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Southern European jurisdictions race to close restructuring law gap on UK scheme but some hurdles remain – conference coverage

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Major Southern European countries were long considered as 'the worst pupils of the class' when it came to their legal restructuring frameworks. Continuous improvements to their toolkits has closed the gap on the tried and tested UK scheme of arrangement, but creditors still face hurdles in some jurisdictions, according to participants at the restructuring conference hosted by Droit et Croissance in Paris last Wednesday (4 November).

The reforms are being instigated both at domestic and the continental level through a mix of improved national legislation and efforts by the EU to harmonise insolvency proceedings across the continent. The ultimate goal remains to find the optimal balance between rights for creditors, shareholders and companies, according to speakers at the event.

There is an urgent need to deal with the increasing number of bankruptcies in Europe, according to Michael Shotter, head of the EU Commission's Civil Justice Policy Unit in the European Commission's DG Justice & Consumers.

"A lot of non-performing loans haven't been cleared yet," he said. "They reduce the creditworthiness of businesses and are a burden to the economy. Also, bankruptcy has a negative impact on entrepreneurial activity and carries social stigma. In several member states viable companies are pushed towards liquidation. Moreover, in many of them it's not possible to restructure companies at an early pre-insolvency stage."

Reforms have already started to bear fruits in many areas, according to a Spanish restructuring lawyer at the conference, who argued that the

Spanish homologacion – despite its limits with regards to imposing solutions on the shareholders – is settling in.

“The UK scheme was very attractive for Spanish companies when there was no Spanish equivalent,” said Adrian Thery, a Madrid-based partner at Garrigues. “But now there are very few COMI (centre of main interest) shifts and the Spanish scheme is working nicely. However, equity is a pending issue. The judge must have the power to force the hands of equityholders. Therefore a large holdout value remains in place.”

Equity cram-down in a reorganization plan context should only be possible after proper valuation of enterprise value, Thery noted.

"Having to resort to liquidation in order to disenfranchise out-of-the-money stakeholders is inefficient and value destructive, and does not work in relation with complex industries in continental Europe. US Chapter 11 system provides excellent guidance for European countries as to valuation and cram-down of out-of-the-money stakeholders,” he added.

In relation with SME’s, in most Southern European countries focus is shifting from the debtor (as a corporate legal entity) to the underlying business, although big European corporations are still missing a Chapter 11 like comprehensive reorganization mechanism that allows for both financial and operational restructurings, which should not be dissociated, he concluded.

Italy, too, has introduced several new reforms in recent years in its insolvency law after decades of legislative inertia.

“The story of Italy is quite similar to that of Spain,” said Milan-based partner at Linklaters, Francesco Faldi. “The insolvency law was introduced in 1942 and was left unchanged for a long time, but since 2005 there’s a reform almost every year. The reforms, from 2005 until the last one, mainly aimed at helping companies to be rescued. The 2015 reform, instead, is more creditor-friendly. For instance, before 2005 the concordato preventivo used to be rigid and lengthy and it allowed for cram down of originally unsecured lenders only (and with significant limitations). Then it became a more flexible, and powerful, instrument that companies can use to preserve the going concern by, among others, cramming down creditors (with limitations, also secured ones) and getting chapter 11-like protections. Finally the 2015 reform introduced important creditor-friendly tools aimed at re-balancing debtors and creditors’ interests.”

However, the improvements in the legal framework have not always been translated into improved practical outcomes, according to Luca Ramella, a Milan-based managing director at Alix Partners.

“I don’t think we need any additional reforms in Italy; the law in its current state is quite efficient, but it faces factual limits,” he said. “Some judges have very strong knowhow, but you may also end up with less experienced ones who would struggle to restructure a multi-billion euro debt structure.”

“You can change the law, but you cannot by magic change the culture,” commented Lorenzo Stanghellini, a professor at the Law School of the University of Florence. “The law was basically the same as in the 19th century until 10 years ago. So it’s a leap forward, but maybe not optimal. Insolvency law is very sensitive to the context.”

A French revolution?

Southern Europe’s largest economy, France, has been criticised by many for the perceived complexity of its insolvency regime. Creditor-unfriendliness is one of the main reproaches made to the French system, as detractors argue that the interests of creditors are not given the same weight as the concerns of employees and shareholders.

“In France when the shareholders of a listed company are completely out of the money, you still need to leave them 10-15% of the upside,” noted Arnaud Joubert, a Paris-based managing director at Rothschild. “That is probably two-three times more expensive than in any other European jurisdiction.”

Despite recent changes to the French insolvency regime in favour of creditors, “getting turkeys to vote for Christmas” still remains part of the process, according to Stephen Portsmouth, managing director at Société Générale in Paris, who believes that the new reforms don’t go far enough, and that there is still a large value leakage in favour of out of the money shareholders.

