EU Insolvency Reform : Lessons from France

Focus on pre-insolvency proceedings can be counter productive

Market for distressed entities cannot emerge without effective valuation methodology and cramdown procedure

European banking supervision needs a pan European insolvency law

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Introduction

Three lessons we can learn from the study of Law and Economics to give businesses the chance to bounce back and to create economic growth

- Pre-insolvency **proceedings** lead to **suboptimal** agreements if the rights of creditors are not respected

- A **valuation methodology** is necessary to determine the ***enterprise value*** and to distinguish the "***going concern"*** *value* from the "***liquidation"*** *value*

- A **cramdown process** is necessary to transfer **power away** from shareholders

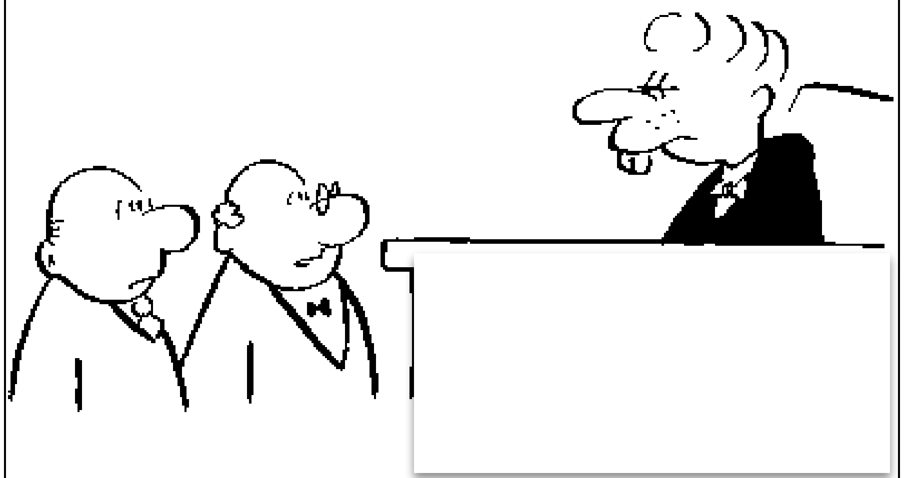
PART I

Theory : The counter-productive effects of pre-insolvency proceedings

I - The counter productive effects of pre-insolvency proceedings

1.1 What are the goals of insolvency law?

- To maximize the value of the assets of the debtor;
- To liquidate non-viable companies;
- If the company is viable, to encourage the parties to negotiate *amicably*, *early* and *out-of-court*, to reduce value destruction.



"No offense, Your Honor, but we've decided to settle out of court."

I - The counter productive effects of pre-insolvency proceedings

1.2 Focus on the third goal: encouraging the parties to negotiate

- According to the **Coase Theorem** created by Nobel Prize Economist **Georges Stigler**, **two** conditions are required:

1. Respect **for property rights**:
   - Distinguish secured creditors from unsecured creditors, junior from senior creditors, treat shareholders as super junior creditors
   - Parties must know where they stand

2. Reduction of **transaction costs** by establishing efficient ***formal*** proceedings:
   - Parties who negotiate out-of-court do so **in the shadow** of the formal proceedings
   - If formal proceedings lead to an inefficient outcome, then so will pre-insolvency proceedings and out-of-court negotiations;
   - Violation of "**the absolute priority rule**" during formal insolvency proceedings will only lead to increased antagonism and suboptimal agreements during out-of-court negotiations

I - The counter productive effects of pre-insolvency proceedings

Countries where **formal** insolvency proceedings involve
substantial changes in the **order of priority**

Only **exacerbate antagonisms** during out-of-court negotiations
and lead to **suboptimal agreements** during pre-insolvency proceedings

I - The counter productive effects of pre-insolvency proceedings

1.2 Focus on the third goal: encouraging the parties to negotiate

3. Reduction in **transaction costs** by establishing efficient **formal** proceedings allowing:

- The **relaxation of the unanimity rule** in order to approve a reorganization plan
- The reduction in **asymmetry** of information between debtors and creditors
- The settlement of conflicts over the **valuation** of the enterprise value

