The Legal System and the development of alternative methods of financing to bank credit...[1]

...Or how French law has failed to adapt to the evolution of the economy and finance

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ABSTRACT

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[1] This article looks in more detail at the topics discussed by the author in a supplement to the report by the *Conseil d'Analyse Economique* (under the guidance of Olivier Garnier and Jean-Paul Pollin), regarding alternative financing methods to bank credit as a result of the implementation of and Base III. The report and its supplements are available in *La Documentation Française* and on the website of the *Conseil d'Analyse Economique* (www.cae.gouv.fr/).

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[3] The Institute for Droit & Croissance / Rules for Growth is an independent Think Tank which is made up of researchers and economic stakeholders from across the spectrum. Its members believe that creating a more effective legal system is a shared responsibility. The Think Tank is open to all avenues of thought which have the aim of promoting education and inter-disciplinary research, spanning economics, law and finance, as well as market economy and European integration. For further information, please visit www.droitetcroissance.fr.

Against the current background of the strengthening of prudential norms, growth in the financing of companies by investors other than banks is becoming increasingly significant. This kind of alternative investment, whether this takes the form of equity or debt, will be facilitated if investors consider the applicable legal framework to be sufficiently favourable, stable and likely to safeguard their interests. From an analysis of French law, it is apparent that this is not the case. French law has adopted a misguided approach, which has come about partly as a result of the unpredictable bias being demonstrated by the French courts in their statutory interpretation, but is more particularly linked to the inflexibility of the governing statutes.

In relation to debt investments, insolvency law and the rules governing security interests are especially significant. A creditor must feel able to manage its risk in the event that the debtor defaults. In relation to equity finance, corporate law must enable parties taking part in a venture capital transaction to overcome any difficulties which might arise as a result of: (1) the significant potential for moral hazard, (2) the existence of a high degree of information asymmetry, and (3) potentially variable future cash flows.

This article advocates that both French and European legislators should revise their strategy in these areas in order to encourage the financing of risky companies and projects by the private equity market and the financial markets on a European scale. Hit hard by the economic and financial crisis, and required to face head-on the challenge of the global race for innovation, France (as well as Europe) must promptly reorganise its Legal System. Otherwise, there is a realistic chance that we will suffer a "Lost Decade".

Keywords: insolvency law, bankruptcy law, U.S. Bankruptcy Code, Chapter 11, Chapter 7, absolute priority rule, adequate protection, *procédure de sauvegarde, procédure de redressement judiciaire, procédure de liquidation, procédure de sauvegarde financière accélérée*, *conciliation, mandate ad hoc*, security interests, collateral, corporate law, banking law, banking monopoly over credit operations, covered bonds, distressed investors, debt fund, turnaround funds, prudential norms, venture capital fund, moral hazard, opportunistic behaviour, information asymmetry, adverse selection, side effects, externalities, organizational structure, corporate governance, distressed mergers and acquisitions, Basel III, UCITS Directive, EC regulation 1346/2000, European law, civil law on insolvency proceedings, *entrepreneur individual à responsabilité limitée* (EIRL) statute, Lagarde's bill regulating late payments, common law, civil law, continental law, law & economics, employment law, co-employment jurisprudence, redeployment of employees, credit derivates, CDS, hedge funds, high yield bonds, fallen angels, rising stars, debtor-in-possession loan, debt for equity swap, loan to own transactions, workout, out of court negotiations, mezzanine debt, second lien loan, hybrid products, deeply subordinated bonds, preference shares, financial markets, securitization, comparative study, legal systems, structural subordination, contractual subordination, forum shopping, special purpose vehicle, flight to quality, medium sized companies (SME), *Entreprise de taille intermédiaire* (ETI), start-up, French law, German law, English law, U.S. Federal law, Luxembourg Law, legal uncertainty, legal security, predictability, double Luxco technique, innovation, competition, investment grade rating, liquidity, secondary market, primary market, judiciary, Eurotunnel Case, Technicolor Case, Coeur Défense Case.

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INTRODUCTION

1. Following on from the strengthening of the "Basel III" prudential regulations, a large number of commentators have predicted that this is likely to result in a reduction of the contribution made by banks to financing the economy.[4] This evolving role for banks invites us to re-examine French law, to the extent that the Legal System (see further below) has an impact on the development of alternative methods to traditional bank financing[5] (that is to say, recourse to financial markets and the private equity market). However, despite laudable efforts by the French legislature in recent years, it seems that the French legal environment still does not allow a satisfactory response to such a challenge.

2. In France, investors currently perceive a climate of relative legal uncertainty. The consequences of this for companies range from a simple increase in the cost of obtaining credit to a total lack of access to certain credit markets.[6] It is submitted that this climate of legal uncertainty has come about, either as a result of imperfections in the approach taken by the law (which itself may be due to its inflexibility), or as a result of the institutional bias being demonstrated by some courts in their interpretation of the law. The purpose of this article is to demonstrate the reasons for this climate of legal uncertainty.

3. The climate of legal uncertainty is made particularly visible when we examine the following:

- *the approach of French insolvency law*. This was originally based, and remains focussed, upon the traditional model of the small business, the value of which rests primarily on and is organised around the owner-manager's human capital, with the owner-manager being solely and personally liable for all the company's liabilities;

- *the rules governing security interests*. These are ineffective and confusing, mainly as a result of the misguided approach taken by French insolvency law;

- *the inflexibility of the corporate law governing the protection of holders of all types of securities (shares, bonds, convertible securities)*. This may prevent the implementation of more suitable contractual mechanisms for experienced parties;

- *the approach taken in relation to employment law by some courts, highlighted by the approach to employees who are made redundant*. This is likely to affect funds' investment policies in respect of risky companies or projects; and

- *the rules which confer on French banks a monopoly over credit transactions*. These rules seem to indiscriminately prevent any primary or secondary market credit transactions in circumstances where the role of banks is, at first glance, reduced.

In this paper we will use the term "**Legal System**" to encompass all of the above factors, which together lead to the current climate of legal uncertainty.

[4] See, for example, Chapter 1 of the IMF's 2012, "Global Financial Stability Report: The Quest for Lasting Stability" (Washington, April 2012).

5 See, for example, B. Black "The legal and institutional preconditions for strong securities markets", UCLA Law Review, Vol. 48, pp 781-855, 2001. See also the comparison of the model of financial markets dominated by banks, which is currently prevailing in continental Europe, with that which is focussed on financial markets, as in the U.S. and the U.K.

6 See, for example, Standard & Poor's reports on the French situation, "Debt recovery for creditors and the law of insolvency in France" of 22 March 2007, and its update, "French insolvency regime remains unfriendly to creditors despite recent reform of bankruptcy proceedings", dated 10 March 2009.

4. The Legal System affects in the investment decisions of those external capital providers which may be interested in financing risky projects, involving borrowers with an increased default risk and which may or may not run into financial difficulties. If we consider it important that such risky projects continue to be funded (which we believe it is), then it is inevitable in any economy which is based on innovation (and thus risk-taking) that there will be investment in certain projects which are very likely to fail.

5. The purpose of this article is, therefore, to highlight to the public authorities the undesirable impact of the French legal system as it currently stands. This is especially significant considering the financing needs of medium-sized companies (*Entreprise de Taille Intermédiaire* or "ETI"); fast-growing companies (e.g. start-ups); and distressed companies. This group is likely to account for an increasingly significant segment of global modern markets.

6. This paper will not cover issues faced by companies that represent a less risky investment opportunity. Such a review would require consideration of the usual drivers behind financing methods: transparency rules and tax regulations. Neither will this paper consider the level of expertise of regulators and / or financial intermediaries.[7] Both of these factors will also affect the development of the various funding markets.

7. An extensive analysis of the economic and financial literature brings to light the relationship that exists between:

- a legal system's ability to create a "climate of legal security", which depends, both on whether the law is predictable (in terms of how it will be applied by the courts), and on whether it is adapted to reflect the changing economy; and

- the development and liquidity of the financial markets.

8. A number of economists/legal academics have conducted very general comparative analyses on this subject, particularly in support of using indices as a measure of the efficacy or otherwise of the law, with a focus on the relative appeal of the Common Law tradition compared with that of the Civil Law[8]. However, this article will take

[7] Furthermore, the rules governing insider dealing and market manipulation, as well as the way that those rules are enforced by the competent courts are also factors which contribute to the development of financial markets. For a recap of conditions which are material to the development of financial markets, B. Black, "The legal and institutional preconditions for strong securities", ibid.

[8] See for instance, R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R. Vishny *"Legal determinants of external finance",* Journal of Finance 52, pp. 1131–50 (1997) and R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R. Vishny *"Law and finance*", Journal of Political Economy 106, pp. 1113–55 (1998). In the 1990s, La Porta and his colleagues, (together the "LLSV" Group) advanced in support of a certain number of indices, the idea that the original tradition of a given legal system (schematically Common Law versus Civil Law) significantly affects how the jurisdictions studied regulated their economies (and thus their perspective on growth). They argue that Civil Law jurisdictions were at a disadvantage as they were less likely to adapt to the changing economic and financial landscape. Since then, some of the early work of the LLSV Group has been challenged by a number of authors, particularly because of the overly general criteria used to support their thesis. However, the essential contribution of the work of the LLSV Group, which highlighted the importance of the Legal System to economic development, remains important within the academic community. See for example, R. Michaels, *"Comparative Law by Numbers*? *Legal Origins Thesis, Doing Business Reports, and the Silence of Traditional Comparative Law",* American Journal of Comparative Law, Volume 57, Issue 4 / Fall 2009. See also J. Armour, S. Deakin, V. Mollica, M. Siems, "*Law and Financial Development: What we are learning from time-series evidence*", (2010) Brigham Young University Law Review p 1435. The LLSV Group has since revised certain of its positions, for example, abandoning the use of certain indices which are judged too simplistic. Nevertheless, the LLSV Group maintains its central thesis, according to which the origin of a legal system is an important criterion in a country's future economic development. This criterion must be distinguished from other criteria such as the culture, history and politics of the country in question. See R. La Porta, F. Lopez-de-Silanes, A. Shleifer, "*The Economic*

a different approach. The author is of the opinion that an approach which is less academic and more focussed on certain specific aspects of the law can better illustrate the effects of a badly positioned law or biased judicial decision-making. This article will also assess the tangible effects on certain financing markets of the combined application of specific branches of the French legal system - the Legal System - in comparison with other jurisdictions (in particular, the U.S., the U.K., Germany and Luxembourg).[9]

9. This paper will consider in detail several methods of financing (**Part 1** to **Part 3**): (1) high yield bonds, covered bonds and mezzanine bonds (all of which are held by institutional investors); (2) loan to own transactions (the purchase of debt instruments on the secondary market by distressed funds with a view to taking control of distressed borrowers; (3) loans made available by hedge funds to a company which is filing for bankruptcy; and finally (4) the purchase of equity by venture capital funds. This article will conclude in favour of a revision of certain French law and / or of European law (**Part 4)** and also in favour of a fundamental reform of the judiciary (**Part 5**), in order to facilitate financing on the financial markets and capital investment in risky companies and projects.

PART I. THE LEGAL SYSTEM AND THE DEVELOPMENT OF FINANCIAL MARKETS: THE EXAMPLE OF THE HIGH YIELD BOND MARKET

10. The high yield bond market is where bonds issued by companies without an investment grade rating[10] are exchanged. The repayment of high yield bonds is historically contractually subordinated to more senior debt (such as bank loans).[11] The bonds can either be unsecured (i.e. with no collateral security) or they can be secured by a second lien (which again is subordinate to the repayment of more senior claims). We will endeavour to demonstrate the extent to which there is a relationship between the Legal System and the development of this segment of the bond market.

11. The types of specialised investors which operate in this segment are typically willing to accept a higher risk profile than traditional banks. The objective of high yield bond investors is to choose an asset which offers an attractive return and sometimes, for investors which participate on the secondary market, the prospect of a capital gain if the rating of the bonds increases. There are, therefore, generally two types of investor in high yield bonds:

- asset managers or *real money investors*, which make long-term investments. Their investment decisions are based on the issuer's ability to service its debt and, eventually, to repay or refinance the principal amount. The proposed return in relation to the rating is equally important to these investors; and

- hedge funds or *hot money investors* which have a shorter and more speculative investment horizon.

12. In general, the first category of investor is usually approached by the arranging banks during the initial credit allocation to investors, and the second category guarantees the bond's liquidity on the secondary market.

Consequences of Legal Origins", (2007), available at www.ssrn.com.

[9] The indexing approach used by the Doing Business team of the World Bank is, in our view, too restrictive and will not be considered further in this paper.

[10] Investment grade ratings are given by rating agencies and range from AAA to BBB (according to Standard & Poor's categorisation). Certain institutional investors are required to invest only in companies with an investment grade rating.

[11] We will see that the structuring of high yield bond issues has changed, especially in Europe, as a result of flaws in the applicable legal systems. Cf § 51.

13. For liquidity reasons, high yield bond issues are rarely for a value less than $200 million. The U.S., which is the birthplace of the high yield market, has an undeniable advantage in this respect: a sizeable internal market[12], a single language and business culture, and especially important, one single Federal law regulating bankruptcy. This market is open to a wide range of issuers, including large issuers which have lost their investment grade rating (*fallen angels*), companies in search of refinancing solutions, and issuers which are in the process of acquiring an investment grade rating (*rising stars*). This last category is made up of a combination of large issuers whose financial performance is improving and medium-sized companies (including start-ups) that can demonstrate sufficient gross profit)[13].

14. Given these liquidity constraints, one might predict that the future development of a similar market on a European scale could only take place if access to the bond market were to become part of the core regulatory strategic aims for all Member States.

15. The liquidity of a high yield bond market, which by its nature groups together issuers with an increased default risk, depends to a great extent on investors' ability to anticipate the legal consequences in the event of a default by the issuer. Such consequences affect the value of investors' claims, i.e. the size of the potential loss which they, as creditors, could sustain. Therefore, the Legal System is an important consideration when investors decide whether or not to buy high yield bonds. Within this, the ability of investors to predict the impact of insolvency rules on their claims is particularly important.[14] These criteria are essential to the determination of the credit rating given to the borrower and its securities by the rating agencies.[15]

16. U.S. law is more attractive for launching high yield bond issues than French law.

1.1 The economic approach of U.S. law

17. Provided that it remains operationally viable, as soon as a limited liability company enters an insolvency situation, its governance should be changed.[16] The company (which is

[12] Thus, even in regulated industries, the U.S. domestic market is, compared to the European market, of a significant size. Many of these industries are mainly regulated within the U.S. at a Federal level, for example, the energy or pharmaceutical industry. As a result, penetrating adjacent markets is more difficult for European growth companies than for their equivalents in the U.S. domestic market. Further, coming up with a business plan which justifies raising funds up to the minimum required level is often problematic in Europe, as the companies may not have obtained all the necessary regulatory approvals in their neighbouring European countries that they have on their domestic market.

[13] Thirty years ago, the high yield bond market consisted almost entirely of "fallen angels". It was a tiny market of less than 10 billion dollars. Since then, the market has grown to a trillion dollars (at the height of the last bull market in 2007). The market is no longer dominated by fallen angels, but by new issuers. See H. Miller, "*Chapter 11 in Transition—From Boom and Bust and Into the Future"*, 81 AM, BANKR, L. J, 375, 379 (2007) p 381. For these new issuers, access to the high yield bond market may represent their first chance to attract investors, before they decide to list their shares on a regulated market.

14 See, for example, Standard & Poor's report on Cegedim,http://www.cegedim.fr/finance/PDF/2011/Cegedim_SA_Recovery_Rating.pdf

[15] In this respect, medium size issuers – even high performing ones- are often rated much lower than larger issuers which may be performing less well, as the rating is based on the likely losses in the event of a default by the issuer (and thus on issuer's liquidity levels). If the rating does not itself preclude the bond issue, it has an impact on the cost of credit and the likelihood that the company's future projected cash flows will be sufficiently strong to absorb this cost (unless a risk of adverse selection is identified, cf. § 44).

[16] For these purposes we have assumed that a company is operationally viable when the value of its business (the sum of its assets and human capital) is greater than the sum of the value of its assets taken individually. In other words, a company is viable if its projected future cash flows exceed projected sale proceeds were its assets to be sold separately. The company is said to be "insolvent" from the moment it is agreed that its projected future cash flows would not allow it to meet its debts as they fell due.

the only tool for producing valuable goods and/or services) should be protected from the risk of moral hazard by its shareholders. There are a number of examples of "opportunistic behaviour" which may be detrimental to the normal running of the business. For example, the shareholders may wish to finance only very risky projects (in circumstances where other options are available) in the hope of a turnaround which is sufficient for them to recoup their investment. On the other hand, the borrower's management may want to finance losses by taking out new loans, by transferring the company's assets at a discounted price, or more simply, by paying dividends to shareholders. Since the negative consequences of such opportunistic decisions are borne, not by those who make them, but by third parties (in this case, the company's creditors), the borrower's shareholders and management are placed in a situation known as "moral hazard"[17].

18. The corporate law of the State of Delaware (which is the law most widely used across the U.S.) and more generally U.S. rules of corporate governance, deal only with potential conflicts between the management and shareholders. They are not designed to deal with any procedural or substantive conflicts of interest which may exist between different categories of creditor and shareholder. It is the remit and objective of insolvency law to limit and resolve such conflicts[18].

19. In order to tackle the potential for opportunistic behaviour resulting from a company's state of insolvency, a Chapter 11 filing allows the parties to agree (under a judge's control and according to an established procedure) a new capital structure for the company according to which its level of indebtedness may be adjusted to its reasonable projected future cash flows.

20. An automatic stay of proceedings is imposed when a company files for bankruptcy under Chapter 11. This is primarily in order to enable the company to compile a list of its debts and to allow all parties (i.e. the stakeholders and the management) to reach an agreement on the company's valuation,[19] (and not to allow the shareholders to encourage the company to wait for a potential turnaround). The rights of the different classes of creditors and shareholders will be determined according to this valuation. The Chapter 11 proceedings will come to an end, under the supervision of the court, either by the sale of the business or by a debt for equity swap. In the latter case, it is critical that when the company emerges from bankruptcy proceedings, it has a new balance sheet which is adjusted to its projected future cash flows. Unless the relevant classes of shareholder or the most junior creditors are willing to inject sufficient fresh equity into the company in order to turn around the business, the shareholders and the most junior creditors will therefore be wiped out. This is so even if the company is not eventually put into liquidation.

21. Enforcing *ex ante* creditors' rights (and thus the contract more generally) is one of the key principles underlying Chapter 11. U.S. law grants significant importance to ensuring that corporate governance remains aligned with the interests of a company's residual owners[20], i.e. holders of debt

[17] In economic theory, moral hazard describes a tendency to take undue risks in situations where the potential costs are not borne by the party taking such risks.

[18] See D. Baird, "*The Initiation Problem in Bankruptcy*", (1991) 11 International Review of Law & Economics 223.

[19] Creditors and shareholders may challenge in court the assessment used for the purpose of the restructuring plan. A valuation is not always carried out if a sale of assets is carried out in accordance with Section 363 of the U.S. Bankruptcy Code. Indeed in some cases, if circumstances warrant, according to the specific terms of Section 363 of the U.S. Bankruptcy Code, a judge can approve an accelerated transfer of the viable part of a company to a third party, without the approval a restructuring plan by creditors. See § 157.

[20] That is to say, those creditors which will not have been fully repaid at the maturity date, but which will not have lost out completely. See D. Baird & Th. Jackson,

securities at the level at which the enterprise value "breaks" (such securities are known as "fulcrum security"). Residual owners are those whose claims have some value even after the payment of all other claims. If we assume for these purposes that the company is insolvent (but remains operationally viable) the residual owners are neither the creditors who would be repaid in full according to the order of priority, nor those who will never be repaid (in light of the fact that the total amount of the company's debt is higher than the company's enterprise value).

22. U.S. law protects businesses from the risk of moral hazard brought about by the opportunistic behaviour of certain classes of creditor / shareholder (the most senior being unmotivated to maximise asset value[21] and the most junior having nothing left to lose). It does this by (i) identifying the class(es) of creditor which will be affected by the consequences of a bad decision - a "bad" decision is, broadly speaking, the liquidation of a viable business or the restructuring of a non-viable business (or of a company whose level of indebtedness is still too high); and (ii) giving this group the sole power to approve or reject a proposed restructuring plan.

23. In this way, Chapter 11 respects the initial risk-sharing agreement as a result of the combined application of i) the implicit contractual relationship between the shareholders and the company, the "*contrat social"*, pursuant to which shareholders are supposed to be the first to absorb any losses; and ii) any agreements entered into with creditors, such as those for collateral security and subordination agreements.

"*Bargaining after the fall and contours of the absolute priority rule"*, 55, U. Chicago Law Review 738, 761 (1988).

[21] We should qualify this statement due to the fact that often, senior creditors have an interest in preserving the interests of more junior creditors in the hope of convincing them to participate in future new investment projects.

24. Further, Chapter 11 facilitates (in principle) the reorganisation of viable companies, i.e. those whose enterprise value is higher than the value of their assets and those companies whose enterprise value is not based mainly on the owner-manager's human capital.

25. Chapter 7 of the U.S. Bankruptcy Code (relating to liquidation proceedings) is intended for companies that do not meet these criteria. The purpose of Chapter 7 is to liquidate the company's assets in order to sell them individually on the market and / or to allow the owner-manager to make a fresh start free from all or part of his/her personal obligations *vis-à-vis* the company's creditors.

26. The development of the U.S. high yield bond market is due in part to the rules of Chapter 11, which not only respect investors' *ex ante* rights, but which also preserve the enterprise value of distressed companies. As a result, investors are able to make investment decisions based on their analysis of the enterprise value of the issuing company. This is because they can rely on the fact that a default by the issuer will not in itself affect the residual value of the bonds they intend to buy[22].

1.2 The classic approach of French law (and other European legal systems)

France

[22]Filing for Chapter 11 proceedings will certainly have an impact on the behaviour of the debtor's suppliers and clients and the extent of this impact will vary depending on the sector in which the company operates. However, filing for Chapter 11 bankruptcy proceedings only has a very marginal effect on the order of priority of payments between creditors and does not, itself, affect the economic value of the debt instruments. Filing for proceedings leads to a crystallisation of the enterprise value of the company for the purposes of approving a restructuring plan. Such a plan may lead, as the case may be, to the wiping out of the shareholders and the most junior creditors. The predictability of Chapter 11 is an advantage for investors, even if the defaulting debtor never formally files for bankruptcy proceedings, as it provides the back-drop for out-of-court negotiations.

