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MAKING LAW A VECTOR OF GROWTH

Memorandum concerning the European Directive of November 2016 on the insolvency of companies

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In case of difficulties, a company attempts to reorganize its liabilities in order to avoid ending its activity. Law defines the conditions under which the company continues its activity as well as the proceedings for the adoption of restructuring plans between the managers and creditors/shareholders (frozen debts, terms and conditions for validation of the plan by the creditors/shareholders and the court, etc.). Insolvency law seeks an equilibrium between the rights of various parties in order to promote economic activity. *Ex-ante*[1], it has an impact on the relations between companies and their creditors: **better protection of creditors incites them to finance riskier projects[2] or increase the share they are willing to finance**. *Ex post*, it has an impact on the prospect of recovery of a company emerging from a debt restructuring process by ensuring significant debt reduction of the company.

1°) *Ex post* effects of French law: the impossible debt reduction of viable but insolvent companies and maintaining of numerous non-viable companies on life support

French law makes a distinction between the prevention of difficulties from how they are dealt with. Several «amicable» proceedings exist (special mediation (*mandat ad hoc*), conciliation). **The success of these amicable proceedings depends on the theoretical outcome of «coercive»** proceedings (safeguarding, judicial reorganization and judicial liquidation).

[1] That is, apart from any default situation.
[2] According to the General Directorate of the Treasury, a 3% rate of improvement in the recovery of debts in France would entail a 3.5% increase in innovative activity. *Diagnostics Prévisions et Analyses Economiques* (Diagnostics, Forecasts and Economic Analyses) no. 101 – March 2006

In France, the legal framework of «coercive» proceedings continues to be founded in large part on the Law of January 25, 1985 whose **primary objective is to enable the company to continue its activity (understood as the continuation of the legal entity rather than the disposal of all of the assets to a buyer), and maintaining employment.**

In the case of a judicial reorganization or safeguarding, a **restructuring plan is drawn up at the initiative of the administrator the approval of which does not take the order of absorption of losses into account** (whenever the plan provides for wiping off the debt, the consent of the majority of two-thirds of the creditors meeting in a lenders' committee or a bond holders' meeting must be obtained, as well as that of the shareholders meeting in a general meeting). **It is not rare to see non-viable companies put on life support by the court to the detriment of creditors as well as companies, while admittedly viable, being over-indebted after emerging from a judicial reorganization or safeguarding proceeding** (the safeguarding or judicial reorganization proceeding allows for extending the debt for a period of ten years, maintaining initial interest[3] and maintaining the shareholders in the capital even when the wiping off of the debt is imperative, thereby reducing creditors' incentive to waive their debts). In a context of mondialization and increased competition amongst companies, this situation penalizes our companies.

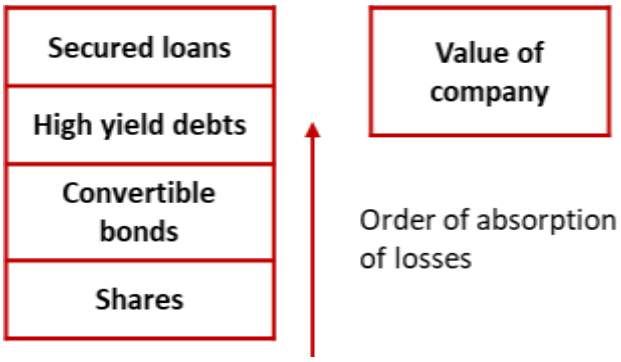
This situation explains the high rate of relapsing: 85% of companies emerging from a judicial reorganization are placed in judicial liquidation 5 years later. This is the case of 50% of companies emerging from a safeguarding proceeding. In comparison, the relapse rate of a Chapter 11 proceeding is 20% (however, a greater number of Chapter 11 proceedings are converted into Chapter 7 proceedings in the course of the proceeding).

The only way of significantly reducing company debt is to organize an asset disposal plan for a symbolic euro, in order to protect employment. In addition to its exorbitant nature vis-à-vis creditors, this measure **can only be instituted at a very advanced stage of difficulties**, whenever the situation is one of «insolvency» (that is, suppliers can no longer be paid).

