

Droit et Croissance
Rules for Growth

The importance of an efficient insolvency law on the development of finance

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The importance of an efficient insolvency law on the development of finance

Introduction: main differences between US bankruptcy law and French insolvency law

US



- A Chapter 11 petition is a recognition event that reduces future possibilities to present value
- Stakeholders' rights are therefore reorganized depending on the present value of the company (taking into account its level of indebtedness and its projected available cash flows)
- The automatic stay imposed upon filing for bankruptcy proceedings provides relief to reallocate rights over the debtor's assets according to the order of priority of the various stakeholders
- Enforcing creditor's ex ante rights is one of the key principles underlying Chapter 11, the so-called *absolute priority rule* :
 - as many classes of stakeholders as tranches of debt/equity
 - only holders of the fulcrum security are entitled to approve the reorganization plan

France



- A petition for bankruptcy proceedings (*procédure de sauvegarde*) is not a recognition event that reduces future possibilities to the present value > no obligation to reorganize the capital structure of the debtor on the basis of its projected available cash flows
- The automatic stay upon filing for bankruptcy proceedings is not used to evaluate the situation of the debtor before a complete reallocation of the stakeholders' rights over the debtor's assets: no cram down of stakeholders is possible
- Main issues: violation of the order of priority is common as all stakeholders are always entitled to approve the reorganization plan > secured creditors are treated in the same way as unsecured creditors, violation of contractual subordination agreements, preferential treatments for shareholders, power of the court to automatically postpone debt maturity by up to 10 years etc.

Part I: Impact of French insolvency law on the deleveraging of insolvent companies

US

Financial Value of the distressed firm

Entreprise Value (EV) 100	Senior secured 50
	Second Lien 60
Negative Eq. 30	Junior 20

Assets	100	Liabilities	130
Neg. Eq.	30		
Total	130	Total	130

Description

- ✓ Junior tranche and equity tranche are crammed down
- ✓ The value of senior secured creditors' claims is preserved
- ✓ The second lien tranche is the "fulcrum security": a part of the second lien tranche is transformed into equity

Resizing of capital structure : sound balance sheet

EV 100	Senior secured 60 (+ 10 New Money)
	Second Lien 15
	Equity 25

Assets	100	Liabilities	75
		Equity	25
Total	100	Total	100

France

Financial Value of the distressed firm

EV 100	Senior secured 50
	Second Lien 60
Negative Eq. 30	Junior 20

Assets	100	Liabilities	130
Neg. Eq.	30		
Total	130	Total	130

Description

- ✓ The equity tranche and the junior tranche are not crammed down
- ✓ The equity tranche is (only) partly diluted as part of second lien and junior tranche is converted into equity
- ✓ The value of senior secured creditors' claims is not preserved
- ✓ Distressed cost remains as insufficient deleveraging post reorganisation
- ✓ Increased interest cost

Resizing of capital structure : unsound balance sheet

EV 100	Senior secured 60 (+ 10 New Money)
	Second Lien 50
	Negative Eq. 25
	Junior 5

Assets	100	Liabilities	125
Neg Eq.	25		
Total	125	Total	125

The US legal system:



- Allows companies to completely reorganize their capital structure according to their projected available cash flows **before** a liquidity crisis
- Allows shareholders and “out of the money” creditors (below where the value breaks) to be crammed down: they lose all their rights over the assets of the company
- Aligns the interests of the “in the money” creditors with the interest of preserving of the value of business > creditors are enticed to adjust interest cost to the debtor’s investment plan
- Increases competitiveness of debtors which emerge with a sound capital structure

The French legal system:



