

KEY POINTS

- While the administration process in England and Wales may require secured creditors to wait a considerable period of time before they receive any proceeds of enforcement, they are usually required to wait even longer in France and Germany.
- Secured creditors are likely to be concerned by the implications of liquidation proceedings in France, where their subordination to the company's employees may result in substantially impaired recovery.
- Secured creditors should be aware of the ability of the German courts to order a stay of enforcement of any mortgage with a view to assisting the sale of the business as a going concern.

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Enforcing security: the challenges

The 2004-2007 leveraged buyout boom saw the rapid proliferation of complex leveraged finance structures across Europe. These structures often had security packages which purported to grant security interests over assets located in multiple European jurisdictions. A key concern is whether enforcement action will, in fact, yield the results or offer the protection expected by lenders.

As global economic conditions worsen, many lenders now have cause to analyse the effectiveness of security packages, if only to assess what their options are in respect of struggling borrowers. This article considers the challenges of enforcing security in England and Wales, France and Germany and in particular:

- ➔ the extent to which enforcement proceedings are dealt with in an expeditious manner;
- ➔ the rights of third party creditors to stay or frustrate the enforcement of security;
- ➔ the recognition of contractual intercreditor arrangements in the context of any security enforcement process; and
- ➔ if there are any circumstances in which the relevant security can become void.

INSOLVENCY REGIMES

In *England and Wales*, if a lender wants to enforce its security it will invariably do so through an administrator or an administrative receiver. Under the Enterprise Act 2002, if a company is or is likely to become insolvent, an administrator may be appointed: (a) by court order; (b) out of court by the holder of a 'qualifying floating charge'; or (c) out of court by the company or its directors. As was demonstrated in the case of four UK Lehman companies – Lehman Brothers International (Europe), Lehman Brothers Limited, Lehman Brothers Holdings PLC and LB UK RE Holdings Limited – which went into administration early on 15

September 2008, a company can be placed into administration extremely quickly. Andrew Barker, Andrew Rotenberg and Peter Baldwin look at some of the specific challenges facing lenders looking to enforce security in England and Wales, France and Germany.

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Enforcing security in Europe is prescribed by the relevant national insolvency regime. In France, three types of proceedings are relevant, namely (a) pre-insolvency proceedings (*mandat ad hoc* and conciliation proceedings), (b) insolvency proceedings (*sauvegarde* and reorganisation proceedings) and (c) liquidation proceedings, although secured creditors can enforce their security against a solvent company with relative ease. In Germany, insolvency proceedings are carried out under the Insolvency Code, which will usually open two to three months after the filing of the insolvency application.

INSOLVENCY OBJECTIVES AND TIMING England and Wales

Once a company has been placed into administration, the administrator is required to attempt to rescue the company as a going concern. If this is not reasonably practical, or would not produce the best result for the creditors as a whole, the administrator will then look to other alternatives with a view to getting a better result for creditors than merely winding the company up. Only if the administrator thinks none of these is reasonably practical will he be required to wind up the company and realise its property (for distribution firstly to secured or preferential creditors). As such, a considerable period of time may elapse from the commencement of enforcement proceedings before secured creditors receive any cash. Moreover, as a general rule, the more complex the capital structure and the greater the number of stakeholders, the

greater the delay before senior creditors get paid out (as lenders to Enron Europe Limited discovered).

For this reason, generally lenders historically used to look to appoint an administrative receiver rather than seek an administration order. This is because an administrative receiver owed his duties specifically to his appointor rather than to all creditors (as is the case with an administrator). The ability to appoint an administrative receiver, however, was dramatically scaled back by the Enterprise Act 2002, which provided that an administrative receiver may only be appointed in certain limited circumstances.

While a lender that had the right to appoint an administrative receiver prior to 15 September 2003 still retains that right (this was the date the Enterprise Act 2002 came into force), the vast majority of holders of qualifying floating charges created after 15 September 2003 will only be able to enforce their security by appointing an administrator.

France

Enforcing security in France may take even longer. First, secured creditors should be aware that there is an automatic stay of between four and eighteen months when insolvency proceedings are opened. Secondly, the typical outcome of insolvency proceedings is the rescheduling of the debt over a ten-year period in accordance with the terms of a continuation plan, during which time a secured creditor cannot enforce its security (although it can during pre-insolvency proceedings).

