

The EU Directive on preventive restructuring frameworks – a chance for France to focus on the long term?

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Abstract :

The directive adopted by the Council of the European Union on 6 June 2019 offers France the opportunity to make a paradigm shift towards effective legislation for companies in difficulty. For the moment, French law conflates the goal of efficiency with that of equity, favouring short-term job preservation and thus penalising the French economy. It is important to understand that effective legislation makes it possible in the long term to achieve not only the desired objective of equity, but also EU-level economic objectives.

Introduction - The restructuring Directive – a pivotal moment?

European legislation on companies in difficulty has just taken a major step forward with the Council's adoption on 6 June 2019 of the Directive on preventive restructuring frameworks. France now has two years to enact the directive into French law. In view of this, this paper examines the economic efficiency of the various ways of dealing with business experiencing difficulties.

According to economists, the purpose of legislation on companies in difficulty is to: 1) sort out viable vs. non-viable companies; 2) lower the cost of credit; and 3) maximise the value of the company's assets.¹

From this point of view, French legislation is lacking in efficiency.

Statistics show a significant five-year relapse rate for companies emerging from insolvency proceedings. This is symptomatic of the difficulty French law has in discriminating, on a case-by-case basis, between viable and non-viable companies, and of the system's failure to sufficiently reduce the debt load of viable companies so that they have a real "second chance".

The fundamental reason for this inefficiency is that France's domestic legislation is unique in that it seeks to preserve employment in the short term at all costs, conflating equity with efficiency.

The new EU directive proposes a paradigm shift by requiring that at least one class of creditors agree to adopt a plan, unlike the current regime in France.

However, it leaves Member States a great deal of latitude when enacting the directive into domestic law. It is therefore essential that France 1) becomes aware of the negative effects of its legislation on companies in difficulty; 2) focuses on the economic basis of legislation on companies in difficulty; and 3) factors in the macro-economic issues underlying enactment of the Directive.

¹ As noted, for example, by Plantin G., Thesmar D. & Tirole J. (2013), "Les enjeux économiques du droit des faillites", note no. 7, Conseil d'analyse économique, June.

The economic inefficiency of French law

Maintaining jobs at all costs

There are two main categories of insolvency proceedings: amicable negotiations (ad hoc mandate and conciliation) and collective proceedings (liquidation, reorganisation and safeguard procedures, with the last constituting an intermediary between the so-called "preventive" phase and actual bankruptcy). The last two are reserved for debtors in a situation of cessation of payments (inability to meeting liabilities due with available assets), which alone, in French law, allows for dispossession of the defaulting company's director in favour of court-appointed administrators. In terms of objectives, there should be no distinction between the two types of proceedings (amicable and collective), yet this is what French law has introduced.

Generally speaking, since the Act of 25 January 1985,² collective proceedings have been an expression of economic interventionism by the courts, who have the discretion to impose on creditors, without their consent, a ten-year debt repayment plan. This is a major oddity in France's legislation on companies in difficulty.

Thus, thanks to mandatory deferral of debt repayment, French law favours keeping a company going to the detriment of transferring its activity to a third party. Such a transfer has the disadvantage, from the legislator's point of view, of legally allowing buyers to choose which jobs they wish to keep.

The second oddity of French law is that it allows courts to choose not the highest bidder as part of a sale plan, but rather the one that preserves the most jobs.

Successive reforms have tended to restore power to creditors, by encouraging so-called "amicable" means of resolving difficulties (ad hoc mandate, followed by conciliation). Where appropriate, this is combined with an accelerated collective procedure (accelerated safeguard procedure, followed by the accelerated financial safeguard procedure). However, French law has never freed itself from the rationale embodied in the 1985 Act.

Statistics highlighting the negative effects of this legislation for businesses

The negative effects of this situation are numerous. Statistics show that collective procedures are not effective and do not ensure a company's long-term sustainability.

In France, while 28% of safeguard procedures were converted into liquidation procedures in 2014³ and nearly 60% of court-ordered reorganisations were converted into liquidation procedures in 2016,⁴ the relapse rate remains very high. According to Euler Hermès,⁵ five years after collective proceedings have been implemented, this rate is 65% for companies that have emerged from court-ordered reorganisations and 50% for companies that have undergone safeguard procedures.

² Act No. 85-98 of 25 January 1985 relating to court-ordered reorganisation and liquidation of companies.

³ Deloitte in collaboration with Altares (2015), "L'entreprise en difficulté en France. Dans l'antichambre de la reprise", March.

⁴ Deloitte (2017), "L'entreprise en difficulté en France en 2016, un équilibre fragile", March.

⁵ 2015 statistics by credit insurance company Euler Hermès, available on request. At national level, these rates are necessarily higher, since companies that insure with Euler Hermes against default by their own customers do so because their customers are relatively large and therefore appear to offer more cover.

