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Inside Story: The Terreal Lenders-Led Transaction – story of a French pre-insolvency proceeding

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Background

The construction sector in France and in Europe has been deeply damaged by the economic crisis. After a slight rebound over the 2009-2011 period, the building industry (construction of new houses, renovation market, sale of construction materials…) declined in 2012 due in particular to (i) the overall negative economic environment, (ii) low consumer confidence and (iii) a drop of consumer credit and residential real estate transactions. The situation was compounded by bad weather conditions for the construction sector, particularly during the winter 2012. While a slight rebound in the French construction market is expected in 2015, it is still forecast to decline in 2013 (hopefully stabilise in 2014). Consequently, many companies operating in the building industry have initiated restructuring processes or insolvency procedures.

Terreal Group is a leading international manufacturer of clay building materials and building envelope solutions (including roofing, cladding and structural materials). The group was created in 2000 and later sold by Saint-Gobain in 2003. Terreal operates businesses all around the world across 25 production sites in France, the United States, Spain, Italy, Malaysia and Indonesia, and counts nearly 2,500 employees.

In 2005, the group was acquired by a private equity fund under a leveraged buy-out transaction (based on an enterprise value of circa 860 million euros) and enjoyed several years of growth.

The case

Having encountered financial difficulties in 2008, the two French holding companies (Terreal Holding and Clay Tiles Europe) as well as their main operating subsidiary (Terreal SAS) sought the protection of the Commercial Court of Nanterre by requesting the appointment of a *Mandataire ad hoc* / *Conciliateur* in order to assist them in renegotiating their financial indebtedness (circa 900 million euros) within an amicable environment.

At the end of 2009, these companies and their financial creditors entered into a *Conciliation*

agreement ratified (*homologué*) by the Commercial Court of Nanterre, providing for the conversion of a significant portion of the bank loans and other debt instruments into equity (equity stake of circa 49% in the top holding company - Terreal Holding - allocated to the pool of lenders).

Following this debt restructuring, the business plan adopted in 2009 was outperformed in 2010 and 2011. However, in 2012, Terreal group suffered financial difficulties again due to the global financial and economic crisis and bad weather conditions, resulting in performance figures falling short of expectations and an expected breach of financial covenants.

The paradox is that Terreal (as many other distressed LBO companies) has been generating positive operational profits and enjoying a comfortable cash position. However, Terreal was weakened by its disproportionate financial debt, a legacy of excessive valuation in the previous transaction completed at the peak of the financial/LBO bubble.

Under these circumstances, the first financial restructuring in 2009 only granted a short-term solution which proved to be insufficient in the context of the double-dip recession.

Our firm of judicial administrators, which had already been involved in the 2009 restructuring, was again appointed by the Commercial Court of Nanterre in August 2012 as *Mandataire ad hoc/Conciliateur* to assist the managers of the three companies in reaching a sustainable restructuring of their financial debts through an amicable procedure (*Mandat ad hoc* procedure followed by a *Conciliation* procedure). Terreal was also assisted in the negotiation by the law firm Weil Gotshal & Manges (Paris). The financial advisor to Terreal was Messier Maris & Associés. The lenders were assisted by De Pardieu Brocas Maffei (in coordination with Bingham). The financial advisor to the lenders was Houlihan Lokey.

French legal framework

French judicial administrators (*administrateurs judiciaires*) are independent restructuring and insolvency practitioners appointed by commercial courts to assist or represent companies experiencing difficulty and subject to pre-insolvency or insolvency procedures. To ensure their independence, these professionals are dedicated only to the assistance or representation of companies subject to pre-insolvency or insolvency procedures. In this respect, the profession of judicial administrator is a regulated profession requiring a specific diploma and appropriate qualifications. The legitimacy of the *Mandataire ad hoc* derives from his/her independence. Creditors, sponsors, investors will accept the *Mandataire ad hoc's* requests and recommendations as a consequence of his/her independent point of view, based on the best-balanced position among opposite interests.

The *Mandat ad hoc* and *Conciliation* are the two amicable insolvency preventive procedures under French law. Both are intended to anticipate and prevent the difficulties a company may encounter through the involvement of an independent mediator (*Mandataire ad hoc* or *Conciliateur*) appointed by the President of the Commercial Court upon request from the debtor, for the purpose of assisting the company in reaching a consensual solution with its stakeholders. Such legal tools are increasingly implemented to restructure other distressed LBOs or distressed loans.

One of the key features of these preventive procedures is that they are confidential by law. Consequently, any person involved in a *Mandat ad hoc* or a *Conciliation* procedure (or who has knowledge of such procedure) is bound by a legal obligation of strict confidentiality.

Another key feature of these procedures is that the debtor retains control over the company, i.e. the management still runs the business, the court-appointed practitioner having no management or coercive powers. Negotiations thus remain governed by contractual law for the duration of the procedure (e.g. no specific rules for payment default –*état de cessation des paiements*), which implies obtaining the consent of each and every stakeholder involved in the restructuring process (e.g. company, financial creditors, shareholders…).

In practice, the parties often opt to open both *Mandat ad hoc* and *Conciliation* procedures successively, initiating their discussions under a *Mandat ad hoc* and finalising them subsequently under a *Conciliation* procedure. Should a consensual agreement be reached ultimately, it will be reflected in a *Conciliation* agreement signed between all parties involved in the restructuring. Depending on the legal security requested by the parties, such agreement may then be submitted either to official certification (constat) from the President of the Commercial Court or official ratification (*homologation*) from the Court (*jugement*).

