

# The intersection of the credit markets and insolvency

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**Positive and negative impact of the credit markets on insolvencies**

**Improvement of the creditor's status ?**

 Marccus Partners  
Paris, France

# I. Overview of the French Economy (2007/2008)

## 1. Negative impacts of the US subprime crisis

### 1.1 Facts and figures

- ❑ French companies tend to underestimate the effects of the US subprime crisis on their own situation (survey IFOP-ARE, October 2007)
  - one year ago, 60% of the French CEOs declared that the US subprime crisis would not have any impact on their business
  
- ❑ Secondary Debt market: 87% of the French CEOs declared not to know this practice (survey IFOP-ARE, October 2007)

# I. Overview of the French Economy (2007/2008)

## 1. Negative impacts of the US subprime crisis

### 1.1 Facts and figures

#### □ Who suffered the effects in France (in Europe) ?

- Banks: cumulated losses of € 17 bn - forced to recapitalize

Recapitalizations in France since July 2007 (examples):

▪ Crédit Agricole SA	€ 8,5 bn
▪ Société Générale	€ 9,4 bn
▪ Natixis	€ 11,8 bn
▪ Dexia	€ 6,4 bn
▪ BNP Paribas	€ 0,0

and : additional write-downs are expected for Q2 2008 (JP Morgan)

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## 1. Negative impacts of the US subprime crisis

### 1.1 Facts and figures

- Rescue of European banks ("*nationalisations*"): examples
    - Northern Rock (UK) February 2008
    - Bradford + Bingley (UK)
    - Fortis (NL- B - Lux)
    - Hypo Real Estate (Germany) } September 2008
    - Dexia (F - B)
    - Glitnar (Island)
    - Landsbanki (Island) } October 2008
  - No European rescue fund, but co-ordinated actions in the EU zone (state guarantees for interbank lending/"nationalisations" if needed/state guarantee for deposits);
  - the 3 European central banks inject liquidities in the market
- French Government/EU G 4 declared: "There will be no failure"

# I. Overview of the French Economy (2007/2008)

## 1. Negative impacts of the US subprime crisis

### 1.1 Facts and figures

#### □ continued: Who suffered the effects in France (in Europe) ?

- Businesses: halt of investments (Q3 2007/2008) and huge increase of default rates (EU +23% ; Spain +65%)
- Individuals: loss of savings (important drop of the French stock exchange (i.e. ↓37,7% since December 31, 2007)/ decrease of purchasing power / tightening in bank lending standards / longer-term lending freeze/ 15% increase of default rates (in Spain + 40-50%)

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## 1. Negative impacts of the US subprime crisis

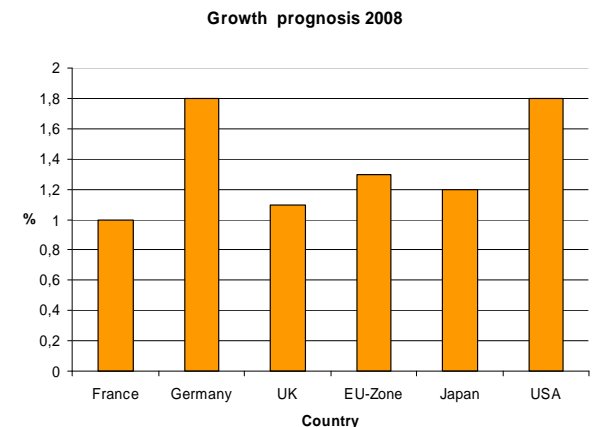
### 1.1 Facts and figures

#### □ Growth prognosis 2008 (OECD)

- France +1%  
(0,8% according to some French economists)

- deficit 2.7% of the GDP
- GDP Q2 2008: -0.3% / Q3 Q4: -0.1%
- inflation rate: 3.2% ↓
- unemployment rate: 7.3% ↑

- Germany +1.8%
- UK +1.1%
- EU-Zone +1.3%
- Japan +1.2%
- USA +1.8%



- Europe admits being on the brink of recession (especially Germany, UK and Spain)
- ECB cut its benchmark interest rate to 3.75% in coordination with 7 central banks (8.10.2008)

# I. Overview of the French Economy (2007/2008)

## 1. Negative impacts of the US subprime crisis

### 1.1 Facts and figures

#### □ Impact on the French credit market

- a 30 to 50 base point increase since the beginning of 2008
  - Drop of the volumes in general and per transaction :
    - 01/2008: €28 bn
    - 07/2008: €15 bn
    - Q3 2008: - 61% of the volumes of syndicated loans (-40% in Europe)
  - General tightening in bank lending standards
- Concerns mainly small/middle sized companies, the big companies “only” suffer from the increase of the rates (e.g. EDF acquired British Energy: pool of 7 banks is lending € 13,9 bn)
- Major problem for small/middle sized companies: financing of the working capital