Furthermore, secured creditors to a company in liquidation proceedings will not be able to enforce their security directly. Instead,

Feature

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a court-appointed liquidator will sell the assets of the company, including the pledged assets, for the benefit of all of the creditors and will pay the proceeds out in accordance with the rules of priority. As the liquidator's primary responsibility is to the company's employees, however, the purchase price for the business as a going concern will often be nominal so as to compensate the purchaser for the assumption of significant employment obligations and will typically be equivalent to the amount of the employees' claims. As French rules of priority rank secured claims behind employees' claims and the costs of the proceedings, secured creditors can find themselves in a more disadvantageous position than they might expect, as was the case in the Smoby case where the lenders suffered severe losses.

That said, liquidators will not be able to sell those assets of the company which are secured by: (a) a pledge over trade receivables under Dailly Law; (b) a pledge over goods with a right of retention (*dépossession*); or (c) the new *fiducie*, which was introduced under French law in 2006, improved under the new order of 18 December 2008 and which came into effect on 15 February 2009. As such, lenders should ensure that these security interests are granted.

Germany

As in England and Wales, secured creditors (*absonderungsberechtigte Gläubiger*) have a right to separate or preferential satisfaction. Generally, such right allows them to claim the proceeds of enforcement up to the amount of the secured claim after the insolvency administrator's costs have been deducted.

The obvious caveat to this is the commonly exercised ability of the German court to order a stay of enforcement of any mortgage. The rationale for this is that enforcement of any mortgage would prevent the continuation of the chargor's business and make a sale of the business as a going concern near impossible. As such, secured creditors may experience considerable delay in enforcing their security interests, although German law does compensate for this delay. As long as their security interests remain unrealised, secured creditors may claim interest. In addition, any resulting loss in value of the secured assets must be compensated for by the insolvency estate.

RIGHTS OF THIRD PARTY CREDITORS

Generally, it is very difficult for third party creditors to stay or frustrate the enforcement of valid security. The primary exception to this rule is if such persons have rights pursuant to an intercreditor agreement. It is worth noting that French law has yet to establish fully the applicability of such agreements in insolvency proceedings.

INTERCREDITOR ARRANGEMENTS

Contractual intercreditor arrangements regulate both the order in which creditors will benefit from the proceeds of enforcement and also the rights of various creditors to commence an enforcement action. So long as the intercreditor agreement is given for valuable consideration, or executed as a deed, its provisions are likely to be enforceable in England and Wales.

Intercreditor agreements are also generally enforceable in Germany. By contrast, recent reforms have muddied the position in France. As of December 2008, a continuation plan is not required to treat creditors equally if their different situations justify it. The reforms are too recent for French case-law to assign any meaning to '*si les différences de situation le justifient*', although the French government has made it clear that this new language is intended to give legal authority to a departure from a uniform approach to senior and junior creditors. As such, it is now unclear if junior creditors are barred from making any recovery in circumstances where senior creditors do not recover in full, potentially making the position for junior creditors more favourable than in England and Wales. Similarly, turnover provisions in intercreditor agreements requiring junior creditors to return monies to senior creditors may no longer be enforceable. Some judicial interpretation of these reforms is eagerly awaited.

CIRCUMSTANCES IN WHICH SECURITY CAN BECOME VOID England and Wales

In England and Wales, when new security is granted, there is a period of time when it is vulnerable to be set aside by a liquidator pursuant to the provisions of the Insolvency Act 1986 ('IA 1986'). This is known as the

security's 'hardening period'. In the main, the relevant provisions of IA 1986 concern transactions at an undervalue (s 238), preferences (s 239) and the avoidance of certain floating charges (s 245).

Transactions at an undervalue

An administrator (or a liquidator) can apply to court to set aside security if the chargor received either no benefit or significantly less benefit than it pledged and in both cases the security was granted within two years of the onset of the chargor's insolvency. Such security must have been granted at a time either when the chargor was insolvent or where it became insolvent as a result of the transaction being entered into. The security will not be set aside if the directors can demonstrate that the security was granted in good faith and for the purpose of carrying on the company's business and that they had reasonable grounds for believing it would benefit the company.

(A similar concept exists under French law. If a lender extends credit to a company that is in difficulty and requires it to grant pledges or other liens or security interests which are disproportionate to the loan, a court may find that the lender has abused its superior position to the detriment of the company and render the guarantees between the lender and company null and void.)