27. By comparison, French insolvency law has not moved on from the traditional so-called "entrepreneurial company model"[23] and neglects creditors' rights as a result. In addition to the risk of valuation errors with respect to the debtor company's business, creditors must also bear risks related to the climate of legal uncertainty described below. The infamous *Belvédère* case illustrates this point[24].

28. French law seeks to prevent the risk of moral hazard in two principal ways: i) by forcing the management to file for bankruptcy proceedings in the event of a *cessation des paiements* (which is broadly speaking refers to the concept of a liquidity crisis); and ii) by providing that the management may incur tortious liability and / or criminal liability in specific circumstances, upon the liquidation of the company.

29. However, French law has many shortcomings. A first shortcoming arises from the fact that French law fails to pay due attention to opportunistic behaviour arising prior to a liquidity crisis. This is despite the propensity for the state of insolvency to:

- damage good relations with third parties (e.g. with a company's suppliers and customers);
- encourage high-performing employees to leave; and
- restrict any equity injection into the company, as the only consequence of any additional funds will be to enrich the creditors, a phenomenon called "debt over-hang"[25], etc.

These consequences, together with any other costs resulting from the weakened financial state of a company which is insolvent or which is entering the "zone of insolvency", are known as "distress costs".

30. In effect, French courts are not empowered to force shareholders to absorb losses in advance of a liquidity crisis (and thus at the same time to trigger a change in the company's governance). This is so even in the face of original contractual agreements to the contrary and in spite of the original agreed order of priority.[26]. Certain provisions in the loan documentation will expressly require the company to maintain certain financial ratios. The purpose of this is to force creditors to restructure the company's balance sheet and change its governance before the agreed loan maturity date (and thus prior to any potential liquidity crisis)[27].

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[23] By "entrepreneurial", we mean a company whose value is inextricably linked to the presence of its founding manager at the helm. This individual is very often also the guarantor of the company's liabilities.

[24] See Th. Philippon and S. Vermeille "*Le droit financier au service des PME" in* "*Quatre-vingt propositions qui ne coûtent pas quatre-vingt milliards*", under the supervision of P. Weil, *éditions* Grasset, 2012. The Belvédère example (the owner of Marie Brizard) demonstrates the negative consequences that French law can have on the turnaround chances of a company which is indebted, but which remains operationally profitable. In the Belvédère case, the manager-shareholders had violated a covenant made by the company not to repurchase its shares on the market (which would allow the repayment of shareholders before creditors). The creditors complained and entered into negotiations with the management. In theory they were able to demand early repayment of the debt. In practice, after proceedings which went on for a year and a half, the management managed to obtain a statutory rescheduling of the bond debts over a ten-year period, This rescheduling meant that any losses automatically fell on the creditors alone. The reorganisation plan is due to be reconsidered by the courts. However, the situation remains unresolved, four years after Belvédère repurchased its shares and hostilities commenced between the management and the creditors. In the meantime, Belvédère's financial situation continues to worsen.

[25] M. Myers, "*Determinants of Corporate Borrowing",* Journal of Financial Economics, 5, 147-75 (1977).

[26] As shareholders benefit from any marginal profit after repayment of all the company's debts, they benefit from the residual value of the assets upon liquidation. We can infer from this that the shareholders are also the first to absorb losses. They therefore naturally come last in the order of priority of payments.

[27] Banking covenants in loan documentation contain both negative commitments for the benefit of creditors and positive obligations to comply with a number of

31. The weakness of French insolvency law stems from the fact that it remains based on the traditional company model, i.e. one where the value of the company is based on the presence of the owner-manager at the helm. These companies are "entrepreneurial" in nature as they have a few, specialised assets and are organised around the owner-operator's human capital. Although they are described as "limited liability" companies", they are, in fact unlimited liability companies. From an economic perspective, this model corresponds to the typical model of an entrepreneur-manager of a limited liability company, who also acts as guarantor for that company's liabilities[28]. As such companies rarely have access to significant amounts of bank credit[29], there can never be a significant gap between their level of debt and their projected future cash flows[30]. In the event of financial difficulties, these companies rapidly experience a liquidity crisis.

32. Provided that this type of company is operationally viable, in spite of its financial difficulties[31], restructuring the balance sheet would make no sense as this would lead to the loss of its main asset (the manager), who would no longer have an interest in staying with the company. Such a change would involve a much more significant loss to creditors than the postponement of the initial maturity date of their claims. This is so regardless of the fact that the total economic value of their claims would be reduced. This explains why, in the majority of the insolvency cases managed by the Commercial Courts, creditors agree to reschedule their debts rather than insisting upon a restructuring of the balance sheet (assuming that the company is viable).

33. The situation should be different for "true" limited liability companies, (again provided that they are operationally viable) the value of which is not linked to the owner-manager's human capital. The management of a limited liability company is not personally liable for its liabilities (and indeed may not even hold shares in the company). By treating all types of limited liability company in the same way, French insolvency law unhelpfully neglects creditors' rights under the "*contrat social"* and under the credit documentation. It is a combination of these two factors which results in the climate of legal uncertainty mentioned above.

34. In 1985[32] the French legislature erred by confusing the interest in maintaining the business and the interests of the shareholders. This is so even though legislators were well aware of the evolution of the economy

financial criteria. This allows creditors to monitor the debtor's financial status and, therefore, to exercise control over the debtor in the event of financial difficulties, as they are then able to demand early repayment of their debt.

[28] The fact that the manager is also guarantor using his own property is not inherent to the entrepreneurial company model described above. However, such a situation is likely to have the effect of reducing the likelihood of moral hazard to some extent. From this perspective, we can see that it is not necessarily relevant for French law (by means of the EIRL statute) to limit the ability of entrepreneurs to be able to pledge their personal assets. Such a limitation will necessarily lead to a limitation of the amount of credit which may be obtained. See also § 172.

[29] For an explanation, please see § 37.

[30] The projected cash flow is an estimate of the cash flow for the current operating period, usually short-term (under five years).

[31] In such situations, from an economic perspective, usually the owner-manager would be better off putting the company into liquidation. This would allow the owner-manager to make a fresh start, free to commence a new entrepreneurial adventure, having been discharged from the company's liabilities. See D. Baird and E. Morrisson "*Serial Entrepreneurs and Small Business Bankruptcies*", University of Chicago Law & Economics, Olin Working Paper No. 236, Columbia Law and Economics Working Paper No. 265, available on www.ssrn.com. Unfortunately, the personal consequences for the owner-manager which result from the liquidation of the company, will very often encourage him/her to attempt the turnaround of the company, even though the company is very unlikely to be viable, cf. infra § 174.

[32] Law no 85-98 of 25 January 1985.

towards more “true” limited liability companies. Having no confidence in the ability of the market (and therefore in the creditors and management of the debtor company) to decide upon which distressed companies were viable, the legislator forced judges to favour solutions which resulted in keeping the legal entity going, instead of a sale of the business (*plan de cession*) or an immediate liquidation.[33] The legislator also empowered judges to force the rescheduling of debt over a maximum period of ten years. This is despite (i) the fact that such a situation would involve a wealth transfer from the company’s creditors to its shareholders in companies which are not of the “traditional” model, and (ii) the more general problem related to the preservation of non-viable companies.[34]

35. The bankruptcy procedure which was introduced in 2005 (the so called *procédure de sauvegarde* / safeguard proceedings) was intended to become a “Chapter 11 *à la française*[35]” and, therefore, the law should have empowered the court, firstly, to allow creditors to use the threat of legal action to prevent the company from suffering any further financial distress costs and, secondly, to prevent opportunistic behaviour before a liquidity crisis. However, in 2005 the legislator[36] made the same mistake as in 1985, with detrimental effects. Indeed, shareholders are now legally in a position to force creditors to bear the losses of an insolvent company (through the borrower’s management). The diminution in the value of their claims goes hand in hand with the diminution of the value of the business (primarily as a result of the financial distress costs)[37].

36. A further difficulty arises from the fact that in reorganisation proceedings as opposed to liquidation proceedings (i.e. *procédure de sauvegarde* or *procédure de redressement judiciaire* by way of a *plan de continuation*), creditors are treated equally under the law. In particular, they are all given the right to vote on the restructuring plan. This is so regardless of the state of insolvency of the company and also that the economic value of the securities may be reduced to zero (such creditors therefore being “out of the money”). Bankruptcy law therefore does take into account the agreed order of priority of payment as part of the process for approving the restructuring plan. The creditors, like the shareholders, cannot be wiped out from a company which is not dissolved.

37. This equal treatment of creditors under French law is not surprising, since in the traditional entrepreneurial company, the company generally only has access to a moderate amount of banking credit. In such a situation, the creditors’ decision to lend necessarily takes into account the status of the entrepreneur’s pledged personal assets. Equally, in this situation, an entrepreneur is less likely to increase his/her activity when such a decision would force the entrepreneur to become more indebted to the company, and thus to risk all his/her personal assets. The entrepreneur (and therefore the legislator) in

[33] Although this preference in favour of a continuation of the business (rather than a sale) is still visible in the smaller commercial courts, there has been a shift in position by the courts of Paris and Nanterre.

[34] The legislature’s preference for shareholders in 1985 may be explained against the contemporary background of bank nationalisation. Law No. 94-475 of 10 June 1994 aimed to restore certain particular creditors’ rights. However, the failure to opt for a law which was tailored for “true” limited liability companies, left the situation in a very precarious balance.

[35] See, for example, http://lexpansion.lexpress.fr/economie/faillites-vers-un-chapter-11-a-la-francaise_100975.html

[36] Law n° 2005-845 of 26 July 2005.

[37] The difference between U.S. and French law in this respect is very significant when the distressed borrower is a listed company. While in the U.S., the commencement of bankruptcy proceedings leads to a rapid de-listing of the company’s shares, the value of which will have collapsed following the announcement, the situation is completely different in France. For example, Technicolor’s share price increased on 1 December 2009, the day after the announcement of the commencement of bankruptcy proceedings and the share price did not really change in the days that followed.

this situation could certainly not envisage the creditors entering into subordination agreements with each other or subscribing for lower rated collateral security. It is, therefore, not surprising that, before the arrival of "genuine" limited liability companies, the French legislature's first concern was to ensure equal treatment of creditors in the event of debtor default (the vast majority of creditors being trade creditors).

38. The French legislature has nevertheless planned some amendments to reflect the changing economy and the difficulty in obtaining the consent of all the creditors in bankruptcy proceedings. Above a certain threshold[38] or upon the request of the debtor or the administrator, the restructuring plan only requires approval by a qualified majority (rather than by unanimity) of each of the groups or "committees" of the creditors. In 2008 the legislator even introduced the possibility for such groups to force a debt for equity swap[39] (although it is still not possible to wipe out creditors without the company being liquidated). The creditors are divided into committees which are determined according to the nature of the company's debts (and not according to the agreed order of priority) as follows: a committee of financial creditors (for those holding bank debt), a committee of trade creditors, and a single committee of bondholders. This division does not take into account the existence of any subordination agreements between the creditors or of any collateral security which may exist over the company's assets.

39. Aware of the impact of a change in the law regulating the initial order of priority on the conduct of inter-party negotiations, the legislator recently tried (unsuccessfully) to challenge the principle of equal treatment of creditors. The law of 22 October 2010 gave the court the authority to "*take into account contractual subordination agreements between creditors entered into before the filing of bankruptcy proceedings*". However, since all the creditors are invited to vote on the restructuring plan, in practice, the court cannot prevent the contractual subordination agreements from being infringed.[40]

40. By disregarding the contractually agreed order of priority, insolvency law ignores the rights of security holders. In principle, in bankruptcy proceedings (as well as in liquidation proceedings) security holders should have a right in priority over the other classes of creditors / shareholders up to the level of the value of the underlying assets over which the security is held[41].

[38] The threshold, set out in Article L. 626-29 of the Commercial Code, is 150 employees and a turnover of 20 million Euros. However, at the request of the debtor or the administrator, creditors' committees can be set up even if the requisite thresholds are not met. This development of bankruptcy law in favour of "real" liability companies is certainly laudable in principle. Nevertheless, it took three separate legislative acts between 2005 and 2011, not counting various decrees.

[39] Ordinance No. 2008-1345 of 18 December 2008.

[40] Without doubt, the equal treatment of creditors is no longer the rule following these amendments. However, subordination agreements are never completely respected, insofar as subordinated creditors are still able to receive something under the plan, and the senior creditors will not be fully repaid. Disadvantaged senior creditors would find it very difficult to use the fact of a violation of the subordination agreement to invalidate a plan which has been approved by vote. On this last point, see M. Douaoui- Chamseddine, "*Question soulevée par un plan de sauvegarde écartant un accord de subordination : quel recours pour les seniors en cas d'atteinte à la propriété*", Review des procedures collectives no. 1, January 2012, étude 5. However, thanks to this law, it is at least being increasingly recognised that the plan may provide for differential treatment to take account of initial agreements.

[41] Therefore, if the enterprise value of an insolvent company is higher than the total value of secured assets (but less than the total sum of debts), those secured creditors should continue to be paid, after the end of bankruptcy proceedings, according to the terms initially agreed. (that is to say that the economic value of their claims must remain the same). The other, more junior, creditors should absorb the losses, along with the shareholders. Conversely, if the value of the secured creditors' claims is superior to the value of the debtor's assets, secured creditors hold an unsecured debt over the borrower which is equal to this difference. Therefore, they must compete for payment alongside the other unsecured creditors. It is also important that the secured creditors be protected against the risk of a decline in the value of assets used as collateral during the automatic stay following the filing of bankruptcy proceedings.

41. The "modern" legislator has tried to find other token solutions to try to prevent credit rationing. Such solutions sometimes favour creditors, for example, by conferring on them a statutory lien (*droit de retention)*, which allows holders to retain the debtor's assets until they are repaid. At other times such attempts favour the debtor, for example, the law regulating French trusts (*fiducie sûreté*), which provides that the underlying assets cannot, in principle, be seized by the creditors for the duration of bankruptcy proceedings. These efforts by the legislator have little overall coherence.[42] Because of the difficulty in achieving a balance between these two conflicting interests between creditors and keeping the business going, the area of security interests is overly regulated by statutes (the several amendments made over the past years to the law regulating the French trust being a good example). The combined effect is that the French rules governing security are not only ineffective in most cases, they are also very unclear. It is therefore not illogical that the French legislator has overly restricted the list of assets that can be used as collateral[43].

42. As a result, the only types of security which are still effective in French law are those granted over assets which are not essential to the conduct of the business of the company, i.e. assets which do not make up part of the business's value (such as a transfer of the company's own claims against its clients under the "Dailly Law" (a technique to facilitate the transfer of claims), or a pledge over cash. Such "non-core" interests may be contrasted with, for example, a pledge over the business's plant, machinery or intellectual property. This type of security effectively gives secured creditors preferential treatment regardless of whether a debtor has filed for bankruptcy proceedings. It is, therefore, not surprising that the French equivalent of the English floating charge – in substance a pledge over goodwill, or "*fonds de commerce*" - is not really of interest to practitioners. Such a pledge does not, in fact, allow the beneficiary of the pledge to protect itself against the diminution in the value of goodwill between the date of insolvency (as defined above) of the company and the date of a liquidity crisis. Often "real" limited liability companies no longer have any value as their assets (which are often intangible)) has already almost completely disappeared by the time such companies face a liquidity crisis.

43. Aware of this, investors try to avoid this climate of legal uncertainty by "forum shopping", i.e. artificially placing themselves under the protection of other legal jurisdictions – in practice, Luxembourg - which are more likely to enforce risk-sharing agreements. Investors do this despite any doubts which may exist concerning the validity of this arrangement[44]. The resulting transaction costs from such initiatives can be huge and, while large issuing companies may be able to absorb such costs, they may be too

Under U.S. law, the principle of "adequate protection" gives comfort to secured creditors in the U.S., see B. Adler, D. Baird and T. Jackson, "*Bankruptcy, Cases, Problems, and Materials*", Fourth Edition, Foundation Press p. 411.

[42] Moreover, French law favours certain categories of creditor by recognising a number of exceptions to the stay in proceedings. This is the case, for example, for holders of special privileged rights, those with certain direct rights of action and creditors with a statutory lien. Ultimately, all such measures are a drain on the company's free cash flows during a critical period and serve to compromise its recovery.

[43] For a comparative analysis, see J. Armour, S. Deakin, V. Mollica, M. Siems, ibid p. 1463.

[44] The present uncertainty (which has come about as a result of the evolution of the economic crisis) is quite favourable to creditors which may, therefore, require the incorporation by the borrower of Luxembourg holding companies - "the Double LuxCo Scheme" - in order to better protect their rights. The sole aim of this technique is to prevent the management of the French parent company from placing the group under the protection of French insolvency law in the event of financial difficulties. This technique is also used in LBO restructuring and poses the same problems in terms of transaction costs (most notably legal costs). The result is that French banking documentation is needlessly the most complex in Europe and there is no guarantee that such schemes will be valid. Cf. also § 77.

much for medium-sized issuers, which may be prevented from accessing the bond market as a result.

44. The issuers which are in the most precarious position are, therefore, those which suffer the consequences of such errors of the legislator. French medium-sized companies seem to face more difficulties in terms of gaining access to the high yield bond market than U.S. medium-sized companies with similar financial aggregates. This is partly due to the increase in the cost of credit resulting from deficiencies in the Legal System. Furthermore, for this reason (among others) investors may choose to refuse to buy bonds from this category of issuers in order to avoid any risk of adverse selection[45].

Other European legal systems

45. Regarding other European legal systems, it is worth mentioning that the principles of Chapter 11 are not fully replicated in any other jurisdiction, even those in the Common Law tradition. To date, all European insolvency laws continue to a greater or lesser extent to rely on the traditional model of the company which is organised around the owner/ manager's human capital. However, there are some notable exceptions.

46. Since 1 March 2012, German insolvency law has authorised, in specific circumstances, that shareholders may be wiped out from insolvent companies. This is despite questions which were raised about the validity of such a wipe out from the perspective of a European Directive[46] and the German Constitution. This arrangement, which gives creditors control over the insolvency procedure, should have some positive effects on the foreseeability of German law[47]. It should also bring to an end the common practice of borrowers transferring their German interests to the U.K. in order to restructure their balance sheets.[48] However, it seems that further reforms are required to improve the predictability and stability of the German legal system. In particular, reform of the German judiciary, which is too far removed from practice, should be welcomed.[49]

47. The insolvency laws of some Eastern European countries (Czech Republic[50], Slovakia and Romania) were developed based on the U.S. model and allow shareholders or creditors to be wiped out from the company. Such countries' most eminent individuals (legislators, academics, etc.) were more than likely educated and trained in the U.S. This

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[45] Adverse selection is a term used in economics, insurance, statistics, and risk management. It refers to a market process in which "bad" results occur when buyers and sellers have asymmetric information (i.e. access to different levels of information) which results in an increased likelihood that "bad" products or services will be selected. In the present example, if investors agree to finance any projects, whatever the probability of default or the potential level of loss, considering their level of information asymmetry, such investors must take the risk of financing projects that are more likely to fail. This is because they are the only ones who can generate enough gross profit in the best case scenario, but are also the least likely to be able to pay for such credit costs. In other words, from the perspective of the lender, financing any type of borrower (even at high interest rates), means it risks going bankrupt.

[46] Directive 77/91/EEC of 13 December 1976 as amended. Note, however, that German law does not force creditors to accept shares in exchange for the forfeiture of their claims. They may, instead, choose to waive their claims outright. In practice, creditors will more often choose to receive optional instruments in order to avoid a write off of their claim for no consideration.

47 Of particular note is the ability for creditors to appoint an administrator following the commencement of bankruptcy proceedings, with responsibility for monitoring the borrower.

[48] A. Buessemaker et U. Hartmann "*German Insolvency Law Reform (ESUG): More Creditors' Influence, More Debt-For-Equity Swaps, More Self-Administration?*" available at http://business-finance-restructuring. weil.com.

[49] Cf. § 55.

[50] T. Richter "*Reconciling the European Registered Capital Regime with Modern Corporate Reorganization Law: Experience from the Czech Insolvency Law Reform"*, European Company and Financial Law review p. 358 – 369 (2009).

may explain why these countries seem to have learned the lessons from U.S. research in Law & Economics (the source of inspiration for modern U.S. bankruptcy law). However, the weaknesses of such jurisdictions' judiciary are a major obstacle to establishing predictable legal environments.

48. English law differs from any other legal system in that there are five different possible procedures for resolving financial difficulties. Four of these are governed by insolvency law *stricto sensu* and the other by provisions of U.K. corporate law. Sometimes these procedures are combined in order to facilitate the restructuring of distressed companies.

49. English law is definitely seen by investors as the most attractive in Europe especially thanks to its judges, who are all former lawyers and who are, therefore, thought to be more qualified to decide upon the issues raised by increasingly complex financial documentation. However, English law is not exempt from criticism. It can be said to excessively favour secured creditors to the detriment of unsecured creditors or creditors with a second lien (e.g. high yield investors). No automatic stay of proceedings is imposed when a company files for the most commonly-used type of bankruptcy proceedings (in relation to large debtors), which means that secured and senior creditors are able to enforce their security over the shares of any operational subsidiaries of a large issuer, even if the amount of their claim is less than the value of the underlying assets.[51]

50. To limit the risk of moral hazard resulting from the shortcomings of English insolvency law, the credit documentation attempts to replicate, through contractual mechanisms, the advantages of Chapter 11 proceedings. This is because one of the objectives of U.S. bankruptcy law is the maximisation of the value of the distressed assets upon the sale of the business. However, English high yield bondholders cannot force senior creditors to agree to reschedule their claims if the bondholders decide, instead, to convert their debt into shares in the issuer. English law remains focussed on a liquidation approach, despite provisions of corporate law under which the outvoted creditors can be forced to approve a debt for equity swap. This can be damaging to high yield bondholders if the business is sold at a time when the M&A market is not favourable.

