MARCH 2014

JONES DAY
COMMENTARY

FRENCH DISTRESSED COMPANIES LAW MODERNIZED

Order No. 2014-326 of March 12 (the "Order"), adopted pursuant to enabling legislation No. 2014-1 of January 2, significantly modernizes French distressed companies law.

The primary objective of the Order is to encourage recourse to mediation proceedings and conciliation proceedings, the efficiency and success of which have been demonstrated consistently in recent major financial restructurings.

The Order also makes important changes to insolvency proceedings, the volume of which has greatly increased in recent years. For example, 509 safeguard proceedings were opened in 2006, versus 1,633 in 2013, and 46,950 reorganization and judicial liquidation proceedings were commenced in 2003, versus 63,101 in 2013. The increasing incidence of such proceedings has encouraged the government to make them more efficient by maintaining the architecture of insolvency proceedings established in 2006, but by modifying the way that such proceedings are organized.

Safeguard proceedings will benefit from wider access with the introduction of the new accelerated safeguard proceedings. In reorganization proceedings, the rights and powers of the creditors have been improved in order to encourage solutions that enhance a debtor's prospects for recovery.

Finally, the French government's intention is to improve the efficiency of liquidation proceedings for companies whose situations are irremediably compromised, and to accelerate the process for companies with no assets available for distribution to creditors or shareholders.

The reforms have already been criticized for not being ambitious enough. As proposed, the Order would have made it easier to displace controlling shareholders, which would have significantly favored lender-led restructurings. These provisions, however, were not retained in the enacted legislation. Even so, the reforms appear to be fulfilling expectations regarding distressed M&A transactions. For instance, the Order includes a mechanism enabling corporate groups to transfer their assets and operations during conciliation

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proceedings. Moreover, the reforms incorporate procedures into French law that will facilitate pre-packaged sales akin to those that are commonly effectuated under UK law.

MEASURES DESIGNED TO PREVENT FINANCIAL DISTRESS

The allure of pre-insolvency proceedings for dealing with financial distress has prompted the French legislature to diversify the tools available to practitioners.

Among the most important aspects of the reforms are new provisions allowing a debtor to file a motion with the president of the commercial court requesting that the conciliator supervise a partial or total transfer of the debtor's assets (article L. 611-7 of the French Commercial Code).

In enacting the reforms, lawmakers intended to introduce, on a trial basis, procedures allowing for prearranged sales similar to those prevalent in the UK. The tools previously available in French insolvency proceedings (*procedures collectives*), which made pre-packs enforceable for recovery plans (e.g., accelerated financial safeguards dealing with the transfer of the outstanding capital of the debtor and allowing the creditors or third-party buyers to become the new shareholders of the debtor), have been supplemented with a new tool: a pre-pack for transferring assets. One of the undeniable advantages of a court-authorized prearranged sale in insolvency proceedings is the protection that is offered to the seller against the risk that an insolvency proceeding will fail. Without making a distinction between small and large companies, which would distort the statistics, recent data suggest that as many as 90 percent of French insolvency proceedings lead to a judicial liquidation. The assets pre-pack therefore appears to be a formidable trump in surmounting this stumbling block.

An assets pre-pack will be negotiated during conciliation proceedings and then finalized in reorganization or judicial liquidation proceedings. Because the Order is silent regarding the timing and conditions of such transactions, practice will refine the conditions for a transfer of assets in reorganization or judicial liquidation proceedings. Article L. 642-2 of the French Commercial Code specifies only that, in determining the conditions for approving a proposed transfer of a debtor's assets, the court "after having solicited the opinion of the public prosecutor department, can take into account the steps performed by the mediator or the conciliator."

Apart from an assets pre-pack, a transfer of a debtor's assets may continue to be effected under the auspices of a conciliator outside of reorganization or judicial liquidation proceedings. New article L. 611-7 of the French Commercial Code may be construed as sanctioning existing practice, which involves requesting a conciliator to supervise a transfer of assets during conciliation proceedings. There are clear benefits to structuring distressed M&A transactions as part of conciliation proceedings.

Court review of a prospective purchaser's business plan is deemed necessary to minimize "boomerang" risks for the seller in the event that insolvency proceedings for a transferred activity are commenced after the transfer. "Boomerang" risks include employees' claims for the nullification of the transfer and/or the payment of a large severance package from the seller in respect of employee claims. The reorganization proceedings of Kem One after its transfer by Arkema, or of LFoundry Rousset following its transfer by Atmel, have recently illustrated these risks. In these two cases, it has been argued—with hindsight—that the purchaser's business plan at the time of the transfer lacked credibility and was unlikely to succeed. In addition, the recent enactment of the *Florange* Law has heightened the advantages of using conciliation proceedings for the transfer of a debtor's assets. A conciliator will be able to certify to the commercial court that the seller has used its best efforts to find a purchaser for a profitable site with respect to which closure was contemplated by the seller.