Preferences

Security can also be set aside if the chargor does anything which has the effect of putting the creditor into a position which, in the event of the chargor going into insolvent liquidation, would improve the creditor's position. To be set aside though, the security must have been granted within six months of the onset of the chargor's insolvency unless the security was granted to a connected person, in which case the period is extended to two years. Again, the security will also only be set aside if it was granted when the chargor was insolvent or where it became insolvent as a result of the transaction being entered into. Moreover, the security will not be set aside unless the chargor was demonstrably influenced by a desire to improve the creditor's position on insolvency.



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Feature

Avoidance of certain floating charges

Pursuant to s 245 of IA 1986, floating charges can be set aside if not granted for valuable consideration, but only if they are granted within 12 months of the onset of the chargor's insolvency. If the security was granted to a connected person, the period is extended to two years. If the creditor is not a connected person, the floating charge will only be set aside if it was granted when the chargor was insolvent or became insolvent as a consequence of the transaction under which the charge was created.

France

French law also provides for a period of time when security is vulnerable to be set aside. This is known as *période suspecte* and is potentially applicable to all transactions which have been entered into by a company currently undergoing any of the insolvency proceedings described above. While this period is established on an *ad hoc* basis and cannot be simply calculated from the default date, it is commonly defined as the period before the insolvency proceedings – either judicial restructuring or liquidation – were officially opened and during which the company began to show outward signs of distress. In exercising its discretion, the court cannot allow this period to exceed 18 months from the default date.

French law makes a distinction between transactions entered into during this *période suspecte*. Some transactions, such as the granting of security to secure existing debt, will be void automatically, while other transactions, such as the granting of security to secure new money, will only be nullified if the counterparty knew or should have known that the company was insolvent. As such, it is crucial that lenders making secured loans in distressed situations obtain court approval for the new loan in the conciliation proceedings, whereupon their security will be protected

from being set aside.

Security may also be set aside if abusive lending practices (*soutien abusif*) are established. Article L650-1 of the Commercial Code states that 'creditors may not be held liable for harm in relation to credits granted, except in cases of fraud, indisputable interference in the management of the debtor or if the guarantees obtained for the loans or credits are disproportionate. If the liability of a creditor is established, the court may reduce or nullify the guarantees obtained for the loans'.

Germany

Likewise, the German Insolvency Code gives the insolvency administrator a right to set aside (*Insolvenzanfechtung*) security interests

"Secured creditors are also likely to be concerned by the implications of liquidation proceedings in France."

granted either within a certain period of time of the filing of the insolvency application or after such application, provided that certain requirements are met. Generally, security interests will be set aside if: (a) granted within three months of the filing of the insolvency application; (b) the debtor was illiquid, namely unable to fulfil its due payment obligations, at the time they were granted; and (c) the creditor knew of this illiquidity. If the security interests were granted after the filing of the insolvency application, they will only be set aside if the creditor was aware of the filing or of the debtor's illiquidity.

However, this three-month hardening period may vary. In cases where the creditor receives a security interest to which he is not entitled or of a different kind to which he is entitled or at a time when he is not entitled to it (*inkongruente Deckung*), the security interest

may be set aside if granted either within one month of the filing of the insolvency application or after such application. In cases where the creditor has been wilfully disadvantaged (*vorsätzliche Benachteiligung*), however, this period is extended to ten years.

SUMMARY

While the administration process in England and Wales may require secured creditors to wait a considerable period of time before they receive any proceeds of enforcement, they are usually required to wait even longer in France and Germany. This would particularly be the case for French security if the outcome of the insolvency proceedings was the rescheduling of the debt over a ten-year period, during which time secured

creditors would not be able to enforce their security.

Secured creditors are also likely to be concerned by the implications of liquidation proceedings in France, where their subordination to the company's employees may result in substantially impaired recovery. As such, it is crucial that lenders, when negotiating security packages, benefit from those security interests as are excluded from the liquidator's power of sale. Likewise, secured creditors should be aware of the ability of the German courts to order a stay of enforcement of any mortgage with a view to seeking alternative or additional security.

Finally, the recent reforms in France have cast a great deal of uncertainty over the effectiveness of intercreditor arrangements. There is considerable uncertainty as to how the contractual positions of senior and junior creditors may be interpreted by the courts. ■