SECTION 04 CHAPTER 23

FRANCE: M&A OPPORTUNITIES WITHIN RESTRUCTURING

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The credit crunch and economic crisis of the past two years have significantly reduced the number of mergers and acquisitions. In the meantime, however, industries have been consolidating and restructuring with increasing speed. Such a dichotomy positively creates acquisition opportunities, particularly for companies with available cash and specific needs for strategic assets. Additionally, the current economic situation increases the importance of M&A capabilities going forward.

Besides, in time of economic distress, corporate restructuring should also be seen in a positive way, as a useful legal tool that helps entrepreneurs preserve the value of their assets. From a legal point of view, strategic corporate restructuring could lead to positive results, as some French out-of-court workouts or assisted court proceedings may help to reduce financial losses while simultaneously facilitating negotiations between debt and equity holders in order to enable the prompt resolution of a distressed situation.

Restructuring may lead to a change of control or ownership structure, spin-off, as a response to a crisis or as consolidation, or buyout. Reorganisations may occur as a result of financial difficulties under the existing corporate structure, activities, or management, and often as an alternative to dissolution. The reorganisation may consist of changes within an existing corporation, such as a recapitalisation, but it may also involve transactions, such as a transfer of shares or assets with another existing company or, for the purpose hereof, a newly created one.

Hence, on the one hand, entrepreneurs suffering from the distressed global economic situation should look to recover, or at least preserve, the value of the assets of their company by restructuring their assets and their debts or filing for adequate insolvency proceedings provided that they are still solvent and that the legal framework is 'debtor-friendly'.

On the other hand, should the preservation of the assets' value be compromised, companies may decide to sell all or part of their assets to a third party. This is provided, however, that such potential buyers pay attention to the fact that today, there are fewer possibilities in the balance sheet to recover from missteps.

Corporate restructuring options

Regarding the first possibility, given that voluntary or involuntary court-adjudicated proceedings, such as rehabilitation or bankruptcy proceedings, often result in the destruction of value for the company and its creditors, entrepreneurs who remain solvent but face difficulties would try (i) to reach an agreement with their creditors and potential investors; and/or (ii) to strategically file for a court-assisted procedure where they remain in control over the assets of the company.

First, provided they consider their difficulties short-term and that they can recover quickly, entrepreneurs may apply classic M&A techniques such as raising private capital to proceed to a balance sheet recapitalisation, fund growth opportunities, sell non-profitable assets (see below), or try to restructure their debts together with their main creditors.

This latter out-of-court restructuring technique may be organised under a debt-for-equity swap, the purpose of which is to restructure the balance sheet of a corporate debtor so that the relevant participating creditors receive equity interests in a reorganised capital structure in return for releasing their debt claim against the company[1].

Having fewer financial charges, the company will be able to recover and attract new investors. Recently, on 24 July 2009, Thomson SA came to such an agreement with its financial creditors and bondholders, which will receive both shares and notes redeemable into shares (ORA for example) in consideration of the reduction of Thomson SA debt from €2.83bn to €1.55bn[2]. Such restructuring has been agreed at Thomson SA's shareholders' general meeting.

Yet, in a debt-for-equity swap deal, shareholders could be significantly diluted and the company's founders could lose political control, in particular where such conversions have been used opportunistically by creditors to acquire sub-performing debt[3] in order to take control of the debtor, thus employing a loan-to-own strategy[4].

Such issues may, however, be avoided under certain circumstances. As a preliminary remark, it is worth noting that creditors may be reluctant to employ such techniques, notably because they will automatically, when they become shareholders of the company, be ranked below secured creditors in case of bankruptcy.

Furthermore, it is possible to conciliate both creditors and shareholders or founders' antagonists' interests, in minimising the dilutive effect of the debt-for-equity swap by implementing simultaneously a recapitalisation to the benefit of an outside investor.

This has been illustrated by the recent restructuring of Autodis[5], an automotive company facing a distressed leveraged buyout situation, where the debt-for-equity swap was implemented parallel to an injection of new money, through a recapitalisation initiated by an independent investor, Towerbrook[6].

The entry of this new investor holding the majority in the share capital has facilitated the renegotiation of Autodis's debts with its creditors. This renegotiation was reached before the company filed for a safeguard proceeding, which further illustrates the interest for an entrepreneur to revert to the second option, i.e. filing for adequate insolvency proceedings.