Impact on the structure of High Yield financing in Europe

51. As a result, to a greater or lesser extent, the various European insolvency laws (as with French law) generate unpredictable effects. This is ultimately detrimental to the development of the high yield bond market and in particular for medium-sized issuers.[52]

52. As a result of flaws in various laws regulating bankruptcy and security interests,

[51] Moreover, we can criticise English law for failing to facilitate the restructuring of companies which experience operational difficulties. Contrary to U.S. and French law, even when commencing bankruptcy proceedings (such as the administration procedure), English law does not preclude contractors from ceasing to trade with the distressed company (provided that the contract expressly provides for this). In addition, in the UK, the sale of all the debtor's assets to a third party is more difficult to achieve. Unlike U.S. law, English law attaches great importance to enforcing contractual non-assignment clauses, even if bankruptcy proceedings have been commenced. Although these contractual provisions have little impact when it comes to restructuring the debt of a company which is undergoing an LBO, which is on the face of it always operationally viable, (as the contractors will not use their right to terminate) this does hinder companies facing significant operational difficulties from making use of bankruptcy proceedings (and allows in principle a stay of proceedings) in order to undergo a restructure. Finally, despite numerous attempts, it is regrettable that English bankruptcy law has changed so little over the years. The U.K.'s European neighbours have undergone a veritable legislative frenzy in comparison.

[52] An ineffective Legal System is more likely to harm small businesses than large ones. Large businesses are less affected by a lack of predictability in the legal environment, and their increased liquidity value is more useful as a pledge to creditors.

European issuers often use structural subordination mechanisms to avoid conflicts between senior and more junior creditors.[53] Junior creditors are ranked even lower than in the U.S., since the repayment of their securities is subordinate to the repayment of all the operational debts of a company (n.b. this refers to debts of any kind, not only those owed to banks). Moreover, while in theory with a contractual subordination mechanism, investors are in a position to negotiate certain amendments to the conditions under which they will agree to be subordinate to the banks, in practice, the structural subordination mechanism is much more rigid, and such amendments are extremely difficult, if not impossible, to obtain.

53. In order to counteract the drastic consequences which result from a structural subordination mechanism, the practice in Europe has been (for significantly longer than in the U.S.) to offer second tier security to high yield bondholders, in the same way as for mezzanine debt holders.[54] The objective for the high yield bond investors is to be repaid before the other creditors of the operational subsidiaries of the group (with the exception of banks). However, in certain jurisdictions, the effectiveness of such security is only limited (France in particular). Furthermore, even if a viable operational company files for bankruptcy proceedings, investors have no say, as they are not the direct creditors of the company (as they are the creditors of the special purpose vehicle only).

54. Finally, European high yield bond issues are often structurally more complex than in the U.S. Due to the lack of clarity relating to such complex structures, investors find it more difficult to assess the risks involved (this is especially so as there is often a significant number of different legal systems to take into account when a borrower has subsidiaries in different European countries).

1.3 High yield bond markets and the judiciary

55. Finally, whether or not a legal system is predictable, depends greatly upon which jurisdiction is competent to decide upon any dispute between the parties. With regard to complex contracts, investors prefer to be able to refer to pre-existing and settled case law. In the event of litigation, it is therefore customary for investors to require that the bond's indenture be governed by New York State law and that the competent courts are those of the U.S. This is the case not only for French investors, but also for English investors (despite the good reputation of English judges in corporate finance).

56. However, this may be inappropriate in certain situations. Although the management of international corporate groups or of companies owned by investment funds may agree to submit the bond's indenture to the jurisdiction of the State of New York at the market's request (and consequently to pay higher transaction fees), the management of smaller companies will view this constraint differently. Indeed, faced with the refusal of the *Mittelstand* companies (i.e. German medium-sized companies) to submit to the jurisdiction of U.S. law, Germany opted in 2009 to reform the law relating to bonds and in particular the rules relating to the amendments of bond indentures[55]. Since then,

[53] See also A. Pietrancosta and S. Vermeille "*Le droit des procédures collectives à l'épreuve de l'analyse économique du droit. Perspectives d'avenir*", RTDF No. 1 p. 20 (2010). Bankruptcy law is not the only area of law which poses difficulties when structuring high yield bond financing. Corporate law and the concept of the best interests of the company (*intérêt social*) have the effect of limiting the conditions under which affiliates can grant upstream guarantees in favour of their parent company, the bond issuer.

[54] Cf. § 70.

[55] Unlike in French law, in Germany until 2009 there were neither rules allowing bondholders to modify the terms and conditions of bond indentures with a qualified majority, nor rules guaranteeing holders' representation against the borrower. Since 2009, German law has been perceived as more respectful of the order of priority of payment (in particular, to the benefit of the senior secured creditors as in the U.K.). This is especially true since the last reform of insolvency law which came into effect from 1 March 2012. Overall German law is more

some of the bonds purchased by foreign institutional investors have become subject to the jurisdiction of German law, with any dispute to be determined by the German court located where the issuer has its registered office[56].

57. However, there have been a number of criticisms of the German courts and this new market practice has not completely satisfied institutional investors.[57] German law, while appearing to be very favourable to secured creditors, provides a good illustration of the gap that may exist between black letter law (as it is written), and practice. Market players have commented that, despite the recent reform, the German system is still insufficiently predictable (and thus not easy to navigate).

58. The adaptability of the Legal System to changes in legal practice, and also the proper training of judges in these specific contractual techniques, are thus important factors in attracting international investors, in the same way as transparency rules and fiscal regulations. This is illustrated by the emergence in Germany of local bond markets, which failed to meet international standards for transparency and liquidity and which had the effect of misleading individual (retail) investors, who were attracted by high interest rates and who believed that the funding of high-growth companies was secure.[58] However, many of the companies in the solar energy sector, which sought funding from such local bond markets rather than from specialised investment funds, are now in difficulty. Four such companies have recently filed for bankruptcy proceedings in Germany[59]. Thus, as high yield bond issues most often take place in connection with the financing of large transactions, retail investors may not be able to properly assess the potential risk they face due to the complexity of the documentation, and in particular, due to the subordination ranking that they inevitably must agree to in the event that the company becomes financially distressed.

1.4 Attempts to remedy the deficiencies in the Legal System: the example of covered bonds

59. The covered bond market is principally a market which allows European credit establishments to refinance some of their banking assets at a reduced cost due to higher protection afforded to bondholders.

60. Covered bonds are governed by specific *mandatory* rules in France. Among others, they are excluded from the scope of insolvency law in order to give more comfort to investors regarding the level of legal protection that they can expect. The covered bond market is an illustration of an attempt by the French legislator to provide a token remedy when required by the market. The introduction of additional and specific legal provisions to regulate this area further complicates the French legal system. This is likely to result in uncontrolled side effects,

favourable to investors than French law, even if German law does partially disregard more junior creditors' rights.

[56] See International Financial Law Review, May 2011, Vol. 30 Issue 4, p 22.

[57] It seems that the German judicial system is causing a number of difficulties for market players and may become, as is the case in France, the source of a number of grievances. Thus, in a recent decision, the Regional Court of Frankfurt held that Pfleiderer AG could not benefit from new provisions in German law, facilitating the renegotiation of bond debt (on a majority basis rather than unanimity) on the ground that documentation contained provisions governed by a foreign jurisdiction. This decision forced other companies, including Q-Cell, to commence bankruptcy proceedings, having been unable to secure unanimity from bond holders. This case has ultimately exacerbated the situation for a number of companies, and has not been well-received by the wider investment community. See § 60.

[58] See B. Lukas "*Citi: Retail high yield is too risky*", International Financial Law Review; Nov 2011, Vol. 30 Issue 10, p 7.1.

[59] In addition to the failure of Q-Cell in early April (which was in 2007 and 2008 the largest producer of solar energy) this sector in Germany has also seen the failure of Solon, Solarhybrid and Solar Millennium at the end of 2011 and early 2012 .

which will be the subject of the paragraphs which follow.

61. In the same way as bonds which are issued within the securitisation programme framework (ABS, MBS, CLO, CDO, etc.), covered bonds are guaranteed by assets which are placed out of the reach of other creditors (i.e. they are ring-fenced) provided that the bondholders have not been completely repaid. However, covered bondholders (unlike ABS bondholders, for example) still retain an action against the original lender. For this reason, the lender is strongly incentivised to better control the credit risk of ring-fenced assets[60]. This explains the proliferation of covered bond issues from 2008 following the collapse of the securitisation market.

62. The law stipulates that the value of the underlying assets should be very high and fixes a minimum over-collateralisation threshold. This requires the issuer to appoint a "*contrôleur spécifique*", who must be duly authorised by the regulator. This *contrôleur spécifique* is responsible for monitoring the changes in the credit risk associated with the assets and for ensuring their replacement where necessary in order to reduce the likelihood that the bondholders will be exposed to any risk linked to the diminution of value in the collateral[61].

63. Equally important to these specific legal rules is the disapplication of French insolvency law. By disapplying insolvency provisions and conferring on covered bondholders a legal priority of repayment, the law ensures to some extent the absolute superiority of covered bondholders' conventional rights.[62]

64. Whilst French insolvency law does not treat secured creditors more favourably than unsecured creditors as long as the company is not experiencing a liquidity crisis (with some exceptions), the law guarantees covered bondholders that they will be paid in priority over the other creditors of the credit establishment (which is the initial lender, i.e. the owner of the assets contained in the asset pool). The assets are placed out of reach of other creditors, and the bondholders continue to be paid according to the initial terms and conditions, even if the original lender files for bankruptcy. This in some way remedies the defects of insolvency law and the law governing security interests mentioned above. However, the law authorises covered bonds to be issued only as part of a transfer of claims owned by the banks against their clients.

65. By giving bondholders sufficient comfort, the law renders French covered bond issues more appealing on the international market and has the concurrent effect of

[60] This legal regime is established by a combination of: the law of 25 June 1999 (article L.515-13 et seq. of the Code Monétaire et Financier) for *sociétés de crédit foncier* (which makes mortgages available); the law of 1985 reforming the mortgage market by creating the *billet à ordre hypothécaire pour la Caisse de refinancement de l'habitat*; and the law of 2011 on the *sociétés de financement à l'habitat* (SFH). In France the issuer is a subsidiary of the original lender. Therefore, the proceeds of the issue are made available by the issuer to its parent company by way of a loan, guaranteed by the banking assets that remain in the balance sheet of the parent company. In the event that the original lender files for bankruptcy proceedings, the issuer can foreclose the assets in order to be able to continue paying the holders of the covered bonds. For a detailed outline of the French regime regarding covered bonds, see in particular X. de Kergommeaux, Ch. Van Gallebaert "*La société de crédit foncier: une structure rassurante en période de crise*", RTDF no. 1 2006, p 103. Covered bonds can be structured in two ways. For example, in the U.K., Holland, Germany and Spain, the issuer is generally the initial lender and its bank assets are transferred as a payment guarantee for the issued bonds which have themselves been held by an *ad hoc* vehicle.

[61] Unlike in securitization transactions, bondholders are exposed to the risk of a possible diminution of the value of the underlying assets upon which their securities are based, as there is generally no obligation for the issuer to replace or maintain the assets in the asset pool.

[62] Thus, article L.515-19 of the *Code monétaire et financier* provides that "*Notwithstanding any provision to the contrary, notably those contained within chapter VI of Code de commerce"* (this chapter contains the insolvency provisions): the eligible assets and the replacement values held by the Société de Crédit Foncier will "*be used for payment in priority to the bonds...*"

significantly reducing the transaction costs associated with such an issue (legal fees, etc.).

66. However, this "remedy" has certain limitations:

- in the event that the asset value is insufficient to fulfil the bondholders' claims, their rights against the original lender (which are unsecured claims), would necessarily be affected as the judge is not able to force shareholders or junior creditors, to absorb losses, prior to a liquidity crisis, as discussed above[63] ;

- due to the over-collateralisation requirement, the borrower's initial unsecured lenders see their general liens over the borrower's assets reduced more significantly than in the context of a securitisation, sometimes without any compensation at all[64].

67. In any case, even if the legislator were to amend French law in order to better respect creditors' conventional rights, this swing towards a more contractual approach could not be done in isolation: it would require a coordinated response at the European level. Indeed, at a European level, covered bonds already benefit from preferential treatment, as regards:

- European rules setting investment thresholds for UCITS[65];

- eligibility rules applicable to the Eurosystem's monetary policy operation[66]; and

- the favourable arrangements regarding prudential norms[67].

68. In summary, the solution which has been reached by the French legislator (as well as other European legislators) to offset the shortcomings of the Legal System are replicated also in other branches of French law. This makes it very difficult to return to a system which is based more on respect for contractual provisions (as in the U.S.). This problem occurs to a greater extent in the context of prudential regulation, which in Europe does not always take into account the existence of security interests in the calculation of capital costs necessary to make a credit transaction.

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[63] While the body responsible for prudential control in France (*Autorité de Contrôle Prudentiel* may appeal to the judge to order the sale of the bank's shares to a third party, in practice, it is clear that such a measure cannot be taken against banks with shares that are admitted to trading on a regulated market. For a detailed description of the specific regulations in matters of bankruptcy, see "*Droit Bancaire*", Th. Bonneau Montchrestien Lextenso éditions, 2011 p 208 et seq.

[64] Issuing covered bonds entails an increase in the risk borne by the original lender's unsecured creditors in the event that the original lender files for bankruptcy proceedings. This is true in particular for those creditors which are not able to demand an increase in the cost of credit to compensate for this increased risk (non-adjusting creditors). See S. Schwarcz, "*The Conundrum of Covered Bonds*", 66 *Business Lawyer* 561-586 (2011).

[65] As they are not issued under the framework of a specific legal system, contractual covered bonds are not compatible with the criteria for banking covered bonds established in article 52, § 4, of the Directive 2009/65/CE of the European Parliament of 13th July 2009 and no. 85/611/CEE from the Counsel of 20th December 1985 supporting coordination of legislative arrangements, regulations and administration concerning undertakings in collective investments in transferable securities ("UCITS Directive") 1. See Ch. Van Gallebaert "*Le financement des prêts à habitat soutenu par la LRBF*", Bulletin Joly Bourse, 1st Feb. 2011 no. 2, p 148.

[66] While the European System of Central Banks (ESCB) may have agreed in the past to take contractual covered bonds as collateral in exchange for funds made available to banks, that was a temporary and exceptional measure, due to a strong risk of credit rationing following the financial crisis. Normally, the ESCB only accepts covered bonds which fulfil all the criteria of article 52, § 4 of the UCITS Directive.

[67] Article 154 on the proposition of European regulation of 20th July 2011 concerning the prudential demands applicable to banks and investment firms refers to the definition of covered bonds given in article 52 § 4 of the UCITS Directive to determine the field of application for preferential treatment concerning risk weighting.

69. It is remarkable that some token remedies to deficient laws are enshrined in prudential regulations (as well as rules relating to asset management). This wrongly suggests that the misguided approach of French legal general rules (in particular those of insolvency law), is ultimately not all that costly to the economy. It gives the impression that the legislator is simply able to amend the prudential regime regulating certain types of assets to offset the consequences of an ineffective Legal System. This is an inadequate method of adapting the capital costs necessary to make a credit transaction depending on the level of risk which is, in reality, incurred by credit providers.

PART 2: THE LEGAL SYSTEM AND ACCESS BY INVESTMENT FUNDS TO THE PRIMARY AND SECONDARY PRIVATE CREDIT MARKETS

70. French law retains certain peculiarities which operate to limit the capacity of investment funds to invest in the primary short and medium term debt market, as well as the secondary banking debt market.

2.1 Mezzanine debt holders: victims or executioners?

71. Mezzanine debt (a type of risked debt the repayment of which is subordinated to the senior debt[68]) is very common in acquisition finance in Europe[69]. Mezzanine debt consists of cash interest payments (which are subordinated to senior debt), capitalised interest which increases annually, the principal amount being amortisable upon the maturity date, and also (usually) share warrants designed to increase the overall return of the investment (the equity kicker). Mezzanine debt holders were unintentionally penalized by the amendments made to French insolvency law in 2005. They were forced to resort to additional contractual protection mechanisms to counteract the knock on effects resulting from the application of the new law. These contractual mechanisms may, in fact, eventually lead to mezzanine debt holders having excessive rights. Therefore, the fate of the mezzanine debt holder provides a good illustration of the ‘swings’ that may be caused by an insolvency law regime that is not rational from an economic perspective.

72. It is not unlikely that, in light of the current climate of strengthening prudential requirements and, more generally, the crisis of confidence which is affecting financial markets (most notably in the high yield sector and the CLO), mezzanine investors may become increasingly prevalent alongside traditional senior debt, and may even replace them in certain cases.

73. Without recounting in full the historical origins of the role of mezzanine debt’s role in acquisition finance, it is worth mentioning that it is as a result of rules which

[68] The term “mezzanine debt” can be used for many types of financial instrument according to the nature of the subordination. These are:
1) Temporal subordination - the debt is ranked as senior debt, but is amortised in full after the senior bank debt,
2) Structural subordination - i.e. the type of collateral (e.g. second lien debt subordinate to the rights of other, more senior debts issued against the same collateral) or the use of a special purpose vehicle affiliated with the issuer in which the mezzanine debt is issued (the proceeds of the issue being reinvested in the borrower),
3) Contractual subordination - a subordination agreement mainly via an inter-creditor agreement, and
4) Legal subordination - where the law expressly provides that certain securities which meet specific conditions will be deeply subordinated to the rights of the other securities (“*titres super subordonnés*” are governed by article L228-97 of the Commercial Code). The rest of this article will focus on instruments within both the first, second and third types of subordination, which are traditionally used in leveraged acquisitions in Europe. To compensate for the effects resulting from the structural subordination mechanism, it is common that mezzanine debt holders (as with high yield bondholders) especially in Europe, are also subordinated to the rights of other, more senior debts issued against the same collateral.

[69] In the U.S., there is no mezzanine debt market in leverage acquisitions. Borrowers use second lien loans instead partly due to legal reasons, cf § 160.

are specific to France in relation to banking monopolies over credit transactions (by way of loans)[70] that mezzanine debt is issued in the form of bonds[71]. In certain specific circumstances, mezzanine debt can take the form of a loan, for instance when the debt is issued by a Luxembourg entity.

74. As the issuer is required to use bonds, this entails a number of constraints which are linked to the application of mandatory rules of company law, regarding the protection of bondholders' rights, such as: the creation of an artificial body (the "*masse*") which must approve any amendment to the bond indenture by a qualified majority, veto rights, statutory auditors' reports for the issue of securities which give access to capital, etc. These constraints can have the effect of making the creditor-debtor relationship very rigid. For example, the bondholders' representative does not itself have the power to grant a waiver to the debtor, being instead obliged to hold a special meeting of all the holders of the same class of bonds and agree to satisfy all the inflexible conditions provided by the law as to the holding of such meeting. In contrast, the agent appointed by the lenders in a syndicated loan is more easily able to grant a waiver, as the parties to a syndicated loan are free to decide themselves the conditions in respect of which the agent must obtain their approval[72].

75. In 2005, the legislator decided that bondholders were required to convene at a single meeting in order to approve a proposed restructuring plan. This left mezzanine investors faced with a previously unheard-of situation. In transactions where the issuer company had, in addition to mezzanine bonds, issued other forms of bond (usually convertible bonds in leveraged acquisitions), which were subscribed to by all or some of the original shareholders, it could mean that, because of the amount issued in the various bond issues, the mezzanine investors did not have a minority veto right at the bondholder meeting. The mezzanine investors, therefore, found themselves bound by proposals which were contrary to their *ex ante* rights. They were thus caught between "a rock" - senior creditors - and a "hard place" - the shareholders.

76. These imperfections in insolvency law also have an impact at a much earlier stage during informal negotiations over corporate debt restructuring. Legal advice is thus required, for example, to set up contractual mechanisms to avoid mezzanine holders finding themselves in a conflicting situation with the shareholders and / or the senior creditors. The parties can agree, for example:

- To structure the transaction so that the convertible bonds held by the shareholders are issued by a special purpose vehicle situated above the issuer of the mezzanine bonds, (structural subordination technique, with all the problems that this technique entails)[73]; or

- To guarantee that the convertible bonds will be swapped for issuer's shares automatically if the issuer files for bankruptcy proceedings (either wholly or to the extent necessary to assure mezzanine bondholders that they will have a majority or a blocking minority at the bondholders' meeting); or

[70] Whereas under French law banks are given monopoly rights over the primary credit market (in the form of loans), most often mezzanine investors do not have a licence to conduct business as a bank. However, banks do not have monopoly rights over the bond market. Cf. Infra §114 et seq.

[71] The use of bonds can be also justified when the equity kicker is structured using share warrants (*bons de souscription d'actions* or BSA).

[72] However, in transactions of a significant size, the use of online platforms (such as Debt Domain) facilitates communication with bondholders, so that conditions for obtaining a waiver from bondholders are in practice actually quite similar to those prevailing in a syndicated loan arrangement.

[73] Cf § 51 et seq.

- To establish contractual mechanisms whereby any other non-mezzanine bondholders (when all the different classes of bonds are issued by the same legal entity) agree to transfer to the mezzanine bondholders a certain number of convertible bonds (with a commitment to sell them back). This would give mezzanine bondholders a say at the bondholders' meeting which is convened during bankruptcy or reorganisation proceedings.

However, it is important to note that Courts have thus far not had the opportunity to rule on the validity or effectiveness of such agreements.

77. Thanks to such contractual mechanisms, mezzanine bondholders could go from being victim to executioner. As they are able to place themselves in a position to block the approval of the restructuring plan at the bondholders' meeting, mezzanine bondholders have managed, during some negotiations, to retain some of their claims against the company and, at the same time, to require senior creditors to absorb part of the losses. This situation conflicts with the initial contractual arrangements, especially when it is very clear that the enterprise value of the company breaks much below the level of the mezzanine debt (that is to say when the company's enterprise value is much below the amount of the senior debt)[74].

78. However, by allowing recourse to Luxembourg law through the Double Luxco Technique[75], senior creditors have managed in some cases to improve their position in the order of loss absorption, despite uncertainty about the validity of such a technique. In the event of difficulties arising during out-of-court negotiations over the debt restructuring of the issuer, thanks to the Double Luxco Technique, senior creditors are able to foreclose their (first rank) pledge over the shares of a company incorporated under Luxembourg law for this sole purpose[76] (which company is the parent of the French group). This is possible under Luxembourg law (unlike French law) because there is no automatic stay of proceedings when creditors seek to foreclose their pledge over any type of financial instruments

79. In this scenario, the position of the mezzanine bondholders is actually quite similar to that of a junior creditor during debt restructuring negotiations in relation to a company incorporated in the U.K. There is a risk that, upon foreclosure of the pledge, senior creditors will sell the company to a third party under circumstances which may not maximise of the value of the assets. Even if contractual mechanisms can be inserted into the loan documentation to counteract the effects caused by the artificial recourse to Luxembourg law, the auction process which takes place when enforcing a pledge to dispose of the company's assets essentially remains under the control of the senior creditors[77]. Incidentally, contrary to a situation

[74] It may be argued that, because of the difficulty under French law of requiring shareholders to absorb losses, often when the parties begin negotiations on restructuring a borrower's debt, the borrower's financial position is already so affected that the value of the mezzanine debt is already below "break" value. This is especially due to the amount of the mezzanine bond issue in proportion to the total amount of the acquisition debt - the mezzanine debt only provides a thin "cushion" for senior debt.