To ensure implementation of the provisions of an acknowledged (*constaté*) or approved (*homologué*) conciliation agreement, the Order provides that the debtor shall have the ability to petition the court for the appointment of a conciliator to act as a representative entrusted with implementing the agreement.

To make pre-insolvency proceedings more efficient, the Order reinforces the privileged status of new money. If a debtor is subject to safeguard or reorganization proceedings after having received new money in conciliation proceedings, the court no longer has the power to impose a uniform payment schedule for new money obligations. In such a case, the new money creditors shall be considered “off plan,” and the debtor shall be obligated, subject to negotiations, to repay the new money obligations immediately and not under the schedule of the recovery plan, typically 10 years. The Order significantly encourages new financing in conciliation proceedings. Lawmakers omitted a provision in the final legislation that would have expanded the scope of privileged status to include the claims of French taxing authorities and social organizations “for overdue interest, enhancements, penalties and fines due on the debts that have been subject to discounts in the approved agreement.”

Another important element of the reforms is a provision making “aggravating” clauses unenforceable in pre-insolvency proceedings as well as insolvency proceedings, in which such clauses are already void. Contractual provisions that penalize a debtor who is later the subject of a mediation proceeding or conciliation proceeding, such as provisions obligating the debtor to bear legal or professional costs of the creditors’ legal or financial advisers, are now invalid.

CHANGES TO RULES GOVERNING ACCELERATED FINANCIAL SAFEGUARD PROCEEDINGS

Accelerated financial safeguard proceedings, which were introduced into French law by the law of October 22, 2010, and for which eligibility requirements were made more flexible by the law of March 22, 2012, have already been subject to important structural modifications. These proceedings, which made the connection between conciliation and safeguard proceedings, enabling the implementation of prepackaged plans, have been split into two phases under the Order. Chapter VIII of Title II, which is entitled *“De la sauvegarde accélérée”* (accelerated safeguard proceedings), has been entirely rewritten to provide for accelerated safeguard proceedings and accelerated financial safeguard proceedings.

Accelerated safeguard proceedings are similar to accelerated financial safeguard proceedings in that only a debtor involved in ongoing conciliation proceedings who has formulated a plan may request the commencement of an accelerated safeguard proceeding. The principal distinction between the two lies in which creditors may be affected by the proceeding. An accelerated safeguard proceeding impacts only pre-existing creditors that have made a demand for outstanding debts owed to them, thereby excluding employees, ongoing vendors and landlords. The deadline for implementing a safeguard plan is three months, without any possibility for an extension. Thus, accelerated safeguard proceedings are now available to operating companies that have suppliers among their significant creditors.

The Order contains two additional provisions designed to clarify the distinction between accelerated financial safeguard proceedings and accelerated safeguard proceedings; namely, (i) as was the case prior to the reforms, accelerated financial safeguard proceedings affect only creditors that are members of credit institutions and bondholders, and (ii) the timeframe for implementing a plan in an accelerated financial safeguard proceedings (i.e., one month, with the possibility of a one month extension) remains unchanged.

The addition of the accelerated safeguard proceedings has been criticized by those who believe that the introduction of new safeguard proceedings will needlessly complicate the rules and procedures governing companies.[1] Although the new regime may seem more complicated to business persons, practitioners have welcomed the change because it provides a greater range of options.

ADJUSTED BALANCE OF POWER AMONG PLAYERS IN THE PROCEEDINGS

The Order is also designed to re-level the playing field by giving creditors greater rights and powers. Most of the rebalancing mechanisms pertain to reorganization proceedings rather than safeguard proceedings, where debtors receive more favorable treatment as a matter of course.

First, the Order provides for a recapitalization mechanism for a company undergoing reorganization proceedings.

1 *Observatoire consulaire des entreprises en difficultés, La réforme du droit des entreprises en difficulté*, CCI Paris Ile-de-France.

In the event that the interests of equity holders will be impaired as part of a recovery plan over their objection, the court administrator can request that a representative be appointed to convene a shareholders' meeting and vote in lieu of the shareholders for a recovery plan providing for a modification of the capital structure. This provision has been subject to criticism by those who assert that a court administrator should have the power to appoint a representative in other situations where shareholders refuse or are otherwise unwilling to cooperate.

