CARROPINION

TURNING AROUND FRENCH BANKRUPTCIES

Sophie Vermeille and **Frank-Adrien Papon** discuss the proposed changes to French bankruptcy law.

There is no end in sight to the economic conditions that triggered an explosion of bankruptcies across Western Europe after 2008. Credit remains constrained as large banking institutions continue to deleverage and adapt to the new regulatory landscape. Meanwhile, the growth of global bond markets has increased the complexity of large bankruptcy cases.

In France, many observers anticipate a substantial increase in the numbers of corporate bankruptcies. What may be less obvious, however, is that corporate bankruptcy poses a special problem in this country because it lacks a dynamic turnaround industry. Only a handful of distressed funds can raise new money as well as the management expertise to put failing French businesses back on track. This means that France suffers from a serious competitive disadvantage because it is ill equipped with private actors who might give failing businesses a second chance.

Having examined this problem in depth, our think tank Droit & Croissance (Rules for Growth) has concluded that France's weakness in corporate turnaround is a direct result of an antiquated bankruptcy law. We advocate a complete overhaul of the French bankruptcy proceedings in alignment with global best practices and the latest academic research. The literature in the field of law and economics has clearly shown that effective bankruptcy laws have an important impact on the swift reallocation of resources and the smooth maintenance of overall economic growth.

The French government appears to have grasped the urgency of the situation. It is finally tackling the much needed reform of French bankruptcy law, which is the most important hurdle to overcome to achieve a dynamic market of private financing for distressed firms in France. France's neighbours including Spain, the Netherlands, the United Kingdom or Germany, have, like the United States, already incorporated changes to their bankruptcy laws to address the increasing weight of corporate debt in a globalized economy. All of these countries have implemented legislation that addresses the well documented conflicts of interests between shareholders and creditors in bankruptcy proceedings which economists have named agency costs. French law, however, remains blind to this source of inefficiency.

Despite a series of major amendments since 1985, the current structure of French bankruptcy laws is frozen in a 19th century vision of credit relationships which valorizes personal responsibility and honour. This kind of legal infrastructure is not suited to a risk and innovation based economy. While the focus of French bankruptcy law has indeed shifted from assigning blame to saving jobs, it is still not focused on saving the enterprise as a whole because it is too heavily biased in favour of the shareholder.

A stubborn remnant of 19th century thinking, the shareholder is still viewed as the principal and ultimate stakeholder of a company who is rarely, if ever, displaced by bankruptcy proceedings. The preponderance of family-owned small businesses in France, where management is often the sole or controlling shareholder, exacerbates this point of view. The common French perception is that a shareholder comes before customers, employees, creditors, suppliers, local communities, government and society at large, who are the true joint stakeholders of a modern corporation.

This shareholder bias is a major source of the law's inability to adapt to the complexity of a modern corporation's diverse source of financing. It is also the source of a lesser known and often overlooked legal problem which effectively places all debt collateral virtually out of reach of the lenders, thus making any form of debt financing virtually impossible for small or distressed companies.

How does France deal with distressed firms in the absence of private sector intervention? One need only scan the headlines to find the French government up to its neck in desperate cases. The Treasury is frequently called in and given free rein to deepen insolvency by extending public credit and asked to arrange mergers born in politics with public or private companies owing favours to the government. Working outside of any legal framework, and under intense media and political pressure to save jobs, Treasury officials routinely twist arms to reach compromises behind closed doors.

Unfortunately, this time honored tradition of interventionism has left the Treasury with several billion euros of bad debt, prompting the government to take on the root cause of the problem.

The Treasury is well aware of the dire state of the turnaround industry in France. This is why the government's draft has designated a public investment bank – the *Banque Publique d'Investissement* – to invest public money into distressed companies. But if this plan were to be implemented under the current state of French bankruptcy law it would simply lead – yet again – to a massive transfer of wealth from the public purse to that of a few private shareholders who really should have been evicted a long time ago from the companies they themselves have quite often, run into the ground.

