



Reforming French Bankruptcy Law

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Financial debt is the primary source of external funding for firms. When an indebted firm appears to no longer be in a position to meet its commitments, its debt must be renegotiated and the firm can be liquidated. This process is carried out by a judge and governed by bankruptcy law. The terms by which corporate failure is managed are a matter of key importance for French firms. On the one hand, they should enable financially distressed firms to quickly restructure their operations with the aim of efficiently redeploying their resources and their human capital. On the other hand, the initial expectations of potential lenders with regards to dealing with any potential default on the part of a firm are an important determinant of credit supply.

French bankruptcy law is very unique in terms of international comparison due to the low level of protection afforded to the interests of creditors in relation to those of other stakeholders, and shareholders in particular. We believe the unique nature of the French situation is detrimental to firms' financing capacities, particularly where small and medium-sized firms are concerned, and thus *in fine* to employment. We would therefore recommend that bankruptcy law be controllably developed to provide better protection for creditors, as inspired by the procedures currently in force in the United States.

Our recommendations are based on three key aspects. Firstly, the priority currently placed on protecting employ-

ment in the case of collective proceedings would appear to be counter-productive. The consequences of firm restructuring initiatives, which can be devastating as far as employees are concerned, must be taken into account by tools other than the often pointless pursuit of activity at all costs. We would suggest that the maximization of the value of the firm's assets be made a matter of top priority.

Secondly, we would recommend redressing the balance of bankruptcy procedures in favour of creditors. We would recommend making it possible for them to control the duration of such procedures, giving them the option of quickly rejecting restructuring plans put forward by the debtor and submitting counter-propositions that might force the dilution of shareholders (by converting debts into shares, for example). We would recommend that the judge not be able to approve a plan without sufficient support from the impaired classes of creditors –those whose claims are partially but not entirely covered by the assets available in accordance with the plan.

Finally, we believe that introducing professional judges at *nisi prius* is not a suitable way of remedying the malfunctions highlighted in commercial courts given their distance from the world of business. We would encourage a reform of the status of elected judges, their obligations with regards to legal training and the handling of any conflicts of interest. We also suggest various avenues of reform for the profession of bankruptcy trustee.

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Introduction

The debt agreement is a financial transaction whereby a lender transfers resources to a borrower resulting in a debt, meaning a commitment on the part of the borrower to repay certain pre-determined amounts by pre-determined dates in the future. The borrower is said to be defaulting when he is no longer able to honour this commitment or intentionally renounces it. In the event that a firm is failing, the commercial court judge will decide, on a case-by-case basis, whether the debt should be restructured (by extending the term or reducing the amount of the debt), possibly combined with the transfer of part of the firm's activity, or whether the firm should be liquidated, meaning that its various assets, including property, equipment, patents, etc., will be sold off. This procedure is governed by bankruptcy law,¹ which, in the case of France, treats creditors relatively unfairly in relation to other countries. We believe that this characteristic of the French system should be corrected for two reasons, these being, on the one hand, that it is not conducive, in the long run, to the pursuit of business and employment, and on the other hand, that it makes it difficult for firms, and SMEs in particular, to obtain debt financing. We would suggest that bankruptcy law be developed in a way that provides greater protection for creditors, rather like Chapter 11 of the United States Code, which ensures that cases of default are dealt with faster and in a way that is more favourable to creditors.

The recession that is hitting European countries has automatically triggered a rise in the number of defaults (61,000 cases of default in 2012, an increase of 1.5% on the 2011 figure).² Furthermore, as a legacy from the pre-crisis years, many firms now find themselves in large amounts of debt, associated in particular with leveraged buyout transactions. Such firms, which are generally large and often economically viable, are likely to have to renegotiate their debts over the coming years. The primary issue is therefore that bankruptcy law should allow for fast negotiation that will result in as little loss of employment as possible.

Indebtedness is the main source from which firms obtain funding, way ahead of the issuance of shares. Whilst bankruptcy might be a relatively rare event,³ creditors do take it into account in their calculations; a resolution that is very unfavourable to them will naturally make them reluctant to lend. At a time when many experts are diagnosing a financing defi-

cit among our SMEs, we need to remove as many barriers to debt financing as possible by making bankruptcy law more favourable to creditors. This is the second issue associated with a bankruptcy law reform.

Adopting a system that more closely resembles "Chapter 11" would help put France in a situation that reflects the average among other major developed countries, bearing in mind that French law currently stands out as the exception to the rule;

- in the United Kingdom, creditors have a right of veto on decisions relating to the restructuring of liabilities. The provisions incorporated in debt agreements continue to apply when collective proceedings⁴ are initiated. For example, creditors may recover the securities they have been promised prior to the closure of the proceedings;
- in France, on the other hand, the commercial court is authorised to permit economic activity to continue and employment to be maintained prior to the credit being repaid. The bankruptcy process gives them a great deal of leeway with regards to respecting creditors' rankings and securities. The legislator gives over-leveraged firms access to a wide range of procedures designed to enable them to restructure their debts prior to the suspension of payments, including an *ad hoc* mandate, conciliation and, since 2005, a safeguard procedure and an accelerated financial protection procedure (box 1). Only debtors (and not creditors) have the option of initiating such procedures. Shareholders can oppose any dilution through converting debt into equity, whereas economic logic would dictate that they would lose the majority of their investment in the event of insolvency. The debtor has the monopoly with regards to presenting the safeguard plan; creditors are merely invited to offer a non-binding opinion on said plan;⁵
- Germany occupies something of an intermediate position in terms of the protection afforded to creditors in that a judge directs the collective proceedings but must obtain the agreement of the creditors before liabilities can be restructured in any way;
- in the United States, meanwhile, the procedures associated with "Chapter 11" were considered to be very favourable to the debtor until 2005. They have since been reformed in the interests of the creditor (box 2). The latter now has the option of quickly putting forward

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¹ Bankruptcy law and the law applicable to struggling firms can be considered synonymous.

² Cf. *Banque de France*.

³ Credit awarded by firms that had failed in 2012 accounted for only 0.5% of the total corporate credit outstanding (1.4% for SMEs). This amount is stable, and only marginally higher than it was in 2007, prior to the crisis. The low frequency of credit events for French firms should not, however, lead us to underestimate the significance of the rules for managing instances of default in balancing the debt agreement.

