

French insolvency law: the light at the end of the tunnel?



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LESS THAN THREE YEARS AFTER THE INTRODUCTION of the safeguard procedure in France, insolvency law there is set to change again. This is because the number of safeguard procedures in France to date accounts for only around 1% of the 50,000 insolvency procedures since the safeguard procedures came in, which is deemed insufficient. The French government wants to make the safeguard procedure more attractive because not enough companies in difficulty seek court protection before a suspension of payments is declared, when a restructuring still remains possible. With the useful clarifications that are expected to be given, most of them arising from the successful restructuring of Eurotunnel, it will also provide a more suitable legal safety net for all players in the French restructuring and distressed M&A market.

WHAT IS THE SAFEGUARD PROCEDURE?

The safeguard procedure is a true insolvency procedure that enables the debtor to obtain the breathing space required to face its financial difficulties. As with the reorganisation procedure (*redressement judiciaire*), which is the other major French insolvency procedure, the safeguard procedure benefits from a standstill of legal proceedings and from the interdiction to pay pre-bankruptcy creditors, thereby leading to a freezing of legal proceedings and liabilities.

It has the advantage, when compared to the reorganisation procedure, of providing a better hope of turnaround and is not, in practice, perceived as negatively by the clients, suppliers and other service providers of the debtor. On the other hand, it does not benefit from the same advantages with respect to industrial restructuring as the reorganisation procedure. For this latter procedure, when the collective economic dismissals (dismissals of more than nine employees over a period of three months) are considered to be 'urgent, unavoidable and indispensable' under the insolvency rules, they can occur more rapidly than pursuant to the Labour Code and can moreover be financed by a loan from the Association pour la Gestion du régime de garantie des créances des Salariés (AGS), the French collective fund that guarantees the payment of wages due from insolvent employers. Therefore, when financial problems overshadow industrial concerns of overstaffing, as is often the case with restructurings of holding companies of troubled leveraged buyouts, the safeguard procedure is the more suitable and attractive rescue option.

The safeguard procedure is only available for companies that are not in a suspension of payments situation. It has the following important elements:

- 1) It can, in effect, provide for the stretching-out of the liabilities of the debtor over a ten-year period, without the consent of the creditors, although the judge does not have the ability to impose discounts on the liabilities.
- 2) The first instalment must be for a minimum amount of 5% of the amount of the liabilities.
- 3) The interest on loans that are fixed over a longer term than one year continues to accrue.

In certain cases, the creditors will accept more important sacrifices, such as debt cancellations, discounts on the interest or rescheduling of the liability over a period that is longer than ten years when they believe that these sacrifices are essential to restore the financial capabilities of the company. With the implementation of the creditors' committees, it is also possible for majority creditors to impose sacrifices on minority creditors. The debtor can therefore hope to force dissenting creditors to make important concessions beyond the forced ten-year rescheduling of their debt when it believes it has obtained a qualified majority of creditors in connection with its restructuring plan. These concessions can be essential to a company's restructuring. For instance, in the absence of more important sacrifices, Eurotunnel's restructuring would have evidently remained inoperative, as the loans contracted by Eurotunnel provided for a maturity period that was far greater than the French standard ten-year period.

EUROTUNNEL

One of the essential aspects of Eurotunnel's restructuring was therefore the operating rules of the creditors' committees. This is why the planned reform will bring substantial clarification regarding the operation of the creditors' committees. Indeed, the legislator is willing to draw lessons from the difficulties encountered in the restructuring of Eurotunnel, one of the most successful debt restructurings in France under the safeguard procedure. In the *Eurotunnel* case, certain hedge funds argued that they had no seat at the bank committee because they had no banking licence. If they did not participate in the bank committee, the worst outcome was a forced rescheduling of their debt over ten years, which was completely inoperative as discussed above.

EASIER ACCESS?