I - The counter productive effects of pre-insolvency proceedings

1.3 Why are the legislation governing most pre-insolvency proceedings counterproductive?

- For the parties
  - It disregards property rights
  - It increases transaction (legal) costs
  - It increases uncertainty and unfair treatment due to the greater involvement of third parties (judicial administrators) with potentially conflicting political or financial interests
- For the company
  - It increases financial distress by prolonging uncertainty and potentially sustaining non viable businesses
- For Society at large
  - It increases bad debt for Treasuries and costs for public safety nets

PART II

Example : The *four* pre-insolvency proceedings available under French law

- The French formal proceedings are well known for their violation of order of priorities

- This increased antagonisms and the difficulty in reaching out of court agreements

- This is the reason why, over time, the French have created no less than **FOUR** pre-insolvency proceedings to facilitate the pre-insolvency resolution of conflicts

- However, each pre-insolvency proceedings has created its own violations of rights and various degrees of arm twisting, from the initial appointment of conciliators to hybrid proceedings involving the Court.

II - The four pre-insolvency proceedings under French law

2.1 The *ad hoc* mandate

- A preventive and confidential procedure aimed at settling disputes out of court to improve the prospects of the company before it becomes insolvent (on a cash flow basis);

- Available to the debtor only, by requesting the appointment of a specially appointed (*ad hoc*) administrator;

- The *ad hoc* administrator assists the debtor with the negotiation of an agreement with its main creditors to obtain an extension of the term of its debts;

- The management remains in control of the company at all times.

II - The four pre-insolvency proceedings under French law

2.2 The conciliation procedure

- A **confidential** procedure aimed at reaching an out-of-court settlement agreement between the company and its main creditors.
- It is available to the **debtor only**, upon request
- The settlement agreement **must** allow the company to:
  - obtain an extension of the term or a partial write-off of its debts, or
  - obtain any loans necessary to continue its operations.
- The debtor has the **option** to request that the court **reviews** and approves the enforceability of the settlement agreement
- If court approves the agreement, then **preferential rights** are granted to *new money* investors :
  - creditors who agree to contribute *new money* during the conciliation procedure are granted a preference in the form of a priority ranking ahead of other creditors for the repayment of their loan

II - The four pre-insolvency proceedings under French law

- However, these pre-insolvency proceedings quickly proved inefficient
  - The ad hoc mandate and conciliation proceedings are **consensual**
  - They can lead to (suboptimal) agreements in a few limited circumstances, such as small LBO companies with **simple debt structures**
  - In practice, however, they have proved **inappropriate** in **more and more** cases**,** because the increasing complexity of the debt structure makes it almost **impossible** to reach the **unanimous** consent required

- Instead of identifying and addressing the **root cause** of this problem, the French legislator merely **compounded** the problem by introducing two **additional** pre-insolvency proceedings.

- This time, however they were “**hybrid**” procedures :
  - **not fully consensual**, as the Court is involved
  - they **replicate** some of the voting procedures of the formal proceedings

II - The four pre-insolvency proceedings under French law

- These proceedings were introduced in:
  - 2009, **Third** procedure: The **accelerated safeguard procedure**
  - 2014, **Fourth** procedure : The **accelerated financial safeguard procedure**

II - The four pre-insolvency proceedings under French law

2.3 The accelerated safeguard procedure

- Available only to **large companies** meeting the threshold of a minimum turnover and a minimum number of employees;

- Available only while the company is already following a **conciliation** procedure;

- The company must have agreed to a **draft restructuring plan** with its **largest creditors** during the conciliation procedure;

- The term of the procedure is limited to **three months** during which the plan must be approved by a **two thirds majority** of creditors in each class of creditors (bondholders, bankers and trade creditors);

- The procedure can affect the rights of any type of creditors **except employees.**

II - The four pre-insolvency proceedings under French law

2.4 The accelerated financial safeguard procedure

- This is the same as financial safeguard procedure but:

- it is available only to **financial creditors** and companies who are **overleveraged with banks** and have obtained the **support of the majority of their financial creditors**, during a **conciliation** procedure;

- the objective is to **solve quickly** the issue of a **minority of creditors** refusing to enter into the settlement agreement;

- it must be conducted over a shorter period of only **one month**, which may be extended by no longer than one month;

- once opened, the procedure entails a **stay** of payments, interests and the opening of proceedings that is enforceable against financial creditors only.