[75] Cf. supra § 43.

[76] The funds are made available to a company incorporated under Luxembourg law, which is also the parent company of a second special purpose vehicle, which in turn is also incorporated under Luxembourg law. Therefore, banks are able to pledge the shares of the company incorporated under Luxembourg law that is also the subsidiary of the first Luxembourg Company, in addition to the pledge taken over the shares of the group's parent company (which is incorporated under French law). Failure to do so would mean the banks would be unable to foreclose their pledge as the French parent company's filing for bankruptcy would trigger an automatic stay over the claims of the banks. The banks would, therefore, not be able to call in their pledge, even though such pledge would be governed by Luxembourg law.

[77] See A. Pietrancosta and S. Vermeille, ibid p 11.

governed by U.S. bankruptcy law, mezzanine bondholders cannot require senior banks to remain as creditors of the company under the same conditions as those which existed before the debtor's default if the bondholders decide to take control of the company by converting their debt instruments into equity.

80. This example illustrates the fact that when the law neglects original contractual agreements without a sufficient public interest justification, market practice will evolve to try to restore the parties' rights. However, in the end, the balance which is struck is never truly satisfactory for any party. The borrower must pay unnecessary transaction costs which are particularly significant when it comes to putting in place arrangements like the Double Luxco Technique.

81. This already precarious balance can be aggravated when a significant misalignment of interest arises within the same class of creditors. This can occur upon the arrival of new investors which buy debt instruments on the secondary market at a significantly discounted price from the nominal value (it is all the more so since the funds may have bought other types of securities[78]). In this respect, the Legal System's misguided approach accentuates this misalignment of interest to the extent that the price offered on the secondary market for securities of a French company logically includes an additional discount, to take into account the risk related to the current climate of legal uncertainty[79].

82. The new *procédure de sauvegarde finanicère accélérée*[80] (the "Accelerated Bankruptcy Procedure") demonstrates the legislator's laudable desire to reduce the impact of these potential misalignments of interests during out-of-court debt restructuring negotiations. However, due to defects in the Rule of the Law's misguided approach, during negotiations, this new procedure may have the effect of unduly reinforcing the bargaining power of majority creditors at the bank creditors' committees or at the bondholders' general meeting to the detriment, for example, of mezzanine bondholders when they are outvoted by another class of creditors, i.e. the shareholders, despite the fact the latter are junior to the former. This situation is likely to affect the liquidity of the secondary debt market, which is vital for the improvement *ex ante* of the economy's financing (in the same way that a law which gives little protection to minority shareholders does not favour the liquidity of the equity capital market).

83. The new procedure aims to force financial creditors (which may be in the minority in the bank creditors' committees or at the bondholders' meeting) to reach an agreement even before the filing for traditional bankruptcy proceedings. In this respect, the new procedure presents two distinct advantages:

- It allows for the acceleration of the timetable for the approval of restructuring plans; and

- It is less stigmatising than traditional bankruptcy proceedings *vis-à-vis* creditors and suppliers. This is especially so given that suppliers are

[78] With regard to the effects resulting from the fact that funds may be "wearing multiple hats", See D. Baird, R. Kasmussen, "*Antibankruptcy*", the Yale Law Journal, 119:648 (2010) p 686.

[79] Cf. infra § 92.

[80] Law 2010-1249 of 22 Oct. 2010 of banking and financial regulation. The *procédure de sauvegarde financière accélérée* allows a company to obtain an agreement from its creditors (which may include a debt for equity swap) by a qualified majority under insolvency law, as if the company had filed for formal bankruptcy proceedings (although in principle usually a unanimous agreement is required to carry out a debt/equity swap during a workout). This is to enable the company to settle on an adequate balance sheet restructuring more quickly, taking into account its projected future cash flows. Because it allows the company to avoid filing for formal bankruptcy proceedings, which are damaging to its reputation *vis-à-vis* its suppliers and clients, the *procédure de sauvegarde financière accélérée* is undeniably appealing to the company, and thus for the vast majority of its creditors.

not convened in a committee to take their share of losses. Indeed financial creditors may decide in some cases that they have more to lose if the company files for classic bankruptcy proceedings than by simply asking suppliers (trade creditors) to absorb losses first (which would be logical as the financial creditors are also secured creditors). This is all the more so because secured creditors know they will not be better treated during bankruptcy proceedings (*procédure de sauvegarde*) than trade creditors in any event.

84. Therefore, even if the rules governing the approval of a restructuring plan during the Accelerated Bankruptcy Proceedings are only slightly different compared to traditional bankruptcy proceedings (i.e. the committee of trade creditors is not convened provided that the majority of the financial creditors agrees), from an economic perspective, the new Accelerated Bankruptcy Proceedings reduce the financial distress costs borne by the borrower company and its subsidiaries as they reduce the costs resulting from filing for formal bankruptcy proceedings[81]. The financial creditors, which are in the minority in the banks creditors' committee or at the bondholders' meeting, therefore *de facto* lose some of their bargaining power. This is so even if, taking into consideration the valuation of the company, they can sometimes legitimately require the initial risk-sharing agreements to be enforced. The rights of a whole class of investors or minority investors pertaining to the same class may be further violated than before. The law continues to treat creditors, whether abusive or legitimate, in the same way.

85. This risk of undue wealth transfer to the detriment of outvoted creditors is significant insofar as French insolvency law does not even empower courts to verify that the creditors are not being put in a worse position than if the company had immediately filed for insolvency proceedings. This is in contrast to German and U.S. law (U.S. law subscribes to the "best interest of the creditor" test[82]).

86. The Accelerated Bankruptcy Proceedings are thus liable to of produce, as with other attempts by legislators to remedy defects in the law, unexpected and undesirable effects[83]. In the end, the public interest – i.e. in preserving the value of distressed companies – would be better served if insolvency law were to pay more respect to creditors' rights.

87. Financing some transactions with a "unitranche"[84] facility, that is to say mezzanine financing which does not involve a senior debt (bearing in mind the current decreasing role of banks in financing the economy), is appealing from the perspective of mezzanine investors as they are in a position to hold a majority stake at the bondholders' meeting without the need to enter into any specific contractual

[81] Before the law on the *procédure de sauvegarde financière accélérée*, filing for bankruptcy proceedings was a very costly decision, in particular for *senior* creditors. This is because, as the enterprise value decreased, the value of the *senior* creditors' claims was likely to be acutely affected when the enterprise value broke at their level. Minority creditors (in particular those who invested relatively little) could use this situation to their advantage. See B. Chopard, S. Vermeille, S. Portsmouth, L. Gregoire Sainte Marie "*Partage des risques, partage de la valeur, étude des effets du droit des procédures collectives sur la négociation amiable de la dette*", Revue Trimestrielle de Droit Financier no. 1 p. 1 (2011).

[82] See D. Baird "*Elements of Bankruptcy",* Foundation Press. Third Edition p. 215.

[83] A consultation was launched in 2011 by the Ministry of Justice about the possibility of changing the composition of creditors' committees (without proposing amendments to the ability to wipe out the shareholders). This consultation has so far resulted in no action.

[84] Thus, in January 2011, Fondations Capital revived the technique by buying Courtepaille restaurants using a "unitranche" private bond debt (€150 million) fully underwritten by ICG. Duke Street followed in spring 2011 by refinancing its LBO of the Biomnis laboratory by a similar six year bond (€150 million) from Axa Mezzanine.

arrangements. However, the potential for borrowers to use unitranche bond financing in the current market appears to be limited, given the limited availability of credit and mezzanine investors' initial risk / return expectations (the expected return of a unitranche debt being lower than that of mezzanine debt).

2.2. A shrunken market of distressed mergers and acquisitions ("distressed M&A")

The shrinking of the distressed M&A market related to the difficulty of carrying out "loan to own" transactions

88. French insolvency law has a direct impact on how French companies which are operationally viable, but financially insolvent because of an inadequate balance sheet, are bought by distressed investors, prior to filing for bankruptcy proceedings by investment funds. Due to the favourable approach taken by the law as regards shareholders, turnaround operations are usually implemented in France through the issuance of new shares which are bought by investment funds (and not by the acquisition of debt instruments which are later converted into equity). This technique is inconvenient in two respects:

- it delays the date on which the balance sheet of the company can be restructured (with a risk that the operational situation deteriorates quickly). This is because it is only on a date close to the liquidity crisis that concessions can be obtained from creditors (and existing shareholders), in return for an injection of equity intended to end the liquidity crisis[85];
- it is inappropriate when the borrower has a complex balance sheet.

89. Whilst a company's level of indebtedness requires the reorganisation of its balance sheet, banks do not generally have the capacity or the will to manage the consequences of a possible conversion of the debt into equity. They are therefore often inclined to dispose of their claims on the secondary market.

90. There are some investors which wish to redeem the debt securities of distressed companies from credit institutions and / or on the bond markets. This technique, featuring distressed funds (such as Oaktree Capital Management) is quite common in the U.S. These investors may take control of distressed companies (if need be in a hostile manner) if they believe its enterprise value is greater than the valuation made by the market through the price offered for the purchase of the company's various claims (an operation known as "loan to own"[86]). By taking a significant equity stake in companies (including in listed entities) following a debt for equity swap, investors are able to assist

[85] The ineffectiveness of the Legal System has a significant pernicious effect for the borrower when it engages in amicable out-of-court negotiations with its bankers: the dedicated teams in French banks for restructuring debt have a tendency to disregard the borrower's enterprise value when negotiating with the company, as a result of the unfavourable legal environment. These teams make decisions by "backwards induction", i.e. they reason strategically. They take into account the cost they would bear (and therefore how much they would recover) in the event that the out-of-court negotiations fail. This means that they asses the consequences of filing for bankruptcy proceedings after cessation of payments (because before this date, during a *procédure de sauvegarde,* they have almost no rights). On the basis of this amount, which corresponds to a floor value (which is bound to be low), teams engaged in restructuring assess their "negotiation surplus", which means what they may try to obtain from the debtor may be above the floor value. As they do not take into account the debtor's enterprise value, banks feel less concerned about the worsening financial distress costs incurred by the borrower. For an explanation of the concept of "decisions made by backward induction" and "negotiation surplus" during out-of-court negotiations, see B. Chopard, S. Vermeille, S. Portsmouth, L. Gregoire Sainte Marie ibid p. 8.

[86] See S. Vermeille " *Peut-on prêter pour posséder (loan to own) en droit français?*", CP Ed. E 09/07/2009, no. 28-29, pp. 21 -31.

companies during the turnaround phase and facilitate their access to new financing.

91. One of the advantages of restructuring the balance sheets of troubled companies this way is that this technique can be performed well ahead of a liquidity crisis (as opposed to the alternative in which turnaround companies subscribe for new shares in the company). This technique, therefore, has a less detrimental effect on the company's value, as the company is able to save financial distress costs.

92. Because of French insolvency law's favourable approach to shareholders, implementing loan to own transactions in France is even more difficult[87] and has unwanted side effects:

- this technique is often misunderstood by French management, who are unfamiliar with this type of transaction, especially when placed in a conflicting position if they are also the majority shareholder; and

- it may also be poorly received by other creditors, as this technique risks a misalignment of interest when investment funds acquire debt instruments similar to theirs, but at a much lower price than their nominal value which, besides, does not reflect the enterprise value of the distressed companies. Indeed, the discount between the price offered by the fund for the debt instruments and the true value of the business of the distressed company reflects the cost of risk resulting from the climate of legal uncertainty. Moreover, this significant discount prevents the formation of a secondary market in France, as credit institutions are unwilling to sell under these conditions. This situation may impede the proper conduct of negotiations over debt restructuring.

- However, this technique can still be used in the event that debtors experience a liquidity crisis, provided that the distressed fund (unlike the shareholders) is willing to inject cash into the company.

93. For these reasons, the so-called distressed M&A market in France remains essentially the prerogative of private equity turnaround funds (for example, Butler Capital Partners, Caravelle, Vermeer Capital, Perceva Capital, Verdoso, etc.) which invest in an amicable manner in accordance with the business' management and its principal partners. These funds invest solely in equity or quasi-equity, provided they obtain a sufficient write-off from creditors so that the debtor no longer suffers financial distress costs.

94. Having said this, takeovers via the increase of shareholders' equity will become more difficult in future because of:

an increase in the distribution of claims among a greater number of people (claims, especially in respect of distressed companies, are circulating increasingly on financial markets). This will make it difficult to obtain a write-off on a consensual basis (i.e. before filing for bankruptcy proceedings) as a condition for the investment fund to subscribe for new shares in the company;

- an increase in the number and size of classes of creditor / shareholder in distressed companies. This forces the funds to invest greater amounts in the company, much of which is wasted among debt classes that in principle are "out of the money" (i.e. they are not entitled to anything) given the

[87] Oaktree Capital Management is the only debt fund which is large enough to carry out loan-to-own transactions and which in the past has made investments in France. In comparison, in the U.K., there are more than twenty such funds.

company's state of insolvency.[88] This is in order to ensure control over negotiations with the existing shareholders and creditors, depending on the configuration of the financial creditors' committee and the single bondholders' meeting (convened to approve a restructuring plan); and

- an increased discrepancy between the company's balance sheet structure and its projected future cash flows (due to increased recourse to leverage and the worsening economic crisis). This situation gives all creditors (even the most senior ones) a degree of bargaining power (and thus the ability to cause difficulties) since, having nearly nothing to lose, they no longer fear the threat of an automatic rescheduling of their debts in the event that the debtor files for bankruptcy proceedings. Creditors understand that they can benefit from this "favourable" situation and impede the turnaround transaction by fiercely negotiating the price of their claims, which may adversely affect the preservation of the debtor company's enterprise value[89];

95. This last statement must be qualified in circumstances where the gap between the borrower's balance sheet and its projected future cash flows is such that, in the context of an LBO, the borrower's management will realise that it would be more advantageous to push out the shareholders and to reach agreement with the creditors, rather than to continue to align their interests with those of the private equity fund. Against a background of such severe financial deterioration, without the support of the borrower's management (and given the risk of litigation if the situation deteriorates further and the impossibility of filling for bankruptcy proceedings without the management, not to mention the reputational risk for the fund), the fund shareholder is then obliged to agree to waive any rights over the company, although theoretically it still has the potential to cause a nuisance by virtue of the preference given by French law to shareholders. The conversion of debt into equity is facilitated in this scenario when the creditors involved are not banks and are, therefore, better able to hold equity stakes in the borrower company.

96. The restructuring of Novasep's balance sheet in March 2012 provides a good illustration. For the first time, it was possible for the high yield bond debt of a French company to be exchanged for shares and a new high yield bond issue and, as a result, this allowed a very significant reduction in the group's level of debt. This transaction was made possible, even in the absence of an imminent liquidity crisis, as most of Novasep's debt was in the form of bullet loans, i.e. the entire principal amount and the interest on the debt instruments were due at the end of the loan term. The investment by one of the financial shareholders in Novasep (accompanied by French Strategic Investment Fund "FSI") was not the decisive factor in the restructuring, as had been the case with Oaktree Capital Management's investment in SGD a few years earlier[90]. Nevertheless, the gap between Novasep's projected future cash flows and its balance sheet was such that the rescheduling of its debts over ten years, made possible by French insolvency law, would not

88 Distressed investors should, in principle, buy back the claims class at the point at which the value "breaks" (the so called "fulcrum security"), i.e. the portion held by the new residual owners of the company. Distressed investors are thus forced to take into account the fact that the law allows all creditors to vote on the restructuring plan.

89 Normally, the management of a distressed busienss uses the threat of the judge rescheduling creditors' claims (over a maximum period of ten years) as leverage in order to obtain a write-off which eventually benefits shareholders. However, in recent years, French banks have been increasingly unwilling to agree to write-offs without any consideration. In several cases, they have agreed to take an equity stake in such companies.

90 See A. Pietrancosta and S. Vermeille, ibid p 12 et seq.

have been sufficient to assure the shareholder fund that it would recover its investment.

97. Ultimately, it is when the borrower's situation is delicate, but not catastrophic, that French law's preference for shareholders leads to "zombie" LBO companies. Such companies are unable to push out their shareholders and thus reduce debt sufficiently as part of a restructuring[91].

98. The banking monopoly rules (or their likely interpretation by the courts) is likely to further discourage distressed investors from carrying out secondary credit transactions and, therefore, from buying back debt held by banks[92].

99. Taxation can also be a major obstacle to corporate restructuring and to loan-to-own transactions in circumstances where the applicable fiscal rules are too focussed on the form rather than the substance of the restructuring. A review of the applicable rules in each jurisdiction mentioned is beyond the scope of this paper. Taxation issues must not be underestimated when it comes to assessing the attractiveness of a particular jurisdiction. Fiscal rules may lead the parties to not always take the most appropriate measures from the perspective of the borrower, in order to safeguard the interests of other stakeholders (shareholders and creditors).[93]

The shrinking of the distressed M&A market for companies which are restructured at an operational level

100. French employment also acts as a significant brake on acquisitions in relation to companies which require restructuring at an operational level (or which have been recently so restructured). An exhaustive study of the peculiarities of the relevant provisions of French employment law is beyond the scope of this article. At this stage, we will note that case law in this area has increased the circumstances in which investment funds can be affected by the restructuring or closure of a business. These decisions call into question the principles inherent to the running of investment funds. On the one hand, by extending the theory of co-employment (*jurisprudence co-emploi*). This principle can be used to attribute liability to a majority shareholder investment fund in order to force the fund to pay claims owed to employees as a result of the restructuring plan. This is in circumstances where the interests, activities and leadership of the fund and the company are indistinguishable from one another (even if there are no inappropriate wealth

[91] For a description of the SGD transaction, see B. Chopard, S. Vermeille, S. Portsmouth, L. Gregoire Sainte Marie, ibid. Concerning the debt restructuring of Novasep, the involvement of the Comité Interministériel des Restructurations Industrielles (CIRI) (the restructuring arm of the French Ministry of the Economy in the negotiations undoubtedly facilitated the push out of the existing shareholders. Furthermore, in the present case, one can question the appropriateness of the involvement of the FSI. In this transaction, the FSI acted as a lender at a high rate of 13%. This contradicts the mission it was assigned by the French government. The electoral context should also probably not be overlooked…Finally, it should be noted that in this case, the high yield bond debt took the form of a bullet loan with a very high rate. Therefore, the filing for bankruptcy proceedings would only have entailed a further increase in the interest rate.

[92] Cf § 114.

[93] The following problems are often noted in restructuring:
- If a claim has been bought back at a discounted price, the holder of the debt which has been converted to equity is at risk of incurring a taxable gain which is higher than the discount and in respect of which he receives only shares (and no money with which to pay tax). There is also a risk that there may be no gain at all if the securities received in return are worthless;
- The risk of non-deductibility of certain debt waivers or subsidies to foreign subsidiaries (notably Germany), when applicable law treats the transaction as a capital contribution;
- Restrictions on the ability to carry forward losses (introduced in France by the law of September 2011). This can lead in some circumstances (including upon a liquidation, a debt waiver, and a reduction of reserve warranties) to the situation where there is a taxable gain in circumstances where the company is unable to pay the tax.

transfers)[94]. On the other hand, the extension of the concept of the group leads some litigants to claim that the fund is, along with all its investment in various companies, a single group within which employees made redundant for economic reasons should be redeployed. However the risk arbitrage strategy of turnaround funds which seek to invest in projects which are inherently very risky requires that they maintain a firewall around each of their portfolio companies[95].

101. Notwithstanding the issue of the redeployment of employees (which has been made the responsibility of investment funds) and co-employment case law, and despite the fact that: the text of the law itself is very clear, it has been clearly defined by the *Conseil Constitutionel* and it has been interpreted in a consistent manner by the *Cour de Cassation* over the last fifteen years, first and second instance courts have recently annulled collective redundancy proceedings for a reason not provided for under the law[96]. Although these decisions were ultimately overturned by the *Cour de Cassation* in the Viveo decision of 3 May 2012[97], the instability of employment case law has had the effect of deterring investors which might otherwise wish to acquire distressed companies. This judicial insecurity also fosters unjustified expectations amongst employees regarding the applicable law and provokes behaviour on their part (and possibly from practitioners) which can add to the companies' difficulties.

102. Moreover, the distressed M&A market may have shrunk because of the risk to funds of incurring tort liability (*actions en insuffisance d'actifs*). This risk has the effect of deterring investors, even though the imposition of such liability is relatively rare. This tort legal action, which lies against the *de jure* manager as well as in some cases the *de facto* manager (i.e. the shareholders), is expressly authorised by governing statutes and is intended to prevent opportunistic behaviour which may worsen the company's financial situation. However, this legal action is not justified in such situations, which differ from the traditional model in which the use of credit is *de facto* limited)[98].

103. Indeed, the interests of the debtor's other creditors (in particular the trade creditors), would be better served if the Legal System was more effective. The financial creditors would usually be able to force, through the credit documentation, a restructuring of the balance sheet before the occurrence of a liquidity crisis. As the other creditors cannot control the opportunistic behaviour of the management, they should be able to rely on the financial creditors to do so[99].

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[94] This occurs even in the absence of any super-subordinate relationship between the investment fund and the company's employees. On the extension of the co-employment theory, see N. Morelli, "*Commentaries on confusion of interests, activities and leadership from a commercial law perspective*", in E JCP 10 Dec. 2009 No 2173 and the Sublistatic case, incurring the liability of an investment fund on the grounds of the co-employment theory, A. Couret and B. Dondero, "*The reclassification of employees, the group of companies, and venture capital (business Unichips, Sublistatic and SGD)*", in JCP E 21 October 2010 No. 1915.

[95] See the court decision of the TGI Nanterre, 20 November 2009, CCE of SGD v SGD, Sagard and Cognetas. The court's decision was set aside by the Court of Appeal but the court's reasoning remains unclear as it set aside the lower court's decision on procedural grounds and not on substantive grounds (Court of Appeal, Versailles, 3rd Feb. 2010, n°09/09068 and 09/09154).