These figures must be put into perspective with the much lower relapse rate of companies filing for Chapter 11. Between 1983 and 2013, only about 18.5% of the companies that emerged from such proceedings returned to the protection of the courts in the years following the end of the first proceedings.⁶ While the conversion rate from Chapter 11 to Chapter 7 (liquidation proceedings) was 21% for a sample of listed companies,⁷ it was over 50% for SMEs.⁸

According to a report by KPMG,⁹ when a company is finally liquidated and a sale plan is organised despite its impact on employment, the average recovery rate for creditors under a disposal plan is only 6%.

These statistics speak to the adverse consequences of giving precedence to the short-term preservation of employment. It forces creditors to take on a greater risk of loss, which increases the cost of financing for companies. Until now, rather than correcting the source of the problem, the French legislature has preferred to address this problem by increasing the number of regimes that are allowed to deviate from the general rules, thus maintaining an unnecessarily complex and therefore costly law.

Legislation that penalises innovative and small businesses

Lawmakers have thus encouraged the use of financing techniques that allow companies to sidestep collective proceedings. Among them, leasing for small and medium-sized enterprises is similar to an asset-financing loan, but it is legally an asset lease with an option to purchase, which makes it possible to demand payment of the lease during the observation period (whereas repayments to the lender are frozen). This provides the lessor with a very powerful resale right in the event of a sale, which sometimes creates a major constraint on the sale of the entire business. The position of the Inspectorate General of Finance is symptomatic of the French approach: its 2015 report¹⁰ seeks to assess whether the use of leasing poses a problem with regard to the practice of collective proceedings, without more broadly questioning the relevance of the legislation governing these procedures.

Similarly, for reasons that are often obscure, the legislative branch grants privileges to certain categories of secured creditors. For example, a creditor financing a particular asset may have a resale right in the event of a transfer of that asset to a buyer, while other security interests granted to the general lender are ineffective (e.g., pledges of business assets), which penalises businesses seeking this type of financing.

Legislation on security interests has become completely opaque. It provides specific underlying regimes for each type of security interest, which is detrimental to granting credit, given the transaction costs (information and negotiation costs correlated to the complexity of the legal framework).

⁶ ALTMAN V. E., "Revisiting the Recidivism-Chapter 22 Phenomenon in the U.S. Bankruptcy System", 8 *Brook. J. Corp. Fin. & Com. L.*, 2014.

⁷ Hotchkiss E., John K., Thorburn K. & Mooradian R. (2008), "Bankruptcy and the Resolution of Financial Distress", janvier. Disponible sur SSRN: <https://ssrn.com/abstract=1086942>

⁸ Morrison E. (2006), "Bankruptcy Decision making: An Empirical Study of Continuation Bias in Small Business Bankruptcies", Columbia Law and Economics, Working Paper no. 239, 25 January. Available at SSRN: <https://ssrn.com/abstract=880101>

⁹ Report entitled "Les reprises à la barre du tribunal: analyse statistique des pratiques en plan de cession 2017-2018", available at <https://assets.kpmg/content/dam/kpmg/fr/images/2019/06/fr-les-reprises-a-la-barre-du-tribunal.pdf>

¹⁰ Report from January 2015 entitled "Le crédit-bail et les entreprises en procédures collectives", A. Jevakhoff, available at <http://www.igf.finances.gouv.fr/files/live/sites/igf/files/contributed/IGF%20internet/2.RapportsPublics/2015/2014-M-099.pdf>

A law that penalises viable but insolvent large companies

The emphasis on employment also means that French legislation systematically pits the interests of creditors against those of the debtor, since the law makes the survival of the company the objective, rather than its business activity. However, in certain situations, the interests of certain (so-called residual) creditors are aligned with the objective of preserving the company's activity when the company is insolvent (it can no longer repay its debts), since their fate worsens or improves in line with the company's activity (the right of creditors to be repaid under the conditions initially provided for being called into question). Conversely, the shareholders' interests and the company's activity are not aligned: having nothing more to lose, they can ask the manager to make risky decisions. French law does not address this potential conflict between shareholders and creditors.

However, large companies often experience this problem of conflict between shareholders and creditors. Indeed, they have the particularity of being able to record a positive operating result while facing considerable debts, due to the increased preference in recent years for financing via debt rather than equity (particularly for tax reasons). Companies may be insolvent but operationally viable. This situation affects management priorities well before debt matures: managers, to cope with short-term debt, tend to make decisions that are detrimental to long-term value and may unnecessarily lead to a significant decline in asset values. The law does not deal with this conflict between creditors and shareholders and therefore does not prevent this destruction of value as long as the company is not declared in cessation of payments. Preference for employment thus indirectly leads to giving massive rights to shareholders and delays the treatment of the company's difficulties.

Can the European directive restore economic efficiency to the rights of European companies in difficulty?

In some respects, the directive seems ambiguous in its ranking of objectives. In particular, it justifies the infringement of creditors' rights not only by the need to create an optimal negotiating framework, but also by the need to take into account "general interest" objectives, which leaves room for the short-term preservation of jobs and fuels fears that the directive was drafted with the idea that all companies should be straightened out, which is economically untrue.

It is because of this incoherent conceptual basis that enactment is critical: the discretion left to national legislators is such that the directive could be enacted in accordance with the lessons of the economic analysis of the law or, on the contrary, based on an extension of the scope of application of economically false presuppositions.