PART III

Analysis: What is not working in the French example ?

"France differs greatly from other countries
in the area of insolvency law
[...]
*This is due to a **weak protection of creditors' rights***
compared to other stakeholders' rights,
including shareholders' .
[...]
We recommend a moderate evolution
of French insolvency law
*towards **better creditor protection,***
***inspired by US insolvency law**."*

*Nobel Prize Laureate and French Economists, **Jean TIROLE, Guillaume PLANTIN** & **David THESMAR***

French Council of Economic Advisors

June 2013

III - Analysis: What is not working in the French example ?

3.1 First Problem : The violation of the rights of creditors

- 3.1.1 – The **nature** of the problem
- Creditors are distributed into **three classes** of creditors **only** :
    - trade creditors
    - banks; and
    - bondholders
- This distribution is made **regardless** of the creditors' seniority;
- In **each class** of creditors, **each member** holds **one vote** and the majority threshold is **two thirds;**
    - For example, **secured and unsecured** creditors or **junior and senior** creditors find themselves in **the same class** and have **equally-weighted voting rights** amounting to the sum of their claim.
    - This mechanism is referred to as a **single-limb** aggregated voting procedure, and it applies to **each** of the **three** separate classes of creditors.
- This **violates** the rights of the senior and secured creditors.

III - Analysis: What is not working in the French example ?

3.1 First problem : The violation of the rights of creditors

3.1.2 - The **narrow procedural impact** of this problem on **out-of-court procedures**:

- Companies **cannot properly deleverage** their balance sheet due to the common disregard for the rights of creditors and the contractual "absolute priority rule";
- Therefore, a large amount of companies (especially LBO companies) abuse the pre-insolvency proceedings to file for it **a number of times**;
- Management is focused on other issues than the business;
- Lengthy and costly negotiations are an expensive option for debtors;
- Debtors are unable to solve their operational difficulties quickly and decisively;
- In practice, *fresh money* investors demand double digit interest rates, in spite of their super-senior priority privilege, expecting the same return as a shareholder would under "normal" (non distressed) circumstances, proving that the company has not been properly deleveraged and that substantial risks remain.

III - Analysis: What is not working in the French example ?

3.1 First Problem : The Violation of the Rights of Creditors

3.1.3 - The **broader economic impact** of this problem on **the economy**

- 85% of French companies successfully emerging from formal insolvency proceedings (*redressement judiciaire*) on a standalone basis, still end up in liquidation within five years, showing that these formal proceedings are highly ineffective;
- That figure falls to 50% for companies emerging from another type of formal proceedings (*procédure de sauvegarde*) making these ineffective as well;
- There is **no market for DIP financing** available to debtors who have filed for formal insolvency proceedings;
- Banks and other lenders often demand significantly **higher collaterals** and personal guarantees than in other jurisdictions such as Germany or the UK;
- Businesses are forced to rely **excessively and dangerously** on obtaining **trade credit** in order to finance their working capital needs

III - Analysis: What is not working in the French example ?

3.2 Second problem : The absence of valuation methodology

3.2.1 – The **nature** of the problem

- Ideally, a **consistent and harmonized framework** should be created for the fast judicial resolution of valuation disputes during restructurings, **short of formal insolvency proceedings**;
- This would enable **practice and precedent** to develop in restructuring valuations, providing stakeholders with relative **certainty of outcome**, whilst avoiding the value loss that arises through the administration and/or liquidation process;
- At present, the situation in France and elsewhere in continental Europe is that **creditors are in effect all but excluded** and have no opportunity to participate in the determination of the **ongoing concern** value of the business;
- They are, in effect, **forced** to accept a **single** alternative**:**
  - either accept the valuation determined by other, the management (often in collusion with the controlling shareholders), the conciliator, or the administrator,
  - or see the enterprise go into formal insolvency proceedings.

III - Analysis: What is not working in the French example ?

3.2 Second Problem : The absence of valuation methodology

3.2.2 – How Europe missed out on the valuation issue

- The Commission's **Recommendations of 2014** make **no** reference to the valuation issue, despite most European countries not having a consistent and clearly established methodology to determine the **on-going concern** value of a business during a restructuring process.