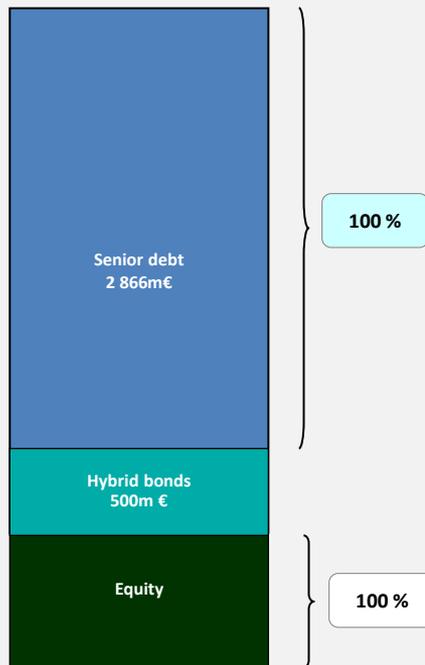
- Does **not** allow companies to completely reorganise their capital structure according to their projected available cash flows
- Does not allow courts to cram down shareholders and “out of the money” creditors as shareholders and creditors can refuse debt/equity swaps (and therefore deleveraging of companies) prior to liquidity crisis
- Does not align the interests of “in the money” creditors with the interest of preserving the value of business > creditors negotiate high interest costs which entail additional financial distress costs
- Results in “zombie companies” emerging from out-of-court negotiations / formal bankruptcy proceedings

Part I – Impact of French insolvency law on the deleveraging of insolvent companies

Business case: Technicolor before and after French bankruptcy proceedings

Technicolor

Debts structure before restructuring



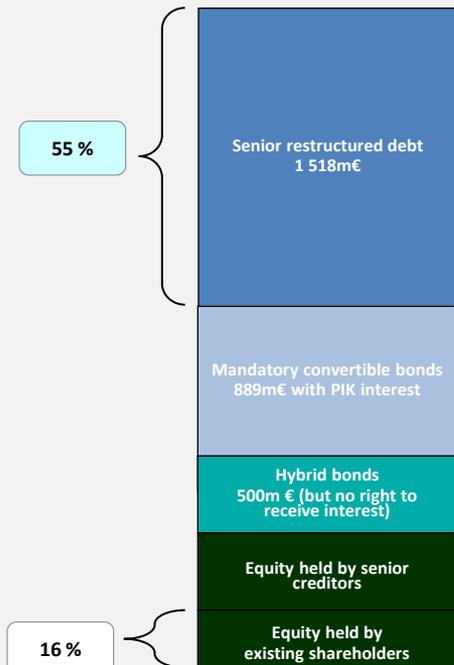
Equity value negative

Description

- ✓ Shareholders and holders of hybrid bonds are not crammed down
- ✓ Existing shareholders still have 16% of shares after restructuring
- ✓ Holders of hybrid bonds receive a cash payment of €25M but lose any future right to receive interest
- ✓ Senior creditors were forced to accept the conversion of 45% of the senior debt into shares or mandatory convertible bonds with PIK interest
- ✓ Refinancing of the remainder of the debt has been negotiated:
 - A new € 300M senior credit facility at Euribor/Libor + 500 bps payable in 2016
 - A new € 631M senior credit facility at Euribor/Libor + 600 bps payable in 2017
 - A new €587 bond issue with a 9% interest rate payable in 2016 and payable in 2017

> Technicolor continues to suffer financial distress costs

Debts structure after restructuring



Equity value remains negative

The US legal system:



- Preserves the specific rights of the various tranches of debt/equity in the event of bankruptcy as only holders of the fulcrum security are entitled to vote on the reorganization plan
- Limits the risk of conflicts of interests between the various stakeholders (even though some issues remain)
- Facilitates deal originations driven by supply side
- Favors financial innovation such as debt diversification (hybrid products etc.)

