

# How French insolvency law has failed to adapt to the evolution of the Economy and Financial Practice

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*Droit & Croissance / Rules for Growth*

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# INTRODUCTION

## Introduction : New context, new challenges

- The severity of the crisis has made it necessary to adopt measures in order to facilitate the conversion of debt into equity; before, the alternative option was either to reschedule debts or to liquidate the debtor
- Financial innovation has made it much more complex to restructure the capital structure of companies > new markets players, different bargaining powers
- A more intense competition in a globalized world, a declining average productivity rate, the increasing digitization of the economy > increase the need for companies to restructure quickly in an efficient manner

## Introduction : New challenges.... but lack of overarching vision

- Many reforms during the last few years, difficulties to offer an overhaul of French insolvency law > complexity, lack of transparency, side effects
- No reform of the judicial system > difficulties for judges to deal with the new issues raised by the evolution of financial practice
- Lack of data is an issue if you want to tackle vested interests and promote an ambitious reform
- Lack of Law & Economics approach; a strong political and cultural sensitivity remains

## Introduction – International comparisons

*“France differs greatly from the other countries in the arena of insolvency law  
This is due to a weak protection of creditors' rights compared to  
other stakeholders' rights, including shareholders' ones.  
[...] We recommend  
a moderate evolution of French insolvency law towards a better  
creditors' protection, inspired by the US insolvency law.”*

*Jean Tirole (Laureate of the Nobel Price in Economy),  
Guillaume Plantin & David Thesmar  
Conseil d'Analyse Economique  
4 June 2013*

## Introduction - International comparisons

### Classification of Insolvency Regimes according to S&P

A1	A2	B	C
Holland	South Africa	Spain	Russia
Ireland	Germany	Turkey	Kazakhstan
Finland	Belgium	Mexico	Ukraine
Denmark	Luxembourg	Chile	
	Switzerland	<b>France</b>	
Hong Kong	Japan	Italia	
Australia	Portugal	Brazil	
United Kingdom	Canada		
Norway	Unites States		
Sweden			

**PART I**  
**RESTRUCTURING DEBT FROM A LAW AND ECONOMICS**  
**PERSPECTIVE**



## PART I – Restructuring debt from a Law and Economics Perspective

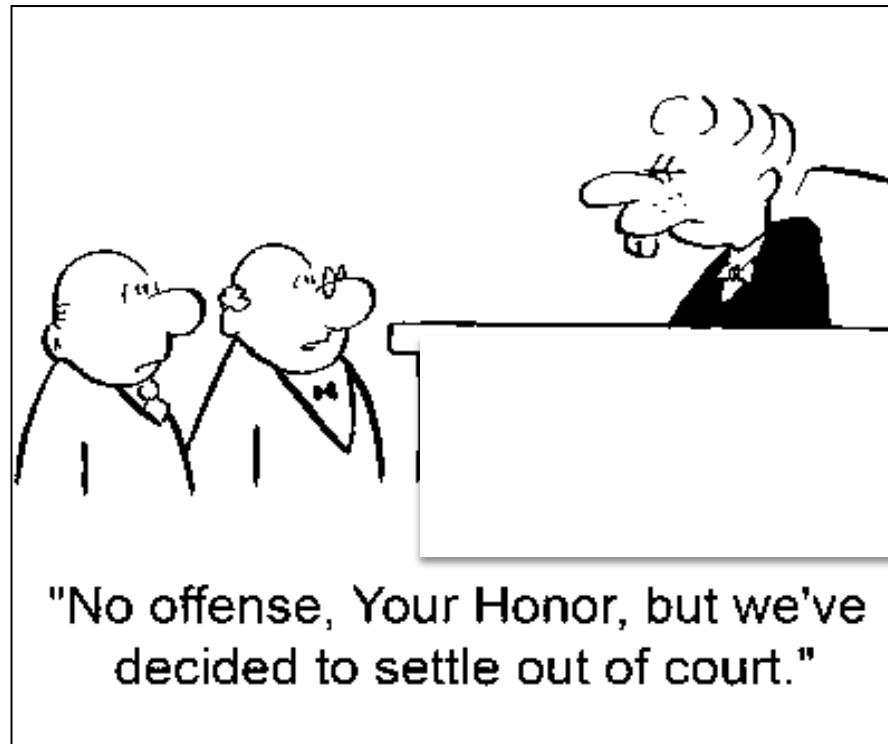
- The objective of an effective insolvency regime is to maximize the value of a firm's assets :
  - the efficient liquidation of nonviable businesses and
  - the efficient reorganization of viable businesses
- If the business is viable > since filling for insolvency proceedings entails cost as a result of the bad signals sent to clients, suppliers and employees, insolvency law should be designed so that the parties are given the right incentives to reach an agreement during out of court negotiations
- Therefore, the bankruptcy proceedings should be designed in such way that property rights are protected (pre-requisite number 1) and transactions costs which impede the negotiation process are reduced (pre-requisite number 2) (Coase's rules)