- The debate over valuation in Europe gravitates around **two** main models : the English versus the US-German approach
  - The **English** approach is based on the **liquidation** value
  - The **German / US** model is based on the **going concern** value

- In **Continental Europe**, most countries have chosen not to address this question and consider that this is not matter for the Court.

III - Analysis: What is not working in the French example ?

3.2 Second Problem : The absence of a valuation methodology

3.2.3 - How to properly address valuation issues during formal insolvency proceedings?

- The UK's approach and its ***scheme of arrangement***
  - This can be viewed as a model for the theory of the "**privatisation of insolvency**" where the vast majority of restructurings occurs out of court;
  - When coupled with a "***pre-pack"*** administration, the scheme is tantamount to the enforcement of the secured creditor's pledges over the shares, thus **eliminating any judicial control** over the valuation of the debtor's assets;
  - This has obvious **detrimental consequences** for unsecured bondholders.

- The US and German approach
  - Depending on the going-concern value of the debtor, creditors/shareholders are either in or out of the money
  - **Creditors who are not affected by the plan** and the **out of the money** creditors are **stripped of their voting rights** on the plan
  - This **protects** the rights of the creditors who are effectively **affected** by the plan
  - For a **hedge fund**, the greater predictability of the formal proceedings regarding the conversion of debt to equity, will lead it to offer a **higher price** for the distressed debt
  - In general, this will create a more **active** and more **competitive secondary market for distressed debt**

III - Analysis: What is not working in the French example ?

3.2 Second Problem : The absence of valuation methodology

- 3.2.3 – How Europe missed out on the valuation issue
- The **English** approach is based on the following dichotomy:
  - is based on the **liquidation** value of the debtor;
  - on the one hand, a **formal insolvency proceeding** conceived as being clearly and in practice geared towards **liquidation**;
  - on the other hand, a reorganization that can **only be carried out in the course of pre-insolvency negotiations** and that is limited to **financial measures**, because English law **does not provide** any means to force an operational restructuring on suppliers and clients.
- In contrast, the **US and German** approach:
  - is based on the value of the debtor as **a going-concern**,
  - creditors and shareholders **clearly** fall either **in** or **out** of the money
  - It is therefore
    - **more predictable** as it does not allow one class of investors to take it all.
    - **critical** for the development of **bond markets** in Europe and
    - for the **resolution of Europe's non performing loans**
  - However, practice shows that inexperienced Judges in Germany affect the outcome of the valuation methodology

III - Analysis: What is not working in the French example ?

3.3 Third Problem : The absence of a cramdown procedure

3.3.1 – Why is a cramdown mechanism necessary to evict out-of-the-money investors ?

- In a distressed company, shareholders and junior creditors have effectively **lost** their entire **economic interest** in the company
- Giving them a vote in the reorganisation creates **holdout situations** that can jeopardize the entire reorganisation
- This is why they must be crammed down in most major reorganizations.
- However, the rule must be clear: a cramdown can only occur if a proper valuation of the debtor **as a going concern** is made and the parties are afforded a **quick legal recourse** to challenge this valuation before the debtors emerges from insolvency proceedings
- Two conditions must be met :
  - The cramdown of **an entire class** of investors may occur provided that they are out of the money by reference to the going concern value of the debtor
  - The cramdown of **dissenting investors** in one specific class of creditors can occur provided that they are **not worse off** than they would have been in the event of a liquidation

III - Analysis: What is not working in the French example ?

3.3 Third Problem : The absence of a cramdown procedure

3.3.2 - cramdown in France – The missed opportunity

- **Shareholder holdouts** have been the main concern of the **French Ministry of the Economy** over the last two years (after the burst of the LBO bubble)
- The same issue arises in other EU Member States, but shareholder holdouts are much more common in France due to the flaws of corporate insolvency law.
- The latest reform of insolvency law, the **"Macron" law** of 2014 introduced a shareholder **cramdown for the first time** under French law
- A judge in formal proceedings now has the power to dilute shareholders' rights or to force the sale of the shares of the majority shareholders
- However, this power is subject to a **vague and arbitrary test**:
  - the presence of a "*serious risk for the local economy and jobs*."
- **No valuation** mechanism is mentioned in the law
- This is a huge **missed opportunity**