However, **Groupe Latecoere**’s restructuring earlier this year showed that handing control to creditors is becoming more mainstream in l’Hexagone. The French manufacturer of aircraft parts trimmed down its cEUR 300m debt to cEUR 100m, while receiving EUR 100m of new funds to boost its slim liquidity reserves and meet capex needs in exchange for a partial debt for equity swap.

Despite the strength of its brand and close to a century of history, Latecoere had entered a zone of turbulence due to major shifts in the aerospace industry, which meant that major clients Boeing and Airbus pushed their subcontractors to spend much larger sums on capex.

The company never had much equity capital, and mainly used debt as source of financing. Therefore the workout was a deleveraging operation.

The creditors, led by Apollo and Monarch, ended up with a relatively small 37% share of the equity; a stake they would have willingly increased if existing shareholders had not signed up to the rights issue in full. As a result, the two funds also took over Latecoere's governance, but it remains a public company and has no official reference shareholder.

It was difficult to get shareholders to accept the deal and ultimately it was the liquidity issue that acted as catalyst, as is usually the case in most situations, participants agreed.

Alternative investors entered the company's debt structure after a number of primary bank lenders sold their claims at below par levels; a move that has become more common among French banking institutions in recent years, according to Laurent Benshimon, Paris-based managing director at Houlihan Lokey.

"There is an increasing trend among banks, French banks in particular, to sell their claims in the secondary market," he said. "This is partly because of Basel 3 rules, which impose stricter constraints on their balance sheets, but also because the secondary market for French credits has become more liquid in recent years with more attractive prices for selling banks."

In the last couple of years, the French legislator has paid particular attention to this area by enacting two major texts, noted Thomas Revial, secretary general of the governmental Interdepartmental Committee for Industrial Restructuring (CIRI) which is in charge of helping large companies restructure their debts without passing by the pitfalls of a full-blown bankruptcy while distributing the efforts among the parties as fairly as possible.

The 2014 reform introduced mandate ad hoc and conciliation out of court proceedings, and then the loi Macron; a ground-breaking piece of legislation named after the finance minister Emmanuel Macron, which will enter into force at the beginning of 2016 and in its article 70 provides a

broader possibility for distressed debt investors to implement loan to own strategies.

The new law arms courts with two new possibilities: the first mechanism is the “dilution forcée”, which allows the court to appoint a mandataire who will then subrogate the holdout shareholders in convening meetings to vote on capital increase measures prescribed by the workout plan. The second new possibility is a squeeze-out procedure (cession forcée) that allows courts to transfer companies’ equity to third parties who commit to implement agreed restructuring plans.

The new law also creates specialised courts for larger and more complicated cases.

“These reforms don’t revolutionise the French insolvency system, but they are useful steps forward and positively contribute to the more general goal of the government which is to rescue viable businesses and to improve France’s attractiveness,” noted Revial.

Sailing back home?

Shareholder-friendly rules were not the only complicating factor in French and Italian restructurings. On top of the need for more flexibility and speed which new laws have tried to address, meeting companies’ liquidity needs in the course of the workout phase, sometimes referred to as ‘deep financing’ on the other side of the pond, remains an issue.

In France, supersenior financing can at times cost the company more than its regular debt service costs.

Benshimon, however, noted that the costs associated with new money is a consequence of high indebtedness levels in many companies.

“In France deals have tended to remain highly leveraged post restructuring compared to other jurisdictions; typically 6x-6.5x whereas you would expect them at levels closer to 3.5x-4x,” he said. “That is why you would rarely see new money in restructurings injected under the form of equity but rather under the form of super senior debt, yet often at a higher yield than in other jurisdictions, reflecting the higher risk.”

“It’s still not possible to create a super senior class above the secured creditors in Italy,” said Faldi. “People try to create superseniority through contractual arrangements.”

These recent efforts are meant to provide southern European jurisdictions with more efficiency and certainty as to the outcome of debt workouts.

“The system is now more creditor-friendly,” noted Ramella. “You can now cram down shareholders. It has an impact on the negotiations too, because they now know that they can be crammed down to zero.”

“People can now come up with counter-proposals, which if approved will need to be complied with by directors and shareholders,” said Faldi. “If the shareholders refuse to do so, the court can appoint a mandataire to vote for them. There have been significant changes in labour laws too. Employee protections are not at the same level as in France anymore and, for instance, it is now significantly easier in Italy to deal with employees redundancies.”

What remains to be seen is whether these improvements will sustainably reverse the South-North tide of restructurings, especially when it comes to the outflow of cases towards London.

by Hossein Dabiri

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