French insolvency rules reformed in the light of Covid-19 pandemic: are they going too far?

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Introduction

The Covid-19 outbreak has far-reaching consequences beyond the spread of the virus itself and became a great threat to the global economy and financial markets. Certain economic sectors are deeply affected in the medium and long term by the crisis.

This is the reason supporting companies encountering slowdown in growth or financial difficulties has quickly also become a major challenge to the French Government, in both social and legal terms.

In such peculiar circumstances, the French Government was very reactive and quickly launched a wide range of extraordinary support measures, helping companies to deal with the most urgent issues, such as, among others:

- payment extensions of social contributions and direct taxes, direct tax write-offs decided on a case-by-case basis;
- grants of €3,500 to €6,500 for small businesses, self-employed and micro-enterprises through a €7bn solidarity fund;
- state-guaranteed credit facilities up to €300bn;
- moratorium on utilities and rental payments for distressed SMEs;
- maintaining employment in businesses through a simplified and strengthened state cover for partial activity (*chômage partiel*); and
- recognition by the state of Covid-19 as a case of force majeure for public procurement.

In this context, France considered that its insolvency law should be readjusted with the aim of preventing and limiting enterprise failures.

The purpose of Ordinance n°2020-431 of 27 March 2020 was to adjust the formalism of insolvency proceedings which may be opened during the lockdown period, and to adapt the various legal time limits applicable to companies within the framework of pre-insolvency proceedings and insolvency proceedings. For example, the assessment of the insolvency test[1] was frozen as at 12 March 2020, one week before the lockdown period, until 23 August 2020. During that time, the debtor had no duty to file for insolvency proceedings[2] and no third party could require the opening of insolvency proceedings against its debtor. The aim of the French Government was to push debtors to file for pre-insolvency proceedings, like *mandat ad hoc* or conciliation where the debtor can, under the supervision of an insolvency practitioner, restructure its major debts 'out of court' and in a confidential frame. During the lockdown period, commercial courts which are competent for insolvency and pre-insolvency proceedings, held the hearings via videoconferences at the judges' homes, as the courts were closed. Filings were accepted electronically.

The Ordinance n°2020-431, dated 27 March 2020, has been subsequently completed and amended by a second Ordinance n°2020-596, dated 20 May 2020, which was intended to lead to a significant strengthening in the efficiency of insolvency proceedings and to speeding them up to enable courts to cope with the volume of anticipated cases.

Although the extraordinary measures introduced by the Ordinances are temporary, they impact some central aspects and foundations of French insolvency law.

Do the lockdown stakes of Covid-19's economic impacts justify the 'deconstruction' of France's substantive insolvency law in particular in the light of the forthcoming transposition into national law of the EU Directive 2019/1023 of 20 June 2019 on preventive restructuring frameworks?[3]

Increase of the court's power in pre-insolvency proceedings to the disadvantage of creditors

Under French insolvency law, a debtor has the choice between two pre-insolvency proceedings, that is, *mandat ad hoc* proceedings and conciliation proceedings, which do not trigger an automatic stay of payments,[4] both of which are for the purposes of reaching a consensual solution with the main creditors aiming at a rescheduling of debts. Management remains in full control throughout these proceedings.

Like *mandat ad hoc* proceedings, conciliation proceedings are confidential, but are also available to cash flow insolvent debtors provided such cash flow insolvency has not lasted for more than 45 days.[5]

The initial term of the conciliator's mission is determined by the court, within a four-month limit (which can be extended for an additional month[6]).

Only the debtor may file for the opening of conciliation proceedings and can propose a conciliator among the insolvency practitioners, in practice, often an insolvency administrator. The conciliator's fees are freely determined between him and the debtor, however, under court control.

The conciliator organises negotiation meetings with the debtor and its main creditors chosen by the debtor. The other creditors will neither be informed nor affected by the proceedings.

The French social, tax and public administrations may grant write-offs of the relevant debts as well as payment grace periods.[7]

The settlement agreement executed by the parties under the supervision of the conciliator is only binding upon the parties thereto. It can either be acknowledged by the court (confidential) or approved by a formal judgment, the so-called 'homologation' (which is public). The advantage of court homologation is to confer legal comfort to the debt rescheduling – for example, new-money privilege[8] for lenders injecting fresh money, or certainty about the 'cessation of payment' date in case of the opening of subsequent insolvency proceedings.

If an agreement is not reached between the debtor and the participating creditors at the term of conciliation proceedings – and provided that the debtor does not file for so-called accelerated safeguard proceedings (*sauvegarde accélérée*)[9] – the conciliator will draft a report and file it to the court, explaining the failure of the conciliation. The court will submit such report to the Public Prosecutor[10] who could request the opening of insolvency proceedings.