PART IV

The impact of a lack of a EU wide insolvency law on EU Bank regulation

IV - The impact on EU Bank regulation

5.1 The choices made by the EU

▪In March 2014 the **EU Commission** issued a **Recommendation** urging Member States to ensure the availability a debt restructuring recourse offering the following **three common principles**:

1. facilitate **early out-of-court** restructuring when debtor is in "*financial difficulties*", i.e there is a "likelihood" of insolvency, to avoid formal and non consensual procedure
    - this is equivalent to the French *ad hoc procedure* or *conciliation* procedure
2. facilitate the restructuring through **formal**, **non-consensual** proceedings , **safeguarding basic rights** for creditors.
    - Some commentators have argued that the French formal proceedings will meet this criteria, if the creditor classes are merely changed to do away with the three mandatory classes of creditors and creditors are distributed instead according to their order of priority
    - This, however, is, as we have seen, missing the **point** and the **broader picture** because it would fail to address the two other flaws of the French formal procedure
3. **facilitate second chances** for failing entrepreneurs

IV - The impact on EU Bank regulation

5.2 The consequences of the EU choice

- **Suboptimal agreements** reached during out-of-court negotiations
- **Wrong focus** on the out-of-court negotiations when it should focus instead on the formal procedure having an effect on the out-of-court negotiations;
- Although some European countries such as **Spain** or **Italy** do not violate the priority rule, out-of-court negotiations yield suboptimal outcomes mainly because of the **length of the procedures** and the fact that **judges are not properly trained and specialized** in insolvency;
- Even in the **United States**, where there is no violation of the priority rule, the procedures are relatively swift, and judges are very specialized, reaching an out-of-court agreement between bondholders who are diluted in financial markets remains **a challenge**
- This is why the US are now considering **abandoning** the 75 year old majority rule for bondholders (enforced through the Trust Indenture Act of 1939) to make financial restructuring easier and faster.
- The EU should have focused on **this objective** and has **missed an opportunity to do so**.

IV – The impact on EU wide bank regulation

- Monitoring the **counterparty risks** of banks across the EU under a single supervisory mechanism is a **challenge**
- The **European Commission** considers that the disparity of the recovery rates of creditors of defaulting businesses in the EU:
  - makes "*the evaluation of the risks associated with investment in another Member State **costly and uncertain***" and
  - creates "**unequal conditions for access to credit**".
- The **absence of harmonisation** of the laws governing insolvency proceedings and security pledges, as well as the application of different and inefficient corporate insolvency laws across the EU:
  - **undermines** the effectiveness of European-wide measures to prevent further bank crises; and
  - makes it **difficult to assess the potential loss** that a bank will suffer in the event of a counterparty default, especially when the majority of a bank's assets are made up of trade receivables

IV – The impact on EU wide Bank regulation

- Counterparty risk is primarily affected by:
  - the **order of payment** of creditors and shareholders, that is to say, the **priority** contractually agreed by them (for example, by signing subordination agreements); and
  - the **effectiveness of the collateral** granted, that is to say, the ability of the bank to enforce the security granted to it by the debtor; or,
  - failing that, when the law prevents the bank from realising its security upon the bringing of insolvency proceedings against the debtor, **the respect for the priority ranking of the secured creditors** in the order of payment of creditors.
- This will depend on both:
  - the **substantive law** applicable to insolvency proceedings, and
  - the **procedural law** determining, for example, the time needed for the adoption of the restructuring plan that will protect the rights of the secured creditors vis-à-vis other creditors.
- It is **unreasonable** to expect the staff of the ECB to
  - have a clear **understanding of the consequences** of the various laws governing insolvency and security pledges in each Member State.
  - **tailor questionnaires** for the purpose of assessing the quality of the banks' assets in each Member State.

Recommendations

- **Harmonise the law of security** across the EU, based on a *functional* approach, to **simplify** to the greatest extent possible the rules governing the **creation and perfection of security**;

- Create a **single insolvency law and proceeding** across the EU, for **large companies,** i.e companies for which there is a market for their control;

- **Harmonise national insolvency laws** and keep **local jurisdiction** of each EU Member State, for **smaller companies**.

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