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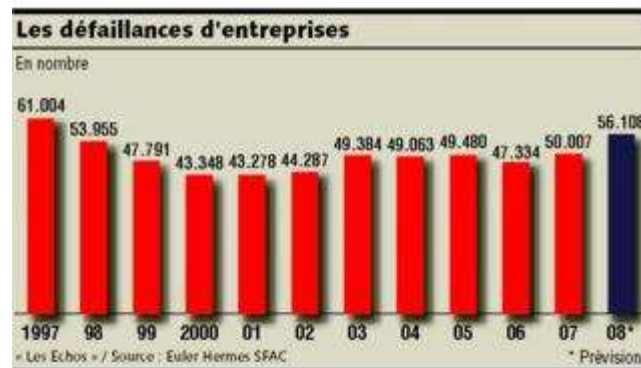
## 1. Negative impacts of the US subprime crisis

### 1.2 Increase of insolvencies in France

#### □ France

- 2007: +5% compared to 2006
- 2008 (Q1): increase of 15% compared to 2007

Number of insolvencies:



Most affected sectors:

- hotels /restaurants (09/08 +25%)
  - construction (09/08 +22%)
  - real estate
- but also: transports, automotive



# I. Overview of the French Economy (2007/2008)

## 1. Negative impacts of the US subprime crisis

### 1.2 Increase of insolvencies in France

#### □ In comparison to other countries (rates for 2007)

- Germany -14,6% (-8,3% 1<sup>st</sup> semester 2008)\*
- UK +0,3%\*\*
- USA +0,1%
- Japan +0,2%

#### ➤ Conclusion: sharp increase of insolvencies in France

\*source: destatis

\*\*source: KSV 1870

# I. Overview of the French Economy (2007/2008)

## 2. Recent reforms of the French Government

### 2.1 In general

- ❑ The rigid rules of 35h-workweek introduced under the socialist government (Jospin) in 2000 have been relaxed
- ❑ So-called "tax shield" ("*bouclier fiscal*") limiting the total taxation of revenue of French residents at 50%
- ❑ Inheritance tax reform
- ❑ Different measures stimulating the business of SMEs (e.g. reduction of the term of payment)
- ❑ "RSA" ("*revenu solidarité active*")
  - ⇒ supposed to stimulate the return to work
- ❑ Near future: strengthen banking supervision at EU/world level ?
- ❑ Regulation of golden handshakes/stock-options

# I. Overview of the French Economy (2007/2008)

## 2. Recent reforms of the French Government

### 2.2 Recent developments in French Insolvency Law

- ❑ Law on the Safeguard of Businesses ("*Loi de sauvegarde des entreprises*", 26.07.2005, EiT 01.01.2006)
- ❑ Law on the Modernisation of the Economy ("*Loi de modernisation de l'économie*", EiT 06.05.2008: "LME" )
  
- ❑ Major characteristic of French Insolvency Law
  - general striving for the rescue of the debtor at the expense of the creditor (maintaining employment)

# I. Overview of the French Economy (2007/2008)

## 2. Recent reforms of the French Government

### 2.2 Recent developments in French Insolvency Law

- ❑ Reform of 2005 introduces the idea of safeguard into French Law (inspired by Chapter 11)
  
- ❑ Three possible pre-insolvency proceedings under court-supervision
  - Negotiation mandat ("*mandat ad hoc*")
  - Conciliation proceedings ("*procédure de conciliation*")
  - Safeguard proceedings ("*procédure de sauvegarde*")
  
- Aim: renegotiation of the term of payments with the creditors before becoming insolvent (early warning system)

# I. Overview of the French Economy (2007/2008)

## 2. Recent reforms of the French Government

### 2.2 Recent developments in French Insolvency Law

#### □ New measures to improve the creditor's status in insolvency proceedings

- reduction of the risk of engagement of the lender's liability
- "new money"-privilege
- establishing of creditors' committees

## II. Improvement of the creditor's status ?

### 1. Liability of the lending banker in insolvency proceedings

#### 1.1 Prior to the Reform of 2005

❑ No legal provisions ⇒ case law

❑ Liability for

- sudden or abusive breach of the loan provoking bankruptcy, case law considering that the client's difficulties do not justify the breach of the loan
- excessive support, case law considering that the banker thus created a seeming solvency which has delayed the filing for bankruptcy

## II. Improvement of the creditor's status ?

### 1. Liability of the lending banker in insolvency proceedings

#### 1.2 Reform of 2005\*

- ❑ In principle no liability of the lending creditor, except:
  - fraud at the expense of the other creditors
  - interference in the debtor's management, see "de facto chief executive"
  - immoderate guarantees in regards to the financial support agreed
- Sanction: in addition to indemnities, nullity of the creditor's guarantees
- But: case law regarding the liability for sudden/abusive breach of a loan remains applicable

\* codification under article L.650-1 of the French Code of Commerce (C.com)

## II. Improvement of the creditor's status ?

### 2. New Money privilege

- ❑ Objectives :

Encouraging lenders to finance ailing businesses prior to insolvency

## II. Improvement of the creditor's status ?

### 2. New Money privilege

#### 2.1 Conditions

- ❑ Granting a new loan/credit during conciliation proceedings to assure the continuity of the company's activity\*
  