To encourage greater use of the safeguard procedure, the opening test will be relaxed in the contemplated reform. The manager will have to demonstrate that their business, while still solvent, is 'unable to overcome difficulties', whereas under the 2005 regime

the manager had to demonstrate that the difficulties 'were likely to lead to a suspension of payments'. The current requirement for the evidence of such difficulties would therefore be removed. The proposed reform will also specify the definition of suspension of payments by taking into account the extensions in the time periods granted by the creditors to the debtor to assess the due liabilities:

'... the debtor that establishes that the credit reserves or deferrals from which it benefits, and granted by its creditors, enable it to face the due liabilities by way of its available assets, is not in a suspension of payments situation'.

PROPOSED REFORMS

Obligation to participate

The new law will make clear that holding a bank debt gives rise to an obligation to participate in the bank committee and therefore carries the risk of cramdown (enforcement of a reorganisation plan despite the objections of some creditors) for bank debt holders. If the reform is accepted in its as-is condition, it is effectively the nature of the debt and no longer the identity of its bearer that shall prevail. The new drafting of article L. 626-30, paragraph 2 of the French Commercial Code thereby provides that:

'... credit institutions and those that are assimilated thereto, as well as any creditor that is the incumbent of an account receivable owned by one of them are, by law, members of the committee'.

During *Eurotunnel*, doubt existed over the outcome of the transfer of accounts receivable contracted following the initiation of the safeguard judgment. The proposed reform provides a clear answer:

'The obligation or, when applicable, the ability to form part of the committees constitutes an accessory of the account receivable existing on the date of the judgment for the initiation of the procedure and is transferred by law to its successive incumbents notwithstanding any provision to the contrary.'

The creditors of a debtor in a safeguard situation can therefore continue to trade their debt without fear of losing their right to participate in creditors' committees. Likewise, transfers of accounts receivable following the initiation judgment will not enable a minority creditor to evade the majority law of the creditors' committees.

A simpler way?

The reform should also simplify the majority rules applicable for the votes of the creditors'

committees. For Eurotunnel, hedge funds shared their claims into many hands because under the 2005 regime the bank committee had to approve the safeguard plan through a majority of its members representing at least two-thirds of the amounts owed to the members of the committee. With the reform, the plan will need to be approved by a majority of two-thirds of the amounts owed to the committee independently from the number of debt holders approving the plan. The transfer of accounts receivable by a creditor to its affiliates or to friendly structures will therefore be deprived of their effect.

Majority required

The 2005 safeguard law also did not deal with the terms and conditions applicable for the vote of the bondholders as regards the safeguard plan, which had raised difficulties in *Eurotunnel*.

Eurotunnel Finance Ltd had performed three issuances of bonds in pounds sterling and France-Manche SA had performed three issuances of bonds in euros. The issuances of bonds (both in pounds sterling and in euros) were moreover governed by deeds under English law providing that the bondholders had to decide on important decisions with a majority of three-quarters. Under these conditions, it was unclear whether the bondholders had to hold two or more meetings to approve the plan and whether the decisions of the bondholders were subject to a qualified majority of three-quarters, pursuant to the deeds, or a qualified majority of two-thirds, pursuant to the French rules governing bondholders' meetings. The answers were far from being neutral with respect to the purchasing cost of a blockage minority. Building up a 25% position of the bonds issued in euros and pounds sterling evidently required a less important investment than the purchase of 33.33% of the bonds.

The new law will make explicit that the decision of the bondholders is to be made with a majority of two-thirds, which is the French standard for bondholders' meetings, notwithstanding any contrary provision in the bonds documentation and independently from the law governing the issuance. More generally, if the reform is voted through, the operating mode of the bondholders' meetings will be more in line with that of the creditors' committees, thereby leading to the existence of three *de facto* committees: the credit institutions, the suppliers and the bondholders.