## PART I – Restructuring debt from a Law and Economics Perspective

- **Pre-requisite N°1 : protection of property rights = respecting the priority of claims with a predictable and established process**
  - the implicit « social contract » between creditors and shareholders arising from the existence of the corporate structure
  - the rights of secured creditors against the rights of unsecured creditors
  - the rights of senior creditors against the rights of junior creditors
  - if the firm is viable but insolvent > transfer of the control of the company to so called “residual” owners who can either decide to convert their debt into equity or to sale the unicorporated business(es)

## PART I – Restructuring debt from a Law and Economics Perspective

- **Pre-requisite N°2 : Reducing transaction costs > the bankruptcy proceedings should:**
  - Provide for a transparent procedure that contains incentives for gathering and dispensing information
  - Resolve conflicts over valuation
  - Force the consent of any minority dissenting creditor (or other dissenting stakeholders) which has deployed hold out strategies



## PART I – Restructuring debt from a Law and Economics Perspective

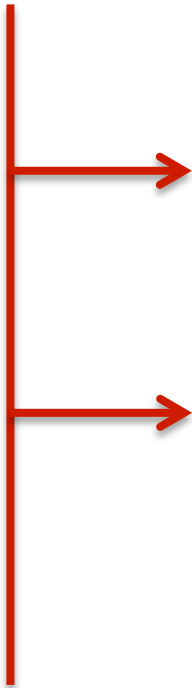
### A French Model?

- No easy separation between viable and nonviable activities when the debtor files for bankruptcy proceedings
- Reduction of transaction cost is limited as 1) no cristalization of the enterprise value during bankruptcy proceedings and 2) limited access to information for creditors
- Since 2008, a majority of 2/ 3 of creditors may force the conversion of all of the debt into equity (provided that the shareholders consent). However:
  - Court may not cram down shareholders and creditors even if they are out of the money
  - The bargaining power of the shareholders is significant as the Court is allowed to approve a plan even if none of the creditors (including the secured creditors) has approved the plan

## PART I – Restructuring debt from a Law and Economics Perspective

- While insolvency law facilitates the coordination of creditors by relaxing the unanimity rule and replacing it with a majority rule of 2/3
- The distribution of the creditors in the various committees is not consistent and disregards the priority rules (trade creditors / banks / bonds)
  - Secured creditors and unsecured creditors are in the same committee and vote together!
  - Junior and senior creditors vote together!
- The only possibility to exclude the shareholders is during an asset sale process, however such asset sale process can only occur after a liquidity crisis (if no viable debt stretch out is proposed) and its main objective is not to maximize the value of the assets to the benefit of the creditors

## **PART I – Restructuring debt from a Law and Economics Perspective**



**Allows junior categories monetize their vote**

**Violation of priority rules, whether during bankruptcy proceedings or during out-of-court negotiations**

## PART I – Restructuring debt from a Law and Economics Perspective



*Change in the rules of the game > exacerbate antagonisms > suboptimal agreements during out of court negotiations*



## PART I – Restructuring debt from a Law and Economics Perspective



- HIGH legal uncertainty

investors: what should be their risk/yield

- Frequent wealth
- Heavy risk of legal transfers
- Forum shopping (Dutch LuxCo )
- No DIP financing )

## PART I – Restructuring debt from a Law and Economics Perspective

Recap:  
Same situation: a viable company which is insolvent > two radically different issues depending on the legal framework

- Shareholders' and junior creditors' rights in the company are preserved
- Shareholders' rights are partly diluted, a portion of the unsecured creditors and the junior creditors is converted into shares,
- economic value of the senior creditors is not preserved
- Value of the equity remains near zero
- Increase in the interest rate weights on economic activity

French legal framework

- Shareholders and junior creditors lose their rights in the company
- The economic value of the senior creditors is preserved
- A portion of the unsecured creditors is converted into equity
- The value of the equity is again positive
- The economic activity is preserved
- The capital structure and therefore the interest rate is adjusted to the business