⁴ The term "collective proceedings" is used to refer to a safeguard, settlement or liquidation procedure that involves all those with a stake in the firm's liabilities. See box 1.

⁵ It is unsurprising, then, that creditors include in their loan agreements clauses implying a default in payment if certain milestones or ratios are not reached (covenants); the purpose of such clauses is not necessarily to force the firm into bankruptcy but rather to regain a degree of bargaining power prior to appearing before a judge.

1. The different bankruptcy law procedures in France

The various procedures relating to bankruptcy law differ in terms of their amicable (non-collective proceedings) or legal (collective proceedings, that is involving all of those with a stake in the firm's liabilities) nature and depending on whether they come into play upstream or downstream of the point at which payments are suspended (when the firm is no longer in a position to cover its current liabilities with its available assets).

Amicable procedures

The **ad hoc mandate** is a preventive and confidential procedure whereby difficulties can be resolved amicably. Initiated at the request of the debtor, its purpose (under the aegis of the presiding judge and with the support of an *ad hoc* representative) is to restore the position of the firm prior to the suspension of payments. The representative's role is to ensure that an agreement is reached between the firm and some of its creditors (payment time frames, potential discounts, etc.).

The **conciliation** is a confidential procedure for resolving difficulties. Initiated at the request of the debtor prior to the suspension of payments, its purpose (under the aegis of the presiding judge with the support of a conciliator) is to endeavour to ensure that an amicable agreement is reached between the firm and its primary creditors and partners. Unlike the *ad hoc* mandate, the conciliation can also be initiated within 45 days of the suspension of payments (the purpose then being to deal with the difficulties promptly), it has a limited time frame (four months plus one additional month) and it is possible to waive the confidential nature of the procedure in order to benefit from the effects of the judge's approval of the conciliation agreement.

The **accelerated financial safeguard**, which was introduced in 2005, represents a bridge between the conciliation procedure and the safeguard procedure (*cf.* below). This amicable and confidential procedure concerns only large and very large firms. It affects only financial creditors (banks, credit institutions, etc.) and takes place within a very short period of time (two months maximum). Its purpose is notably to very quickly resolve difficulties relating to a refusal on the part of a minority of financial creditors to be part of a conciliation agreement.

Legal procedures

The **judicial settlement**, which must be requested by any firm whose payments have been suspended, is intended to enable the firm to be safeguarded, activity and employment to be maintained and the firm's debts to be cleared. Initiated at the request of the debtor, a creditor^a or the public prosecutor, it can therefore result in the adoption of a recovery or transfer plan following an observation period (of 6 to 18 months), during which an economic and social report on the firm is compiled. The firm continues its activity during the observation period under the control of a court-appointed administrator (representing the firm) and/or an official receiver (representing the creditors).

The **court-supervised liquidation** procedure assumes that the firm concerned has had its payments suspended and that it would clearly be impossible for the firm to recover. Initiated at the request of the debtor, a creditor or the public prosecutor, it puts an end to the debtor's activity, with all of the debtor's assets being sold off to pay the various creditors in accordance with the order of priority stipulated in the *Code de Commerce*. Court-supervised liquidation can be implemented directly or as the result of the absence or failure of a recovery plan.

The **safeguard procedure**, which was introduced in 2005, is a preventive procedure that enables a firm to resolve its difficulties before its payments are suspended. Initiated at the request of the debtor, its purpose is to enable the firm to continue its activity (by restructuring, if need be), to maintain employment and to clear its debts. As is the case with legal settlement, it enables the firm to benefit from a number of measures set forth by the judge and which apply to all of its creditors, including the cessation of individual proceedings, suspension of debt maturity dates, etc.

^a In practice, creditors hardly ever request that a settlement or court-supervised liquidation procedure be initiated. Indeed, the courts are careful to avoid using such requests as a means of exerting pressure to recover the outstanding debts whilst there are amicable and legal solutions that can be implemented. Consequently, in the event that a creditor requests that a settlement or liquidation procedure be initiated whilst the firm has not had its payments suspended, they risk being held liable for damages for abuse of process.

2. The American “Chapter 11”

Chapter 11 of title 11 of the United States Code offers financially distressed firms the option of renegotiating their liabilities with a view to continuing their activity. This so-called “Chapter 11” procedure came under great criticism prior to 2005 as it gave the debtor too much power to renegotiate its commitments, notably due to the inability on the part of creditors’ to protect themselves against the wait-and-see delaying strategies implemented by a debtor under the protection of Chapter 11. Chapter 11 was significantly reformed in 2005, by and large in favour of creditors. The primary features of the reformed procedure are as follows:

- the debtor has the exclusive option of putting forward a restructuring plan within 120 days only. The creditors may reject this plan and put forward counter-proposals once this period has expired. Furthermore, any extensions that the court may grant the debtor may not exceed 18 months;
- a restructuring plan includes detailed activity forecasts and a listing of creditors by class. All claims within a given class have the same ranking. There are three types of class that result from activity forecasts, namely those whose initial rights are not affected by the plan, those who lose all of their rights as part of the plan and those impaired classes who only partially recover their claim as part of the plan;
- with regards to voting on the plan, only the impaired classes take part in the vote;
- a class is considered to accept the plan if at least half of its members, with claims amounting to at least two-thirds of the total claims of the class, accept it;
- the court can only approve the plan if at least one voting class accepts it. Under certain circumstances, however, it does have the power to require everyone to adhere to the plan provided that at least one voting class accepts it (“cram down”).

In all, three aspects of this procedure provide greater protection for creditors’ interests than that offered by the French safeguard procedure. Firstly, creditors can limit the duration of the procedure. Secondly, they have the option of making a counter-offer in the event that they consider that of the debtor to be against their interests. Finally, the bargaining power of each class of creditor depends directly on their ranking within the firm’s liabilities.

It should be noted that American firms frequently resort to the “pre-packaged plan”, which involves the option for the debtor to present to the bankruptcy court a restructuring plan that has been negotiated with the creditors prior to the procedure in order for it to be quickly approved.

