October 31, 2017
Amended on November 6
Amended on November 28

DROIT ET CROISSANCE
FAIRE DU DROIT UN VECTEUR DE CROISSANCE

MAKING LAW A VECTOR OF GROWTH

Memorandum concerning the draft bill on the reform of law of secured transactions

by Sophie Vermeille,
founder and president of Droit & Croissance
Benjamin Fremaux,
member of the executive committee of Droit & Croissance

Law of secured transactions sets the conditions under which a company offers its assets to its creditors by way of guarantee, as well as the conditions under which the latter may exercise their rights to such assets. Law of secured transactions allows for facilitating the financing of companies, in particular small-size entrepreneurial projects and companies in difficulty. **With respect to these type of debtors in a fragile financial situation, effective law of secured transactions is a condition for access to sources of private financing.**

Before the introduction of **insolvency schemes for the benefit of companies, which provide for the stay of proceedings preventing the realization of the securities,** the application of law of secured transactions led to a binary situation: so long as the debtor was not in default the creditor had no right to the assets whereas once the debtor was in default, the creditor could seize the assets of the company in order to be reimbursed by way of priority from the income of the sale without awaiting liquidation.

When a lawmaker decides, as in France in 1985, to introduce an insolvency scheme (providing for the temporary stay of proceedings in order to avoid the useless destruction of wealth due to the disorderly race of creditors for the assets), **he seeks reconciling both creditors having security interests and the rights of a company in default but which is still viable.** For this purpose, the lawmaker must:

- On the one hand, take into account the priority rights of creditors having security interests in relation to the other creditors and shareholders so as to guarantee the efficacy of the securities and guarantee company access to private credit;
- On the other, provide a viable company with a real chance to recover, which implies that the assets allowing it to continue its activity are not seized by creditors having security interests.

These contradictory interests cannot be reconciled before the creditors having security interests are guaranteed that in an insolvency proceeding they shall not be treated worse economically as if they had been able to realize their securities. In other words, the rights of the creditors may not be affected by measures reflecting a decrease in the economic value of their debts to a level less than the market value of the assets given as security (for example, by the effect of a rescheduling of debts in connection with a continuation plan).

The defaults in French law of the scheme for the protection of beneficiaries of security interests:

Even if certain countries having introduced stays of proceedings have succeeded in reconciling the interests of creditors having security interests and the right of a viable company to recover (for example, the United States with the use of Chapter 11), France has failed:

- **France is the only country in the OECD that authorizes the court to be able to have a plan for continuation of the company approved, affecting the rights of creditors having security interests:**
    - **without the consent of at least some of the creditors being necessary**; the law provides that the court may, in its discretion reschedule the debts of creditors having security interests for 10 years without any financial consideration;
    - **without the creditors having security interests being treated worse than in a liquidation scenario.**

- Even if the law provides that the court may take into account differences in the situation of the creditors at the time of approval of a plan (according to whether or not they have security interests), it has not established the principle that unsecured creditors, just as shareholders, cannot allege rights to the company that is being continued from the moment that the rights of secured creditors are affected.

- Furthermore, the law has multiplied «niches» and granted certain categories (the Treasury, employees, sub-contractors, carriers, the seller of marketable[1] goods, etc.) privileges that, for the most part, are not justified and often the consequences of measures of opportunity, aiming at giving priority to sectional interests which knew how to mobilize themselves more than others with the lawmaker at a given time[2]. Such privileges lead to undermining the rights of creditors having security interests.

Furthermore:

[1] Translator's note: I believe this should read «bien marchands» and not " bien marchants".
[2] For example, all European countries have little by little abolished the privilege of the Treasury, which is acceptable from the moment that the practice consisting in not paying its social charges in order to finance its working capital needs during the observation period has ended cf. Droit & Croissance memorandum dedicated to the reform of insolvency proceedings.

- too many non-viable companies are artificially kept alive[3], leading to impoverishing creditors' securities: the longer time goes on, the more the value of the company's assets diminish.

- whenever liquidation is ordered the existence of too many privileges prevailing over the rights of creditors having security interests, and the slowness of the proceedings, renders illusory, with a few exceptions, the recovery by creditors having security interests of at least part of their debts.

The adverse effects are numerous:

The impasse of French law, whenever the reconciliation of the rights of secured creditors and the right of recovery of a viable company is involved, entailed a great number of adverse effects:

- **too great a recourse to sureties and other guarantees that escape from insolvency proceedings in an economy that is constantly evolving:** in practice, the amount of the equity injected by the manager of a company at the time of the formation of his company is of little import as a surety shall be systematically required by the banks or, failing this, a pledge of a blocked bank account[4]. Before reaching a certain level, the greater the working capital needs of a young company, the greater the amount of the personal or financial guarantees required by the bank tends to increase, regardless of the level of profitability of the company observed during the initial years. Sureties are sources of responsibility for managers in respect of their property, which are often unjust (due to competition, a manager may today find himself in bankruptcy for reasons which are more often than not outside of his control more than in the previous century); indeed, the implementation of managers' responsibility may be long and costly for creditors as the lawmaker, just as case law, has attempted to limit the most glaring abuses in the use of sureties, instead of attacking the sources of the disaffection/inefficacy of classic securities (pledge of an on-going business, pledge of inventory, etc.);

- **an excessive complexity of both law of secured transactions and insolvency law**, so as to find an impossible equilibrium between the rights of creditors and the rights of debtors, such complexity being the source of elevated transaction costs. For example, the services of a specialized attorney is necessary in order to draft a security interest, such as a pledge of intellectual property rights, which, for example, prevents the creditor supplier from using in-house counsel to draft this type of guarantee in the absence of adequate expertise;

- **excessive recourse to public financing** (Oseo (a French public organization that supports SMEs) guarantees, BPI (a French body for the financing and development of companies) loans to mitigate market failures caused by the limits of the law;

[3] Ibid
[4] See, for a quantitative analysis, based on the data base of the Banque de France (French central bank) «*Do bankruptcy codes matter? A study of defaults in France, Germany and the U.K.*» S. Davydenko, J. Franks, The Journal of Finance, Vol. IXIII, no. 2, April 2008.