[96] See for example, *Cour d'appel* of Paris, 12 May 2011, Works Council of Viveo France c / Video France.

[97] Decision No. 1299 of 3 May 2012 (11-20.741) of the Chambre sociale of the *Cour de Cassation*.

[98] This tort-based legal action, is intended to attribute liability to the company's officers and other parties (such as the *de facto* managers, i.e. the shareholders) when, as a result of the management's wrongdoing, the company's existence has been artificially maintained to the detriment of the creditors. This is despite the fact that the management may not have personally benefited. For a description of the impact of this tort legal action on the behaviour of investment funds see § 102.

[99] This problem is not unique to France. The majority of European countries have also maintained a "classical" approach regarding the law's treatment of moral hazard

Macroeconomic impacts of the atrophy of the shrinking of the distressed M&A market

104. Unless the Legal System is amended, there is a high risk that many firms with inadequately structured balance sheets (or even simply with operational problems) will fail to find a new majority shareholder among the investment funds specialising in turnarounds (and thus to restructure their level of indebtedness sufficiently) until a liquidity crisis is imminent. These companies will only be able to start negotiations with their shareholders and creditors at a very late stage, usually beginning on an amicable basis with a "*mandat ad hoc"* (under the supervision of a trustee appointed by the president of the Commercial Court) or a "*procédure de conciliation*" (mediation process)[100].

105. Furthermore, these negotiations are likely to be too long (and therefore too costly for the debtor) because of the difficulty for the parties to agree on new risk-sharing agreements. This difficulty arises as such a new agreement must be reached by the parties, taking into account not only the initial contractual agreement, but also the binding rules which apply upon filing for bankruptcy proceedings.

106. As a result of the law's favourable approach to shareholders, the parties will also reach an unsatisfactory agreement as to the amount of debt to be converted into shares or to be written off by creditors in order to limit the diluting effect resulting from the debt for equity swap[101]. A significant number of French companies will find themselves at a disadvantage compared to their less indebted foreign competitors, which will have benefited from a more opportune legal environment.

107. The maturing of approximately €10.4 billion of LBO debt in France in 2015 (compared to €4.6 billion in 2013 and 2014 and only €591 million this year[102]) calls for a prompt response by the legislator. The trend of renegotiating covenants (which neutralises their effects), that the market has witnessed since the beginning of the economic crisis is necessarily coming to an end as we approach the maturity date of various financings. Since the beginning of 2012, there has been a significant increase in restructuring cases within specialised teams working in French banks. Distressed companies are experiencing more significant difficulties than with which such specialised teams worked during the middle to the end of 2012/2011. This time round, very difficult restructuring processes are going to be required.[103]

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due to the management's opportunistic behaviour. This is the case particularly in Germany. The management is required to file for bankruptcy proceedings as soon as it finds that the value of the debtor's assets is insufficient to enable the debtor to repay its creditors (i.e. before the maturity date). This obligation has a counterproductive effect during out-of-court negotiations in relation to the debt of LBO companies. However, the German legislator passed emergency legislation on 17 October 2008 to temporarily suspend this obligation to commence proceedings for the management of distressed companies, provided the company is not facing an imminent liquidity crisis. This law (which was supposed to be temporary), has been extended until 31 December 2013. See A. Gallagher, W. Harlfinger, "*Expected Return Former Overindebtedness Test under German Insolvency Law*", ABI Journal, 30 October 2011, p. 30. For an overview of German law, see M. Schillig, "*The Transition from Bankruptcy Corporate Governance to Governance - Convergence of German and US-law?*", European Company and Financial Law Review (2010), pp. 116-157. While the French legislator (rightly) recently limited the recourse to tort legal actions in similar cases in order to take account of the changing economic environment, it has so far not considered reducing the scope of the law which authorises tort actions in this area. Cf. 200.

[100] The involvement of a third party, such as a mediator, is another example of a token remedy provided by the legislator. Such measures are intended to counteract the side effects caused by the change in the rules of the game (resulting from the impact of insolvency law on the dynamics of out-of-court negotiations).

[101] See B. Chopard, S. Vermeille, S. Portsmouth, and L. Gregoire Sainte, ibid p. 14.

[102] Source: Crédit Suisse

[103] Moreover, given the changing nature of that part of the economy which is based on innovation, it is reasonable to expect an increasing number of bankruptcies of listed companies, even those of significant size, in the future. The recent filing for

2.3 The absence of a DIP loan market

108. An analysis of the Debtor-In-Possession (DIP) loan market in the U.S. also illustrates the appeal for companies to be able to rely on a Legal System, which protects the rights of their investors. The DIP loan is a new method of financing which is made available to a company which has filed for Chapter 11 proceedings and which enables it to meet its cash requirements, until the end of the procedure. U.S. bankruptcy law encourages DIP loans by granting lenders senior ranking under section 364 of the U.S. Bankruptcy Code.

109. In the U.S., half the companies under Chapter 11 protection find themselves being granted new short term funding in order to meet their needs until the approval of a viable plan. Besides an increased interest rate, the demands of a DIP Loanprovider are realised in 92%[104] of cases by obtaining top level security prevailing over existing security on assets of value to the company or its subsidiaries, and by the assurance of being able to seize the underlying assets without having to obtain a judge's authorisation, if the company fails to respect the covenants.

110. The lenders in DIP loan transactions also place a high value on being able to predict the issuing of Chapter 11 proceedings. Since the senior creditors (banks) of the companies and hedge funds are in competition in this segment of the market, the borrower benefits from a better cost of financing[105].

111. By comparison, two anomalies can be identified in French law:

- while the idea of the DIP loan may look in part like the statutory "new money" privilege in the "*procédure de conciliation*' (i.e. a combination of out-of-court negotiation and formal bankruptcy proceedings), there is no equivalent to the legal privilege which is granted by the U.S. Bankruptcy Code to providers of DIP loans when the debtor formally files for bankruptcy; and

- the rights of creditors which benefit from the statutory "new money" privilege (which must be authorised by courts during informal proceedings) are not protected sufficiently in the event that the company files for reorganisation proceedings, a *procédure de sauvegarde* or a procedure de *redressement judiciaire*: creditors will in principle be subjected to the automatic stay triggered by the filing, and the approval of a reorganisation plan would not guarantee their privilege (i.e. their right of priority over the other creditors) [106].

112. It is certainly possible to continue to lend after bankruptcy proceedings have been commenced. However, lenders would be subordinated to a number of other creditors in the event of a liquidation. By way of illustration, the very favourable treatment granted to employees when implementing an operational restructuring plan has hindered the provision of new money to the company.

Chapter 11 proceedings by Kodak illustrates this point. The capitalisation of the company has decreased by $31 billion in the space of only fifteen years due to the company missing the shift to digital photography.

[104] See K. Ayotte and E. Morrison, "*Credit Control and Conflict in Chapter 11"*, Columbia University – Center for Law & Economics Research Paper no. 21, available on the website: www.ssrn.com

[105] Lending banks agree to lend more to their debtors, through fear of seeing an alternative fund take control of the company by this mechanism (another form of "loan to own"). Some commentators have noted that there is some scope for abuse of the DIP Loan market in the U.S. due to the increasing role played by hedge funds in this market segment. See H. Miller, "*Chapter 11 in Transition-From Boom and Bust and Into the Future"*, ibid p 391. See below § 159.

[106] However, uncertainty remains and it would be desirable for the legislator to clarify this area.

113. Finally, the DIP loan market could only develop in France under similar conditions if the rules on investor protection were reviewed, most notably those concerning banking monopoly on credit transactions.

2.4. The banking monopoly over credit transactions and the difficulty for investment funds of accessing primary and secondary debt markets

114. As mentioned above, the current rules of banking monopoly restrict the liquidity, and even the formation, of several financing markets. However, they could be useful, especially since credit establishments tend to step back from specific segments of the market.

115. In France, apart from some restricted exceptions[107], credit transactions are reserved to credit institutions approved by the Bank Regulator (the *Autorité de Contrôle Prudentiel*). Assimilated with these are entities from other countries in the European Economic Area (EEA) approved in their country of origin.

116. This regulation has not been taken up at the European level, as the European Directive[108] only gives credit institutions monopoly rights over the receipt of deposits or other refundable assets received from retail investors. In other words, the provision of credit is a regulated activity, which is open to entities other than credit establishments, provided that this does not involve the receipt of deposits from retail investors.

117. For example, in the U.K., the 1987 Banking Act regulates banking activity in as much as it also applies to the receipt of deposits (whether from retail investors or not) and the granting of credit / debt. Other Member States refer to the definition of "credit establishment" as defined under the EC Directive (which implicitly provides the scope of the monopoly). Therefore, such Member States do not consider credit activity to be a banking transaction in the absence of the receipt of funds from retail investors. Such is the case in Spain, Italy, Belgium and the Netherlands. Investment funds in these countries can demand approval in order to carry out transactions on the primary debt market, provided they comply with the applicable conditions in the relevant jurisdiction.

118. Moreover, in France, irrespective of the fund's origin, because the transfer of unmatured claims is seen as a credit transaction[109], the secondary debt market is, in principle, inaccessible to investment funds (even if funds may not always comply with such prohibition). However, the free transferability of banking credit in recent years has become standard in most European countries, taking the example of the U.S. By favouring the liquidity of the secondary market, the loan documentation under which the claims are freely transferable facilitates *ex ante* companies' access to primary credit markets.

119. Today, besides an unclear field of application due to the differences in interpretation of the administrative, civil and criminal courts, the reasons which historically

[107] Among the exceptions to the law are: trade credit, shareholder loans, cash-pooling agreements and long term loans in the form of quasi-equity which fall within the scope of the law (*prêts participatifs*), as well as securitisation schemes under specific conditions provided by the law.

[108] Article 5 of Directive 2006/48/CE of the European Parliament and Counsel of 14 June 2006 concerning access to the activity of credit establishments and its usage (revised).

[109] *Cour de Cassation*, criminal division, 20 February 1984, 83-90.738, published in the Bulletin and CE 6/2 SSR, 8 July 1987, 47192. However, since the *Assemblée Plénaire de la Cour de Cassation* has indirectly refused to pass civil sanctions for the violation of banking monopoly, which could have led to the nullity of the loan contract (and therefore possibly to the loss for creditors of the right to receive interest payments), the law often seems to be violated in practice. See Assemblée Pléniaire, 4 March 2005, JCP 2005, éd. E, 690, comments by Th. Bonneau.

justified a banking monopoly, namely the protection of depositors, the control of monetary creation and credit control, do not justify, *without more,* maintaining the rule in the present[110]. The stopgap measure for French companies of issuing bonds, for example, mezzanine financing of companies under LBO, is not fully satisfactory because of the binding provisions of French corporate law in relation to bond issues and also, from a financial perspective, because the bonds lack flexibility compared with loan documentation (in the case of multiple drawdowns from the same line of credit, revolving credit, etc.). Moreover, the other stopgap measure of banks transferring their assets to securitisation vehicles may have unwanted effects for borrowers when they face difficulties[111]. Finally, the prohibition applicable to the funds from implementing secondary credit transactions has a detrimental impact on the liquidity of the bank loan market and, in particular, prevents the implementation of loan to own transactions which are useful to turn around distressed companies.

120. We must therefore question the existence of microeconomic or other macroeconomic reasons which may justify maintaining the banking monopoly (albeit as amended), and weigh up the benefit which the law provides against the cost to companies in the context of credit rationing. This reflection should lead the legislator to determine whether or not it is possible to maintain a level of security which is similar on financial markets (if this reason were to be the new rationale for the existence of a banking monopoly[112]), by opening up access to the primary and / or secondary credit markets to entities other than credit institutions within the conditions set by EC law, as in other Member States.

121. In this respect, it seems that a middle way is possible. French lawmakers must identify the necessary lessons, that is to say they must find the right answer in terms of regulation. This requires comparing the advantages and disadvantages of the U.S. system, which allows hedge funds to carry out credit operations without any specific regulation[113].

PART 3: THE LEGAL SYSTEM AND THE DEVELOPMENT OF THE VENTURE CAPITAL INDUSTRY

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[110] Indeed, on the one hand, institutional investors do not have the same objectives as retail investors (i.e. the public) who deposit their savings in a checking account with a credit establishment. On the other hand, the activity of alternative funds does not contribute to the rise in the monetary mass (contrary to a bank which receives checking deposits), as the funds cannot provide funding without having the necessary funds to do so. Moreover, in the Eurozone, only the European central banking system can influence monetary creation by controlling banking liquidity, i.e. the conditions under which banks can refinance from the European Central Bank. To this end, intervention in the monetary market (interest rate, the list of claims that the European Central Bank agrees to refinance) and the minimum reserves are the principal techniques used.

[111] In the current context in which banks deconsolidate their balance sheets, we can observe the proliferation of a new generation of securitisation schemes. For instance, the asset manager, Axa Investment Managers, has announced that it is about to launch a securitisation scheme of several billion Euros intended to buy banks'' claims over medium-sized companies. This type of transaction can facilitate *ex ante* the access to bank credit for medium-sized companies. In the present context, this is particularly welcome. However, securitisation schemes can raise difficulties for borrowers with a high probability of default. Securitisation schemes reduce borrowers' ability to negotiate, if necessary, new terms and conditions with their creditors.

[112] For example, the question as to the risk posed by hedge funds being given access to primary market debt, including the DIP loan market, has been raised in the U.S. (Cf. §108). They are able to exercise disproportionate control over the borrower and they prioritise the promotion of a short-term approach. See H. Miller "*Chapter 11 in Transition-From Boom and Bust and Into the Future*", ibid p 393 et seq. Conversely, according to the author, the development of derivatives seems likely to reduce the systemic risk associated with the failure of larger hedge funds. This was not the case when Long-Term Capital Management collapsed in 1998 as such a collapse nearly entailed a severe liquidity crisis in the financial markets (1998).

[113] Cf. 159 et seq.

122. An ineffective Legal System does not only have an impact on investments by way of debt instruments, it also affects equity investments. The study of the corporate governance of venture-backed companies highlights the detrimental consequences resulting from the excessive inflexibility of French corporate law and the misguided approach of French insolvency law.

123. Venture capital refers to the financing of a company with strong growth potential at different stages of its development cycle:

- the "seed and start-up stages" which corresponds to the preparation phase (often major research and prototyping work) before the start of substantial business activities, then

- the "early growth stage" which corresponds to the first years of business, often on a limited scale. This phase is intended to confirm the viability of the project, and finally

- the "rapid growth phase" which corresponds to the deployment of large-scale enterprise (launching a new product line, renewing the production apparatus or production system).

124. The following developments mostly relate to the early growth stage. The venture capital industry is structurally affected by new prudential norms since those norms affect the banking and insurance sectors. Indeed, banks and (particularly) insurance are the two types of market players which traditionally hold a major position among providers of external capital in specialised funds in France[114].

[114] In its report "*Risks and tendencies*" (2011), the French market authority (*l'Autorité des Marchés Financiers* "AMF") indicated that institutional investors (banks and insurance companies) represented only 23.2% of fund raising, against 34% and 47.8% respectively in 2009 and 2008. At the same time, fundraising from public authorities and from retail investors made up a significant proportion. Retail investors have recently been attracted by new tax incentives.

125. Venture-backed companies have specific features, such as a potential for high growth, provided their innovative products become technically and commercially successful. The probability that the products will become successful is, however, low. Funds arbitrate their risks by betting on the over-performance of a small number of businesses. The relations between venture capital funds and the company founders - the company's corporate governance - must therefore be organised taking into account theses facts.

126. Besides, there is a high risk of moral hazard which has to be taken into account:

- investors finance projects that have a great variability in terms of the possible future cash flows;

- the management of the company will not have invested much in the company compared to the venture capital fund; and

- the providers of external funds are in a situation of information asymmetry which is unfavourable to them: the person whose idea leads to the formation of the investment project is very often also the manager and founder of the company.

3.1 A comparative study of the venture capital practices in France and the U.S.

127. A comparative study highlights the consequences of an ineffective Legal System.

How it works in practice in the U.S.

128. When venture capital funds buy new preference shares and enter into contractual arrangements (for instance a shareholders' agreement), they set up an organisational structure, which is deemed to be optimal by all parties concerned, because it:

- gives investors the right to receive the fruits of the company's success prior to the other shareholders (the management) since preference shares include a liquidation preference clause);

- aligns the interests of the management to those of the investors, as the management is financially incentivised to take sufficient risks in order to give the company the opportunity to grow quickly during the first years[115];

- reduces the risk of opportunistic behaviour on the part of the management. Investors are able to impose a fundraising timeline with regular and close deadlines according to the different milestones the company must reach: implementation of a prototype, client validation of the product, etc[116]. The funds are specialised by industry (in order to reduce the impact of information asymmetry), and investors collaborate very closely over strategy at the commercial and marketing levels of the company, i.e. not only at the financial level; and

- enables investors to recover all or part of their investment when the company is not performing in accordance with the initial targets (the venture capital funds bring to an end, on average, two out of three projects). The investors may recover their investment either directly from the company (as the preference shares have a redemption right) or following the voluntary liquidation of the company after the business is wound up. In the latter scenario, the venture capital funds take advantage of their right to receive any liquidation dividend prior to the ordinary shareholders (for example the proceeds from the sale of undeveloped patents). If necessary, the funds will financially incentivise the management to maximize the value of the dissolved corporation's assets.

129. Besides, as the venture capital funds are specialised according to the different phases of the development cycle (see above), investors do not hesitate to sell their stake in the company when the time comes. The funds therefore benefit from a liquid market as they are easily able to find a buyer for their stake, provided the company meets the ambitious targets set out[117].

How it works in practice in France

130. In France, investors subscribe to preference shares with different features. Indeed, they are subject to constraints imposed by the Legal System which do not exist in the U.S. As a result, the organisational structure is not the same:

- investors tend to have more difficulty in controlling the opportunistic behaviour of the management as the fundraising timeline is often determined according to the company's cash flow needs and not according to specified development milestones;

[115] See for example, U. Hegey, F. Palominoz and A. Schwienbacher, "*Venture Capital Performance: The Disparity Between Europe and the United States*", Université Catholique de Louvain & University of Amsterdam Business School February 2009, available at ssrn.com (we disagree however as to the conclusions on the impact of law on the founder/investor relationship).

[116] See A. Landier and D. Thesmar 2004, *"Financial contracting with optimistic entrepreneurs: theory and evidence"*, Mimeo, New York University and HEC Paris.

[117] Besides, a liquid market gives U.S. funds (contrary to European funds) the opportunity to use the money raised during the fund's formation more than once during the same cycle of investment. This is a clear advantage in term of investment return.

- investors rarely bring to an end a project ahead of a liquidity crisis by arranging the voluntary dissolution of the company. Investors are therefore less able to recover even part of their investment when the company fails to meet its targets. Investors are not given this right either directly from the company (as preference shares do not have redemption rights), or following the sale of the assets of the dissolved company. Such dissolution occurs most often during liquidation proceedings under the supervision of the court. The sale is organised by a third party - the liquidator appointed by the court - who has no incentive to maximise the value of the assets as quickly as possible;

- as the funds cannot bring projects to an end at an early stage, they cannot focus their attention on projects that create significant value (and which offer a sufficient level of return given the level of risk). Additionally, they tend to be more focussed on the financial aspects of projects and are usually less industry-specialised[118].

131. This is a simplistic notion of the venture capital practice. Of course, there are some disparities depending on the business of the venture backed company. Ideally, a distinction should be made between venture capital funds that invest in only France and other funds. The particular industry sector and the experience of the fund managers should be also taken into account. It is nevertheless possible to identify a general trend that stands out from the U.S. model.

132. Finally, while specialised by different phases of cycle, French funds do not tend to buy out investments made by other funds (preferring to obtain their stake by way of a share capital increase) The situation is different in the U.S. This is due in part to the small number of exit opportunities during the rapid growth phase, which is supposed to take place after the early growth stage[119]). The funds therefore have less incentive to acquire stakes owned by business angels[120] if they anticipate that it will be difficult for them to sell their own shares. This situation risks a conflict of interest between investors which bought stakes in the company at different times. It impacts all the more on the company's corporate governance. For example, as the investors will have invested on the basis of different valuations, it will be more difficult to enforce the liquidation preference clause.

133. To avoid their stake being diluted, funds may decide to re-inject cash during all the phases of the development cycle of their portfolio companies, even if they would rather invest in different projects. From then on, the economic model of French funds specialised in seed capital is completely modified. It is therefore critical that venture capital partners manage to raise enough money when they set up their fund.

3.2. The impact of the Legal System on the founder/investor relationship in venture backed companies

[118] See the report of the Conseil d'Analyse Économique "*Private Equity et capitalisme français"*, (2008), J. Glachant, J.-H. Lorenzi and Ph. Trainar (2008), available at *la Documentation Française* and on the web site of the Conseil d'Analyse Economique: www.cae.gouv.fr

[119] The difficulty in listing high tech companies' shares on financial markets is not unique to France. Due to the information asymmetry which exists in this type of industry, the initial public offering of the shares of the company is not always the best way for venture capital funds to dispose of their stakes. Instead, they have to rely on the M&A market or leveraged buyout market, provided that those markets are large enough to take over the venture capital stake.

[120] A business angel is an individual who invests part of his/her wealth in an innovative company with potential and who, in addition to financial support, makes available to the entrepreneur (at no cost) his / her skills, experience, and network, as well as a considerable time investment.

134. There are many factors which may explain why the U.S. market seems to allow a more efficient and transparent capital allocation process than is the case within the heart of Europe[121], such as a different business culture, more salient risk adversity and a single market of a significant size.

135. However, the Legal System is also a factor than could explain the difference in practice between France and the U.S. during the early growth stage. Firstly, the Legal System prevents the U.S.'s optimal style of corporate governance from being implemented in France by way of a similar organisational structure. Second, the Legal System affects companies' access to other funding techniques. This obstacle may also indirectly affect the company's corporate governance during the early growth stage.

Influence of the Legal System on the company's organisational structure during the early growth stage.

136. Despite that reforms in 2004[122] and 2008[123] have led to the liberalisation of corporate law, some inflexibilities of the law in relation to the protection of providers of external capital of any type (shares, bonds, convertible bonds, etc.) pose problems, which we list here in no particular order: the rules governing the representation of securities holders; the mandatory pre-emption right conferred on existing shareholders in the event of any capital increase; the restrictive conditions for share buybacks by an unlisted company; the risk of expropriation of holders of preference shares in the event of a reduction of the legal capital to zero[124]. Some inflexibilities have been replicated at the European level through numerous directives.