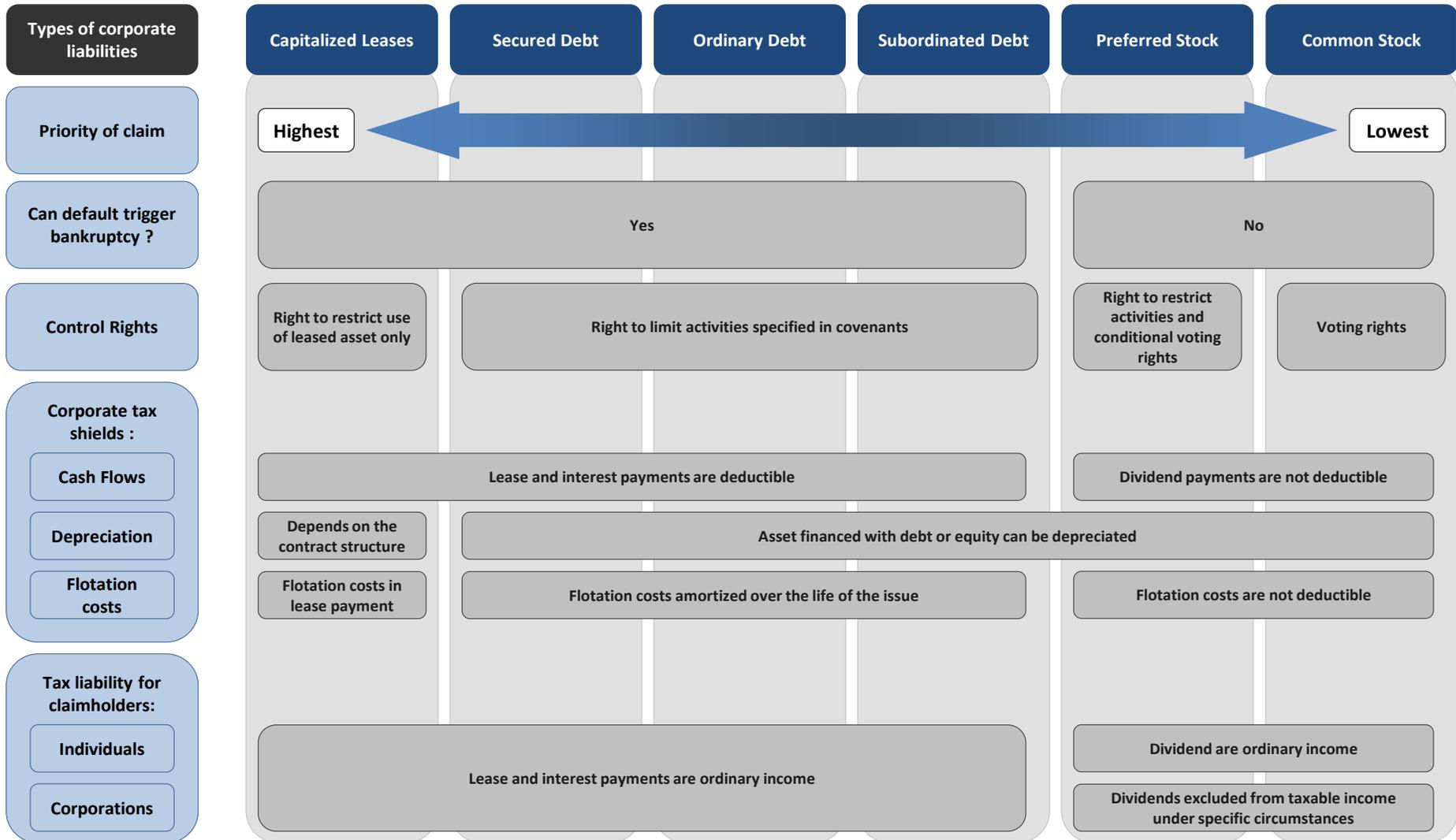
The French legal system:



- Does not preserve the specific rights of the various tranches of debt/equity in the event of bankruptcy as all the different classes of investors are entitled to vote on the reorganization plan
- Increases the risk of conflicts of interests between the various stakeholders > increases bankruptcy costs
- Prevents development of deal originations driven by supply side (sell-side approach)
- Reduces incentives to develop financial innovation so as to avoid greater bankruptcy costs
- Greater debt specialization

