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Agreement on EU restructuring directive on the horizon; testing times for bond workouts – Droit et Croissance restructuring conference coverage

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Agreement on the European Commission's restructuring directive is within sight, according to speakers at a restructuring conference organised by Paris-based think tank Droit et Croissance ('Rules for Growth') held at the French Ministry for the Economy and Finance on Friday, 19 January. Panellists also debated 'cram-down' and the more controversial 'cram-up' and mooted challenges for bond workouts.

European makeover

The conference – which featured three in-depth roundtable discussions – kicked off with a keynote speech from Mihaela Carpus Carcea, legislative officer at the European Commission. Providing an update on the commission's draft directive, she explained that a revised version has been produced which member states have started discussing. "We might have agreement on the 'second chance' title before June", she said, adding that she hoped there would be agreement on the whole proposal in a year.

Outlining the various challenges the project faces, including how to make restructurings work for SMEs, Carpus Carcea was pleased that member states and the European Parliament have been receptive to the 'cross-class, cram-down' mechanism. "It has been widely accepted and the question is now how to protect dissenting classes," she said.

Aside from the restructuring directive, Carpus Carcea noted that the commission is looking at the issue of non-performing loans (NPLs) in a broader context and – while the restructuring proposal is important to prevent the build-up of NPLs – the commission is reflecting on other measures to complement the proposal to deal with NPLs.

Thomas Andrieu, head of the Civil Affairs and Seals Directorate at the French Ministry of Justice, seconded Carpus Carcea on the importance of taking the "sensitivities" of different countries into account. He posited that the Germans, for instance, were wary of any abuse of proceedings, while the French constitutional law is very cautious when it comes to affecting property rights. "The French constitutional law protects property rights of the shareholder much more than that of the creditor," he said. "So, if [a company is] not insolvent, there should be a really strong case of public interest for the court to get involved [and affect property rights of the shareholder]."

Andrieu also observed that France had concerns on the effect of the directive on existing consensual proceedings. He noted that each year the French courts dealt with around 4,400 such cases (including mandat ad hoc, conciliation, and sauvegarde), and that the current success rate was close to 70%.

He posed three key questions for stakeholders to consider while evaluating the EU restructuring directive. Firstly, since the directive deals primarily with prevention and pre-insolvency frameworks, it would perhaps be prudent for the rules outlined for the pre-insolvency processes to also impact the existing court-led insolvency processes. "It would be bad to have a different set of rules when in sauvegarde or redressement judiciaire," he said.

Secondly, for the practitioners, should governments work to integrate specific parts of the EU directive into the sauvegarde and redressement judiciaire procedures right away or take the time to write the laws correctly and do everything at once (which would inevitably take more time)?

Lastly, Andrieu raised the idea of making procedures in France specifically more open and accessible to the public. "This transparency in France of the judiciary may be cruel but then it may also be transformative," he said. France is currently working on a structured 'open data' database where all decisions made in procedure collective would be made public except for the name of private individuals (according to the EU GDPR).

This last point - while not specifically part of the EU directive – opened up a lively debate in the conference room on the extent to which restructuring negotiations and decisions should be public for fear of damaging an entrepreneur's and a corporation's rights to "le droit a l'oubli" (right to be forgotten/forgiven). It should be noted that some decisions are already publicly available through the court registry in France, though must be picked up in person and are not available online such as is the case with the US court system, for example.

Top trumps

The first roundtable considered the concept of an automatic stay and secured creditor rights, in the context of the draft directive. A particular talking point was the idea of 'cram up', ie enforcing a plan on secured creditors.

Donald Bernstein, partner at Davis Polk Wardwell, felt that the effect of a stay is one problem that needs to be addressed in designing a balanced reorganisation law. He explained that, based on the US experience, there can be costs to secured creditors in being stayed from exercising their remedies because the value of their collateral can drop, so the secured creditor is prejudiced by the stay. To balance this, the secured assets should not be used unless the secured creditor is given 'adequate protection', he added.

Pointing out that the draft directive has the concept of 'unfair prejudice', Sophie Vermeille, president of Droit et Croissance, queried whether this was sufficient to protect creditor rights. Nico Tollenaar, partner at RESOR, responded that he was not sure that unfair prejudice has a fixed meaning. It might be that the European Court of Justice (ECJ) looks to the US and interprets it to mean 'adequate protection' and draws inspiration from the US, he said.

A key issue for Tollenaar was that – unlike the US system which is very court-driven – there is very little oversight under the draft directive. He explained that the thinking in the Netherlands is that a court-driven process is undesirable as it is expensive and cumbersome. "We're thinking of the concept of a court-appointed independent monitor who sits in the company and advises the court on whether the position of secured creditors is being prejudiced and, if so, it can lift the stay", he added.

According to Stephan Madaus of Martin Luther University Halle-Wittenberg, the idea in Germany is not to have a collective stay for solvent debtors. "If you're thinking of protecting a workout negotiation you can go to court and have a remedy against one creditor – but you don't need a collective stay".

The panel tackled the thorny issue of when a plan should be capable of being imposed on dissenting secured creditors.

While Tollenaar considered it a "no-brainer" that it should be possible to impose a plan on out-of-the-money junior creditors, imposing a plan on in-the-money creditors was completely different. He proposed that it should only be possible to impose a plan on them if members of that class have a choice between, firstly, rights under the plan equal to their share of the reorganisation value (possibly not in cash); or, secondly, their share of the liquidation value in cash. So, it is possible to impose a plan over a dissenting senior class but they need to be bought out at liquidation value, he concluded.