137. By way of example, the mandatory provisions of French corporate law, intended to protect the rights of holders of convertible securities or share warrants, impede the fundraising process. For each new issue of securities (share warrants, convertible bonds, etc.) a "mass" must be formed (a legal fiction allowing minority bondholders to be outvoted, see further above). This "mass" holds its own meetings and enjoys specific veto rights under French corporate law in the event of a change in the allocation of profits and therefore the creation of new preference shares.[125] However, as all the market players in the venture capital industry are experienced parties, they should be free to agree on the appropriate contractual protection mechanisms desired.[126]

138. Meanwhile, as turnaround funds, venture capital funds can incur tort liability in the event that individual portfolio companies are put into liquidation. This risk obliges funds to refrain from interfering too much in the daily management of their individual portfolio companies. They take a more hands-off approach than U.S. funds, regardless of the fact that the project's success lies in the close collaboration between the fund and the management (which is much closer than in a

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[121] According to the report of the *Conseil d'Analyse Economique*, "*Private equity and French capitalism*", J. Glachant, J.-H. Lorenzi and Ph. Trainar (2008), investment in venture capital,(in relation to PIB) is three times higher in the U.S. than in Europe or France. But this gap is even worse if the role of high technology sectors in venture capital investments is considered: 75% for the U.S., but only 35% for Europe and 37% for France.

[122] Ordinance no. 2004-604 of 24 June 2004.

[123] Ordinance no. 2008-1145 of 6 November 2008.

[124] In addition to these issues, there is uncertainty as to the validity of preferential liquidation clauses under Civil Law. See the opinions and recommendations of the *Comité juridique* of AFIC No. 2, December 2005.

[125] Besides, the way the bondholders' meetings are organised is restrictive and a number of legal conditions must be satisfied. Cf. 71

[126]This freedom should nevertheless be accompanied by a strengthening of the obligations owed by the company's management, in accordance with the model of the fiduciary duties owed by the management under U.S. law. See, for example, S. Bainbridge "*In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*", 50 Washington and Lee Law Review 1423 (1993).

listed company). The funds are forced to use avoidance strategies so that the courts do not consider that they have, as *de facto* manager of the company, taken wrongful decisions leading to its liquidation. The funds are usually represented on the supervisory board instead of the board of directors, and they avoid leaving written proof (in the minutes, emails) that they give direction to the management on the way business should be conducted, etc.

139. In this case, the threat of tort legal action has no real ground. If the operational profits of the company are insufficient, the venture capital fund will want to interrupt the operations of the company quickly anyway, since it is preferable for the fund to focus on high-growth companies. Creditors of the relevant companies do not need to be protected against the risk of moral hazard.

The influence of the Legal System on the access of portfolio companies to other financing markets

140. The Legal System can have the effect of reducing companies' access to other financing markets during the downstream phases of the development cycle: for example, the market for venture loans[127] (mainly because of the law granting monopoly rights to banks over credit operations[128]) and the high yield market, for reasons mentioned above[129]. The Legal System may therefore indirectly reduce the investment return of venture capital funds. This interferes with the proper turnover of investors between the different phases of the development cycle and therefore affects the corporate governance of the company during the early phases of the development cycle.

141. In conclusion, the shortcomings of the Legal System seem to prevent the establishment of an optimal organisational structure and also to affect the liquidity of the market for the stakes held by the venture capital funds, and all this at different phases in the development of the company. In terms of consequences, the following assumptions are made:

- *ex ante*: a reduced supply of funding - the parties' inability to establish the optimal organisational structure necessary to limit opportunistic behaviour of the management has the mechanical effect of increasing the investment risk borne by external capital providers. The risk appetite of management companies of venture capital funds is also strongly influenced by the origin of the funds they manage. In this respect, we notice in the U.S. that venture capital funds are funded a lot more by experienced private investors who have made their own fortunes in venture-backed companies. In France, it should be borne in mind that the French public authorities invest in a large number of seed funds as well as, more recently, wealthy individuals who have been attracted by recent tax incentives; and

- *ex post*: a lower return on investment for venture capital funds, as the parties find it more difficult to work symbiotically, leading to an increase in the total weighted average cost of capital for the company seeking financing.

[127] Indeed, we see that U.S. venture capital funds are able to make portfolio companies subscribe to *bullet loans* (amortisable upon maturity date), in order to increase the return on their investment. Providers of venture loans rely on the reputation of venture funds when making their investment decision. Indeed, when subscribing to the loan, portfolio companies have no tangible assets, do not realise operating income, and are not granted any personal guarantee from the management. See D. Ibrahim, "*Venture Capital as Debt*", Legal Studies Research Paper Series, Paper No. 108, available at ww.ssrn.com. In France, the venture loan market is very underdeveloped.

[128] Cf. supra § 114. et seq.

[129] Cf. Supra § 27. et seq.

142. As mentioned above, other reasons may be advanced to explain the differences in practice between France and the U.S.:

- we should not discount cultural factors (greater difficulty in admitting failure, less entrepreneurial culture);

- it is also very important to consider the personal consequences for the management of a liquidation of an individual portfolio company (prohibited from carrying on business, etc.);[130] and finally

- we should consider the difficulty for the parties of putting in place suitable value-sharing agreements (stock options, bonus shares, etc.), due to a restrictive tax policy which is not particularly appropriate for start ups. The optimal organisational structure is indeed based on the idea that the management must have a strong financial incentive to create value.

143. Finally, the legal instability in some regulated areas, such as in the renewable energy sector, also poses significant challenges for investors. They have little incentive to invest sufficient amounts, for fear that the expectations which formed the basis of their initial financial commitments are no longer valid.

PART 4: FUTURE PROSPECTS – TOWARDS AN EFFECTIVE LEGAL SYSTEM IN FRANCE AND EUROPE?

4.1. Consequences of an ineffective Legal System; reduced effectiveness of remedy; approach to Law & Economics

Lack of public awareness on the impact of an ineffective Legal System

144. This analysis of various alternative financing methods to bank credit shows the impact of the misguided approach of the Legal System and, to a lesser extent, the unpredictable bias of courts in interpreting governing statutes. Raising public awareness of the importance of a law adapted to the co-evolution of economy and finance is no easy task. The effects of an ineffective Legal System[131] are less easily perceived than those of a new tax policy.

145. Most market players are only familiar with their own legal environment. Without a benchmark, be it better or worse than their own environment, it is harder to appreciate the importance of an effective Legal System. This is all the more true since the minority of market players regularly exposed to other foreign legal systems – the multinationals – are, because of their size, significantly less likely to be negatively affected by the Legal System's ineffectiveness. Rather, they have easy access to international capital markets and are, therefore, less concerned by these issues (unless they are concerned that they might one day go bankrupt). This outcome, on the scale of a small country like France, remains relatively rare[132].

146. The number of large companies which may one day file for bankruptcy proceedings in France may, in fact, be even smaller due to the fact that large companies with complex balance sheets may be better off by avoiding filling for French bankruptcy proceedings. Indeed, due to the Legal System's inefficiency, in particular its inability to respect the rights of the various classes of

[130] Cf. also § 174 et seq.

[131] A Legal System is considered to be effective when it ensures that the control over the company is with the person whose interests are most aligned with it and who is thus most likely to gain to gain most from the right to exercise such control. See in this regard, "*The economic structure of corporate law*", F. Easterbrook and D. Fischel, Cambridge, Mass.: Harvard University Press, 1996.

[132] The most high profile cases in the past 5 years are those relating to the restructuring of Astom, Eurotunnel and Thomson/Technicolor.

creditor and shareholder, the cost of French bankruptcy proceedings is particularly high for large companies[133]. The length and complexity of Eurotunnel's debt restructuring serves as an illustration (and this is despite the use of the new bankruptcy proceedings, *procédure de sauvegarde*). For large companies with a complex balance sheet, French bankruptcy proceedings can understandably deter potential "clients". Large companies are not necessarily as fortunate as Eurotunnel, which was endowed at the time with monopoly rights on rail transport under the Channel. This situation has made Eurotunnel's turnaround easier despite all the years the company spent restructuring its debt.

147. Additionally, because of the favourable approach of French law towards shareholders, French bankruptcy proceedings are likely to end with the approval of an unsatisfactory *plan de sauvegarde* in relation to the amount of debt to be converted into equity (as in the case of Technicolor, which emerged from bankruptcy proceedings with a CCC rating, below the investment grade level). While they may conduct business in very competitive sectors and/or in an industry that requires significant investment, there is a high risk that these companies will gradually lose competitiveness through a failure to make appropriate use of bankruptcy proceedings. The announcement by the Technicolor syndicate it intends to initiate bankruptcy proceedings in respect of one of its subsidiaries in June, demonstrates the difficulties which Technicolor continues to face, two years after emerging from bankruptcy proceedings.[134] On 3 May 2012, the company also announced that it had negotiated the acquisition of a new equity holding by JP Morgan Chase (subject to shareholder approval) in order to accelerate its debt reduction.[135]

148. Having better benchmarks would make more market players aware of the importance of an effective Legal System. It is important to realise that in France, as in Italy, is it possible to establish a positive correlation between the sector of the econonomy which is financed by the inter-company credit market, and the deficiencies of the Legal System[136]. In other words, French companies rely more on short-term credit, even though it has been shown that long-term financing, in the form of equity or long-term debt, is more likely to fund growth and reduces the cost of capital for businesses[137].

A necessary change of method: an interdisciplinary approach which combines

[133] The term "cost" includes, for present purposes, all direct and indirect costs to the company which result from the application of bankruptcy law. Strictly speaking, the term does not include costs related to lawyers' court fees. Chapter 11 Proceedings are often criticised for being very expensive for the debtor, taking into account the amount of advisory fees involved. However, in assessing the cost of a legal system, it is important to consider all costs, both visible as well as hidden (such hidden costs often being by their nature very difficult to calculate). On this last point, the French system seems to be very costly for the economy to the extent that it prevents companies from accessing certain funding markets.

[134] See Le Figaro, 17 April 2012 http://www.lefigaro.fr/flash-eco/2012/04/17/97002-20120417FILWWW00673-thomson-en-difficulte-a-angers-syndicats.php

[135] See the Company's press release: http://www.technicolor.com/uploads/investor_documents/05_03_2012_jpm_press_release_fr.pdf

[136] See P. Santella, "*The Legal Cost of Trade Credit*", European Securities and Markets Authority, available on the website, www.ssrn.com. See also A. Demirgiiu-Kunt, See Maksimovic, "*Firms as financial intermediaries, evidence from trade credit data*", Policy Research Paper 2696, available on the web site of the World Bank: www-wds.worldbank.org. Economists at the World Bank also came to the conclusion that the importance of inter-enterprise credit in the financing of the economy may be related to the inability of the legal environment to adequately protect the rights of banking institutions. In this respect, please refer to the "Lagarde law" of 4 Aug. 2008, which caps payment delays at 60 days so as to reduce the amount of inter-enterprise credit in France. This is merely a token remedy with limited impact, taking into account the ineffective Legal System.

[137] See A. Demirguc-Kunt & V. Maksimovic, "*Institutions, Financial Markets, and Firm Debt Maturity*", 54 J. Fin. Eco. 295, 321 (1999).

law, economics and finance, working alongside academic research

149. The government's strategy should not be limited to designing an appealing fiscal policy, especially since granting categorical subsidies is also likely to generate uncontrolled consequences, as the *Conseil d'Analyse Économique* has pointed out in past reports[138]. The efforts of the public bank, Oséo, and other public institutions such as the *Caisse des Dépôts* and its subsidiaries[139], as well as the French strategic investment fund (*Fonds Stratégique d'Investissement*) to facilitate the financing of the French economy are laudable. That said, these entities are custodians of taxpayers' money, and are in a situation of information asymmetry (as they are not specialised by industry). They are not able to completely overtake private investors, especially in relation to financing very risky projects. If they decide to invest in such projects, it would at least be preferable that public authorities invest through private investment funds.

150. Legislators must be careful not to resort to token strategies to remedy the Legal System's major shortcomings. Failure to do so is likely to result in an ineffective and confusing law (as exemplified by French insolvency law and the law governing security interests); unintended consequences (as illustrated by the fate of mezzanine debt holders); and high transaction costs (for instance legal fees).

151. Legislators should, in particular, take more care regarding "ad hoc" laws aimed at sanctioning behaviour by market players which, although reprehensible, is statistically marginal. Of course, ideally, it should always be possible to punish "abusive" conduct (provided that it is properly characterised as such). However, there is a significant risk that the cost to the economy of a legislative measure taken in haste may be more significant that the benefit gained as a result of such legislative measure. In the Petroplus case, the French legislator, under pressure from the media and against a delicate political background, passed a new law in less than three weeks[140].

152. Creating an optimal Legal System requires, above all, a better understanding of the law's impact on the availability of external funds for financing the economy. It also requires a more transversal approach to the various problems: on one hand, between the two big areas of law and the economy, and on the other hand, within the various branches of both law and economics.

153. Deputy Warsmman's first recommendation in 2008, after he was commissioned by the French Prime Minister to prepare a report on the quality and simplification of the law[141], was to entreat

[138] Report of the Conseil d'Analyse Economique, "*Private Equity et capitalisme français* ", ibid.

[139] In this regard, we highlight the efforts of CDC Entreprise which invests in medium-sized companies in the form of convertible bonds, to which share warrants are attached (Operation OC+).

[140] See for example, F. Pérochon "*Editorial – De la mesure dite conservatoire à l'exécution sommaire anticipée*." Bull. Joly Entreprises en Difficulté, 1 March 2012, no. 2, p 73. Ph. Roussel-Galle, "*La loi du 12 mars 2012 : halte au pillage des entreprises en difficulté!*", JCP E – No. 12 - 22 22 March 2012. Research in law and economics can help to restrain the legislature from the temptation to react in the heat of the moment. For example, in the 1980s, the U.S. consumer credit lobby tried to change the law which allows individuals to be discharged from the obligation to pay all of their debts in certain circumstances (in particular consumer loans) on the grounds that the system encouraged fraud. Several U.S. researchers and their teams demonstrated that, in fact, the statistics showed that the level of fraud had only increased to 2%. It was decided at that time that such a level did not warrant a change in the law. T. Sullivan, J. Westbrook, E.Warren, "*As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America*", New York: Oxford University Press, 1989 (hard), 1991 (paper), xii + 357 pp. Reprint edition, Washington, DC: Beard Books, 1999.

[141] The report is available on the government portal, www.gouvernement.fr. In his engagement letter addressed to Warsmann, the French Prime Minister started from the opinion that: "*Our country suffers from a normative inflation unanimously denounced by politicians, practitioners, courts and market players. This uncontrolled production of norms harms the quality*

public officers to carry out more impact studies in order to improve the preparation phase of statute enactment. But carrying out impact studies is equivalent to conducting research in law and economics. While it is important for the administration to be more concerned about the impact which the laws it promulgates will have, it is increasingly important that individuals who are independent from the French executive – such as academic researchers - are able to conduct prospective studies on subjects which are important for society. Of Warsmann's 397-page report, the word "Université" appears three times and no academics were interviewed among the sixty-two people contacted. Academic research in social sciences should continue its transformation in order to have more influence in the preparation of statute law.

4.2 A necessary development of, in particular, French insolvency law, French corporate law and French security law in conjunction with the development of the economy and finance

A necessary revision of the law's objectives regarding distressed companies, taking into account financial development

154. In areas such as their relationships with the management and other shareholders (whether minority or majority shareholders), it is legitimate that experienced providers of external capital would rather not be bound by an inflexible Legal System concerned with protecting investors. Indeed, experienced parties would rather choose their own contractual protection mechanisms. However, when the company in which they have invested, defaults, experienced external investors are faced with the prospect of other parties holding claims of a very different nature against the same company (i.e. trade creditors or financial creditors, whether secured/unsecured creditors or junior/senior). In this scenario, the parties should not be able to agree in advance on the law which should apply.

155. In this kind of situation mandatory rules should prevail over the parties' will for several reasons:

- during bankruptcy proceedings there are involuntary creditors which are, by definition, not able to opt into contractual protection mechanisms in advance. A typical example of this is creditors which hold claims against the debtor grounded in tort law;

try as they might, creditors cannot anticipate all the difficulties the company may face. Creditors are therefore unable to predict how to resolve every kind of potential dispute (the most prominent example is the *Coeur Défense* case: a covenant in the loan documentation was breached as a result of Lehman Brothers's demise. Lehman Brothers was, in this case, the contracting party to a derivative contract signed by the borrower;

- in the interests of particular groups (e.g. employees), it is crucial for insolvency law to have at least a nominal principle of redistribution, i.e. it is necessary that the law does not exactly follow the initial order of priority set out in contractual agreements. Indeed, contractual freedom is not an absolute principle[142].

of the legal system, affects the credit of public action, generates costs for the community and is a factor of legal uncertainty. "

[142] However, as mentioned earlier, when a start-up backed by venture capital funds ceases its business activities, mandatory rules are not necessarily the best option to deal with its creditors. The individual portfolio company has few creditors and sometimes the venture capital fund (in its capacity as preferred shareholder) is the only creditor since the fund makes sure it stops the company's business "properly", i.e. by paying for all the claims of all the other non-financial creditors. Besides, all parties, including the management of the venture backed company, are experienced. Their situation is, unlike "traditional employees", i.e. not precarious enough that they should expressly benefit from a favourable treatment. There is therefore no point in imposing a redistributive approach during the disposal of a troubled company's assets. In any event, venture capital funds will try to maximise the asset value of the dissolved company with the assistance of the company's

156. U.S. bankruptcy law seems to proceed on the basis of balanced choices, which are determined taking into account key objectives, (which themselves are sometimes contradictory):

- the necessary enforcement of initial contractual arrangements in order to favour *ex ante* financing of the economy;

- rehabilitating only viable enterprises (and not necessarily their legal entity). This justifies wiping out shareholders / creditors despite some companies' continued existence;

- maximising asset value for the benefit of the debtor's stakeholders. This objective sometimes justifies the parties not strictly following the existing order of priority provided that at the end the parties receive more than they would have had the initial agreements been strictly enforced upon a liquidation of the company. Reaching a settlement faster saves unnecessary costs for the distressed company; and

- the need for insolvency law to serve a redistributive purpose.[143] The issue of the redistributive purpose of the law gave rise to sometimes virulent exchanges in the 1980s between supporters of the redistributive approach and those of the *contractuarian theory* (which is based on strict enforcement of the initial contractual agreements[144]).

157. It goes without saying that no law is perfect and U.S. bankruptcy law is no exception. It would be desirable for the law to improve in parallel with the evolution of finance, which requires a constant adjustment in its practice. Chapter 11 proceedings, as described during the first part of this article[145], evolved while dealing with larger distressed companies. Rather than leading to the borrower's rehabilitation by way of a debt for equity swap, filing for Chapter 11 proceedings increasingly leads to the sale of the distressed company's assets in favour of the most senior creditors (according to the order of priority), under Section 363 of the U.S. Bankruptcy Code[146]. No restructuring plan is approved as the decision to arrange for the disposal of assets lies with the court. The court may reduce the length of Chapter 11 proceedings if it can justify its decision by preserving the borrower's enterprise value.[147] This has given rise to debate.

158. In other situations, the parties' legal advisers have been forced to innovate so that

management. If needed the funds will financially incentivise the management. See David C. Smith and P. Strömberg "*Maximizing the value of distressed assets: Bankruptcy law and the efficient reorganization of firms*",www.sifr.org/PDFs/ smithstromberg(wb2005).pdf p 43. See also, D. Baird and R. Rasmussen, 2001, "*Control rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*", 87 Virginia Law review 921 and D. Baird and R. Rasmussen, 2002, "*The end of bankruptcy*", 55 Stanford Law Review 751.

[143] For certain claims, and in repsect of employees, this redistribution is in favor of the U.S. Treasury. However, such redistribution is restricted as the maximum amount which may be claimed in respect of each employee is $11,725 and there are guarantee mechanisms in place for claims relating to retirement plans.

[144] See for the supporters of the redistributive approach, E. Warren "*Bankruptcy Policy"*, 54 University Chicago Law Review 775-814 (1987). In response to E. Warren, it is worth mentioning D. Baird, "*Loss distribution, forum shopping, and bankruptcy: a reply to Warren*", 75 University of Chicago Law Review 81534 (1987).

[145] Cf. infra § 17 et seq.

[146] It is as a result of Section 363 of the U.S. Bankruptcy Code that the U.S. department of Treasury managed to take over the assets of General Motors only 45 days after the company filed for Chapter 11 proceedings. The U.S. Treasury became the most senior creditor, having providing financing to cover the company's cash needs by way of a DIP loan. See § 108 et seq. See also E. Morrison, "*Chrysler, GM and the Future of Chapter 11".* Working Paper No. 365, 30 Dec. 2009, available at www.ssrn.com.

[147] After the sale of the business has been completed, the Chapter 11 process continues with a view to satisfying the company's liabilities and will distribute the proceeds of sale of the business as the company moves towards liquidation.

an agreement on the restructuring plan could be reached more quickly (again to save costs for the borrower). These innovative tools of practice have at times been dismissed by courts on the grounds that they did not comply with the absolute priority rule, i.e. did not strictly respect the initial agreements. This interpretation of the rule by the courts may have been a little too rigid in the circumstances[148].

159. These developments show the difficulty - even in the U.S. - of adapting the law to the evolution of finance due to the fact, that in large companies, there are numerous classes of creditor / shareholder. Further, the role played by hedge funds in Chapter 11 proceedings is becoming so significant that some commentators have expressed their unease about the fact that Chapter 11 proceedings may have become too creditor friendly[149]. While the arrival of hedge funds is seen as a good thing for improving the liquidity of the secondary market for both bonds and bank loans (in this respect, the mood in France must evolve), it is true that hedge funds are not like other creditors.