The assets of firms entering Chapter 11 in 2008-2009 amounted to 1,800 billion dollars, that is twenty times more than the two previous years. Many observers believe that the procedure has enabled such firms to be restructured in a controlled manner, thus avoiding the mass liquidation of assets that would have significant macro-economic consequences.⁵

⁵ See Gilson S. (2012): “Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the US Economy”, *Journal of Applied Corporate Finance*, vol. 24, no 4, pp. 23-35.

their own restructuring plan should they reject the one put forward by the debtor. Those classes of creditors whose dues are not entirely covered by the assets available vote on the restructuring plan, and the judge can *in fine* impose a particular plan on any classes that might have rejected it.

A comparative study of different bankruptcy laws illustrates these differences, allocating a minimal score of 0 to France in terms of creditor protection, with a maximum score of 4 going to the United Kingdom and 3 to Germany.⁶ Existing research indicates that improving the protection of credi-

tors under bankruptcy law improves the funding available to healthy firms and contributes to the survival of firms in difficulty (see below). First and foremost, and indeed unsurprisingly, improving the protection of creditors improves their recovery rates. The second observation is a consequence of the first in that protecting creditors facilitates access to credit for firms; this empirical fact partially explains the lower level of indebtedness among French firms in relation to their foreign competitors. Finally, protecting creditors would appear to increase the likelihood of a failing firm continuing its activity. This third observation is *a priori* counter-intuitive insofar as, as we will see, it is generally in the interests of

⁶ See La Porta R., Lopez-de-Silanes, F., Shleifer A. and R.W. Vishny (1998): “Law and Finance”, *Journal of Political Economy*, vol. 106, no 6, pp. 1113-1150. We would like to point out that this study dates back to before the French reform of 2005, which was itself not very favourable to creditors.

shareholders and management for a failing firm to continue its activity, which is not necessarily the case where creditors are concerned. One possible explanation is that when shareholders maintain significant control over a failing firm they implement (with the aim of “gambling for resurrection”) overly risky strategies which frequently fail, resulting *in fine* in a lower likelihood of the firm continuing its activity.

The present *Note* develops an economic analysis of the way the financial distress of a firm is handled. We shall begin by looking at the current state of economic reflection on managing financial distress, before turning our attentions to the consequences of bankruptcy law on employment and eventually outlining six proposals for the development of bankruptcy law in France.

Collective proceedings: economic efficiency

Bankruptcy law has a two-pronged role to play; firstly, it acts downstream as a sieve, separating those over-leveraged firms that are viable (that is those for which continuing their activity is preferable to liquidation) from those that are not. Upstream, meanwhile, it should facilitate firm funding. The conventional analysis of bankruptcy law only takes into account shareholders and creditors that feature among the firm’s liabilities. It does not take into account the fact that other stakeholders, such as employees or the State, can be affected by a firm’s failure in ways that are not protected by the guarantees provided by super-privileges (Treasury priorities, URSSAF (social security contribution collection office funds), AGS⁷ and legal fees). The contrast between the primarily asset-based vision of this conventional analysis and French law, which puts maintaining employment at the forefront of collective proceedings, is striking. We shall proceed to analyse the causes of this difference and observe that French law merely appears to be more favourable to employment.

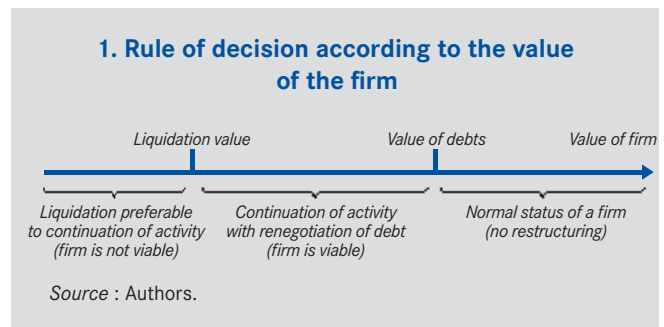
A Framework to understand Financial Distress

The health of a firm is systematically measured by comparing its firm value, its debts and its liquidation value. The enterprise value is the present value of the firm’s future cash flows in the event that it does continue its activity, that is the difference between its operating receipts and its disbursements (sales, wages, raw materials, etc.), minus any net investment and taxes. The enterprise value, which is a core concept in corporate finance, therefore corresponds to the wealth generated by the firm for all of its investors. The liquidation value corresponds to the proceeds generated from the sale of the firm (either as part of a takeover or on an asset-by-asset basis), net of any costs associated with the transfer. When

the value of the firm exceeds this liquidation value, the firm is considered to be economically viable. If the value of the firm is less than its liquidation value, however, the firm is no longer considered to be viable. The total value of the firm is then the maximum of the enterprise value plus its liquidation value.

A firm starts to experience financial distress if its firm value falls below its total debt (insolvency). It is then necessary to either restructure the debt to bring it down to a level below that of the firm’s value or liquidate the firm (meaning that its various assets will be sold off) in order to repay as much of its debt as possible. The decision will therefore depend on the liquidation value of the firm. In the event that its liquidation value is greater than the value of the firm, the decision will be made to liquidate the firm in order to pay back as many of its various creditors as possible. If, on the other hand, the liquidation value is less than the value of the firm, creditors will be better off if the firm continues its activity and restructures its debt (Figure 1).

It should also be noted that the decision to liquidate a firm



whose firm value is less than its liquidation value is the optimum situation from a social perspective. Indeed, the firm’s assets will be more attractive to new buyers than to those investing in the firm as it stands, which is why the former are prepared to pay more. The firm value of the firm can also be negative, meaning that its operating costs exceed its income, in which case, for the purposes of performance, the firm ceases to trade, even if there is no-one to take over its assets.

How to restructure

Once the decision has been made to restructure the debt in order to bring it down to a level below that of the firm’s value, there are two practical difficulties that must be overcome. Firstly, firm value is not easy to estimate. In a situation that is both urgent and uncertain, distinguishing between structural economic problems and temporary or purely financial difficulties is a delicate matter. Secondly, establishing the new level of debt to aim for typically involves a harsh negotiation process. Differences in the opinions and interests of the parties involved make it difficult to reach a consensus, particularly in situations involving a complex balance sheet structure.