According to the new measures,[11] for all pending and future conciliation proceedings opened prior to 31 December 2020, should a creditor expressly or implicitly refuse the debtor's demand to postpone the due date of its claim within the timeframe set by the conciliator, the debtor can request at court the issuance of an order: (1) suspending any legal action or enforcement proceedings initiated by this creditor; or (2) rescheduling said claim. No late payment interests or penalties will then be due. Such measures shall remain effective for the duration of the conciliation proceedings.

Furthermore, the debtor may also request at court, in a simplified way, payment grace periods up to two years, before any notification or legal action is launched by the creditor.[12]

There is no doubt that these new measures expand the powers of the courts and imply a higher risk for creditors within conciliation proceedings.

While imposing a stay towards the main creditor or several creditors, such new court powers may be equivalent in practice to a general stay which is normally only triggered by court-controlled proceedings which are public: that is, safeguard, reorganisation and liquidation proceedings.

Moreover, conciliation proceedings are deemed consensual where a solution could not be forced but must be agreed among the debtor and willing creditors. The new possibility of imposing a stay of payments and actions creates an additional disruption of the balance between the debtor and its creditor(s) at the disadvantage of the latter.

A sale bid can now be presented by the manager of the debtor in insolvency

Until the new measures, neither the debtor,[13] in respect of any of its assets, nor the *de jure* or *de facto* managers of debtor companies, nor the relatives of the managers, nor the current or ex-controllers[14] appointed in the proceedings, were permitted to participate in a sale bid at court with respect to the business or the assets of the debtor.[15] However, as an exception, the court, on request of the debtor or, more likely, the insolvency administrator, may authorise, the business sale to one of these persons,[16] if the latter offers the most beneficial job-savings alternative plan.

Such legal provision was justified by the fact that it would be found immoral that a manager could repossess his company, after the discharge of all its liabilities, often for a very low price, by depriving the creditors from their proceeds and claims.

As from the Ordinance n° 2020-596 dated 20 May 2020, on request of the debtor himself, a sale plan of assets can be endorsed to the benefit of managers of debtor companies, provided that the proposed sale bid ensures the preservation of jobs.

As a minimum protection, the Ordinance set forth that the Public Prosecutor must be present at the relevant debates during the hearing and the opinion of the controller(s) is required, without, however, being binding. In practice, the courts do not follow systematically the suggestion made by the Public Prosecutor.

It is well known that the preservation of jobs is the main aim of French insolvency law. However, such theoretical consideration – although honourable – does not take into account economical constraints, that is, the right size in number of employees with respect to the business. A third-party bidder should calculate in a more objective way the right adjustment in terms of numbers of employees fitting with the business to be taken over. In practice, one can see a general downsizing of jobs in the frame of a third-party sale bid compared to the number of employees working in the business contemplated.

Therefore, under this new regulation, the sale of the business to the manager who was not able to rescue it in the past, should not necessarily lead to a long-term rescue of the business and the jobs, unless such manager has the right level of objectivity.

However, a slight fraud suspicion may remain on the table: from a moral perspective, why should a manager who obviously failed, be allowed to take over the business for a symbolic purchase price while leaving the creditors behind and despite the fact that he failed in the past? Is the Covid-19 pandemic a sufficient excuse to open the door for fraud? Furthermore, we know that in practice it is exceedingly difficult (if not impossible) to prove the existence of fraud, in particular at the moment of a sale plan which takes place early in the process.

Third party bidders are all equally able to preserve jobs!

State guaranteed loans – nice to have but…

Like most of the European jurisdictions, France put in place various financial measures to avoid a liquidity crisis. In addition to solidarity funds, the most important measure is the set-up of state-guaranteed loans (*prêts garantis par l'Etat* (*PGE*)).

The French State set aside a fund of €300bn as guarantee for loans to French corporates to be granted by commercial banks – often the house bank – before the end of 2020.

In France, the total state-guaranteed loans stand above those guaranteed by other European countries. Until mid-May 2020, loans of a total amount of €100bn were lent and they are expected to reach €120bn by September.

Due to European Union law, the state guarantee is limited to 90 per cent of the loan amount – leaving the remainder of ten per cent at the lender's risk and for which no guarantee can be requested. Obviously, this leads the banks to analyse, at least at a minimum, the creditworthiness of the borrower and, of course, can end up in refusals – what is, in the authors' opinion, a sane market regulation.

The French Government included, surprisingly, into the list of candidates to state-guaranteed loans, corporates which are already insolvent since 1 January 2020. 'Insolvent' in this context means either under safeguard, reorganisation or …liquidation proceedings!