Court certification (*constat*) of a Conciliation agreement must be requested jointly by all parties before the President of the Commercial Court. One of the legal effects attached to the certification order is that the Conciliation protocol becomes enforceable by law. The significant advantage of a Court certification (*constat*) (as compared to the Court ratification/homologation) is that the Court order (as well as the *Conciliation agreement*) is not publicly disclosed. Court certification (*constat*) therefore ensures full confidentiality of the procedure.

A Court ratification (*homologation)* can only be requested by the debtor provided that the following three legal conditions are met:
- the company must not be in an event of payment default (or the *Conciliation* agreement puts an end to such situation)
- the provisions of the *Conciliation* agreement ensure the sustained viability of the company's

business;
- the *Conciliation* agreement shall not harm the interests of non-signatory creditors.

It should be pointed out that Court ratification (*homologation*) grants a specific legal security to the benefit of creditors having contributed to a new money injection in the event of future insolvency procedures filed by the company (the so-called *"Privilège de conciliation"*) (1) .

In addition, in case of any subsequent event payment default, the date of such default cannot be set prior to the date when the ratification court order was issued.The court ratification (*homologation*) is therefore appropriate to secure share capital reorganisations and spin-off transactions.

Since the ratification court decision then produces effects vis-à-vis non-signatory creditors, it is filed with the commercial registry where any third party can access it. However, such court decision does not provide details on the terms and conditions of the *Conciliation* agreement (which can only be disclosed to its signatory parties or to persons entitled to benefit from said agreement).

Proceedings of the amicable procedures

In accordance with best market practices and to ensure a successful restructuring process, independent financial and operational reviews of Terreal group were completed to make sure that (i) all parties shared a common diagnosis on the situation of the group and (ii) the contemplated solution was based on relevant and accurate information and analysis.

Following a tendering process designed to identify parties willing to purchase the group, several acquisition offers were submitted. However, given the group's results and outlook, the lenders (also minority shareholders of Terreal group) decided to file their own proposal for acquiring full control of Terreal group (lenders-led transaction), showing their confidence in the future of the group.

The parties then entered into a negotiation phase aimed at reaching an agreement on the lenders-led proposal. The complexity of the legal framework of a *Mandat ad hoc* and *Conciliation* resides in the fact that such process requires a unanimous agreement between all stakeholders (Terreal's lenders, shareholders and management team). However, it should also be considered that such a legal framework offers a maximum chance of preserving the company and maximizes the possibilities of loan recovery by the banks (as compared to insolvency procedures).

If the parties intend to implement a successful and consensual restructuring process, they have therefore no other choice but to reach a balanced agreement that will secure the interests of every single stakeholder (and, first of all, the interests of the company and its employees).

Another challenge in the case at hand that was induced by the lenders-led transaction was to set up an efficient governance structure compatible with best corporate governance practices conducive to allowing the management to expand the business and maximize the operational performance.

After several months of negotiations, the parties succeeded in reaching a unanimous and consensual restructuring agreement based on the lenders-led proposal. This agreement, which was ratified (*homologué*) by the Commercial Court of Nanterre on 22 July 2013 (and has therefore been disclosed), meets several key requirements for Terreal group by ensuring:

- sustainable capital structure through a significant reduction of the financial debt (leverage ratio) and amount of the debt service (interest costs);
- financial flexibility through extension of the debt maturity and absence of debt amortization;
- efficient governance structure in particular through the involvement of independent directors with solid industrial expertise.

This agreement will hopefully enable Terreal to regain the trust of its trade partners and resume its growth path upon the market rebound.

While lenders-led transactions are relatively rare in France due to the unanimous agreement required from all parties (lenders, sponsors and management), it may become a more frequent opportunity to ensure the consensual restructuring of numerous distressed LBOs or distressed loans, in particular in a context where sponsors fail to offer solutions and where there are no potential buyers. However, it does imply a consensual approach and the design of efficient governance rules so as to mitigate two difficulties resulting from a lenders-led transaction: (i) the large number of institutions parties to the pool of lenders becoming shareholders, and (ii) the conflict of interests induced by their capacity as both shareholders and lenders of the restructured company.

It goes without saying that the specter of a fast-track financial safeguard procedure (s*auvegarde financière accélérée*) constitutes a significant lever to reach a unanimous agreement (2).

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(1). A special note in the "homologation" court order provides that any new contribution in cash or in kind via new assets or services, intended to secure the company's business continuity and sustained viability, may be granted a preferential senior rank enabling the contributor to be reimbursed in priority in the event of a subsequent insolvency procedure, after payment of super-preferential claims related to wage liabilities and court costs incurred by said insolvency procedure. Such senior rank may however not be granted for their contributions in the form of share capital increase or of credit facilities

provided prior to the opening of the Conciliation procedure.

(2). A debtor experiencing financial difficulties and having already filed for the opening of a Conciliation procedure may opt, should it fail to reach an unanimous restructuring agreement with its creditors under the Conciliation, for opening a fast-track financial safeguard procedure provided that (i) it is not in an event of payment default, and (ii) it can demonstrate that a qualified majority of the financial creditors will vote in favour of the restructuring plan.

Should such a fast-track financial safeguard procedure be initiated and the restructuring plan approved by the creditors' committee and bondholders' assembly by a qualified majority of two thirds (of the amount of the claims), such restructuring plan will become enforceable against all creditors (including the dissenting creditors).

The first fast-track financial safeguard procedure was initiated in February 2013 (with our firm FHB appointed as judicial administrator). This procedure enabled a company who had failed to reach a unanimous restructuring agreement with its creditors under a Conciliation procedure to successfully restructure its financial debt, thereby overriding the refusal of a financial creditor (Commercial Court of Nanterre, 27 March 2013, Hejenion SA, RG 2013L00611).

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