In consideration of the increasing volume of restructurings in France, the regulator's attention is focused on the adequacy of the legal framework within a distressed situation. As a result, France adopted a new Ordinance on insolvency proceedings on 18 December 2008, which came into force on 15 February 2009. This reform is principally aimed at improving former insolvency regimes, in particular safeguard proceedings in effect since 1 January 2006, and consequently creating a more attractive 'debtor-friendly' legal framework similar to Chapter 11 of the Bankruptcy Code of the US.

Such debtor-friendly developments make it possible to implement a new corporate restructuring tool in France: the prepackaged deal. For the debtor, it consists of signing a restructuring agreement with its creditors and possibly soliciting the plan's acceptance, prior to filing for safeguard (or insolvency) proceedings. The company simultaneously files a plan of reorganisation. Given such advance negotiation, a confirmation hearing can be scheduled quickly, leading to a quick exit from the distressed situation[7].

As already observed, in the Autodis case the corporate restructuring was contractually agreed in a protocol entered into by the debtor and its main creditors, under the supervision of a special mediator (*mandataire ad hoc*)[8]. Autodis then filed for safeguard proceedings on 18 February 2009 (three days after the new Ordinance came into force), and less than 45 days after the opening of the safeguard proceeding, a plan was endorsed.

Although theoretically not necessary since an agreement has been settled upfront, the opening of the court-assisted safeguard procedure was essential in order to cram-down the minority of recalcitrant creditors. This was the first prepackaged deal to be implemented in France, but may not be the last one.

Thus, where the entrepreneur seeks to anticipate the situation at an early stage and to agree on a safeguard plan with its creditors to restructure the company's indebtedness and consequently ensure the continuation of the company's activities and maintain, as much as possible, employment, it should file for one of the court-assisted proceedings before a suspension of payment is declared.

This is as true as, under safeguard proceedings, the debtor now has the possibility to propose an administrator of its choice to the court opening the proceedings, thus retaining control over the procedure and its assets[9]. It also no longer needs to demonstrate that the difficulties it is facing will lead to it becoming insolvent; instead it is now possible to trigger the procedure if it demonstrates that it is encountering "difficulties that it is not able to overcome"[10].

Finally, the efficiency of the safeguard procedure may be supported by the newly introduced possibility for the financial institution's committee to convert their debt into equity, as explained above, but under court supervision.

This last provision was inspired by the restructuring negotiation techniques that Eurotunnel has operated under the protection of France's former bankruptcy law[11], where creditors received notes redeemable into shares to be issued by a newly established company that would be traded in Paris and in London.

New M&A opportunities, new M&A challenges

In line with the implementation of 'debtor-friendly' measures and practices, the recent reform also provides that a safeguard procedure could be ended by way of transfer of the business during the safeguard observation period.

In fact, Article L.622-10 of the French Commercial Code allows the debtor itself to convert the safeguard procedure into a rehabilitation procedure (*redressement judiciaire*) before it becomes insolvent. Then, if the entrepreneur early identifies that the outcome of the insolvency proceeding will be negative, it should, even under an out-of-court process, consider transferring the assets of the company to a buyer before it goes insolvent.

From a buyer's point of view, the current context is ideal to improve and expand its business by purchasing attractively priced distressed assets, notably because the valuation techniques are based on a multiple of EBITDA, which is usually low for a distressed asset. Valuation-driven investments are usually made when reasons for triggering an increase in value can be ascertained, even if the timing of the increase is uncertain. Typically, investors target over-leveraged, hence distressed, companies that generate cashflows.

Such a distressed M&A process is time-sensitive and the valuation of the company as well as the assessment of legal or financial risks are crucial but may be complex. As previously observed, in order to preserve the value of their assets, distressed companies must often be sold quickly, before they devalue and are forced to cease operation and liquidate.

In addition, it is today rather difficult to forecast a target's performance or its ability to honour its obligations. In fact, a distressed seller may not be in a position to stand behind its indemnification obligations to the purchaser should he breach its representations and warranties[12].

Thus, as the seller may not be able to provide sufficient guarantees, in particular for sales out of insolvency, the buyer will have to consider all potential risks when coming up with a purchase price offer. Such risks have to also be assessed by the seller itself as recent case law in France, in particular the Alcan Rhénalu and the Samsonite cases, outlined the necessity for a seller to ensure that the purchaser of a troubled business has sufficient financial capacities to handle a restructuring plan.

This was held on the basis of the seller's obligation of loyalty to its transferred employees. By selling its company knowing that there is a high likelihood that the buyer will put the company into bankruptcy, a seller commits acts of negligence or even fraud, giving rise to damages to the company's employees who would have otherwise been entitled to more advantageous termination benefits from him.