Theoretical legal framework which embraces a Law & Economics approach

**PART II**

**THE BELVEDERE CASE**



## PART II – Case Study : Belvédère

- **Early 2006** : Belvédère purchases Marie Brizard for €560 M. Belvédère issues floating rate notes (FRN) governed by New York law as well as junior notes (Obligations à bon de souscription remboursables ou BSAR) governed by French law. Both notes contain bullet repayment provisions, in 2013 and 2014 respectively .
- **2007** : Following a dispute between the two founding partners of Belvédère and CL Financial Ltd a conglomerate which was the main shareholder of Belvédère at the time, Belvédère buys back several million shares put on sale by the conglomerate thus breaching a restrictive covenant of the FRN. The breach amounts to € 25.79 M in December 2007 and € 37.89 M in the first quarter of 2008.
- **2008** : Subsequent to market rumors referring to the breach of the restrictive covenant, the price of the FRN collapses on secondary markets. Distressed funds purchase a significant portions of the distressed FRNs.

## PART II – Case Study : Belvédère




## PART II – Case Study : Belvédère

- **What is a covenant?**
  - from a legal perspective : a right to accelerate the payment of a loan > a nuclear weapon for the lender
  
- **What is the purpose of a covenant?**
  - to force the management to change their strategy or to restructure the debt before the initial date of repayment of the debt
  - from an economic perspective: an attempt to align the interests of the creditors with those of the shareholders by reducing the costs associated with financial distress and a tool to grant leverage to creditors in their monitoring of the debtor

**This objective can be reached only where insolvency law provides an « absolute priority rule »**

**In the absence of such a rule, the creditor has no leverage over the debtor**



**In Belvedere, the creditors had no leverage over the management of Belvédère to re-negotiate the terms of the debt in out-of-court negotiations**

## PART II – Case Study : Belvédère

- The management of Belvédère refused to reduce the level of debt of the group
- Distressed funds offered to reduce the debt by € 200 M. This offer was turned down by the management because it would have been very dilutive for the shareholders
- On 16 July 2008, Belvédère filed for relief from creditors in Court (*procédure de sauvegarde*). The relief was granted and triggered an automatic stay of payments of all debts. The creditors challenged the Court's decision which was confirmed.
- The subsidiaries of Belvédère were subsequently forced to file for bankruptcy proceedings because they had provided a guarantee for part of the debt of their parent holding company.
- The duration of the stay of payments was extended to up to eighteen months after the filing of the relief from creditors.



## PART II – Case Study : Belvédère

- During this time, the earnings of Belvédère collapsed as a result of the impact of the various litigations on the group's reputation. At that time however, the company did not need any new money.
- On 10 November 2009, the Bankruptcy Court approved a restructuring plan submitted by the management seeking an automatic ten year extension of the term of the debt (with no increase of the interest rate). The debt of Belvédère reached 24 times its EBITDA.
- The restructuring plan was conditioned upon two main obligations for Belvédère to:
  - reduce its debt through the disposal of the group's core assets (i.e. Marie Brizard)
  - refinance its debt through a new bond issue
- On April 2011, Belvédère having failed to meet the obligations, the Court cancelled the restructuring plan.

## PART II – Case Study : Belvédère

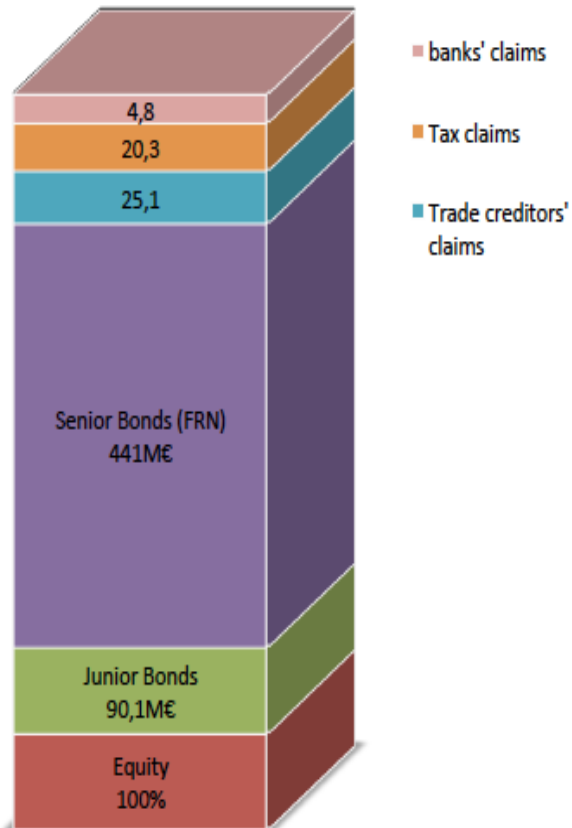
- **In March of 2012**, Belvédère was placed under Court ordered receivership (*redressement judiciaire*).
- **In September of 2012**, the management of Belvédère and a group of FRN holders agreed on a restructuring plan providing for two alternative scenarii.
- After a failed attempt to dispose of core and non-core assets in unfavorable market conditions (Scenario 1), the receiver allowed distressed funds to take control of Belvédère by way of a debt for equity swap (Scenario 2). Distressed funds become the effective owners of 87% of the equity.
- The holders of junior notes (Obligations à bon de souscription remboursables ou BSAR) (now *out of the money*) received stock warrants as payment for their notes. Several holders consider that they have not been treated fairly and threatened to sue the company. They reached an agreement with the company and managed to obtain minor concessions from the company.