160. Hedge funds will not hesitate to demand the management's dismissal, unlike banks. Banks have often built up long-term relationships with the management of the debtor and are usually more conscious of their reputation. As hedge funds are driven by one sole objective - maximizing their investment return - they are more inclined to impose drastic measures on the borrower in order to ensure its recovery. Further, since hedge funds often hold second lien loans (the number of this type of loan has increased dramatically in the U.S.)[150], they are more able to take control of the negotiations. As secured creditors, they are more easily able to bid for the debtor's assets in exchange for a write-off of their claims (a "credit bid") as part of a sale of the business of the debtor, pursuant to Section 363 of the U.S. Bankruptcy Code. This procedure is equivalent in France to creditors foreclosing their security and appropriating the debtor's assets, in a provision called "*pacte commissoire*" (when this is provided for in the documentation). However, contrary to situations that may have developed in Europe, secured creditors in the U.S. may only receive their pledged assets if a court-supervised public auction process has already taken place.

161. Moreover, the prolific use of credit default swaps (CDS) is likely to pose real difficulties. Debt restructuring carried out,

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[148] There is thus currently a controversy in the U.S. on the scope of the "gifting doctrine". The question arose as to whether *senior* creditors (be they secured or not) could voluntarily surrender a portion of the shares that they would have had the right to receive under a restructuring plan, to the shareholders, despite the fact that intermediate creditors had lost all their rights against the debtor. While this innovative tool of practice is important in that it facilitates the successful completion of a restructuring plan (and therefore saves unnecessary costs), two important courts in the U.S. have held the gifting doctrine to be invalid. See H. Miller & R. Berkovich, "*The Implications of the Third Circuit's Armstrong Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?*", p. 1435 American University Law Review (2006) p. 1347. See also the comment made on the DSBD case, R. Berkovich, S. Coelho & D. Kaufman "*2011: A Reminder to Secured Creditors to Take Nothing for Granted*", LSTA Loan Market Chronicle 2012.

[149] See H. Miller, "*Chapter 11 in Transition—From Boom and Bust and Into the Future"*, ibid p. 384. See also D. Baird, "*The End of Bankruptcy"*, 55 STAN. L. REV. 751, 753 (2002) and A. Wood "*The Decline of Unsecured Creditor and Shareholder Recoveries in Large Public Company Bankruptcies"*, American Bankruptcy Journal Vol. 85 (2001) p. 431.

[150] In the U.S., borrowers are increasingly using second lien loans. In Europe, this practice did emerge at the height of the last bull cycle (2007). However, the use of second lien loans in Europe will never be comparable to the U.S., mainly for legal reasons. See C. Wells and N. Devaney, "*Is the Future Secure for Second Lien Lenders in Europe?*", Legal Analysis: [2007] J.I.B.L.R. p. 443 It is worth mentioning that the interest on second lien loans is generally lower for the borrower than that of mezzanine financing, in European LBO transactions. See L. Matalon, E. Tutterow, M. Verde, A. Zaydman "*Overview of the U.S. Second-Lien Loan Market*", Fitch rating 6 February 2006, available at http://people.sternnyu.edu/igiddy/ABS/fitchcdorating.pdf

either before or during bankruptcy proceedings, is based on the premise that when the debtor company is insolvent, the creditors' interest is aligned to that of the business. This assumption challenged as soon as certain creditors (holders of CDS) may be better off if the borrower were to experience a credit event, undergo a restructuring, or default on its loan agreement.

162. U.S. law ought probably to consider further reforms to adapt to the increasingly important role played by hedge funds. Improving market transparency should be considered[151]. Nevertheless, the proposed model seems, so far, the most likely to promote the funding of risky companies and projects. Besides, the advantages of Chapter 11 are not only visible in statistics compiled from court data or from the market (in the case of listed debt). The very existence of Chapter 11 has effects on the *ex ante* financing structure of the U.S. economy and this advantage is very difficult to measure. Chapter 11 favours the proliferation of intermediate securities between the senior debt layer and the ordinary shares, which reduces the cost of credit[152]. In contrast, the ineffectiveness of the French Legal System makes the accumulation of different classes of debt dangerous. This is evidenced by the Technicolor restructuring [153]. The ineffectiveness of the Legal System impedes the access of companies incorporated under French law to specific financing markets. There is extensive literature on this subject which highlights the importance of an effective Legal System and financial markets for business growth[154]. There is likely a positive correlation between the effectiveness of the Legal System in France and France's small number of medium sized companies, compared to Germany, the U.S. or the U.K. Ultimately, it is remarkable that none of the companies in the French CAC 40 are less than 20 years old.[155]

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[151] Calls for a regulation of hedge funds, in particular on the issue of information transparency have been made. See H. Miller "*Chapter 11 in Transition-From Boom and Bust and Into the Future*" ibid p 386 et seq. The author notes: "*As US Chapter 11 is becoming more creditor-friendly, or shall I dare say beholden to the strong lobby creditor interest, Chapter 11 is being seen and will be seen by companies as less of an attractive option*". See also, M. Harmer, "*The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*", 77 Fordham L. Rev. Nov. 2008 p 101. and D. Baird and R. Rasmussen "*Antibankruptcy*" ibid.

[152] However, this statement must be qualified when because of the very complexity of their balance sheets, companies of a significant size are no longer able to restructure easily. The evolution of finance can also lead to an increased cost of bankruptcy proceedings for the borrower.

[153] The terms of the Technicolor restructuring have destroyed any chance that French corporate groups will issue hybrid securities in the future (other than banking institutions). During the Technicolor restructuring, holders of hybrid securities received more favourable treatment than senior creditors. The senior creditors had to accept, despite the violation of the order of priority of payments, a conversion of 45% of the total amount of senior debt into shares. The shareholders were able to retain a 15% stake (with the prospect of receiving an increasing stake in the future through convertible instruments). The rights of holders of hybrid products were preserved because there was a risk that they would block the approval of the *plan de sauvegarde* at the single bondholders' meeting convened for this purpose (senior bondholders were the majority bondholder at such a meeting). On a unilateral basis, it was decided that holders of hybrid products would immediately receive a cash payment of 25 million Euros as a settlement (corresponding to the market value of securities, which also took into account the rights of the holders of the hybrid products to block the restructuring). It was decided that the hybrid security holders would lose any right in the future to receive interest on their debts (the face value of the hybrid securities was 500 million Euros). See A. Pietrancosta, S. Vermeille, ibid p. 11 et seq. The *plan de sauvegarde* was definitively approved by the *Cour de cassation* on 21 Feb. 2012.

[154] See for instance: K. Kumar, R. Rajan, L. Zingales "*What determines firm size?*", working paper 7208, National Bureau of Economic Research http://www.nber. org/papers/w7298. See also B. Black "*The legal and institutional preconditions for strong securities markets*" ibid p. 831. With the benefit of financial markets, companies can have access to external financing and therefore grow more quickly. Financial markets also entice companies to focus on their core business and to depart from the conglomerate model.

[155] This issue has already been addressed in several officials reports in recent years. See, for instance,
C. Picard, "*Le tissu productif : renouvellement à la base et stabilité au sommet*", Économie et Statistique n°371 (2004) : Between the 50 first biggest employers among

163. The idea that France would need to restrain itself from adopting a law which is too favourable to creditors, so as to prevent the improper behaviour of hedge funds (as in the U.S.) is unfounded. Not only can France now not enjoy the benefits of an effective financial system, that is to say the allocation of resources to those who will make the best use of them (due to a failure to distribute the assets of the company according to their valuation). But also, like other developed countries, France is suffering the consequences of capital market imperfections, due to a lack of proper regulation.

164. The restructuring of Technicolor, the most significant in France over the last five years (three billion Euros of debt restructuring), serves as an illustration. The problem of the detention of CDS by the creditors which forced Technicolor to file for bankruptcy proceedings[156] has undoubtedly increased tenfold due to the lack of rational economic sense in French insolvency law.

The law's redistributive objective and, in particular, the fate of employees

165. French insolvency law differs from other applicable laws in jurisdictions with a similar level of development (whether of a Civil or Common Law tradition). French law is the only system which prioritises the preservation of employment as its primary objective. By doing so, French insolvency law takes on a dimension that is too political. The shortcomings of French insolvency law, such as the confusion of the interests of the business and those of the company (and thereby indirectly those of the shareholders) resulted mainly from the legislator's intention to protect employees and jobs in a difficult (1985) economic environment. However, it should not be overlooked that preserving businesses' value, through better management of financial distress costs, will also have the effect of preserving jobs. When the company is insolvent, the interests of the employees are aligned to the business, rather than to the corporate entity and the shareholders.

166. Employees' interests therefore should not automatically be opposed to those of financial creditors whose interests may also be aligned with those of the business. That said, employees' interests may conflict with those of the financial creditors when the company's worsening situation requires the restructuring of all of its debt (not just the financial claims) or, worse, when the situation requires the company to be put into immediate liquidation with all its assets being sold individually on the market. In this case, due to the amount of salary claims which remain unpaid, employees should not be treated merely as unsecured creditors. This is the route that French law rightly follows.

167. For this reason, it is morally desirable to favour employees over financial creditors (which may in any case have protected themselves against the risk of their borrower's default). Moreover, when the company goes bankrupt, employees may suffer additional costs, e.g., costs incurred as a result of a change of location to find a new job. These costs are not taken into account when calculating the amount of their claims as part of the bankruptcy procedure. For this reason insolvency law should have a redistributive purpose. Lawmakers are faced with the challenge of determining the extent to which insolvency law should have such a redistributive purpose[157]. In any event, the

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corporate groups in 2000, 41 were already among the first hundred in 1985 and 8 were created as a result of a spin off or following a merger between two medium sized groups. See also, G. Chertok, de P.-A. Malleray & P. Pouletty, "*Le financement des PME, Conseil d'Analyse Economique*", Rapport no. 83 and, with respect to the reasons explaining the small number of medium sized companies in France, see the thesis of R. Florian "*Trajectoires de croissance et stratégies financières des PME en France*", Université Paris I. (2012).

[156] See A. Pérès, J. Loget : "*Technicolor : Une restructuration riche d'enseignements"*. Bull. Joly Sociétés, 1 January. 2011 n° 1, p. 64.

[157] Furthermore, in France, the Association for the Management of the Guarantee of Employees' Claims

interests of employees should not justify companies' continued existence (contrary to what was implied by the legislator in 1985).

168. Though contractual freedom should not be an absolute principle, the French legislator should better assess the externalities which justify its actions in areas not only such as employment law, but also of environmental law and of the protection of inexperienced investors. The legislator must equip itself with the necessary means to measure the effects induced *ex ante* and *ex post* by its redistributive approach. Preserving the interests of specific creditor classes (especially the interests of employees of the most risky companies) may, for example, conflict with the company's rehabilitation. "co-employment" jurisprudence illustrates this point, as do the decisions made on employees' redeployment in the various portfolio companies of investment funds[158]. A particular effort in social science research is required to help to guide the court and the legislator on this subject.

A more harmonious coordination of insolvency law and Civil Law

169. Were French law to embrace a more economic approach, it would resolve a number of issues that are the subject of much controversial debate in France. Investors consider French insolvency law as a tool that gives the parties too much scope to depart from their initial binding contractual obligations. One might find this discussion somewhat dated. In 1985 the new law introducing the *procédure de redressement judiciaire* (i.e. the first reorganisation proceedings in France) gave rise to heated debate among legal academics on this issue[159]. However, this issue has recently resurfaced in real estate litigation cases in circumstances where preserving the rights of the employers was not an issue (as there were no employees).

170. Despite uncertainty over the scope of the ruling of the *Cour de cassation* in the Coeur Défense Case[160], legal practitioners

(AGS) has been established. This is an employer organised organisation founded on ideas of employer solidarity and funded by employer contributions. It intervenes upon a reorganisation, or liquidation of a company and also sometimes during bankruptcy proceedings. It guarantees payment of the amounts due to employees (salaries, notice payments, severance payments) as soon as possible and in accordance with the provisions of the Labour Code. It then recovers (or attempts to recover) the sums paid from the administrator or the liquidator.

[158] Cf. supra § 99.

[159] Some legal academics took the view that the new 1985 Insolvency Act betrayed the so-called legal liberalism founded on the primacy of contractual agreements and therefore on absolute compliance with *ex ante* rights and the principle of creditor equality (equality of treatment was justified as the authors referred only to the traditional model). They detected a whiff of Marxism in the need to save employment contracts, and saw this as an economic condemnation of capitalism. The laws of 1985 were therefore considered to be a type of revolutionary instrument going against the current evolution towards economic liberalism in France. For a detailed description of this controversy see A. Rizzi's thesis, "*La protection des créanciers à travers l'évolution des procédures collectives*", LGDJ 2007. After this, debate on this question ceased among legal academics. The aim was rather to find the elusive balance between the interests of creditors and those of debtors, instead of calling into question the very foundations upon which "modern" French insolvency law was built. All this despite the fact that "modern law" has moved increasingly further away from any consideration of economic theory, a key principle of which is the allocation of assets to the highest bidder.

[160] *Cour de cassation*, commercial branch, no. 240 8 March 2011 (10-13.988 / 10-13.989 / 10-13.990). For a presentation of the case, see. B. Chopard, S. Vermeille, S. Portsmouth, and L. Gregoire Sainte-Marie, ibid p. 15. See Also JCP E 2011. 1215, A. Couret and B. Dondero ; Ph. Roussel Galle, "*Conditions d'ouverture de la sauvegarde : les textes, rien que les textes*", Dictionnaire permanent difficultés des entreprises n° 324 ; M. Menjucq, "*Affaire Coeur Défense : la Cour de cassation recadre la cour d'appel de Paris sur la notion de difficultés justifiant une sauvegarde* ", Rev. proc. coll. 2011, repère 2 ; B. Saintourens, " *Conditions d'ouverture de la sauvegarde : la Cour de cassation fait le maximum*", Lettre d'actualité des Procédures collectives civiles et commerciales no. 7, April 2011, repère 106 ; L. Arcelin Lécuyer, "*Procédure de sauvegarde et concurrence : le divorce consommé (à propos de l'affaire « Coeur Défense »)*", D. 2011. 1441; Ph. Pétel, "*Sauvegarde, redressement et liquidation judiciaires des entreprises*", JCP G n° 21, 23 May 2011, 627.B. Grelon

consider that the court's ruling renders contractual protection mechanisms stipulated in the loan documentation virtually useless. In particular, the decision calls into question the appeal of financial covenants intended to empower creditors to force the management and shareholders to deal as early as possible with the debtor's financial difficulties.

171. Relying on the ruling of the *Cour de cassation*, shareholders are able to use the law to their own advantage. This is even easier since filing for bankruptcy proceedings entails no detrimental consequences (except possibly for shareholders and management, which may suffer reputational damage). Indeed, the value of the Coeur Défense Tower has not really been affected by the debtor's filing for bankruptcy proceedings. Ultimately, the court's ruling ensures the Double LuxCo Technique's[161] sustainability for a long time to come. Such a decision will only be welcomed by the intermediaries (legal advisers).

A hoped-for revival of the French law relating to security interests over assets which are essential to the company's business

172. Were insolvency law to be improved, several types of security, in particular those taken over assets which are critical for the conduct of the company's business, would once again become effective. This type of security could therefore be used once again in legal practice. For example, the pledge over the *fonds de commerce* could come to be used in the same way as the floating charge is used in English law, (subject to some changes being made to the law).

173. Other reforms would also be possible if there was to be a change in the approach taken by French insolvency law. There would be less need for structural subordination mechanisms in financing transactions and high yield bondholders or mezzanine debt holders would not need to demand security. As a result, the second lien loan market would almost certainly take off in Europe at the expense of the mezzanine debt market, thereby reducing the cost of capital for corporate borrowers. Indeed, we can observe that, although second lien debt was able to develop at the height of the last bull market, it has virtually disappeared since that time.[162]

Coordinating more harmoniously the law dealing with protecting creditors and that which protects entrepreneurs

174. Improving the law which regulates the protection of external capital providers does not necessarily have to be carried out at the expense of entrepreneurs: in fact, it is rather the contrary. In this area, the French legislator really ought to reconsider its current strategy in order to more adequately encourage entrepreneurship. The law which protects entrepreneurs should not lead to the creation of a full shield against creditors prior to entrepreneurs being able to obtain any funding. The failure of the *Entreprise Individuelle à Responsabilité Limitée* (EIRL)[163] illustrates that the legislator cannot force financial creditors to become irrational

"*La loi de sauvegarde prise à la lettre, à propos de l'arrêt Cœur Défense*", Revue Sociétés 2011 p 404.

[161] Cf. supra §43 and §77.

[162] Cf. supra § 158.

[163] The law establishing the EIRL was enacted in 2010. It is a legal status conferred on individuals. The EIRL is intended to allow any entrepreneur, who has been conducting a business, craft, agricultural or liberal activity, regardless of its turnover, to protect his/her private assets from the risks associated with his/her business activity, especially in the event of bankruptcy. The law provides that the assets associated with the business activity of the individual should be artificially separated from the other assets of the entrepreneur. Trade or financial creditors may have claims over the assets associated with the business only, while other creditors (for instance as a result of consumer activity) cannot have any claims over the assets associated with the business. While access of entrepreneurs to credit is already reduced when they are solely and personally liable for all the liabilities of their company (based around the owner-entrepreneur's human capital), this fiction of the law (i.e. the EIRL) is very likely to lead to even stronger credit rationing.

market players. A bank is not supposed to lend money to someone who has no assets, as it is important to reduce at least the risk of moral hazard. It is therefore not surprising that the stated objectives of the French Government, in terms of application to EIRL status, were not completed[164].

175. It would instead be more appropriate, following the example of U.S. law, to consider downstream protection mechanisms for individuals where the risk of the entrepreneur defaulting becomes reality. Entrepreneurs should be able to file for a single bankruptcy proceedings, which would deal with both business and consumer claims faced by the entrepreneur (especially since consumer claims may be linked to the entrepreneur's difficulties related to his/her business). As part of such bankruptcy proceedings, necessarily judicial in nature (i.e. not administrative), individuals may have the choice to demand a write-off of part or all of their debts, provided that the rights of the secured creditors are preserved to a minimum level[165]. Moreover, a number of administrative and criminal sanctions seem unnecessary in view of containing the risk of opportunistic behaviour by the management of a company put into liquidation. Amendments to these measures should be contemplated.

4.3. An imperative change of direction in the European Union's strategy dealing with protecting investors

The need for a harmonisation of insolvency law at the European level.

176. It is critical for the French legislator to realise that adapting the law to the evolution of economy and finance solely within France will not be sufficient, as a result of the economy's increasing globalisation. France suffers a handicap, just like the other Member States of the European Union in that the size of its internal market does not facilitate the development of financial markets that meet international liquidity standards, as illustrated by the local high yield bond markets (such as in Germany, described above[166]).

177. Developing financial markets similar in size to those of the U.S. is necessary in order to maintain the future competitiveness of European Member State economies. To achieve this goal, a unified insolvency law should apply throughout the European Union. The European legislator therefore must go further than merely harmonising rules on conflicts of law and jurisdictional conflicts, as is currently contemplated in the consultation recently launched by the European institutions on the revision of EC Regulation 1346/2000.

178. Neither an argument based on cultural differences between Member States, nor one based on the differences between the legislative systems (Civil Law tradition) and the spontaneous creation of legal norms (Common Law) seem relevant. In the 19th century, the substantive rules of French and English insolvency law were much more similar than they are today[167].

179. The most political aspects of insolvency law relate to determining the extent of its redistributive purpose. Taking into account insolvency law's other objectives, these policy aspects should not themselves impede negotiations towards the

[164] Six months after the enactment of the law, only 2,000 entrepreneurs elected to receive such status (the Government had anticipated 200,000 EIRLs by the end of 2012).

[165] The legislator would need to determine the amount below which creditors can no longer seek repayment (i.e. minimum living costs). The legislator should be careful to not unduly favour homeowners compared to other individuals who may have chosen to invest their savings in a company instead.

[166] Cf. supra § 57.

[167] See on this subject, P. Di Martino and P.-C. Hautcoeur "Insolvency law and practice in historical perspective: A European comparative view (C.1880-1913)", available at http://www.parisschoolof economics.eu/IMG/ pdf/DiMartino-Hautcoeur_feb2011. pdf.

harmonisation of substantive rules. If necessary, it may be possible to leave the extent of the law's redistributive purpose to the discretion of Member States. This should not affect the formation of liquid financial markets on a European scale.

180. Harmonisation is feasible only if the judiciary is reformed in parallel. The rapid establishment of specialised courts, which would decide all cases of a significant size, would to a great extent, solve the problem of uncertainty which is inevitably linked to any major legal reform. The argument that reform in the near future is not an option, because French bankruptcy law has already changed significantly, seems difficult to accept. In any event, French bankruptcy law has already created a significant climate of insecurity. Whether or not yet another reform of the (very imperfect) tax system is appropriate is a very different one indeed.

181. It is also important to bear in mind that a policy of gradual or piecemeal substantive rule harmonisation, for example through a revision of EC Regulation 1346/2000, is dangerous as it is likely to have significant uncontrolled effects, as shown by French experience. The authors have long been of the opinion that the *procédure de sauvegarde* was a "*Chapter 11 à la française*" i.e. a Chapter 11 in the French vein, because the criteria for filing the two procedures were similar and because the management was authorised to continue running the company during the process. The "dynamic" of negotiations between the parties resulting from the application of, on the one hand, French law and, on the other hand U.S. Law, is, however, obviously totally different.

182. Harmonising the law in this area would also allow the European legislator to better control the consequences of some of its initiatives, which are laudable in principle, such as the enactment of a specific regime for financial guarantees. This specific regime was intended in principle to reduce the systemic risk involved in derivatives markets[168]. Yet it is on the basis of this European Directive that Luxembourgian law has now become a haven for French senior lenders[169].

183. A simple and direct transposition of U.S. bankruptcy law is obviously not the solution to remedy all the problems with the French legal system (nor even those of its neighbouring jurisdictions). It is important to take into account local particularities when attempting to reproduce the legal system of one jurisdiction into another[170]. This state of affairs certainly means that harmonisation at a European level will be a delicate exercise. However, harmonisation will not be impossible, provided that the relevant judicial institutions are also fundamentally reformed in parallel.

A necessary revision of the E.U.'s strategy on the harmonisation of company law

184. As each Member State's law recognises the existence of an implicit contractual relationship between the shareholders and the company, the "*contrat social*", harmonising the insolvency laws of the Member States becomes much more important than harmonising corporate law. It is worth mentioning that in each Member State:

- shareholders exercise their control over the business of the solvent company *vis-à-vis* third parties, through the management that they appoint since, as they are the residual owners of the company, they benefit from the marginal profit after the payment of all claims;

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[168] Cf. Directive 2002/47/CE of the European Parliament and the Council of 6 June 2002.

[169] Cf. supra § 77.

