority of bondholders, the shareholder and its major customers.

The creditor issues

Approval

In a CVA, the key issue is to obtain approval to the proposal which the company makes from more than 75% by value of those unsecured creditors which are present and voting in person or by proxy. There is a requirement to have a shareholder vote, but if the creditors approve the proposal then it will take effect regardless of the shareholder decision unless the shareholders apply to court for it to be overturned.

In Schefenacker, the key unsecured creditors were the bondholders in respect of a bond issue of EUR 200 million face value. However, there were also unsecured subordinated intercompany creditors having a value of some EUR 91 million and other unsecured creditors of some EUR 24 million. Neither of these groups were to

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be compromised within the CVA, but both were entitled to vote. To prevent there being any unfair prejudice, which might have arisen if sufficient of these unaffected creditors voted in favour of the CVA to pass it regardless of the wishes of the majority of affected creditors, a second, non-statutory, condition was imposed. This was that more than 75% by value of those bondholders present and voting should vote in favour of the CVA. The CVA thus differed from the CVA which failed in Powerhouse in which affected and unaffected creditors voted together without any protection for the affected creditors. There is no concept of a class in a CVA (in contrast to a S425 Companies Act scheme or a Chapter 11 Bankruptcy Code proceeding) but the approach taken in Schefenacker is a practical means of ensuring that a CVA should not fail because the unsecured creditor group includes persons whose rights are so different that they could not necessarily work together in their common interests.

The first proposal

Schefenacker's original CVA proposal was simple: all creditors were unaffected other than the shareholder (and associated) loans and the bondholders. The shareholder loans of EUR 100m were to be written off and the shareholder would (i) provide further lending of EUR 20 million and (ii) transfer a valuable shareholding to the group, in return for approximately 25% of the restructured equity. The bond guarantees would be released and the bonds converted into 5% of the restructured equity. The alternative to the proposal was that the secured creditors would enforce their security and on that basis bondholders would receive nothing. The company felt able to propose this deal on the basis that the equity could have value in the future, which would be a better outcome than the alternative. The evolution of this proposal was complicated but for these purposes it is sufficient to note that there was very little opportunity to discuss the proposal with representatives of the bondholders and with only a few days to go before the original creditors' meeting, it became clear that the original proposal did not have the support of bondholders. In the few remaining days prior to the meeting there were intensive negotiations between the other stakeholders, the company and holders of a substantial amount of bonds (by value), but the Insolvency Rules provide only limited scope for the Chairman to adjourn the meeting.

Adjournment

IA86 rules 1.21(2) and 1.21(3) allows the creditors' meeting to be adjourned for up to 14 days by the chairman or by vote of the meeting. Bearing in mind the complexities of notifying bondholders and receiving votes back, this would not be long enough to produce a revised proposal, give creditors time to consider it properly, and allow creditors to confirm or modify their vote (or indeed vote for the first time).

There were two issues which needed to be considered in order to give creditors the time to consider the revised proposal properly. The first was whether the Insolvency Rules permitted the time limits in rule 1.21 to be extended. Rule 1.21(2) appears to be prescriptive: '… adjourn that meeting for *not more than* [emphasis added] 14 days.' However, Rule 12.9(2) allows the court, under the provisions of the Civil Procedure Rules, Rule 3.1(2)(a), to extend or shorten the time for compliance with anything required or authorised to be done by the Insolvency Rules. It was therefore thought possible to use this provision to allow the length of the adjournment to be extended to give a reasonable time for a revised proposal to be produced and for creditors to receive and consider it.

The second was who had standing to make the application, and in particular whether the Nominees were able so to do. It was felt that the Nominees had the best standing to apply for directions in relation to the conduct of the meeting, as the extension sought related to their position in chairing the meeting and allowing adjournments.

The High Court was content with this reasoning, made in an ex-parte application, and granted an adjournment of up to 35 days. However, the court required that the Nominees announced at the first meeting that creditors were permitted to object to the extension by application to the High Court on two clear days' notice. No creditor objected.