⁷ The Association pour la Gestion du Régime de Garantie des Créances des Salariés, which guarantees the employee’s wage arrears.

One reasonable approach to making the process work would therefore involve clearly identifying the rankings of the firm's various creditors, then transferring control of the firm to the class of investors whose claims are partially but not entirely covered by the assets available, known as the impaired creditors. Given that the full force of every marginal euro of value created or destroyed is felt by the value of their partially covered claim, the interests of these impaired creditors are relatively well aligned with the maximisation of the enterprise value, unlike those of either very junior or very senior creditors or those of shareholders.

In order to understand the key role played by creditor rankings, let us take as an example a firm whose firm value is estimated at 150. This firm has three types of creditor, namely mortgage lenders (100), senior (100) and junior (50). Mortgage lenders, which might, for example, include a bank that has accepted a property as security, take priority, with junior creditors, which can include, for example, suppliers, ranking bottom on the list. Senior creditors are ranked between the two and can include investment funds that have loaned without security but contractually take priority over suppliers. The value of the firm's equity (owned by its shareholder) is calculated as the difference between the value of the firm (150) and its total debt (250), in this case 100. This negative equity is shown on the left-hand side of the balance sheet in Figure 2.

In theory, then, the mortgage lender should receive 100, the senior creditor 50 and the junior creditor 0, with the shareholder also losing their entire stake. In practice, negotiations are often a drawn-out affair and investors have conflicting objectives since they do not benefit in the same way from taking risks. Mortgage lenders, whose credit is guaranteed and takes priority, wish to adopt a conservative strategy in order to minimise losses. If the liquidation value of the firm is greater than their own claim (100), for example, mortgage lenders prefer to liquidate the firm rather than take the risk of resuming activity, which, as far as they are concerned, would involve a possibility that they might not *in fine* recover the debt. They prefer this option even if the value of the firm exceeds its liquidation value and therefore even if this option destroys the value. Conversely, junior creditors know that they will lose everything if the debt renegotiation process reaches its conclusion (since the value of the firm is lower than the debt of a higher rank). It is therefore in their interests to delay discussions for as long as possible and hope for a return to profitability, even if this option is actually value-destructive. Mortgage lenders will seek to accelerate the liquidation of the firm whereas junior creditors and shareholders alike will aim to adopt an excessive and potentially value-destructive risk-taking approach. In our example,

2. Example of an over-leveraged firm

Assets	Liabilities
Value of firm 150	Negative equity 100
Mortgage debt 100	Senior debt 100
	Junior debt 50

↑ Increasing priority

Source : Authors.

those creditors that are the best placed to decide whether the firm should continue its activity or be liquidated are the senior creditors, since they will completely absorb the consequences of this decision on the overall value of the firm.

Transferring control of the restructuring initiative to impaired creditors therefore generally helps ensure that the collective proceedings result in the least inefficient option being chosen, even prior to payments being suspended. It also makes the restructuring process faster, more straightforward and more comprehensible and is the approach adopted under Chapter 11 of the American Bankruptcy Code. The restructuring plan put forward by the debtor includes an estimation of enterprise value and a listing of creditors by class so that all the creditors in a given class are ranked with the same degree of importance. The enterprise value makes it possible to identify the impaired creditor classes, that is those intermediate classes that only partially recover their original credit as a result of the plan and therefore have neither a strong incentive to liquidate, as would be the case with mortgage lenders, nor a strong incentive to continue at all costs, as would be the case of junior creditors and shareholders (in our example, this would be the senior creditor). These classes then vote for or against the plan. The judge has the power to impose a plan to all classes under certain conditions provided that one of the impaired classes votes in favour of it (box 2).

Facilitating funding for SMEs

As we have just seen, it is possible to improve bankruptcy law to make it more efficient in the sense that it would better preserve the value of the firm. The effects of this efficiency would also be felt upstream by improving firms' access to credit. Indeed, in the current climate, a business plan is that much more highly valued if its financial backers are convinced that the firm's assets will be exploited as best as they can in the future, irrespective of the circumstances and particularly in the event of financial distress.⁸

⁸ This reasoning, which reflects a forward-looking vision, is not always accurate. For reasons of moral hazard, it could prove important for shareholders and the management team to be penalised when their decisions have been harmful to the firm. This retrospective vision notably implies that when things go wrong, the firm's assets should be managed extremely conservatively, and therefore in the interests of the most senior creditors (see Dewatripont M. and J. Tirole (1994): "A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence", *The Quarterly Journal of Economics*, vol. 109, no 4, pp. 1027-1054). This does not, however, affect the message that maximising the value of the firm is preferable to taking decisions that favour shareholders over creditors.

For those firms experiencing credit constraints, it might even be preferable to put in place a special arrangement that is even more favourable to creditors than the situation outlined above. This might be the case when the efforts and motivation of the management are critical to the survival of the firm, although the creditor does not have the means to verify these aspects (take, for example, a small storekeeper whose efforts and motivation would be critical to selling off inventory). In this case, the creditor knows that they run the risk of being forced to write off a large part of their credit to encourage the business owner to work for them. In anticipation of this, they will initially refuse to loan to the firm, or will only do so at a very high rate. Both parties (business owner and creditor) are therefore in a position whereby they would initially prefer that the firm be systematically liquidated in the event of the suspension of payments, with no discussion or renegotiation, even if this destroys some of the firm's value in the sense outlined above. The creditor will be better protected whilst the business owner would regain access to credit. This arrangement might also be beneficial when the firm has little in the way of tangible assets, or when it is just coming out of collective proceedings, with a particularly uncertain future.

bbbThe advantages of a law that is more creditor-friendly

There is little comparative empirical work, and what there is should be taken on a case-by-case basis, but it does suggest that, on the whole, better protection for creditors' rights increases their recovery rates in the event of corporate failure and facilitates firms' access to funding. Creditor protection also appears to increase an over-leveraged firm's chances of survival.