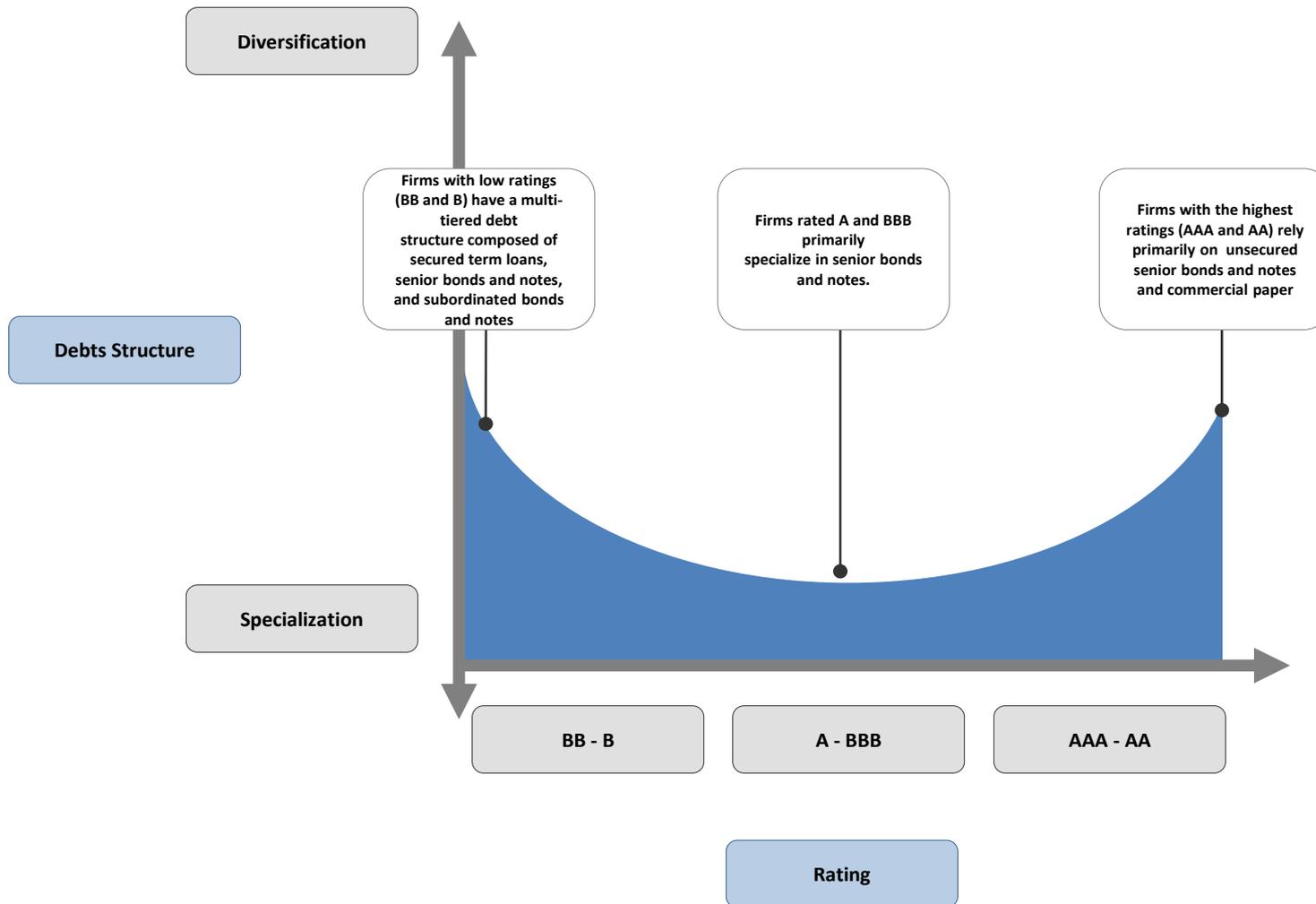
Part II: Impact of French insolvency law on debt diversification