Tollenaar justified his proposal on the basis that in-the-money senior creditors have rights to enforce their claims and receive distributions. "I don't think the system should take away these 'exit rights' as they are part of the bargain between a company and all capital providers. They are part of the deal and why secured creditors get a lower interest rate".

Bond workouts: challenging climate

The day drew to a close with a panel discussing challenges for bond workouts and loan-to-own strategies.

Stephen Portsmouth, managing director at Société Générale, identified cramming down subordinated shareholders as an overriding problem. The longest workouts – leading to high costs – feature an inability to cram down out-of-the-money stakeholders, he observed.

Pierre Bour, partner at Attestor Capital LP, pointed out the importance of cultural differences in the design of restructuring regimes. For example, in France the government may often find itself in a shareholder position and therefore could be more inclined to protect shareholder optionality when designing a restructuring process. In the US, given the US government cannot own any shares, it would naturally be less pre-occupied with protecting shareholder interests. He added that shareholders empower managers by approving business plan and investment programmes, and that if their plan fails, the shareholders should not be in a position to blame the bank lenders who only have limited indirect influence over business decisions (mostly via covenants when they exist). "If a company fails, the shareholders have to accept that they are no longer in charge if they are unwilling to provide the funds to ensure a going-concern strategy," said Bour.

Kon Asimacopoulos, partner at Kirkland & Ellis, explained that the way to think about the situation is that the company is at the centre and the stakeholders are around the edge. Shareholders are one stakeholder and are typically treated according to their economic and strategic position, he argued. "The UK has tools to ensure dissenting minority stakeholders can be dealt with," he said, explaining that enforcements including through pre-pack administrations are a powerful tool to threaten stakeholders who seek to hold up a restructuring. “We have seen COMI shifting so prepacks can occur for non-UK companies”. Asimacopoulos continued to describe the UK scheme of arrangement while noting the need for caution as things have changed over the years. “Fifteen years ago, practitioners were more flippant about how to constitute classes” he said, pointing out that now this needs to be carefully contemplated, with consideration given to even minor items which could cut across the applicable class tests.

Referring to the cross-border restructuring of CGG, Pierre Bour explained the need to file for Chapter 11 in the US, to protect US assets from enforcement, complicated the process. Chapter 11 takes at least two months – that essentially removed the option of a Sauveguarde Acceleree in France, creating a conflict of law, and forced the company into a longer process. Another issue he raised was that though bondholders will own 95% of the equity post-restructuring, the company falls into a governance vacuum between the time a restructuring agreement is signed and the time the company re-emerges from the restructuring. “It creates odd situations where you have new, future shareholders, committing significant amounts of capital, but not getting much governance rights for periods that can last up to one year”, he surmised.

Portsmouth drew a distinction between a restructuring dealing with private debt versus one that encompasses both public and private debt, observing that public debt is at a disadvantage in terms of transparency. In the early stages of financial distress, corporates may be tempted to take out bondholders at prevailing market prices, or refinance at par in order to avoid going through a public negotiation, according to Portsmouth. He pointed to a few examples where distressed investors could have made money buying subordinated debt at distressed levels as it is often complicated to bring all the bondholders to the negotiating table and easier to get relationship banks to make concessions through a private negotiation.

Predicting that we will see more restructuring cases with a cross-border aspect, Pierre Bour noted that he has observed a deterioration in credit quality in the last two years. “The reality is that, away from cyclical industries like energy and commodities, most businesses that went through a distressed situation over the past two years tended to be very mixed quality with questionable business models. In addition, due to covenants getting looser, asset quality tends to deteriorate a lot before creditors actually get a seat at the table”.

As to the effect of Brexit, Asimacopoulos remained optimistic. “History demonstrates that in a time of distress, practitioners have always found a way to implement a restructuring – sometimes with additional enormous cost – but we do get there. Brexit will have an impact, but we’ll find a way”, he predicted. “We are certainly disadvantaged by a lack of harmonisation, but there is usually a path through and the consequences of a European insolvency is often motivation enough.”

For Portsmouth in comparing the relative merits of the outcomes of capital restructurings in different legal jurisdictions, a key question is “how do you measure success?”, one objective measure being whether the debt of the new structure is capable of being exchanged at par. “If it’s still at 60-70 cents of par, then perhaps it’s in need of another restructuring!” said Portsmouth. According to

Asimacopoulos, “the real test for success is looking forward two, three, four....or ten years: is the company still alive and thriving? All restructuring does is give a decent springboard – you can’t measure restructuring success now."

Pierre Bour added that one of the hindrances to success of restructurings is the (politicised) debate, particularly in France, around preserving existing jobs rather than focusing on how the injection of new capital can create new, better paying jobs. “Being forced to preserve something that doesn’t work does not make it sustainable, but to be fair, public stakeholders increasingly recognise this and have become much more receptive to support disruptive business plans” he said.

A final issue identified by Asimacopoulos is that very few restructuring regimes allow both an operational and a financial restructuring at the same time, eg Chapter 11. Asimacopoulos gave the example of Fitness First gym chain, which prior to its restructuring grew quickly and had too many properties. While a company voluntary arrangement (CVA) worked in the UK to get rid of some leases and reduce rent on others, none of the other jurisdictions where the company had properties facilitated this kind of lease reduction.

by Dawn Grocock, Hossein Dabiri and Marion Halftermeyer