[170] On the issue of transplanting a law into a foreign jurisdiction, see D. Berkowitz, K. Pistor, J.-F. Richard, "*Economic Development, Legality, and the Transplant Effect*", November 1999, available at www.ssrn.com

- in exchange, the shareholders are the first to absorb losses, as they are only entitled to receive the residual value of the assets after payment of all the claims upon liquidation of the company.

185. Therefore, the harmonisation of company law, that is to say of the rules governing the relationship between the management and shareholders, should not be such a priority. This is made evident by the relative failure of the SE (European Company)[171].

186. There can certainly be differences between Member States as to the scope of the protection for minority shareholders. There will also be some differences as to the rules under which the company functions. However, these differences are not so critical from the point of view of experienced providers of external capital and are, therefore, not so detrimental to the financing of the economy. From the perspective of experienced investors, the judge's ability to enforce contractual agreements agreed to by the parties (including the articles of association), seems more important.

187. One may therefore question the relevance of European institutions' strategy of focusing on the harmonisation of corporate law (through various European directives), which also leads to increased inflexibility of French law in this matter[172]. By comparison, the U.S. left each states to organise itself competitively in this area (the winner being the State of Delaware). The U.S. has concentrated its efforts on providing a single law – at a Federal level – to deal with firms in financial difficulty.

188. A shift in European policy is already underway. Regarding a policy of forced harmonisation, there has been a general shift towards the establishment of a body of law which is applicable by default. This shift should be accelerated[173]. French lawmakers, in conjunction with European authorities, should allow the parties to derogate from the governing statute in relation to the protection of holders of securities. Securities law at a European level would then fully take over in order to protect inexperienced investors. The scope of securities law should therefore not be limited to matters concerning market transparency. Reflection is also necessary as to whether rules should be retained relating to governing legal capital (a fixed registered capital) for European corporations. However, this reflection cannot develop while the issue of the harmonisation of insolvency law is not also reviewed in parallel. These two branches of law must evolve in a co-ordinated manner[174].

4.4. A necessary transversal economic approach (macro and micro) when

[171] Cf. Council Regulation (CE) 2157/2001 on the Statute for a European Company (SE). Indeed, the European Company has been very little used in practice, please refer to the report "*Reflection Group on the future of EU company law*", (2011) available on the website of the European Union: www.europea.eu.

[172] Cf. Secondary Directive 77/91/CEE du Conseil, du 13 décembre 1976. See for instance, J. Armour, « *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?* », 63 *MLR* (2000) p. 355; L. Enriques and J. Macey, « *Creditors Versus Capital Formation: The Case against the European Legal Capital Rules* », 86 *Cornell LR* (2001) p. 1165; P.O. Mülbert and M. Birke, « *Legal Capital – Is There a Case against the European Legal Capital Rules?* », 3 *EBOR* (2002) p. 696; J. Rickford, ed., « *Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance* », 15 *EBLR* (2004) p. 919; W. Schön, « *The Future of Legal Capital* », 5 *EBOR* (2004) p. 429; E. Ferran, «*The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union* », ECGI Law Working Paper No. 51 (2005).

[173] See, for example, G. Hertig and J. A. McCahery, "*Optional rather than Mandatory EU Company Law: Framework and Specific Proposals*", ECFR 2006, 341-362.

[174] In its communication of 7 December 2011, "*Action Plan to Improve access to finance for SMEs*", the European Commission envisaged a number of finance law measures (as with prudential standards) designed to facilitate the financing of smaller companies.

assessing the impact of the Legal System's ineffectiveness

189. It goes without saying that the ineffectiveness of the Legal System entails consequences from a macro-economic perspective. Transversal issues which are critical to the functioning of the economy and the security of the financial market deserve to be better addressed in this respect. Among others, they relate to the following:

- maintaining (or amending) laws which restrict companies' access to credit financing; for instance the law conferring upon banks monopoly rights over credit transactions (for the reasons mentioned above[175]). Without pleading for thoughtless mimicry, the fact that France has a unique regime in Europe should give the French Government even more pause for thought;

- dealing with troubled banks and insurance companies. The risk of moral hazard is not limited to opportunistic behaviour on the part of officers of credit establishments *vis-à-vis* taxpayer's money. The interest in having an effective Legal System when dealing with institutions the failure of which could cause systemic risks must be better understood by public authorities. Furthermore, it seems desirable for efficiency and predictability in our legal system that any system of *ad hoc* treatment of European bank failures should rely on a common set of rules for corporate failures;

- The possible worsening of problems linked to the sale of significant assets by banks, due to the Legal System's preference for shareholders. Unless they can hope to recapitalise on good terms, French banks (as well as other European banks) will want to sell their assets in order to be able to conform to new prudential rules and to adapt to the current economic climate. In its latest report, the IMF highlighted significant risks to the stability of financial markets and to the financing of the economy which are posed by the simultaneous sale by many European banks of their assets for reduced prices. The deficiencies of the various Legal Systems are likely to increase this risk; and

- the need for a better alignment of prudential regulations, not only to the risks posed by banks and insurance companies for the security of financial markets, but also (and especially) to the risks actually borne by these entities which must comply with prudential norms. It is possible to contemplate prudential regulations that are less costly to the economy provided that regulators and the entities which enforce prudential norms have a better understanding of the extent of the loss borne by the investors in the event that the debtor defaults (and therefore of the effectiveness of the Legal System). The multiplication of specific favourable treatments (such as the one which benefits covered bonds[176]) is not wholly a desirable solution. The regulator cannot inherently know all the investment techniques that may justify preferential treatment regarding prudential rules. An effective Legal System would avoid a prudential regulation system which proceeds from a multiplication of casuistry measures that unnecessarily complicate the regulatory environment.

PART V: THE JUDICIARY AND LEGAL INSTITUTIONS AND THE CHALLENGE OF DEVELOPING FUNDING MARKETS

[175] Cf. supra § 115.

[176] Cf. supra § 68.

190. However effective the law may appear on paper, is not sufficient to guarantee market players an environment which is favourable to funding market development or to private equity. The ability of the judiciary to enforce the law is absolutely crucial in this regard. Russia offers a good example in this respect. Russian company law contains a number of procedural rules which, on paper, seem likely to prevent the most complex crimes, such as insider trading. However, the Russian corporate law is regularly ignored, to a large extent due to the high levels of corruption within the Russian judiciary[177]. However, proportionately speaking, foreign investors' confidence in French courts is limited[178].

5.1 Independence, expertise and the effectiveness of the judiciary

191. A suitable judiciary is one in which the judges (i) are honest, which implies that they must be paid enough to remain independent and that they must not have any conflicts of interest, (ii) have sufficient expertise, (iii) are likely to respond quickly with preventative measures when necessary, and (iv) make decisions based on sound reasoning and in good time.

[177] Ibid.

[178] To illustrate, when drawing up the restructuring plan for the Eurotunnel Group in 2006, Eurotunnel bondholders demanded that the mandatorily convertible bonds redeemable in shares ((*Obligations Remboursables en Actions* or ORA), which they were due to receive in exchange for their bonds as part of the restructuring plan would be issued by a company operating under English law and incorporated for this sole purpose (Eurotunnel Group UK Plc); and that the bonds would be subject to English law. Although (i) these ORA were convertible into shares issued by the new French listed company, the parent company of the group (Groupe Eurotunnel SA); and (ii) the terms of these ORA were exactly the same as they would have been had they been governed by French law, as the provisions of French law were replicated in the bond's indenture (with the exception of the provisions of French insolvency law), the bond creditors were worried about the approach of French Courts and the uncertainty as to whether the contractual documentation and the bond indenture would be enforced.

192. If the French Government was more supportive of the judiciary, by giving it the resources to achieve its ambitions, it would certainly facilitate a better reception by the courts of these technical subjects. In this respect, on 25 October 2010, the European Commission for the Efficiency of Justice (CEPEJ) unveiled its comparative report on European judicial systems[179]. While two years ago France was ranked 35th among the countries of the Council of Europe for its allocation of the total public budget to the judiciary (courts, prosecution and legal aid) in proportion to its Gross Domestic Product (GDP) per capita, it has now fallen two places and is 37th of 43 countries (behind Azerbaijan and Armenia).

193. The issues which are likely to be brought before courts in civil, commercial or criminal cases[180] require solid knowledge in economics and, in particular, in finance. When dealing with distressed companies, such is the level of complexity of the cases involving larger companies, that they require the constitution of specialised courts along the lines of the competition law model (and ideally at a European level for the reasons outlined above[181]). For example, in the U.S., when dealing with distressed companies, cases are handled at first instance by specialised courts. Indeed, the courts of Delaware and the Southern District of New York have developed special expertise in dealing with the problems of very large companies. Furthermore, the judges themselves have virtually all previously practised as lawyers prior to entering judicial office.

194. Furthermore, the judiciary must be appropriate for the subject matter, as with the professional world, in order to be able to keep

[179] Available at www.coe.int

[180] See Th. Marembert, "*Transfomer la justice pénale",* in "*80 propositions qui ne coûtent pas 80 milliards"*, ibid p 41.

[181] Cf. supra § 176.

up with practice, but also to be able to make their position known in judgments using accurate and reasoned arguments. A significant number of judgments of the *Cour de cassation* are, in this respect, not sufficiently clear and do not provide sufficient reasoning for the purposes of practitioners. The procedurals rules used by the *Cour de cassation* to set aside rulings rendered by appealing courts, seem unnecessarily complex when compared to the stated objective. Moreover, judges are suspected of deliberately making their decisions unclear, in order to hide their reservations, when faced with a law which seems inappropriate. Judges also hope to avoid contradicting themselves in the future too conspicuous a manner.

195. Turning to the specific situation of the *Tribunaux de Commerce*µ (commercial courts) comprising judges who are not members of the judiciary* (but rather lay businessmen elected by their peers), the controversy continues. Already in 1998, MPs argued that these courts were proof "*of bias, delay, denial of justice, or, worse, in some cases - of impropriety*".[182] The *Conseil constitutionnel* (i.e. the French Constitutional Court) has recently, in a decision of 4 May 2012[183], held that the rules relating to the appointment of lay judges to commercial courts, and those who oversee disciplinary proceedings against them, are constitutional. At the public hearing, the lawyer for the applicants had pointed in particular to the issue of competence of such judges. There is no established review procedure and the only requirements to become one of these lay commercial judges relate to age and length of service.

196. It is regrettable that the *Conseil constitutionnel* was not a little more daring, given the difficulties related to the composition of lay courts, particularly in the field of bankruptcy law with complex balance sheets. This being said, the accusations made against the commercial courts in this area, should take into account that, once a liquidity crisis has been declared, the law grants a judge the discretionary power to decide what happens to the assets of the distressed company, without any consideration of the value of the business, and thus of the value of the assets. History teaches us that a market that is not yet regulated by price (in this case the price of the distressed company's assets) is necessarily not transparent and is thus less liquid[184].

The judiciary and the predictability of judicial decision-making

197. The predictability of judicial decision-making and respect for contractual agreements are essential for the development of financial markets[185]. On this subject, Common Law

* Note: *Tribunaux de Commerce* are the lower courts of the *Ordre Judiciaire* which deal with cases involving companies and businessmen.

[182] Extract from a report issued on 3 July 1998 by the Parliamentary Commission of inquiry chaired by F. Colcombet on the activity and functioning of commercial courts, (rapporteur A. Montebourg). The investigation report is available on the website of the Assemblée Nationale, www.assemblee-nationale.fr

[183] Decision No. 2012-241 QPC of 4 May 2012, available on the website of the Conseil constituitionnel www.conseil-constitutionnel.fr. Regarding the principles of impartiality, the independence of the judiciary and the separation of powers, the judges were of the opinion that the provisions of the Commercial Code relating to the appointment of these judges "*established safeguards prohibiting a judge of a commercial court from involvement in reviewing a case in which he has an interest, including an indirect interest*".

[184] If the composition of the commercial courts is effectively a handicap when it comes to dealing with large distressed companies, it is primarily the lack of confidence shown by the legislature in the market that is responsible for the criticisms which have been addressed to commercial courts. Ultimately, the remedy which was used by the government, which consisted of increasing the role of prosecutors (professional judges) in bankruptcy proceedings, is of limited value.

[185] In this area, researchers have demonstrated that there is a positive correlation between measures taken to improve the predictability of legal decisions and respect for contractual agreements on the one hand, and GDP per capita in a given country on the other. Conversely, the level of corruption is negatively correlated with GDP per capita. See, for example, D. Kaufman, A. Kraay & P.

benefits from a comparative advantage and succeeds, as a result of superior reasoned arguments, in being more predictable, while remaining flexible faced with developments over time. Lower courts must follow the legal reasoning of higher courts by virtue of the system of precedent, although they may reach a different decision when faced with different facts[186].

198. However, it would be a mistake to infer that Common Law courts always render predictable judgments. In the bankruptcy arena, the U.S. practice must be ingenious in order to adapt to financial developments. Therefore, it is not uncommon that U.S. practice develops in areas ungoverned by any specific legal rules and that, eventually, tactics employed in practice are defeated by court rulings[187]. However, higher courts seem overall to maintain a high level of consistency and coherence in judicial decision-making.

199. By contrast, in France the lack of overall consistency, in particular of the lower court decisions of the *Ordre Judiciaire*, is notable. The concern of the judges, in particular those of the *Conseil d'Etat**, to ensure legal security is nonetheless very real[188]. However, the *Cour de cassation* is keen to ensure compliance with Article 5 of the Civil Code which prohibits courts of the *Ordre Judiciaire* from expressly referring to other courts' decisions as a source of law in judicial decision-making (the "*prohibition des arrêts de règlement*")[189]. Furthermore, the *Cour de cassation*'s decisions are not very detailed.

200. French Courts of the *Ordre Judiciaire* seem no more to anticipate the consequences of their rulings at a macro-economic level (and in particular with respect to the development of the financial markets), than the French legislator seems to anticipate the

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Zoido-Lobaton, "*Governance Matters*", (World Bank, Policy Research Working Paper 2196, 1999).

[186] In addition, a number of studies show that Civil Law jurisdictions are disadvantaged compared to Common Law jurisdictions by virtue of their more obvious respect for formal rules, which generates unnecessary costs for litigants. See in this regard, S. Djankov, O. Hart, C. McLiesh, A. Shleifer, "*Debt Enforcement Around the World*", Working Paper 12807, December 2006. http://www.nber.org/ papers/w12807

[187] See R. Berkovich, S. Coelho and D. Kaufman ibid. In the U.S., a number of key court decisions in 2011 illustrate that parties cannot completely rely on existing precedent, as it is subject to constant change, in particular, in the bankruptcy arena. When the courts finally do weigh in, they sometimes make bold, unpredictable decisions that fundamentally change existing assumptions. At other times, they make their decisions incrementally, in cases that leave significant questions unanswered and room for additional developments. The analysis of American jurisprudence in this area reinforces the idea that the French legislator must confine itself to developing a limited number of strict rules which establish the main principles. A great deal of flexibility must be left to courts, which need to be more specialised than they are today.

*Note in France, legal actions involving the state and other public entities (such as cities, provinces, etc.) are dealt with by the courts of the *Ordre Administration* under the supervision of the *Conseil d'Etat*. Other cases are brought before Courts of the *Ordre Judiciaire* under the supervision of the *Cour de cassation*.

[188] Under French law, predictability and legal certainty remain unknown principles. However, there has long been a desire to have predictable laws. See in this respect A-J Kerhuel and A. Raynouard "*Measuring The Right To The yardstick of legal*", Georgetown Business, Economics & Regulatory Law Research Paper No. 10-12 July 2010. The authors indicate that recent court decisions have shown a dramatic shift towards a proper recognition of the concept, as evidenced by the consecration of a "*principle of legal certainty*" by the *Conseil d'Etat* in the KPMG case CE, ass., March 24, 2006, KPMG, No. 288460 rec, p. 154. AJDA 2006, p. 1028, chron. C. Landais and F. Lenica. These developments go hand in hand with the development of European law, which provided a real legal basis for the principle of legal security. ECJ April 6, 1962, De Geus in Uitdenogerd C / Bosch (Case 13/61, Rec. P. 89), as well as the principle of legitimate expectation which is a corollary. June 7, 2005, VEMW (C-17 / 03 Rec. PI - 4983); rappr. M.-H. Planchon, "*The principle of legitimate expectations before the Court of Justice*", Law Review Prospective, 1994, No. 2.

[189] See Civ. 2nd 8th July 2004 Bull. civ. II, n°361; RGDA 2004. 933, note Kullmann. One may regret the too general statement of the Court of Cassation according to which, "the requirements of legal security and the protection of legitimate expectations would not devote a vested law to a constant jurisprudence, as it is Courts' role to evolve jurisprudence by enforcing the law."

consequences of the laws it enacts. The adoption by the courts of the *Ordre Judiciaire* of a more economic approach to the law should reduce the number of purely opportunistic judgments. Knowledge by courts of economic concepts, such as moral hazard, opportunistic behaviour, information asymmetry and adverse selection is likely to improve the predictability of their decisions and to reassure market players about the risk of incurring tort liability.

201. As an illustration, neither directors in law nor in fact should incur tort liability upon the company's liquidation, and creditors should not incur tort liability for having artificially maintained the company's existence (which is possible despite recent improvements to the law[190]), unless it is first shown that they behaved opportunistically to the detriment of a class or several classes of clearly identified creditor. The risk of "deep pocket litigation" which is harmful to the development of both the financial markets and the private equity market, would thereby be reduced.

202. A real effort from the courts, in particular in areas such as employment law is hoped for[191]. Furthermore, the *Cour de cassation* should also abandon the distinction that it intends to establish, between decisions that court publishes in its official journal (the so called "*arrêts de principe*" i.e. the decisions which can be used as precedents) and those decisions which are not published (as they should not be used as precedents, the so-called "*arrêts d'espèce*"). Decisions which are not intended to be used as precedents according to the *Cour de cassation* will nevertheless have addressed very significant substantive issues[192]. It is illusory to believe that practitioners will not focus on this type of decision on the basis that these decisions are not published in the official journal, not least because everyone can access them online. The legal consequences associated with difficulties resulting in excessive debt or the financing of innovation will not have beneficial effects for French growth without a pragmatic approach to these issues[193].

CONCLUSION

[190] Ordinance n°2008-1345 of 18 December 2008 - art. 129. When a *procédure de sauvegarde, de redressement judiciaire, de liquidation judiciaire* is filed, creditors may not be held liable for harm in relation to credits granted, except in cases of fraud, indisputable interference in the management of the debtor or if the guarantees obtained for the loans or credits are disproportionate.

[191] In an article published in the *Droit Social* review (November 2005 p. 951), the former chairman of the *Cour de cassation*, Canivet, summarised this situation as follows: "*Is the impact of economic factors on employment law a social taboo? At first glance, it may surprise a lawyer (and even more so a lawyer specialising in employment law): insofar as employment law is an autonomous discipline and is taught as such, it is in effect built around the concept of a law designed to protect the worker. The subject can equally be regarded with disbelief by economists: specific legislation, which is often passed following major collective disputes with the aim of achieving social progress, as well as the courts, have favoured the emergence of legal concepts with a social purpose. Such legal concepts are generally criticised by economists. They are perceived as factors which are regarded as capable of disturbing the labour market*."

[192] Note that in a judgment of 25 October 2011 (which was not published in the official journal of the *Cour de cassation*), the court upheld the decision of the *Cour d'appel* which imposed a penalty upon an officer for having offered to the shareholders a distribution of dividends, which distribution contributed to the company's liquidity crisis. Cass. Com, 25 October 2011, Sorim, Bull. Joly Soc. 1 March 2012, No. 3, pp. 243. This decision is highly questionable in many respects. Imposing liability on a particular officer was excessive in this case, given that the officer probably acted upon the instruction of fund shareholder. In reality, it is regrettable that French bankruptcy law (in contrast to U.S. law) does not permit the liquidator to recoup from shareholders any sums paid after the company became insolvent. This issue will be the subject of a later article.

[193] Other institutional factors are equally essential for the development of financial markets, such as: an effective regulator, the existence of sufficiently competent intermediaries, investment banks, auditors and law firms as well as the potential for incurring liability for breach of the rules. See B. Black, "*The legal and institutional preconditions for strong securities markets*", UCLA Law Review, ibid p 826.

203. It is critical that governments realise that the questions raised in relation to the Legal System go beyond the issues which arise when companies go bankrupt or which are related to the LBO maturity wall. The Legal System has an impact particularly on the financing of risky projects and companies, and thus on the competitiveness of the French economy.[194] A fundamental reform of the judiciary is also necessary.

204. In addition to the disadvantage borne by small and medium sized enterprises ("SMEs") because of the trend of the "flight to quality"[195] observed since the explosion of the financial crisis in 2008, there is also a penalty related to the climate of legal uncertainty. In France, we tend to forget that offering a creditor (effective) security is, from an economic standpoint, a way for SMEs to reduce the difficulties resulting from a situation of information asymmetry that a bank might find itself in. The transfer of pledged property can indeed prevent the bank from embarking on a study of projected future cash flows of the company when it is not able to recuperate the cost of this due to the risk of anti-selection[196].

205. Hit hard by the economic and financial crisis and required to meet the challenge of a global race for innovation, France and Europe must promptly reorganise their legal systems in order to improve the financing of risky companies and projects. Otherwise, the risk of a Lost Decade in Europe should not be underestimated. We could end up in the wake of Japan, which is still recovering from the burst of the speculative bubble of the early 1990s.

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[194] It is hoped that in the future, research in social science in France will develop sufficiently such that the arguments presented in this article can be supplemented with robust statistics, which are now unfortunately lacking due to a lack of resources.

[195] The explosion of a financial crisis like the one we have witnessed automatically entails the payment of an external finance premium. This premium results from the increasing climate of uncertainty in the markets and increasing problems of information asymmetry. Banks reduce the portion of funding allocated to uncertain projects, require increased surveillance, and prefer to take refuge in more secure projects for which the agency risk is less likely (mainly projects from large companies). This movement of the "flight to quality" implies a marked asymmetry in the effects caused by the financial crisis according to company size. See "*Transmission d'un choc financier à la sphère réelle : le rôle de l'accélérateur financier*", C. Dolignon and F. Roger. Amundi Working paper # 4 - January 2010, available at www.amundi.com.

[196] See M. Manove, A. Padilla, M. Pagano "*Collateral vs. Project Screening:A Model of Lazy Banks*" CSEF Working Paper n°10, available on the website ssrn.com.