## PART II – Case Study : Belvédère

- Several minority shareholders attempted to challenge the validity of the decisions made by the shareholders meeting of Belvédère even if they managed to keep only 13% of the equity of the company. Under French law, all shareholders, including those who are out of the money are required to vote to approve or reject a restructuring plan.
- In **March of 2013**, the Court approved the restructuring plan.
- In **April of 2013, after 5 years of various lawsuits and bankruptcy proceedings and in an uncertain business climate**, Belvédère finally managed to effectively deleverage its balance sheet. Yet it is too late, earnings of the group have collapsed, and the group's EBITDA falls to **€3,2M** in 2012 from a high of **€60M four years earlier**.
- In the end, the shareholders of Belvédère are in a worse position than if they had accepted the initial offer of the company's creditors while holders of junior debt have lost almost everything. The distressed funds have managed to dispose of their stakeholding in the company and to recover their investment

## PART II – Case Study : Belvédère

### Debt structure BEFORE the reorganization

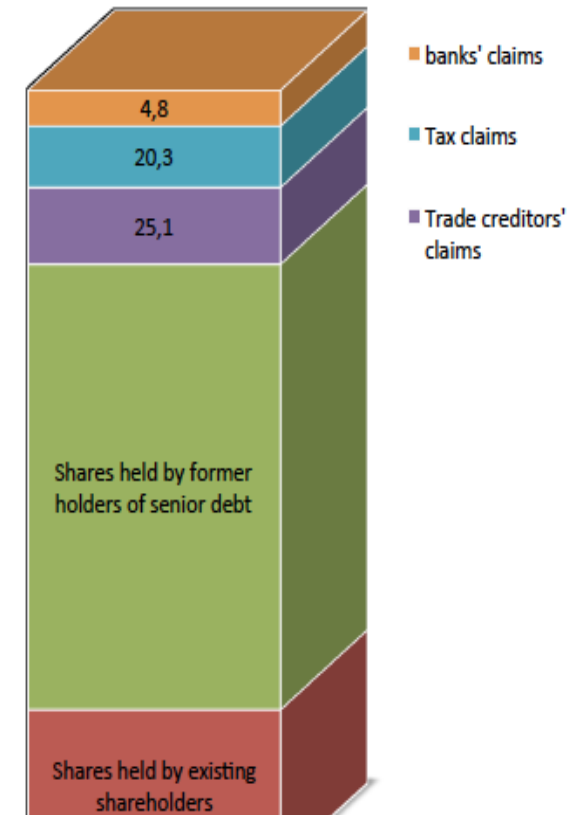


### Description

- FRN holders manage to convert all their notes into equity
- Existing shareholders manage to keep roughly 13% of the equity and receive stock warrants granting them a share of the profits in the event of the firm's recovery
- Holders of junior bonds receive stock warrants in lieu of payment. The warrants grant them a small share of the company's value in the event of the firm's recovery.
- Holders of junior bonds eventually lost their investment and were left worse off than shareholders who should have absorbed the losses first
- The term of other debts was extended by up to seven years