A. Characteristics of Corporate Liabilities



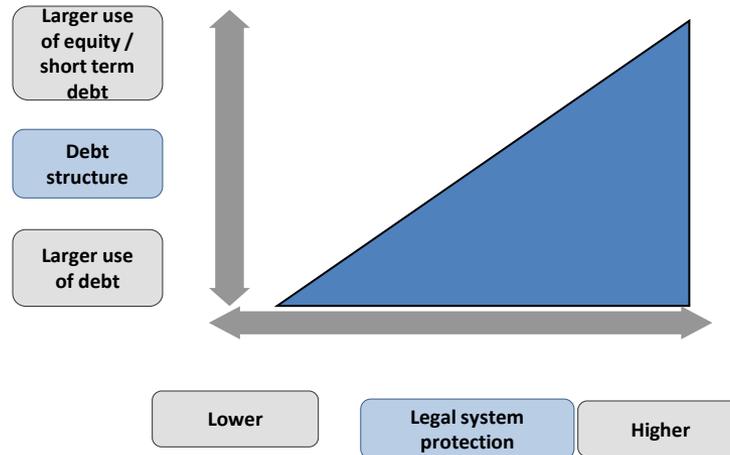
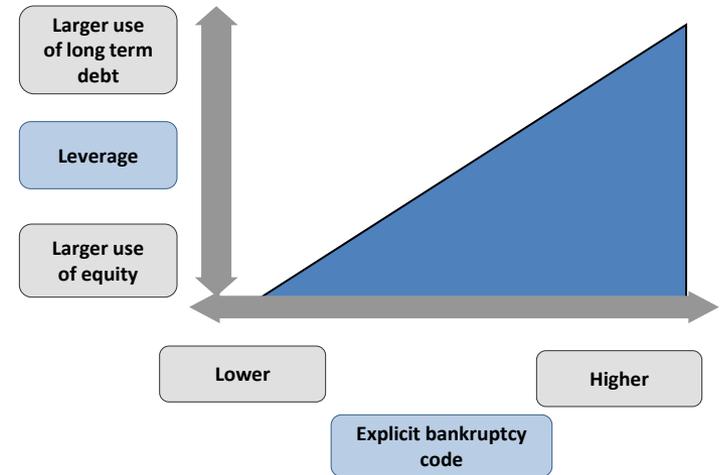
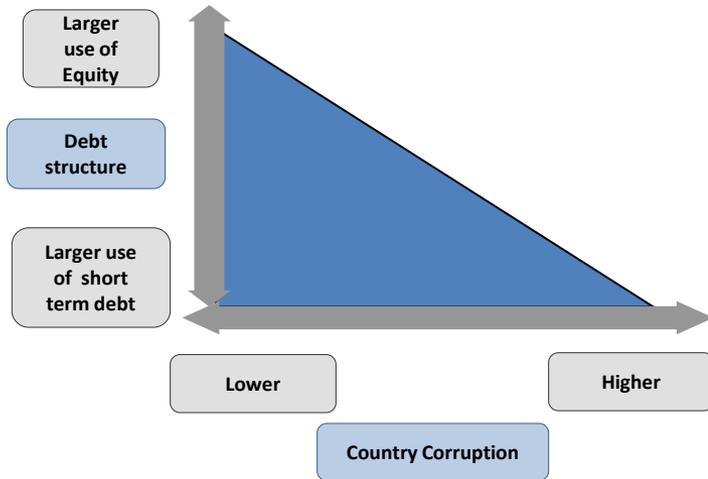
Part II : Impact of French insolvency law on debt diversification

B. Debt specialization /diversification in a favourable legal environment (U.S. example)



Part II: Impact of French insolvency law on debt diversification

C. International Comparison of Capital Structure



Part III: Focus on the impact of French insolvency law on the development of high yield bond markets for medium sized companies

The US legal system:



- Provides investors with a strong predictability, enabling them to adjust their risk appetite to the probability of default and likely loss given default
 - Allows the use of contractual subordination mechanism which facilitates :
 - negotiations between banks and bond investors on the terms of subordination
 - the restructuring of the issuer's capital structure in the event of a default
- favours the development of financial markets even when the issuer has a high probability of default as the risk to creditors is therefore limited to the risk of a valuation error
- is very favorable to medium sized companies and facilitates their access to bond markets