Creditor protection increases their recovery rates

An empirical study carried out on a sample of 2,300 collective proceedings in France, Germany and the United Kingdom revealed, for comparable firms, a creditor recovery rate in France that was 12 percentage points lower than that of Germany and around 20 percentage points lower than that of the United Kingdom,⁹ which is why French banks try to avoid formal restructuring initiatives and prefer to implement upstream procedures, where they have a little more bargaining power. Study data that is regularly updated by the World Bank confirms this diagnosis; out of 31 OECD countries, France ranks 25th in terms of mor-

tgage debt recovery rate, with 45% as opposed to the average 65%. The speed of the procedure, which ranks France in 19th position, fails to compensate for this weakness.¹⁰

Creditor protection facilitates firms' access to arm's length finance

Whilst it might be difficult to accurately measure this effect, existing empirical studies generally conclude that procedures that are too heavily biased in favour of shareholders end up being detrimental to firms' borrowing capacity. It has been shown, for example, that bank loans are more costly and have a shorter life span in countries where creditors are less well protected.¹¹ This effect is particularly pronounced in the case of risky firms with little tangible assets. Similarly, other studies show that countries that offer greater protection for their creditors have a better developed credit market and even that individual entrepreneurs based in U.S. states where individuals are very well protected against their creditors (by means of the ring-fencing of certain assets) experience greater difficulty when it comes to taking out a loan or borrow lesser amounts at higher rates.¹²

Protecting creditors increases the likelihood of firm continuation for distressed firms

The aforementioned study of a sample of 2,300 bankruptcy proceedings shows that the likelihood of a firm being continued is greater in the United Kingdom than in other countries. This consequence of increased protection for creditors is confirmed by a second study based more on the (simulated) practice of law than on its literal interpretation.¹³ It is based on the handling of the fictitious case of the *Mirage*, a small, profitable hotel but one inheriting a legacy of excessively high mortgage debt. The case is a straightforward one, as is its theoretical solution, namely to maintain the firm in its current state (it is currently viable) and reduce the amount of the debt by making the mortgage lender the sole shareholder. The case is submitted to a series of specialist legal firms belonging to the International Bar Association in a large number of countries. They are then asked to predict the outcome of the collective proceedings in their respective jurisdictions. It would appear that those countries where the law is more favourable to creditors (namely those countries with the highest credit recovery rate) are those in which the activity of the *Mirage* has the greatest chance of being protected and where the proceedings take the least time.

⁹ See Davydenko S. and J. Franks (2008): "Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK", *Journal of Finance*, vol. 63, no 2, pp. 565-608.

¹⁰ See Djankov, S., McLiesh, C. and Shleifer, A. (2007): "Private Credit in 129 Countries", *Journal of Financial Economics*, vol. 84, no 2, pp. 299-329. If we take the estimations at face value, the introduction of the safeguarding system in 2005, which effectively gave shareholders the power in the event of a restructuring, could have reduced the total credit volume by 10 points of GDP. These estimations are precarious since they are based on information relating to countries that are very different from one another and measurements that are sometimes very approximate, but they do suggest that bankruptcy law could have an extremely significant impact on the availability of credit for firms.

¹¹ Qian J. and P. Strahan (2006): "How Law and Institutions Shape Financial Contracts: The Case of Bank Loans", *Journal of Finance*, vol. 58, no 6, pp. 2803-2834.

¹² See Djankov, McLiesh and Shleifer (2007), *op. cit.* and Berkowitz J. and M.J. White (2004): "Bankruptcy and Small Firms' Access to Credit", *RAND Journal of Economics*, vol. 35, no 1, pp. 69-84.

¹³ See Djankov S., O. Hart, C. McLiesh and A. Shleifer (2008): "Debt Enforcement Around the World", *Journal of Political Economy*, vol. 116, no 6, pp. 1105-1149.

Bankruptcy Law and Employment

In framework outlined above, the firm's employees¹⁴ are only rightfully entitled (as a matter of the uppermost priority in France) to any potential wage arrears, paid leave and redundancy payments owed. Any future wages that the firm pays them in the event that it does continue its activity do not constitute a commitment to them on the part of the firm. Likewise, the human capital they will provide the firm with in return for said wages is not considered as an asset of the firm. As a result, the interests of employees are not explicitly referred to as part of the maximisation of the value of the firm when it comes to restructuring. Conversely, maintaining employment is at the heart of French law. One might therefore wonder about the compatibility of protecting the interests of creditors with protecting employment.

Before we look at this issue in greater detail, there are two initial remarks to be considered. Firstly, liquidating a firm does not necessarily mean that its activity will cease altogether. In this respect, it is important to distinguish between a site closure and a transfer whereby the buyer continues the firm's activity, perhaps on a smaller scale; indeed, only in the first case do the stakeholders (and the employees in particular) suffer any damages. Secondly, the damages suffered in the event of a site closure depend very much on other regulatory frameworks since bankruptcy law interacts with other pieces of legislation and regulations, which partially explains the much greater emphasis placed on safeguarding employment in France than in most other countries. The malfunctions of the French labour market naturally create unemployment; indeed, the human cost of a redundancy is far greater than it needs to be; losing one's job is often perceived as being a human tragedy given the poor prospects of a return to stable employment. In addition to this human cost there is also the financial cost associated with the additional expense of employment insurance to consider. *In fine*, the government (if it covers the unpaid costs left outstanding) and other employees (in the form of unemployment associated with the creation of fewer jobs owing to increasing social costs) will also be negatively affected by the redundancy.¹⁵

In light of this observation, the intellectually satisfactory reaction would be to maintain that the management of the labour market does not fall within the scope of bankruptcy law and that it is better to tackle the relevant institutions in the labour market directly rather than try to reduce their negative effects through laws, such as the one relating to collective proceedings, which has completely different objectives. This is the solution adopted in Sweden, for example, which prefers to protect employees rather than jobs and where bankruptcy law is far more favourable to creditors than is French law.

A radical change in our labour market and a move away from protecting jobs and towards protecting workers are, however, part of the challenge, and we must ask ourselves which changes need to be made to bankruptcy law in the absence of such a radical change.

We do not believe that the flaws in the French labour market justify the abandonment of collective proceedings, which take the respective rankings of creditors into account and delegate the decision of whether the firm continues to operate to the impaired creditor. Furthermore, the decision to pursue activity at all costs is more than likely detrimental to employment:

- downstream, that is when a firm fails, French law is likely only to safeguard jobs in the very short term, since the likelihood of the firm continuing its activity *in fine* is not very high and might even appear reduced, according to the studies available;
- upstream, meanwhile, it makes it more difficult for firms to obtain financing or refinancing and therefore reduces their growth or jeopardises their survival, thus preventing the creation of new jobs and the protection of existing ones.