Companies are also often very indebted after coming out of conciliation proceedings (with high rates for loans of new money) since the result of these amicable proceedings depends on the theoretical fate of the parties involved in a coercive insolvency proceeding.

In the United States the court requests that the company present the creditors by class and establish the value of the company, with the consent of its creditors. **The only creditors who vote on the reorganization plan are those affected by the plan but who have not lost everything.** It is therefore easier to squeeze out those shareholders and subordinated lenders who have theoretically lost everything and, consequently, to massively reduce the indebtedness of companies at the end of a proceeding.

[3] Case of the Belvédère company in 2015



In the above example, under American law, high yield debt holders would be the only ones to validate the plan. The holders of convertible bonds and shareholders would be squeezed out (their opposition to the plan cannot be an obstacle to the debt reduction, subject to compliance with certain safeguards) and in such case a company's debt would be greatly reduced. Under French law, a restructuring plan providing for a conversion of debt into shares must necessarily be approved by a majority of the lender creditors, bond holders and shareholders. The search for a compromise in violation of the rules of absorption of losses frequently leads to high debt at the end of the proceeding. Indeed, creditors refuse to waive debts for the benefit of the shareholders; maintaining shareholders in the capital of the company (in order to encourage them to vote for the plan) necessarily leads to converting less debt into capital.

The rules of American proceedings, favoring the reduction of company debt, in keeping with the various categories of investors, favors *ex ante* amicable negotiations. This renders possible, for example, the organization of public offers of exchange of bonds into shares, without going through insolvency.

In France, as soon as the debt is dispersed over financial markets, the company has no other choice than opening an insolvency proceeding (Thomson/Technicolor and CGG). In a context of development of bond markets, the situation risks worsening.

2°) *Ex ante* effect of French law: the restriction of private credit to the detriment of the most fragile debtors and substitution by public credit

France has chosen to protect employment at the expense of creditors' rights: asset disposals for a symbolic euro (a solution which admittedly enables a company's debt to be reduced, but at a very advanced stage of difficulties, which is not an option for a large company), reorganization plans without the consent of at least a sole creditor (even one having a security interest) are possible (on condition of limiting the plan to a rescheduling of the debt and not a conversion of the debt into shares) even if the company is not viable. **This «legal uncertainty», from the creditors' point of view, is ineffective for financing our economy. There is also a cost for this for public finances:** the State finances the observation periods (via the paying of social costs[4]) as well as the most fragile debtors via the *Oseo* (a French public organization that supports SMEs) guaranty (which entails a risk of moral

[4] Translator's note: it is not clear whether "le rapport des charges socials" means "paying of social costs" or "relation of social costs".

hazard for banks). Furthermore, banks request more personal guarantees from the entrepreneurs. Conversely, in other countries, in particular in the United States, a very liquid private market exists for financing companies in difficulty.

The extremely high relapse rates of companies emerging from insolvency proceedings are well known by credit players, which increases the cost of company difficulties; thus, for example, credit insurers are the first to terminate their support upon announcement of the difficulties of companies that are debtors of their own customers, and are not reticent in making a distinction between viable or non-viable debtors.

France is the big winner of the European Directive proposal on the insolvency of companies of November 22, 2016:

- this proposal allows for dealing with the complex liabilities of viable but insolvent companies having different categories of creditors,
- this proposal allows for correcting a certain number of adverse effects by favoring the debt reduction of companies in spite of the opposition of shareholders and subordinated creditors, such proposal favoring the granting of credit for the benefit of fragile companies,
- this proposal favors the development of financial markets needed by French companies for their development,
- this proposal joins French law with the volition to anticipate difficulties as soon as possible; a restructuring proceeding may be opened without any special conditions,
- this proposal provides for a short observation period, an expert appointed by the court in order to assess the value of the company and the possibility of making a challenge.

Nothing must prevent the squeeze out of an entire class of shareholders and junior creditors, as far as necessary for reducing the company's debt. Abuses exist once the proceeding is in the hands of persons whose incentives are not aligned with the objective of maximizing the value of the assets, the only objective which permits long-term protection of employment.

The French as well as the Germans must become conscious of the on-going paradigm shift with the development of financial markets, the development of the digital economy necessitating massive investments, and the absence of inflation which does not allow for a «natural» reduction of debt.