The government has recently released a draft proposal, which, for the very first time, considers the eviction of a controlling shareholder who cannot offer a viable recovery plan for a distressed company. This is an important first step towards repairing the damaging imbalance between shareholders and the other stakeholders of French corporations, in particular, its creditors.

The proposal is encouraging, but it is not enough. An efficient bankruptcy procedure must also contemplate the eviction of some creditors and effectively force them to take on a portion of the losses as soon as it becomes clear that the burden of the company's debt has exceeded what it can repay in the future.

A modern bankruptcy procedure is geared towards forcing the shareholders and creditors to sit at the table and accept their loss at an early enough stage, in accordance with the terms of their existing agreements, in order to spare the company the accelerated destruction of value that inevitably occurs when suffering financial distress. Unfortunately, for French companies, French law is not focused on this objective and no compromise can be forced upon shareholders or creditors until it is already too late.

One illustration of this tardiness is the focus of current French law on an elusive and legally unsettled milestone of cash insolvency known as *cessation de paiements* (withdrawal of payment), which triggers bankruptcy proceedings. For most companies by the time this threshold has been met it is far too late to force shareholders out and sit bankers down to negotiate.

The government's draft also contains provisions curtailing some fundamental rights of creditors. For example, under the proposed rules, creditors would be banned from obtaining legal advice at the expense of their debtor. This provision, which deprives creditors the opportunity to defend their position against shareholders, goes against the current trend and best practices worldwide, and will certainly have a negative impact on the attractiveness of French businesses to global investors.

In response to the government's proposal, Droit & Croissance has suggested an overhaul of the French bankruptcy law articulated around two distinct processes, one for large corporations and another for small and medium enterprises.

Large corporations should be governed by a slow, complex procedure that should be geared towards transferring the control of the company to a specific class of creditors known as residual creditors. These are creditors who have some stake in the company's future because their debt can and will be partially repaid from whatever assets are left in the company.

Economic analysis teaches us how to distinguish residual creditors from so-called "junior" creditors whose debt enjoys no seniority or is not secured by any assets. When a company is bankrupt and its assets do not cover its liabilities, junior creditors are in the same positions as shareholders; they have, in effect, lost everything. With nothing to lose creditors in this position are prepared to entertain any option including the riskiest ventures or plans to dismantle the company and destroy its aggregate value. Their interests are no longer aligned with the long term survival of the company as a whole and that of its many stakeholders.

Junior creditors should be removed from any decision regarding its future. The residual creditors, on the other hand, have an interest in finding a reasonable recovery plan, giving the company time to recover or an outside buyer that will allow the company to bounce back. They should be given sole control over the future of the company. Recognizing this central conflict of interest between creditors is absolutely essential in order to strip and reallocate the power to decide the future of a bankrupt company.

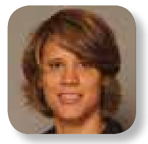
Knowing where to draw the line between various types of creditors can be a complex exercise. To determine who will be left with something and who will not, requires a very careful estimate not only of the company's residual value, but also of the complex structure of its debt. In most jurisdictions, where the law grants some form of automatic stay on creditors claims, this careful distinction has become the focus of modern bankruptcy law. There is no reason why the same cannot be true in France.

In the case of small companies, these should be spared the complexity of sifting through the contractual rights of creditors. To avoid large, crippling transaction costs, SMEs should benefit from a simplified and expedited procedure in which the control of small bankrupt companies should be swiftly transferred to those creditors who have secured their debt with the company's assets. This type of procedure exists in many countries and it is the fastest and most efficient way to allow viable small companies to recover and non-viable ones to be quickly liquidated.

How does France deal with distressed firms in the absence of private sector intervention? One need only scan the headlines to find the French government up to its neck in desperate cases.

Much remains to be done in France to build a coherent legal framework that will encourage the swift reallocation of power in bankrupt companies. In our view, evicting shareholders and creditors who have failed the company will bring France into the 21st century. At Droit & Croissance we believe this is the only proven and effective way to bring new talent and financial resources to those struggling French companies that deserve a chance to be turned around.

The authors are lawyers in France and the United States. The views expressed here do not reflect those of their clients or employers.



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A full length version of this article is available in French at www.droitetcroissance.fr.