This is where the traditional duality between the destruction of jobs and the creation of jobs comes into play, with French legislators focusing on the former (which makes front-page news) and forgetting the latter (which doesn't).

We therefore believe that a bankruptcy reform to ensure greater respect for creditors' rights and therefore greater compliance with international standards would not increase unemployment in the short term and would reduce it in the medium and long term. It might also be advisable to devise a reform that only comes into effect a year or two after it has been passed in order to avoid the very short-term effects whilst immediately benefiting from easier access to credit and therefore net job creation.

Six proposals for a bankruptcy law reform

A bankruptcy law reform should, in our opinion, ensure the smooth running of the firm's financing system. Expanding on the matter, we shall also look at the issue of the legal institutions responsible for dealing with bankruptcies and the new challenges facing the law in this respect.

Proposal 1. Making the maximisation of the firm's total value the main objective for collective proceedings.

¹⁴ Other stakeholders who are also affected by the firm's failure include the community, when the closure of a site results in significant clean-up costs, and suppliers, who stand to lose a trade outlet, among others. We will not be dealing with these other stakeholders in the present Note.

¹⁵ In France, liquidation is unfortunately sometimes a (socially ineffective) way of circumventing mass redundancy procedures.

French law sets three other objectives for collective proceedings, namely “to enable the firm to continue its economic activity, maintain employment and clear liabilities”.¹⁶ The pursuit of these objectives can sometimes coincide with the maximisation of the total value. It would nevertheless appear to create, as a result, a systematic bias in favour of the continuation of activity and of risk-taking, to the detriment of rapidly achieving the firm’s liquidation value when this is optimal.

It is not a case of overlooking the significant costs that the restructuring or transfer of a firm’s activity can generate for its employees and for the local economic fabric. We do, however, believe that a principle bias in collective proceedings in favour of continuation is an inappropriate tool when it comes to taking these costs into account. Explicitly taking these externalities into account by means of a “Pigouvian” approach (based, for example, on experience rating depending on the firm’s behaviour with regards to redundancies) would appear more appropriate. Furthermore, we have seen that the law as it stands would not *in fine* appear favourable to employment.

Proposal 2. In the framework of safeguard and judicial settlement procedures, classifying creditors according to rank and leaving the final decision in the hands of the impaired class.

In order to clarify the decision-making process when it comes to collective proceedings and avoid deleterious conflicts of interest among investors, we would suggest that changes be made to the judicial settlement procedure (as well as the safeguard procedure) based on the following three stages:

- classifying creditors according to rank, taking all securities into account;
- the putting forward of a restructuring plan, first by the debtor and then potentially by the creditors, that includes an activity forecast and identifies the impaired classes, that is those whose credit is partially affected without being entirely written off by the restructuring plan;
- voting on the restructuring plan within these impaired classes only, combined with the option for the judge to impose the plan in the event that only certain classes approve it (“cram down” procedure in US law).

As explained above, this approach offers two main advantages. On the one hand, the process is clear and is more quickly implemented, which enables the firm to more quickly return to a healthy financial position and limits the stigma and disorganisation associated with debt restructuring initiatives. On the other hand, the impaired classes do not *a priori* have either the bias in favour of continuation and risk-taking of those that will more than likely lose everything in the

event that the firm ceases to trade (such as shareholders, for example), or the conservatism of the best-protected classes of creditor. Their motives therefore more accurately reflect the objective of maximising the total value of the firm.

It should be noted that this proposal represents a complete breakaway from the procedures in their current form in the following three respects:

- creditors’ rankings and securities are observed right throughout the procedure. Under current legislation, however, creditors are grouped into classes that do not necessarily reflect the ranking of their claims (suppliers, banks, bondholders, etc.);
- the shareholder becomes a marginal player, which reflects the notion whereby the value of their residual rights to assets is *a priori* very low at this stage. Under the procedures currently in place, shareholders are generally not obliged by the judge to absorb any losses or to lose any rights, except in the event of court-supervised liquidation;
- the new role of the commercial court judge is to ensure that creditors correctly implement the procedure and arrive at a decision. They also have the authority to impose a particular plan on all those concerned provided that at least one class of impaired creditor votes to adopt it.

Proposal 3. Reducing the bargaining power of shareholders in procedures upstream of court-supervised liquidation.

The legislator provides firms in difficulty with a wide range of procedures to choose from (box 1). An individual analysis of each of the systems would not make sense. Indeed, these procedures are typically used sequentially; the anticipations of the various parties involved with regards to the implementation of later procedures therefore determine their bargaining power and strategies with regards to the current procedure.

The main flaw in this sequence of procedures as far as we are concerned is that it creates a situation that is overly favourable to shareholders:

- the final stage in the judicial settlement procedure does not guarantee that creditors’ claims will be recovered in accordance with their respective rankings and/or securities. Indeed, the judge can always decide to uniformly extend the maturity of their credit, irrespective of their priority, or reduce their amount, which considerably weakens their position with regards to previous procedures. Our 2nd proposition compensates for this deficiency;
- the management, which often represents or even personifies the interests of shareholders, has the monopoly with regards to presenting the settlement plan during the safeguard procedure;

¹⁶ First article of the 1985 so-called Badinter Law.

- during this procedure, shareholders maintain their ownership rights over the firm and are therefore in a position to block any dilution by means of a conversion of credit into new equities. On the contrary, the option of rescheduling or reducing the debt results in the creditors alone absorbing any losses.

We would suggest redressing the balance of the entire sequence of procedures available in favour of creditors, in accordance with their respective rankings and securities;

- management must lose its monopoly with regards to presenting safeguard plans;
- the way in which the plan is adopted should grant overriding weight to the impaired class of claimants. It would be particularly undesirable for shareholders to be able to oppose their dilution.