To the best of the company's and its advisers' knowledge, this is the first time that an adjournment has been required in a CVA where bondholders holding their interests through the clearing systems have been voting. It is clear that the High Court will be prepared to assist to try to ensure that a fair period is given to allow creditors properly to consider a revision to proposals, strengthening the position of the CVA as a flexible restructuring tool.

The amended proposal

The amended proposal improved the offer to bondholders to be: EUR 7.5 million (cash); 5% of the restructured equity and warrants of up to 10% of the original restructured equity. The warrants would be issued if the group met certain performance targets.

The outcome

The amended proposal was passed both by the statutory majority and by more than 75% of bondholders present and voting. No challenge was received to the

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CVA in the UK courts within the 28 day deadline allowed under section 6, IA86. The CVA became effective immediately upon approval, thereby preventing creditors taking action to enforce their debts, other than by challenging the validity of the CVA under section 6 IA86. (material irregularity or unfair prejudice). However, it is possible to draft a CVA such that certain aspects of it only come into effect on, or following, the occurrence of certain events. This technique was used in the Schefenacker CVA in order to allow the whole restructuring to be implemented at the same time, although the CVA had to be approved before other aspects of the restructuring could be completed.

Chapter 15

Following the close of the challenge period in the UK, it was necessary for the Supervisors of the CVA to request Chapter 15 relief as a Foreign Representative under the US Bankruptcy Code. This was in order firstly to protect the group from any action in the US or against group assets located in the US, and secondly to protect assets in Australia. The US position clearly required US protection. The Australian aspect arises because although there is no recognition procedure under Australian law, as a matter of common law the Australian position is that where there is an effective compromise of a debt made under the law governing that debt, that compromise will be recognised in Australia. As the bonds were issued under a New York law debenture, to protect Schefenacker's Australian operations the compromise had to be made effective under New York law.

In general, Schemes of Arrangement have been recognised by the US courts as appropriate subjects to which to grant relief under the precursor to Ch15, S304 of the US Bankruptcy Code. However, although relief for a CVA had been given in the TXU case, this had been accompanied by an administration. Schefenacker is believed to be the first case where a 'standalone' CVA has been recognised by the US Courts.

Certain bondholders who had voted against the CVA, but who had not filed objections under section 6 IA86, raised objections in the Chapter 15 process. The presiding judge dismissed the arguments of the opposing bondholders that the UK process had been unfair, noting that they had had, and known they had, opportunity to challenge in the UK and yet had not done so. He would not permit the US process to be used as a way of circumventing the CVA. The question of COMI was raised, but the US Court concluded that, as under Ch15 it could grant the relief sought by Schefenacker whether the CVA proceedings were main proceedings or non-main proceedings (as mandatory or discretionary relief respectively), it would grant the relief without concluding on the point.

Is it a precedent?

Can Schefenacker be taken as a precedent for transporting companies to a jurisdiction where one can achieve a form of restructuring which is either unavailable or impractically complex in the initial jurisdiction? Only maybe.

Schefenacker had a number of features which made it suitable for a migration:

– the holding company which migrated had no operating businesses, it existed only to hold shares in subsidiaries and to undertake the restructuring;
– there was an intermediate holding company which was based in the UK, further separating the operating companies from the holding company;
– the operating companies were in jurisdictions all over the world. Schefenacker may originally have been 'German' but by the time it ran into difficulties it was truly global;
– there were no complex tax issues which would have complicated the deal further;
– the majority of the negotiating parties were based in the UK.

Conclusion

Schefenacker's successful restructuring depended on two factors: its group structure and the commercial deal. The CVA process, even with the added complexity of the migration, was the fastest way to achieve the desired outcome.

It should be noted that this was not the first refinancing of Schefenacker. However, in the earlier wave of liquidity the underlying issues did not need to be addressed in order to patch the position. It was not until the operational performance had deteriorated as well as the interest cost become prohibitive that a substantial restructuring was undertaken. With the sudden change in the credit climate, might there be more such companies out there?

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International Corporate Rescue

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