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LEGAL ANALYSIS: European Commission's proposed restructuring directive: Fresh start for France?

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In late 2016 the European Commission published a proposal for a directive which will ultimately oblige EU member states to have 'preventive restructuring frameworks', adhering to certain minimum standards, in place. While French insolvency law has undergone reform in recent years, some commentators believe there is still room for improvement and that the proposed reforms at a European level provide France with a window of opportunity to bolster its restructuring framework.

Harmonisation on the horizon

Last November, the European Commission published its draft directive on restructuring and insolvency laws across the EU – prompting some to hail the imminent arrival of 'Europe's Chapter 11'. The proposal, which has three primary areas of focus, including the use of early restructuring tools to rescue viable businesses, does not seek to completely rewrite member states' national laws to make them identical. Rather, it aims to harmonise regimes by laying down minimum standards that they must adhere to, while allowing the states some discretion as to how they implement the proposals.

You can read more about the proposed directive on *Debtwire* HERE.

Across the Channel

French insolvency law provides for pre-insolvency restructuring procedures, including conciliation, mandat ad hoc (specific purpose mandate) and sauvegarde (safeguard), as well as formal insolvency proceedings (reorganisation or liquidation). The system facilitates the 'cram down' of dissenting minority creditors through safeguard, with the 'accelerated financial safeguard' procedure enabling debtors to reach a compromise, on an expedited basis, with just its financial creditors (as can be done via a UK scheme of arrangement).

Conciliation and mandat ad hoc are confidential, contractual procedures that aim to facilitate a consensual agreement with creditors and other stakeholders. A significant limitation is that they require unanimous creditor consent. Therefore, it may be necessary to resort to a type of safeguard proceeding to impose a restructuring (formulated during the conciliation) on dissenting minority creditors. Tactically, the mere threat of this may be sufficient to persuade creditors to agree to a consensual deal.

According to lawyer Sophie Vermeille, Founder and President of Paris-based think-tank Droit et Croissance ('Rules for Growth') which campaigns for the reform of French law, "the success of these amicable procedures depends on the theoretical outcome of 'coercive' procedures (safeguard, reorganisation and liquidation)". Vermeille explains that "the legal framework of 'coercive' procedures is still largely based on the law of 1985 which has core objectives of allowing the continuation of the company's activities (as opposed to the sale of all its assets to an external buyer) and the preservation of jobs".

In the case of reorganisation or safeguard, a restructuring plan is devised at the initiative of the administrator. When the plan foresees debt forgiveness, the approval by a two-thirds majority of creditors in creditors' committees or bondholder assemblies is required. Further, in the case of a debt for equity swap, a shareholders' resolution would also be required (again, the threshold is generally two-thirds, depending on the company's by-laws).

Stumbling blocks

In a recent paper, Vermeille identifies two key issues with the French system: firstly, obstacles to the deleveraging of viable but insolvent companies, and the support back to life of non-viable companies.

"It is not unusual to see non-viable companies being put on a drip by the court at the expense of creditors, as well as viable companies coming out of reorganisation or safeguard proceedings over-indebted," Vermeille notes. "The safeguard or reorganisation procedures facilitate terming out the debt by ten years while maintaining initial interest rates and existing shareholders – even when wiping out the debt is necessary – and reduces the incentive for creditors to write off the debt. In a context of globalisation and increased competition, this is detrimental for our companies. Companies also often come out of conciliation procedures with high levels of debt, with high interest on new money loans."

Vermeille points to the high level of relapse: "85% of companies that come out of reorganisation fall into liquidation within the next five years, as is the case with 50% of companies coming out of safeguard. In contrast, the relapse rate following Chapter 11 is 20%, although a greater number of Chapter 11 procedures are switched to Chapter 7 [liquidation] along the way."

The requirement for shareholders to consent within safeguard (eg to equitise debt) is one reason why Chapter 11 proceedings can prove more straightforward: out-of-the money shareholders in a French safeguard proceeding would need to approve any deal, while out-of-the money shareholders in a Chapter 11 can just have a plan crammed down on them via creditor vote (assuming they are truly completely out-of-the money).
"In the US, only the lenders whose rights are affected by the restructuring plan and who have not lost everything will vote on the plan. It is therefore easier to evict shareholders and subordinated creditors who in theory have lost everything, and, as a consequence, to reduce the level of debt of companies at the end of the procedure," explained Vermeille. "In French law, a restructuring plan comprising a conversion of debt into equity has to be approved by a majority of creditors, bondholders and shareholders. Creditors refuse to accept debt write-offs in favour of shareholders; maintaining shareholders in the capital (in order to encourage them to vote for the plan) necessarily results in less debt being converted into equity."

"The US rules, prioritising the deleveraging of companies within the rights of the different investor categories, promote amicable negotiations allowing for eg the organisation of tender offers of bonds into equity outside a collective procedure. In France, as soon as debt is scattered across financial markets a company has no other choice than to open a collective procedure (eg CGG). In the context of developing bond markets, the situation risks getting worse," she concluded.

Secondly, Vermeille refers to what she terms the “ex ante effect of French law”, ie the restriction of private credit at the expense of most fragile debtors and the substitution by public debt. “France has chosen the safeguard of employment at the expense of creditor rights with restructurings even where a company is not viable and is inefficient for financing. By contrast, in other countries, in particular the US, there is a very liquid private market to finance troubled businesses. The extremely high relapse rate for companies emerging from collective procedures are well known by credit providers which increases the cost for struggling businesses; ie credit insurers are the first to walk away upon the announcement of difficulties, and they do not even distinguish between viable and non-viable debtors,” Vermeille noted.

A climate of change

So, given these criticisms of the French system, could the European Commission’s proposed directive mark a positive sea change for France? Vermeille thinks so.

“France is the big winner of the November 2016 project. It will enable it to address the complex debt structures of viable but insolvent companies which have different categories of lenders and promotes the deleveraging of companies in spite of the opposition of shareholders and subordinated creditors,” she explains. “Further, the project promotes the development of financial markets, which French companies need in order to keep growing.”

Some of the key points of the EC’s proposal are that it aims to anticipate difficulties at the earliest point (in accordance with French law). It supposes a short observation period, introduces an expert appointed by the court and the possibility of challenge.

Vermeille concludes that “nothing should prevent the eviction of an entire class of shareholders and junior creditors to the extent necessary to deleverage the business. Abuse exists whenever the procedure is under the control of people whose incentives are not aligned with the objective of maximising the value of assets, and whose only objective is protecting jobs in the long run”.

“The French – like the Germans – need to be aware of the ongoing change in paradigm with the development of financial markets, the development of the digital economy which requires significant investments as well as the lack of inflation which does not allow for a “natural” deleveraging.”

Droit et Croissance’s International Conference on Restructuring and Reform of Bankruptcy Law takes place at the Ministry of Economy and Finance, Paris, on Friday 19 January 2018 (details HERE).

by Dawn Grocock

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