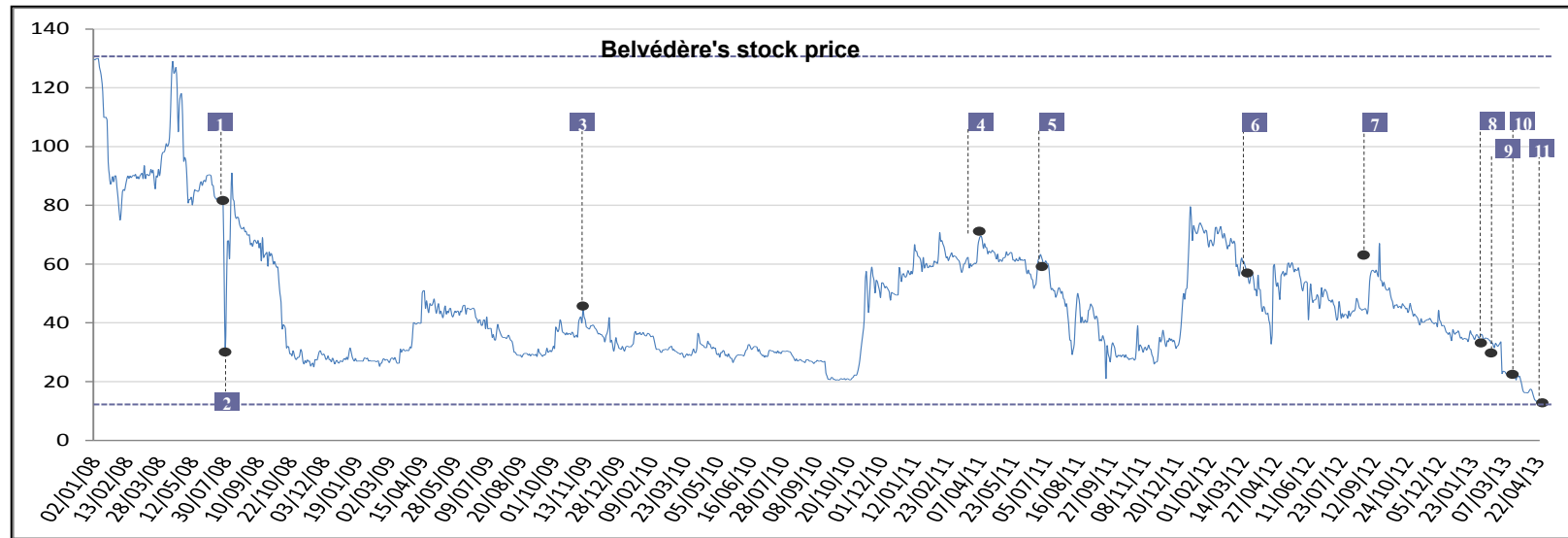
**Belvédère was eventually successful at deveralaging its balance sheet but it came five years too late. In the meantime, the company's earnings have vanished.**

### Debt structure AFTER the reorganization



BELVEDERE

## PART II – Case Study : Belvédère



- |    |                                                                                                             |
|----|-------------------------------------------------------------------------------------------------------------|
| 1  | 20 June 2008 : The listing of Belvédère is suspended and the Court opens bankruptcy proceedings             |
| 2  | 30 July 2008 (trading of the stock resumes) : €29,80                                                        |
| 3  | 10 November 2009 approval of the restructuring plan : €44,40                                                |
| 4  | 4 April 2011 cancellation of the restructuring plan : €66,20                                                |
| 5  | 1 July 2011 the group files for bankruptcy proceedings (safeguard proceedings) for the second time : €60.19 |
| 6  | 20 March 2012 (the safeguard proceedings is converted into a receivership procedure) : €56,10               |
| 7  | 18 September 2012 (agreement with a majority of bondholders) is signed : €55,78                             |
| 8  | 4 Fébruary 2013 (a settlement agreement with the FRN creditors is signed) : €36,12                          |
| 9  | 28 February 2013 (approval of the restructuring plan) : €33,50                                              |
| 10 | 11 March 2013 (confirmation by the Court of restructuring plan : €22,91                                     |
| 11 | 9 April 2013 (approval of the restructuring plan and sale of Marie Brizard by the Court) : €16,32           |

## PART II – Case Study : Belvédère



- Transfer of corporate control came too late
- Fire sales were prevented only at the last minute
- Multiple violations of the initial order of priority between investors were a direct result of the application of French insolvency law
- High level of litigation was due to frequent departures from the strict enforcement of contractual rights

## **PART III**

**WHAT CAN WE EXPECT FROM FUTURE FRENCH INSOLVENCY ?**

## PART III – What can we expect from future French Insolvency ?

- First tentative to implement a cram down has failed as pursuant to Executive Order on 12 March 2014
  - It is possible to dilute shareholders rights only provided that 1) the company has filled for *redressement judiciaire*, i.e. after a liquidity crisis = too late and 2) to the extent that shareholders have failed to restore the level of shareholders' equity
  - the Court appointed administrator may request the designation of a judicial representative (*mandataire judiciaire* ) charged with the task of convening a shareholders' meeting and voting on the restoration of shareholder's equity in place of dissenting shareholders.
- The Ministry of Justice and the Conseil d'Etat took the view that cramming down the shareholders' before a liquidity crisis is unconstitutional
- Difficulty to consider that creditors' property rights deserve the same level of protection as shareholders





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