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DROIT ET CROISSANCE

FAIRE DU DROIT UN VECTEUR DE CROISSANCE

MAKING LAW A VECTOR OF GROWTH

Memorandum concerning the progress of discussions on the draft of the European directive

by Sophie Vermeille,
founder and president of Droit & Croissance

1. **The risk of a minimum convergence of various insolvency laws**

The European Commission recently stated that it was in the process of rewriting a proposed directive that will be less restrictive for the Member States than the prior one. The objective is to enable Member States to waive certain mandatory provisions in the first version of the text. **The disadvantage of this small-step strategy is the delaying of the convergence of the various insolvency laws.** The advantage, however, of such strategy is **to avoid the stalemating of the draft directive**, while leaving the possibility for the European Commission to clearly indicate the direction that the Member States must take in order to eventually converge.

Another advantage of such strategy is to not undermine the law of certain Member States (for example, that of the Netherlands) **which may legitimately claim that their legal framework, as a whole, is sufficiently effective** and does not require aligning itself with the Commission's proposal. Indeed, the proposal of the European Commission addresses only a limited number of aspects of bankruptcy law (it contains nothing concerning liquidation, statutory liens or company disposal plans).

The risk of this small-step strategy is that those countries whose national law must indeed be changed, such as French law, deviate from the objective.

2. **Converging very different laws is complex**

The lawmaker of a Member States is frequently prisoner of its history. Thus France has never freed itself from the logic of the Law of 1985 and the objective of short-term employment protection in spite of the fact that France is the only country in the OECD having adopted such a system and numerous reforms launched between 1993 and 2014.

France is in an isolated situation, considering its law which is focused on short-term employment protection, even if the government seems to desire a significant change of approach. **Spain and Italy**

suffer in particular from the lack of expertise of their courts and law that does not adequately allow for significant debt reduction of companies. Undoubtedly **Germany** has the best law in Europe (although in our opinion not as good as the American Chapter 11 procedure) but has a very legalist approach in dealing with company difficulties (fear of excessive infringement of shareholders' rights). **The United Kingdom** has the benefit of the high level of expertise of its courts but envisages amending its law in order to integrate provisions of Chapter 11.

3. The European Commission committed several errors concerning its draft directive

a. **The European Commission did not adequately base its proposals on a conceptual foundation that would enable it to effectively reply to the criticisms of the Member States and the various lobbies.** Reorganization proceedings must be a means of coordinating the various creditors, as an extension of existing debt agreements. This is the vision of Chapter 11 and, according to this logic, **the stay of proceedings must not be set against the creditors but must be understood as serving their interests** (the idea being to avoid an unnecessary dismantling of the company due to a race for assets). Insolvency proceedings must not be a means for a debtor to free itself from its obligations vis-à-vis creditors.

b. **The European Commission wrongly put forth the idea that the effect of the proposed directive was to settle the issue of non performing loans in Southern Europe.** This frightened off the banks. By providing mechanisms for the conversion of debt into shares and the forced squeezing out of shareholders, the proposed directive **addressed itself first and foremost to companies having a certain size for which there exists a market for their control (even in difficulty, via the purchase of the debt at a lower price than the nominal value on the secondary market).** The European Commission gave European banks the feeling that the new instrument for the resolution of difficulties could be used by non-viable companies, in violation of creditors' rights, as is the case in France. The **initiative of the DG FISMA [Directorate-General for Financial Stability, Financial Services and Capital Markets Union], consisting in finding means for facilitating the enforcement of security interests, will allow for dealing with the issue of non performing loans. The proposal of the DG JUST [Directorate-General for Justice and Consumers] of the European Commission must be understood as a means of allowing for the development of bond markets in Europe.**

c. **The European Commission renounced amending insolvency proceedings by opting for a proceeding referred to as pre insolvency; and then afterwards introducing provisions relating to the squeezing out of shareholders and creditors** – even when these squeeze-outs can only be envisaged on condition that the company is insolvent and carried out within the framework of a totally transparent forum, under the control of a court. This schizophrenia explains the criticisms of the German Ministry of Justice attached to observance of the rights of investors. **The European Commission thus committed the same error as France during these last years, which believed it could settle the problem of companies in difficulty by relying solely on prevention, within the framework of absolute confidentiality. The European Commission must attack more head on the issue of insolvency proceedings, whose contours may greatly influence (positively or negatively) the dynamic of amicable negotiations.** The objective is avoiding companies putting too much time into reducing their debt following negotiations.

4. Recommandations

France must continue contemplating a major reform of its bankruptcy law, which necessitates:

- **Modifying the safeguarding procedure in order to ensure observance of the order of absorption of losses and facilitating company disposal plans in favor of the best bidder**, all within a totally transparent framework, which is the indispensable condition for observance of the rights of investors liable to be squeezed out.
- **Eliminating reorganization proceedings as well as associated safeguarding proceedings** (accelerated financial safeguarding, accelerated safeguarding) in order to improve the clarity of French law from the investors' point of view and in order to avoid management of the debtor company engaging in arbitrages between this or that proceeding, leading to a totally unforeseeable modification of the rights of investors.
- **Improving the effectiveness of insolvency proceedings by decreasing the privilege granted employees**, and recognizing that the protection of employees is better served by an improved system of social protection. Bankruptcy law must be restricted to its only role: the coordination of creditors in order to preserve the value of the company with the aim of wiping off liabilities and, consequently, preserving viable activities.
- **Eliminating the rule of absolute confidentiality in conciliation proceedings** (so as to allow the parties to impose relative confidentiality) in order to improve the liquidity of the secondary market and enable banking establishments to more rapidly finance new projects.

France must set as its objective achieving:
- **The reduction of the five-year rate of relapse of companies emerging from a continuation/safeguarding plan** (the 50% to 85% rate of relapse depending on the proceeding must be decreased to 20%)
- **The reduction of the number of judicial liquidations to a number that is at least similar to that in Germany**, by eliminating incentives for very small companies to have recourse to insolvency proceedings whereas they have only one or two creditors (in particular the rules of labor law), so as to **favor voluntary liquidation and reduce the congestion of the courts**
- **Favoring the competition of private platforms thereby enabling investors, in a more transparent manner, to both realize the assets of non-viable companies under better conditions and restructuring the liabilities of viable companies** within a framework that protects the rights of investors.

France must carry out a complete audit of the future of companies in *ad hoc* mandate/conciliation proceedings, in particular companies having used these proceedings in the last three years.

France must continue to be a **motor in the construction of the capital markets union** which is indispensable for maintaining Europe's competiveness vis a vis the United States and China.