In practice, if DIP financing is useful, now secured by a post-money privilege (*privilège de sauvegarde ou de redressement*),[17] the ratio of it at a very late stage of the proceedings (ie, at the ultimate moment of pure asset disposals), is not understandable. Moreover, the fact that these loans benefit from the state guarantee (up to 90 per cent of the loan) is, from a macroeconomic point of view, not reasonable nor justified. It is true that the practice should correct this legislator's mistake, as the credit applications should not get credit committee approval.

Moreover, not to forget, the easy money of a state-guaranteed loan remains a loan. And the problem is the loan term. The cash loan must be reimbursed within five years, with however one year off at the start (most repayments will only start in 2022). One must note that the borrower can request a loan amount up to 25 per cent of the 2019 turnover – which is a lot – for a tiny interest rate.[18] Obviously, a huge cash amount might be loaded up first time. However, having done so, and given the short term of five years for serving the debt, the corporate must, during the five years, realise a free cash flow of five per cent of its annual turnover.

Such amount should be a huge challenge for most of the French SMEs which might face new financial difficulties in a later stage. Only a strong equity could help, which is not the case for the majority of the French SMEs, which are largely undercapitalised.

A series of a later defaults cannot be the interest of the state either.

Therefore, the easiest way should be the prorogation of the term of such loans, that is, to ten years, like in Germany, which would divide the debt pressure by two. In such a case, it might be fair to raise the current low interest rate a little.

Conclusions

Do the economic impacts as a result of the Covid-19 pandemic justify the 'deconstruction' of France's substantive insolvency law, in particular in the light of the forthcoming transposition into national law of the EU Directive 2019/1023 of 20 June 2019 on preventive restructuring frameworks?

The measures amending French insolvency law in the context of the Covid-19 pandemic provide more protection to the insolvent debtor than is already the case under current French insolvency law. These measures stand in opposition to the provisions and the spirit of the EU Directive, ie, the strengthening of creditors' rights. Therefore, we hope that such measures are temporary as linked to the Covid-19 pandemic, as announced by the French government.

Notes

1 The insolvency test in French insolvency law is a purely cash flow test.
2 Unless the debtor could not pay wages, in which case the debtor was supposed to file nevertheless for insolvency proceedings in order to get wages paid by the state guaranteed wages system (AGS).
3 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.
4 Although no automatic stay is triggered with the opening of the *mandat ad hoc* or the conciliation proceedings, it is common practice that the participating creditors stand still and refrain from any enforcement act in order not to jeopardise the negotiations.
5 Freezing of the cash flow insolvency status to 12 March 2020 until 23 August 2020. As from 24 August 2020, companies that are still in a state of 'cessation of payments' will have to file for insolvency proceedings within 45 days.
6 Since the Ordinance n°2020-431 dated 27 March 2020 and the Ordinance n°2020-596 dated 20 May 2020, the maximum duration is extended for an additional five months (ie, a total of ten months). This applies for conciliation proceedings pending on 29 March 2020 but also to conciliation proceedings opened between 29 March 2020 and 23 August 2020.
7 Articles L. 611-7 and L. 626-6 Code de Commerce. A prior formal notice sent by the creditor to the debtor is necessary prior to the filing of such request to the relevant authority.
8 Benefiting of a preferential ranking in the insolvency estate for repayment.
9 Which requires special conditions (Art L.628-1 to 628-8 Code de Commerce) and is interesting in the presence of a minor dissenting creditor being able to hinder the reaching of an agreement.
10 The Public Prosecutor is present during insolvency proceedings and plays a supervision role.
11 Since the Ordinance n°2020-596 dated 20 May 2020 (art 2)
12 A prior formal notification or a legal action introduced by the creditor was, before the Ordinance dated 20 May 2020, a prerequisite to such court request.
13 Including the shareholders of the debtor.
14 The so-called 'controllers' are creditors appointed by the court upon their request. They have a limited control function in insolvency proceedings as for various actions (eg, disposal of debtor's assets), their opinion is required.
15 Prohibition of art L. 642-3 Code de Commerce.
16 Except controllers.
17 The Ordinance n°2020-596 dated 20 May 2020 (art 5) introduced a 'post-money' privilege applicable to cash contributions carried out during the observation period or for the purpose of the implementation of a safeguard or reorganisation plan. These claims benefit from a preferential ranking, ie, after wage super priority claims, legal costs, new money granted during the conciliation proceedings and wage claims of the AGS. The 'post-money' privilege may extend to all third-party post-money financings but exclude shareholders capitalisation funding. The 'post-money' priority claims are applicable to safeguard or reorganisation proceedings opened on or after 22 May 2020 and will apply until the implementation into French law of EU Directive 2019/1023 of 20 June 2019 on preventive restructuring frameworks (and no later than 17 July 2021).
18 Close to 0 per cent for the first year, the interest rate will be determined afterwards directly with the lender according to the market conditions at the date of the rescheduling, and according to the chosen term (within five years).

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