The Order also provides that, in a safeguard or reorganization proceeding, a creditor that is a member of one of the committees has the ability to propose and submit to the administrator a competing plan. Unlike chapter 11 proceedings under U.S. law, in which the debtor has the exclusive right to propose and solicit votes for a plan for up to 18 months, the Order does not provide for any such exclusivity, even in safeguard proceedings. However, a creditor's ability to submit a competing plan for court review and approval is a major improvement that should encourage the participation of new players in French investment markets.

The Order does not make any significant changes to the rules governing committees of creditors. The statutory majority required for approval by a committee remains at two-thirds of the amount of the receivables held by voting members. The Order also retains existing rules governing the composition of committees. Proposals for merging the bondholder and credit institution committee representatives were not included in the final legislation.

The Order introduces significant changes pertaining to the recognition and enforcement in interim proceedings of voting and subordination agreements. This is expected to be a welcome development in international markets and among senior creditors intent upon enforcing their preferred status vis-à-vis junior or mezzanine creditors.

The Order also modifies the rules governing the validity and enforcement of shares transfer consent clauses (*clauses d'agrément*) contained in the articles of association of a company. Under the reforms, such clauses are enforceable only in reorganization proceedings and no longer in safeguard proceedings.

An important proposal in the draft legislation for involuntary transfers of the equity capital of shareholders or controlling partners under certain circumstances was not retained in the Order. It is anticipated that this controversial measure will be included in reforms to be implemented later in 2014.

The Order slightly modifies the criteria for subordination of the terms of a transfer plan (*plan de cession*) to the provisions of a recovery plan. Previously, the adoption of a transfer plan was possible only if the debtor was faced with an "inability to ensure rehabilitation without assistance." Going forward, a partial or complete transfer of a debtor's assets will be possible only if "it is obvious that the recovery plan(s) proposed for the company cannot result in successful rehabilitation."

The Order also eliminates the requirement under previous law that, in safeguard proceedings, the company must pay its trade creditors immediately. The company subject to safeguard proceedings will be able to continue to rely on more favorable terms of payment. The insolvent company subject to reorganization proceedings will continue to be obliged to pay its trade creditors immediately.

IMPROVEMENTS TO LIQUIDATION PROCEEDINGS

Possible reforms to Title IV of Book VI of the French Commercial Code have long been discussed. Efforts toward simplification and acceleration of liquidation proceedings initially resulted in the introduction of simplified judicial liquidation proceedings. However, the protracted nature of liquidation proceedings under French law is still of great concern. So much so that in 2011, France was reprimanded by the ECHR for violations of article 6, § 1 (regarding failure to comply with reasonable timeframes) and article 1 of *protocole n°1* (regarding due respect for property rights).[2] The Order is intended to mollify these concerns. The reforms are aimed at improving liquidation proceedings by introducing "ultra simplified judicial liquidation" proceedings as well as various measures designed to accelerate the administration of liquidation proceedings.

2 ECHR, September 22, 2011, 60983/09, *Tetu v. France*.

Along the lines of the provisions governing simplified judicial proceedings, the Order introduces new proceedings referred to as *"du rétablissement professionnel"* (professional recovery). These new "ultra simplified" proceedings are available only to individual debtors who: (i) are not subject to existing insolvency proceedings; (ii) have not hired any employees during the six months prior to commencement of the proceeding; and (iii) own assets of only nominal value. The duration of a professional recovery proceeding is four months, after which the court will order that the proceeding be closed, triggering a discharge of debts that have been disclosed by the debtor to the court. The aim of professional recovery proceedings is to provide expedited financial relief to individuals who have a professional occupation of the *micro-entreprise* type.

The Order also modifies various rules and procedures governing "ordinary judicial liquidations" with the goal of facilitating the closure of liquidation proceedings and alleviating constraints imposed on debtors. The reforms introduce a new basis for closure—namely, "when the interest of continuation is disproportionate compared with the difficulties associated with selling the remaining assets." This change is significant, particularly in liquidation proceedings involving negligible assets, and should reduce the number of unclosed liquidation proceedings languishing in the charge of bodies entrusted with recovering assets. The Order also empowers the court to appoint a representative for the purpose of "continuing the pending proceedings and distributing any amounts received upon closing the proceedings when such closure does not follow a court ordered discharge of liabilities." As noted previously, the objective of the Order is to remove impediments to the closure of liquidation proceedings, even if, at the time of closure, certain disputes regarding the grounds for closure remain unresolved and must be resolved afterward.

The Order shall enter into force on July 1. With certain exceptions, it will apply only to insolvency proceedings commenced on or after that date.

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