- **excessive recourse to instruments allowing for circumventing the stay of proceedings**: possessory pledges conferring on a creditor a right of retention over the assets, financing of assets via recourse to leasing agreements with an option to purchase, trusts by way of security the effect of which is to remove the assets from the debtor's property due solely to the signature of a contract and a transfer of the assets, from account to account (without the new owner disposing of the effective attributes of the property, such as the right to dispose of the *res*)[5]; assignments of receivables by way of guarantee, sureties over sums of money such as pledges of current accounts, preventing the debtor from having access to his cash reserves during the observation period, even if the creditors are otherwise adequately secured; this type of instrument reduces the chances of viable companies from recovering and give excessive power to certain creditors over the future of the company;

- **a quasi non-existent high-yield financing market of non-banking players at the level of small companies**, due to the latter being unable to benefit from effective securities coming in second rank after the banks, in spite of the openings allowed by the reforms made in respect of the monopolies of banks.

The draft bill of reforms does not meet the challenges

The draft bill reforming securities follows directly in the line of previous reforms:

- **it contributes to uselessly increasing the level of complexity of the law,** it leads to adding or amending not less than 216 articles; whereas, however, there was a major reform in 2006;

- **it reinforces the legality of strategies used in practice as well as the «niches» created by law allowing for circumventing the rule of the stay of proceedings during insolvency,** accordingly reducing the chances of a company's recovery;

- **it does not take into account the upcoming reform of bankruptcy law initiated by the European Commission in its communication of November 22, 2016,** providing a unique opportunity for French public powers to render classic security interests more effective.

It is necessary to take into account the upcoming reform of bankruptcy law

By way of extension of the reform initiated by the Directive, the next reform of bankruptcy law shall guarantee creditors having security interests that their interests shall survive an insolvency proceeding; in other words, a veritable right of priority over the assets shall be conferred on them. **This reform shall be translated as follows:**

[5] For example, in arrangements that are supposed to transfer, in the assets of a trustee, the ownership of capital shares issued by the subsidiaries of a parent company which is a loan debtor, the parties agree that in the absence of default, the trustee shall act in a general meeting in strict conformity with the debtor's voting instructions. Consequently, the debtor exercises complete economic ownership of shares held in trust.

- creditors having security interests shall no longer be lodged within creditor committees with respect to approval of the plan; **the vote of a plan by unsecured creditors shall not have an effect on the rights of creditors having security interests**;

- **inception of the absolute priority rule**: creditors having security interests shall have priority in relation to unsecured creditors and shareholders for an amount equal to the market value of the assets given as security; in other words if, for example, the value of a company's intellectual property rights given as security is equal to 500 million euros and the business value of the company is equal to 300 million euros, then creditors having security interests alone shall maintain the rights to the company and the shareholders and unsecured creditors may be squeezed out;

- **inception of the right of creditors to not be treated worse than in a liquidation scenario.**

This situation shall be such as to considerably reinforce the attractiveness of traditional securities (pledges of on-going businesses, pledges of inventory, etc.).

Law of secured transactions and insolvency law renewed together

Considering the major upcoming change in insolvency law, law of secured transactions must be considerably revamped. Accordingly:

- **a single register for the publication of securities for all securities must be created** in order to facilitate creditors' information and therefore the provision of securities;

- **a single general system of the rights and obligations of creditors having security interests with respect to all securities must be established**, regardless of the nature of the underlying assets, so as to simplify the law; any exception to the general system (for example, in the case of the pledge of a current account in order to ensure the smooth running of the banking system) must be explicitly justified in the law;

- **exceptions to the rule of the stay of proceedings for the benefit of this or that sectional interest must be eliminated to the greatest possible extent**; for example, the privilege of employees must be reviewed in light of the reform of labor law; **and uniformly treat possessory pledges, as pledges without dispossession in case of the opening of an insolvency proceeding;** pledges unnecessarily entailing a tying-up of assets must not be encouraged;

- **the use of instruments fictitiously conferring transfers of property as security based on the model of foreign laws** - for example, sales with differed transfers of ownership must be analyzed as simple loans; in general, a principle of substance over the form, in order to avoid, as much as possible, financial techniques for escaping the rules of insolvency proceedings;

- **encouraging other forms of pledges than those of sums of money**: securities in respect of sums of money often lead to blocking sums of money belonging to the debtor on a pledged account, at the time when the debtor has most need of it, that is, in the case of the opening

of an insolvency proceeding. It is preferable to give priority to the constitution of pledges producing effects over all of the debtor's assets (and not only the on-going business), based on the model of a floating charge under English law, without dispossession for the debtor.

This is an ambitious work which is indispensable. Other countries with a continental legal tradition have succeeded in making this transition (Quebec, for example).