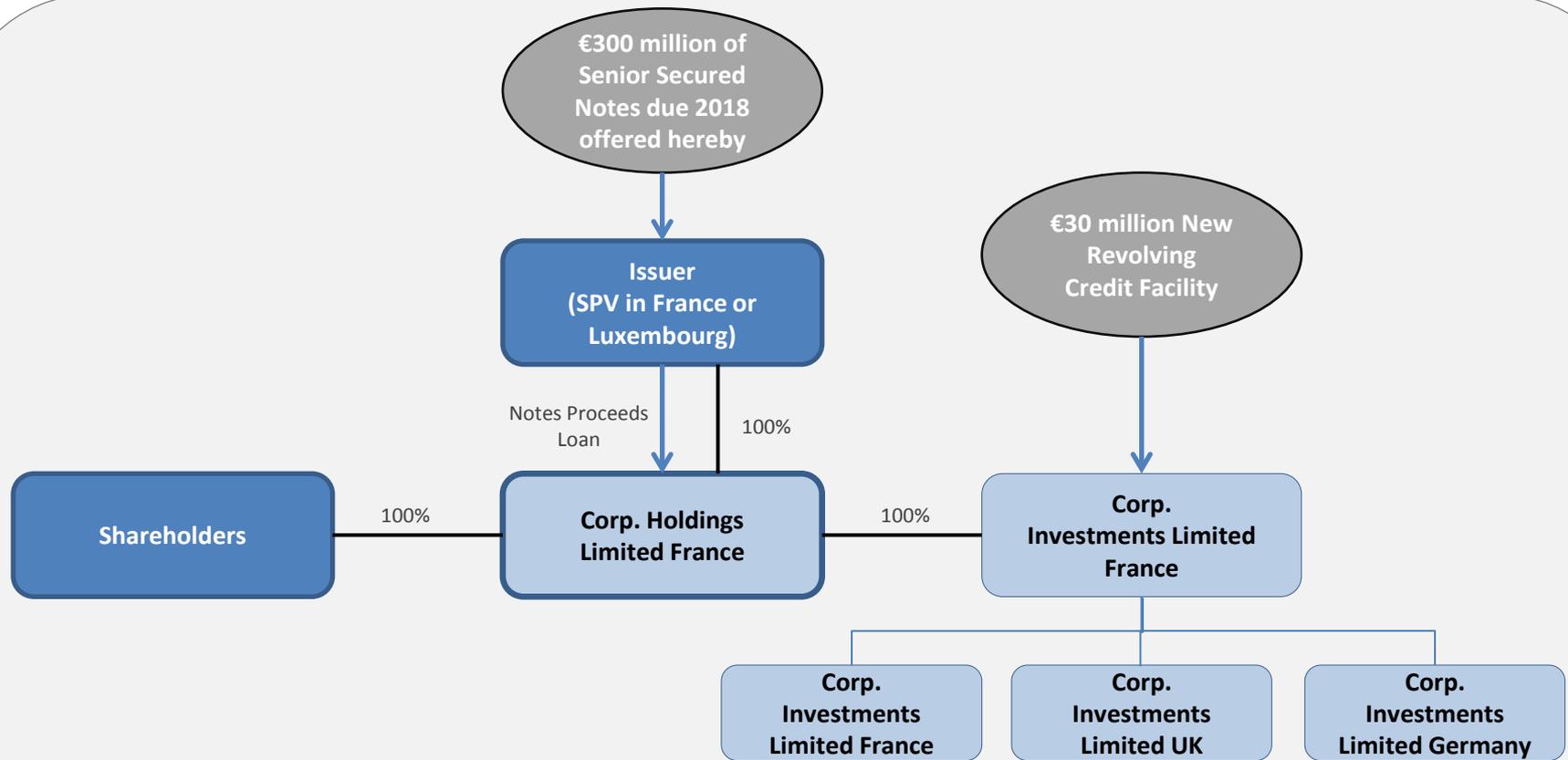
The French legal system:



- Increases cost of financial distress : violation of the contractual order of priority prolongs conflicts between stakeholders
- Creates a legal uncertainty which is a deterrent to investors and creates price uncertainty
- Compels investors to require a structural subordination mechanism with detrimental effects:
 - high yield bond investors are junior to all the other creditors of the debtor (not only banks) > use of second tier lien and guarantees compensation, but with limited efficiency
 - more difficulties to restructure the debtor's capital structure in the event of default
 - lack of transparency for investors
- Access to markets is therefore impaired for medium sized companies or more costly

Part III: Focus on the impact of French insolvency law on the development of high yield bond markets for medium sized companies

A. French high yield bond issue – Example of structural subordination mechanism



*Guarantees are of limited use due to corporate/bankruptcy law issues.

Part III: Focus on the impact of French insolvency law on the development of high yield bond markets for medium sized companies

B. US High yield bond issue – Example of contractual subordination mechanism