One of the significant consequences of proposals 2 and 3 will be encouraging the development of a secondary market for non-performing loans, which, in return, will help finance risky firms. This market is very active in the United States or the UK, but not in France. Respecting creditors' rankings and rights to the firm's assets should facilitate entry for specialist financial institutions to a secondary debt market, which should therefore become more liquid. The prospect of being able to transfer their outstanding credit to such institutions in the event of the borrower experiencing difficulty can, in turn, lead lenders to offer more favourable (re)financing conditions. This effect would be particularly significant for struggling firms (which are likely to be restructured) that require an injection of new capital.

Proposal 4. Introducing the possibility of opting for a special “administrative receivership” arrangement at the time the credit is granted.

For firms that are subjected to a high level of credit rationing, a fast and efficient liquidation procedure can be the only means of raising funds, even if the liquidation itself is ineffective in the sense that it destroys value. This is the case of most small businesses, where the involvement of the management is essential and cannot be easily verified by the creditor.

In order to take such situations into consideration, we would suggest that firms be given the option to depart from the general principles of default by offering creditors the option of adopting a form of administrative receivership inspired by English law at the time the credit is granted.

Administrative receivership represents a departure from the collective nature of the default, providing the creditor with a

means of individual action. The creditor owns either a security relating to a specific firm asset (“fixed charge”) or a general security that is not associated with a particular asset (“floating charge”). These securities give them the right to appoint a representative who acts on their behalf and whose sole mission is to recover the outstanding credit based on the assets that form the basis of the floating/fixed charge. Creditors in possession of such securities also have the option of appointing an administrator who then becomes responsible for the day-to-day running of the firm as a whole. The administrator and the representative (“receiver”) are often, in practice, one and the same person.

We would consider this option to be appropriate only in cases where the firm is experiencing extreme difficulty in obtaining financing. This option should be reserved for firms with no existing financial debt. In opting for this system, the firm naturally makes this information public.¹⁷

Proposal 5. Favouring a reform of commercial court justice over increasing the role of professional magistrates in bankruptcy law.

The commercial court reform is a long-standing project aimed at correcting a number of malfunctions within the commercial court justice system. These malfunctions include the following:

- a lack of representativeness among elected judges;
- a lack of legal authority among elected judges, which can sometimes result in the clerk being fully responsible for writing up rulings;
- territorial jurisdiction that results in the fragmentation of expertise and can create conflicts of interest;
- insufficient monitoring where administrators and representatives are concerned.

The plans for reform examined over the course of the past fifteen years recommend increasing the role of professional judges within commercial courts in a bid to compensate for the lack of legal authority among elected judges and reduce conflicts of interest. We are against this for two reasons. Firstly, we would consider economic competence to be of the utmost importance with regards to commercial justice. In the case of collective proceedings in particular, it would appear appropriate for the decision to be made by a judge who has recent experience as a manager and is familiar with the economic environment of the firms on which they are passing sentence. This is one of the positive consequences of the French exception of the commercial court judge and one that should be preserved. Secondly, the vast majority of French magistrates have neither training nor experience in the economic sphere.¹⁸ Furthermore, a recent study shows

¹⁷ This system makes it difficult for the firm to secure new credit in its later life, prior to this debt being extinguished under a special regime. It would appear perfectly reasonable, however, to assume that the firm anticipates this type of issue in its debt calculations. We consider this possibility to be an increase in the number of choices available to firms.

¹⁸ Certain supporters of the principle of lay magistrates, or more generally those in favour of increasing the role of professional magistrates, logically recommend that professional judges have a specialisation, as is the case with competition law, for example.

that judges display far greater distrust with regards to market economy and private firms than other civil service employees of equivalent qualification, income, gender and age. Civil service employees are themselves distinctly more distrustful than the rest of the French population, which is more so than 90% of the world's population.¹⁹ In accordance with our primary proposal, which involves establishing the maximisation of the firm's total value as a guiding principle for collective proceedings rather than protecting employment, it would seem inappropriate to increase the role of professional judges in commercial matters in the short-term. Their collective beliefs with regards to economic matters, which are of course respectable, would seem somewhat incompatible with the changes we recommend.

The legislator can, on the other hand, help raise suspicion in the event of any potential conflict of interest that might be detrimental to the reputation of commercial court judges. One of the early steps would involve requesting an annual sworn declaration of their economic interests and forcing commercial court judges to make them public. The legislator must also step up the effective control of any potential conflicts of interest among judges, preventing them from potentially deliberating on firms with which they have commercial ties and prohibiting them from investing in firms on which they have passed sentence; great vigilance is required with regards to the implementation of Article L. 111-6 of the *Code de l'organisation judiciaire* in particular. Finally, restructuring the rules of jurisdiction and introducing more flexible and frequent transfer of cases to another court can help both avoid conflicts of interest and compensate for the fragmentation of expertise.

Furthermore, if the legal training of commercial court judges is deemed to be insufficient, it might be considered beneficial to require elected judges to fulfil further obligations.²⁰ It should, however, be borne in mind that such courts rely on volunteers and that it is important to achieve a delicate balance that too many additional obligations will only disrupt if not accompanied by some form of compensation.

There are two other major players involved in the default handling process. Downstream, the official receiver is supposed to represent the creditors at the point of liquidation. Their payment consists of both a non-incentive-based component (fixed plus fees proportional to the size of the firm) and an incentive-based component (a share of the profit from the

sale).²¹ Upstream, the court-appointed administrator (which is compulsory for firms over a certain size) is responsible for safeguarding; their fee²² increases by 50% if a plan²³ is favoured over liquidation by a full-bench court. The lively debate on the level of remuneration and the incentives afforded to administrators and representatives has been running for many years. In the case of official receivers, for example, it would be appropriate to relax the *numerus clausus* and ensure that there is sufficient competition within this profession (whilst maintaining a high level of expertise). Administrators and representatives are then paid in the form of a fixed component plus a share of the final profit. There would not, at first glance, appear to be anything amiss with the notion that remuneration should be profit-based, but the devil is in the detail. Many observers (including the French magistrates' trade unions) recommend basing administrators' fees on the number of jobs safeguarded. In addition to the fact that the "number of jobs safeguarded" is a hazy concept (for how long? at what cost? which jobs? based on which counter-factual assertion?, etc.), this recommendation goes against economic analysis and, as we have already explained previously, has every chance of eventually being detrimental to employment. In more general terms, we would suggest that incentives continue or be made to comply with the determined objectives of bankruptcy law.