The reform will also provide important specifications on the scope of the decisions of the committees. In effect, the proposed reform provides the ability for the creditors' committees to decide on the

conversion of the accounts receivable – including bonds – into capital or into any other financial instrument, which was what happened in *Eurotunnel*. However, this aspect of the proposed reform is still under discussion. On the one hand, the proposed reform does not make the distinction between companies and partnerships. Many believe that the Paris marketplace has nothing to gain from the forced conversion of the creditors of French companies into partners of companies that are indefinitely and jointly and severally bound by partnership liabilities. Moreover, some would like the conversion to only be decided with a superior majority to the normal majority of two-thirds; for example, a majority of 75% of the amount of the accounts receivable, as with English plans such as a company voluntary arrangement or a section-425 (of the Companies Act 1985) scheme of arrangement. Deciding on such a qualified majority rule would indisputably reinforce the protection of creditors and could be justified by the fact that the conversion forces the creditor to become the shareholder of a company against its will. On the other hand, conserving the majority rule of two-thirds governed by the French legal principles would provide French law with a competitive advantage when compared to English law, from the point of view of investors specialising in the debt restructuring market.

OUTCOME OF SAFEGUARD PROCEDURES

Under the current regime, the typical outcome of a safeguard procedure is the implementation of a safeguard plan, the court still having the ability to end the procedure if a debtor proves to be in a position enabling it to overcome its difficulties. In this respect, the reform provides a major innovation by providing that a safeguard procedure could also be ended by way of a transfer plan (*plan de cession*) transferring all the assets of the debtor to a buyer. Under the current regime the transfer plan is typically dealt with through the liquidation procedure (*liquidation judiciaire*). When the operations of the debtor form a more valuable whole than its subdivisions, the liquidator transfers the business of the debtor instead of the isolated asset items.

The transfer plan may also, under the current regime, represent an alternative to the recovery plan (*plan de redressement*) of the reorganisation procedure. The reform would, on this point, provide for an alignment of the recovery plan with the safeguard plan, but this proposed measure has been met with resistance from parts of the business community. Some believe that the safeguard procedure has as its purpose the restructuring of a company's liabilities on a consensual basis with the creditors and that a transfer plan decided in connection with a safeguard

procedure must imperatively provide for the relief of all the creditors. The proposed reform also enables the court to initiate a reorganisation procedure (when its conditions are met) before the imposition of a liquidation procedure when a debtor fails to comply with the safeguard plan. French law will thereby offer 'two chances' to the debtor in difficulty, while under the current regime the breach of the safeguard plan automatically leads to the liquidation of the business. If it becomes obvious to the bankruptcy court that the safeguard procedure will not succeed, for example, because the existing shareholders are refusing to invest new money into the company, or the creditors will vote against the plan, and the company needs more than a rescheduling of its liabilities over a period of ten years, it would be interesting to facilitate in the contemplated reform the conversion of the safeguard procedure into a reorganisation procedure. Now, under the current system, the transfer from a safeguard procedure to a reorganisation procedure supposes that the debtor is in a suspension of payments situation, which is not easily verified in the safeguard procedure since the claims incurred prior to the beginning of the procedure are subject to the payment standstill.

The proposed reform also clarifies any ambiguity regarding the distribution of the positions between the managers and the court-appointed administrators, with respect to the preparation of the safeguard plan. The law will thereby specify:

'... that with respect to the economic, corporate and, when applicable, environmental report, the debtor (ie, the managers), with the assistance of the administrators, offers a plan'.

It will therefore only be the managers that shall have the ability to take all the necessary decisions for the recovery of their company. Correlatively, in order to induce managers to overcome the psychological barriers leading to the bankruptcy court, the reform will limit the variety of sanctions that can be used against managers. For example, the judge will only have the ability to allocate the amount of the insufficiency of assets to the faulty managers in the event of a liquidation procedure and no longer, as is the case today, in the event of a liquidation or termination of a safeguard or recovery plan.

CONCLUSION

If the draft order finding its inspiration in the successful restructuring of Eurotunnel is approved, possibly before the end of 2008, companies in difficulty will undoubtedly be keen to adopt the safeguard procedure as a potential rescue strategy.

Eurotunnel, Paris Commercial Court (2 August 2006); Paris Commercial Court (15 January 2007)