Giving the power of decision to those who suffer the consequences of their actions

For small businesses, this means that the bank decides their fate. In the event of liquidation, a director should be entitled to propose a price for recovering assets. This is not provided for in the directive, which tends to impose a restructuring of the debts of small businesses.

For larger companies, this means, during collective proceedings, allowing pivotal classes of creditors (those with the greatest interest in a reorganisation or maximisation of assets) to decide the company's fate, i.e. those creditors whose interests are only partially covered by the assets available under the plan (the so-called "residual" creditors). This results in the rule of forced inter-class

application of the plan on the basis of support by a majority of voting classes. The rules governing creditor classes are a means of aligning interests within those classes, and of avoiding abuses where the interests of different creditors diverge. Alignment of interests makes it possible to understand that, when it comes to facilitating the conversion of claims into shares, a decision-making monopoly of the shareholders must be avoided, but excessive judicial interventionism must also be avoided. The directive offers this possibility but does not oblige Member States to facilitate the conversion of debt into equity.

Facilitate rapid, upstream processing of difficulties

To maximise the value of corporate assets (in the interest of all stakeholders), it is important to address corporate difficulties as early as possible (as this reduces the costs to business of corporate over-indebtedness). This is a subject on which France is ahead of other European countries.

The statistics presented in a report by France Stratégie in April 2018¹¹ illustrate the value of an early procedure, since companies in safeguard procedures are twice as likely to benefit from a safeguard plan as companies placed in a court-ordered reorganisation procedure are to obtain a continuation plan or a sale plan, the alternative to safeguard being liquidation.

In addition, shorter observation periods would speed up proceedings and reduce the cost to creditors (as the claim is frozen) and to business (as a result of the effect on suppliers and customers), leading to maximisation of the value of the companies' assets and better protection of creditors' interests. This would lead to maximisation of the value of the companies' assets and better protection of creditors' interests. The solution being more satisfactory, it is also likely to be adopted more quickly.

Strengthening the rights of secured creditors

In order to strengthen the rights of secured creditors, reduce the use of financing techniques that escape collective proceedings and simplify security legislation, it is important that secured creditors are not placed in the same classes as unsecured creditors (as theoretically envisaged by the directive, although this is not clearly stated). Under the best interests rule, the legislator cannot ignore the existence of such security interests.

If we return to the very essence of legislation for firms in difficulty, i.e. the objective of obtaining the best possible maximisation of value, a security regime could be only contractual (therefore simplifying legislation), with the exception of disclosure requirements. The law for firms in difficulty would thus allow a satisfactory solution to be found, since optimal treatment of the different types of creditors would already be guaranteed.

¹¹ Report by France Stratégie, April 2018, "Entreprises en difficulté financière: procédure de sauvegarde ou redressement judiciaire ?" disponible sur le site de France Stratégie: https://www.strategie.gouv.fr/sites/strategie.gouv.fr/files/atoms/files/fs-ns-2018-entreprises_en_difficute_financiere-17042018.pdf

What is at stake for Europe in improving the economic efficiency of legislation on companies in difficulty?

For Europe, the main economic objectives behind legislation on companies in difficulty are to ensure equivalent and cheaper financing conditions for companies (SMEs in particular), to reduce the number of non-performing loans on the balance sheets of European banks and to improve the Capital Market Union . Let us examine these last two points.

More effective legislation for companies in difficulty – a prerequisite for the completion of the Capital Market Union

Studies have shown that a dynamic financing market must necessarily rely inseparably on banks and capital markets, as this provides a diversification of funding sources that could improve the resilience of the economy to banking crises and would lead to greater financial stability.¹² More effective legislation on companies in difficulty would facilitate the coordination of the action of a large number of creditors and thus the development of bond markets, a key issue for Capital Market Union . It is important that the legislator has this in mind and does not forget to treat bondholders in the same way as banks.

Reducing banks' exposure to non-performing loans: a priority of the European Central Bank

The objective of cleaning up banks' balance sheets raises a complex issue, which has repercussions at several economic levels and is one of the ECB's central concerns: that of non-performing loans. Indeed, owing to applicable prudential rules, exposure to non-performing loans forces banks to cover their risks, thereby mobilising part of their resources and reducing the total amount they can lend. With a reduced credit supply, resources are not allocated to financing new businesses, which are potential sources of innovation and long-term job creation, and the available credit can be held captive by keeping non-performing businesses with large numbers of employees afloat. For this reason, the ECB, like the Scandinavian countries, has been pushing hard for a law on companies in difficulty in line with the lessons of the economic analysis of the law.

Enactment of the directive in line with such an analysis would be a first step towards a necessary transformation of the French system, in a context of normative competition, which should hopefully encourage domestic legislators to propose schemes that are as attractive as possible for investors. It should be pointed out that the French objectives of social equity, like the EU's economic objectives, can be achieved by being aware of the positive long-term consequences of more effective legislation for companies in difficulty.

¹² Anderson N. *et al.* (2015), "A European Capital Markets Union: implications for growth and stability", *Financial Stability Review*, paper no. 33, February.

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