Proposal 6. Adapting bankruptcy law to reflect the challenges of the 21st Century: redefining "super-privileges", relaxing the law as it applies to groups, continuing to eliminate the stigmas associated with bankruptcy and encouraging convergence at European level with a view to limiting regulatory arbitrage.

As is the case with all regulations, those that relate to bankruptcy law must evolve to adapt to new economic challenges. There are a few examples we might list, the idea being not to provide specific responses but rather to emphasize the fact that prior reflection on these matters as well as others would be preferable before any reform of bankruptcy law is implemented.

Firstly, thought should be given to the exact scope of "super-privileges". Take, for example, the new problem of data hosting, which involves a high level of risk for e-commerce operators. In the event that payments are suspended, the customer

¹⁹ Cahuc P. and S. Carcillo (2012): *Les juges et l'économie : une défiance française*, Institut Montaigne.

²⁰ See the many recommendations made in the Untermaier report on this matter: Untermaier C. and M. Bonnot, (2013): "Conclusion des travaux de la mission d'information sur le rôle de la justice en matière commerciale", *Rapport d'Information de l'Assemblée nationale*, no 1006.

²¹ This does not necessarily prevent misappropriation, since the potential gains to be achieved through a sale at a rock-bottom price can be far greater than those achieved through profit-sharing. Furthermore, the official receiver can choose transactions by mutual agreement with buyers.

²² Article R663-4 of the *Code de Commerce* ("French Commercial Code") specifies that their remuneration is determined according to the number of employees employed by the debtor or their turnover. Furthermore, Article R663-12 grants the court-appointed administrator a proportional fee calculated based on the amount of the increase in equity anticipated in a safeguard or settlement plan.

²³ A plan comprises a component designed to stabilise activity, a financial component that extends the maturity of the credit or reduces the value thereof and a social component (number of redundancies per category).

runs the risk of losing their domain name and all of the data they have entrusted to their host; this data constitutes, or could constitute, the essence of their business capital if they are, for example, an e-commerce operator or a firm operating in the retail sector in general. Furthermore, the data can be auctioned off with the liquidated firm's assets and might end up in the hands of a competitor. The development of cloud-computing distinctly increases the significance of this problem and the need to find an appropriate, and preferably collective, solution.²⁴

Another example is the "repo" (repurchase transactions) market, which underwent a period of spectacular growth as soon as the legal uncertainty surrounding ownership rights was resolved. The law of 19 February 2007 relating to trust law actually introduced the possibility of holding assets that are separate from the firm's holdings per se, thus excluding them from collective proceedings; we might also wonder about the reasons behind the lack of popularity²⁵ of this solution (unlike the leasing system, which also determines the division of assets following collective proceedings). Conversely, it is important that its limits also be considered; to what extent could the practice of trust law enable certain creditors to acquire excessive priority over other creditors, who would then find themselves facing an "empty shell" (such reflection is currently under way in the prudential field, where banks are increasingly limiting assets in favour of individual lenders seeking to ensure that they are given priority over other lenders).

Another avenue of reflection relates to the law as it applies to groups. As we are reminded by the *Petroplus* affair, in France, the parent firm is generally not responsible, except in the event of *de facto* management. This creates an incentive to outsource activities that are risky to both employment and the environment and to "not really know what's happening within the subsidiary". The costs and benefits of the very extensive Anglo-Saxon "extended liability" approach are also worthy of reflection.

Furthermore, French bankruptcy law is traditionally associated with the harmful consequences it has on firm managers. The government recently took a step in the right direction by withdrawing the requirement for firm managers to file a FIBEN (firm bank record) with the *Banque de France* in the case of non-fraudulent bankruptcy. There is every reason to consider the opportunity of eliminating other stigmas associated with bankruptcy.

Finally, firms nowadays are becoming increasingly multinational. The issue of resolving instances of default in this context has significant consequences for the location of activities, the repatriation of assets in the event of difficulty, etc. Generally-speaking, European integration facilitates regulatory arbitrage where bankruptcy law is concerned, as well as in many other fields. As a result, certain financing packages have already resorted to using Luxembourg-based holding firms, which ensure that the management does not hide behind French law in the event of default. The risk of the accelerated development of such a "shopping forum" on the part of lenders would be significant if French law as it applies to defaulting firms were to maintain its high level of idiosyncrasy.

Conclusion

The relatively low level of protection afforded to creditors' rights as part of French collective proceedings might prove particularly costly in a post-crisis context in which the balance sheets of financial institutions are being downsized. We believe that two conceptually straightforward reforms could rapidly improve the current situation, these being the redefinition of the objective of collective proceedings and the increasing of creditors' proposal and decision-making powers in the framework of such proceedings. ●

²⁴ The hosting problem is not specific to France. See, for example, Kaplan D. (2012): "Bankruptcy in the Cloud", *NYSBA The Senior Lawyer*, vol. 4, no 1, pp. 12-19, for the United States and Lifshitz L.R. (2011): "Cloud Computing: Legal Risks and Pitfalls", *CCH Commercial Times*, no 529, August, pp. 1-7, for Canada. Within Europe, only Luxembourg, in late 2012, has adopted a bill that introduces a right of claim in favour of the individual or firm who has entrusted intangible, movable, non-fungible assets to a data-hosting firm that has filed a petition in bankruptcy. The provisions of the new Article 567 of the Luxembourg Commercial Code could therefore serve as a useful reference for a similar development in the provisions of the French Code de Commerce. In France, the CNIL and the ENISA recommend that cloud computing offerings include specific provisions relating to reversibility which would not only make the data portable in the event of a change of host but moreover would enable the data to be restored or completely destroyed, notably in the event of the firm filing a petition in bankruptcy.

²⁵ The reasons behind this lack of popularity would appear to be, on the one hand, the fact that this practice is still recent and needs to be developed with case law (particularly since the rulings of the Supreme Court come into play), and on the other, the fact that not all trusts are shielded from collective proceedings (cf. Art. L.622-23-1 of the *Code de Commerce*).



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