- ❑ Court approval of the voluntary agreement executed between the debtor and the creditors
  
- Consequence: in case of insolvency proceedings, preferential right over all creditors, except employees' wages and court costs

\* codification under article L.611-11 of the French Code of Commerce (C.Com)

## II. Improvement of the creditor's status ?

### 2. New Money privilege

#### 2.2 Criticism by banks

- ❑ Unwanted publicity
- ❑ In case of safeguard/reorganization plan: risk of a 10 years long reimbursement in the worst case scenario
- ❑ New Money privilege only gives a preferential right in the creditors' ranking but does not give the right to be reimbursed at the contractual maturity
- In practice, the "new money privilege" did not prompt banks to grant loans

## II. Improvement of the creditor's status ?

### 3. Creditors' Committees\*

- ❑ One of the main measures of the Reform of 2005
- ❑ Inspired by Chapter 11 US Bankruptcy Code but “with French touch”
- ❑ Objective: to give creditors a real bargaining power
  
- ❑ Safeguard / reorganisation proceedings:
  - creation of 2 mandatory committees by the administrator (> 150 employees/annual turnover > 20 m €)
    - committee of credit institutions
    - committee of the main suppliers of goods and services
- ❑ Creditors excluded by law : State, public institutions (save public credit institutions), employees, bondholders

\* codification under articles L.626-29 and L.626-35 of the French Code of Commerce (C.Com)

## II. Improvement of the creditor's status ?

### 3. Creditors' Committees

#### 3.1 Formation of the Committees

#### □ ≠ US law

- in France, the law provides that the committees are not formed according to the type of debt but according to the quality of the creditor (e.g. credit institution defined in the French Financial Code\*)
- no fiduciary duties of the committee members ⇒ each committee member represents itself
- a debtor's competitor can be member of a committee

\*article L. 511-1 of the French Financial Code (Code monétaire et financier)

## II. Improvement of the creditor's status ?

### 3. Creditors' Committees

#### 3.1 Formation of the Committees

- ❑ The law does not include into the committee of credit institutions :
  - the transferee in case of assignment of debts if it does not qualify as "credit institution" according to the legal definition (e.g. hedge funds, insurances)
  - mezzanine financing bank = bondholder
- ❑ But: since the Eurotunnel case, the Courts permit the inclusion of the transferee of a debt into the committee considering that it is in an identical position than the transferor (bank)\*
- French law does not reflect the economic reality and constitutes a hurdle for effective negotiations of a plan

\* Ordonnance Eurotunnel Trusties Limited, Tribunal de Commerce de Paris, 20.11.2006

## II. Improvement of the creditor's status ?

### 3. Creditors' Committees

#### 3.2 Role / functioning of the Creditors' Committees

- ❑ the creditors' committees vote on the safeguard / restructuring plan proposed by the debtor (majority of the members representing at least 2/3 of the total amount of the claims of that committee)
- ❑ in case of a negative vote of one of the committees: individual consultation of each creditor
- ❑ the excluded creditors are consulted individually
- ❑ the court is bound by the plan approved by the creditors' committees (but verifies the protection of minority rights)

## II. Improvement of the creditor's status ?

### 3. Creditors' Committees

#### 3.2 Role / functioning of the Creditors' Committees

- ❑ the creditors' committee can adopt a plan exceeding a 10 year reimbursement and can impose to minority creditors the partial abandon of their claim
  
- ❑ ≠US law
  - in France, the committee members cannot investigate against the debtor
  - no cram down ⇒ if the plan is rejected by a committee, all members are to be consulted individually
  - the majority cannot impose an additional funding of the debtor nor the conversion of the debt into equity on the minority members

## II. Improvement of the creditor's status ?

### 4. Converting debts into equity

- ❑ This is the first restructuring instrument named by professionals to be used in a crisis (survey ARE/STP/S+P, October 2007)
- ❑ But in France, the law does not provide it
- ❑ Risks for the investor under French law
  - ⇒ engagement of liability for interfering in the management

## II. Improvement of the creditor's status ?

### 5. Another insolvency reform ?

- ❑ Announced for the end of 2008
  
- ❑ Examples of measures to be included in the reform
  - conversion of debt into capital: sort of "cram down"
  - creditors' committees : clarification of the membership (e.g. in case of assignment of the debt); certain funds to be included; vote only to be made according to the amount of claims (2/3 of the amount of claims of the voting members of the committee)
  - introduction of the "pre-packaged plan" ?
  - introduction of a sort of committee for the bondholders

and ⇒make the safeguard proceedings more attractive and efficient in order to "avoid insolvency"

## Contact

### **Anja Droege**

Avocat à la Cour, Partner

23 rue Balzac

F-75008 Paris

Tel: +33.1.53.53.02.80.

Fax: +33.1.53.53.02.81.

[anja.droege@marccuspartners.com](mailto:anja.droege@marccuspartners.com)

[www.marccuspartners.com](http://www.marccuspartners.com)