In Alcan Rhénalu, the court granted damages to the company's employees[13], while in the Samsonite case, the court cancelled the transfer with retroactive effect, because the seller did not ensure that the purchaser had a realistic restructuring plan and the ability to implement it[14]. The theory was previously validated by the French *Cour de Cassation* in the Bull case[15]. Specific vendor due diligence on the purchaser may therefore be carried out (for example by independent experts) to reduce the risk of transfer cancellation.

In distressed times, vendor due diligence (i.e. on the target) speeds up the sale process, thus saving costs and value, since it eliminates the duplication of due diligence work by multiple buyers. Firm control must be maintained at all times in the due diligence process which must be based on an assessment of future perspectives (i.e. restructuring opportunities, business plan as well as legal risks) as much as on an investigation of the past. From a legal viewpoint, it is highly likely that a restructuring concept has already emerged, for example the reorganisation of the debt or the insolvency plan, and the emphasis of the audit is placed on the validation of this existing concept[16].

At the same time, buyers may consider securing their transactions, and will likely recur to condition precedent and/or specific clauses such as material adverse changes clauses (MAC clauses). Their function is to offer the buyer the possibility to terminate a deal without paying a reverse break-up fee to the seller[17]. It generally covers the period between the date of the seller's most recently audited or non-audited financial statements and the closing.

In distressed economic times, particular attention should be paid to the drafting of such clauses in order to avoid any time-consuming litigation. Under the French regime, they may not be *'potestative'*[18], which means (i) they shall not enable the buyer to unilaterally argue a material adverse change in order to withdraw from the deal; and (ii) the event causing the withdraw shall not be left to the sole buyer's will.

This practically means to specifically described causes and events that may constitute a material adverse change. It must at least be an event, the materiality of which shall significantly and durably affect the activity of the distressed company, rather than the market where it operates[19].

To take into account the evolution of the financial situation of a company between the signing and the closing, buyers will also highly likely forecast price-adjustment clauses, which will help correcting, for example, the variation of the net assets value of the target during this period.

More likely, in support of their negotiation of a 'distressed' price (meaning 'attractive'), buyers may negotiate with the seller's earn-out clauses. While it gives an incentive to the seller, it minimises to the buyer's advantage the risk of mis-evaluation of the purchased distressed company. As a result, the valuation of the assets may reflect the reality, for the sake of both parties, or of the market.

These clauses are nevertheless relatively unstable and can present legal risks, likewise price-adjustment clauses, if they are not drafted with precision and stringency as Article 1591 of the French Civil Code sets out the following principle: "the sale price must be determined and designated by the parties".

This principle was nevertheless relaxed by case law, allowing the price to be at least determinable[20]. Practically, this means to highlight the underlining calculation methods to be used so that the price may distinctly and independently be established, set the duration period of the clause, and where appropriate, define the role of the seller within the company following its sale[21]. Besides, like MAC clauses, they may not be *'potestative'*.

It is also important that the parties, by precaution, simultaneously forecast in the sale agreement to refer to a third-party expert to determine the value of the shares sold, as they are invited to do so pursuant to Article 1592 of the French Civil code[22]. This provides that if the expert is unwilling or unable to make an estimate, there is no sale, since the price is not determined or determinable.

As a consequence, in absence of any agreement between the parties regarding the elements taken into consideration to calculate the earn-out and if no expert has been appointed by the parties to fix the price, the price is not determined or determinable, and the whole transaction would accordingly be void and should be unwound.

Thus, even if historically armed, the current economic situation generates new restructuring and M&A challenges as well as techniques that must be apprehended with the adequate corporate restructuring tools, and, in conclusion, one may recall the words of Thomas Watson, the founder of IBM: "That's where success lies – on the far side of failure."

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1 Definition given by Karl Clowry; '*Debt for equity swaps*'; Globe Business Publishing, Ltd.
2 AFP on 24 July 2009.
3 Either directly or after they have been traded on a secondary market.
4 '*Peut-on prêter pour posséder ("loan to own") en droit français*'; S. Vermeille, JCP E No 28, 9 July 2009, 1709.
5 Autodis is the holding of the Autodistribution group.
6 '*Conversion de la dette en capital, une arme à double tranchant*'; G. Benoit; Option Finance No 1019 – 9 March 2009, p. 4-5 ; '*Le retournement d'Autodistribution marque une nouvelle ère du LBO en difficulté*' ; E. Amiel and P. Hammeau, MdA No 39, March 2009, p. 9.
7 See '*An empirical examination of prepackaged bankruptcy*'; B. L. Betker; financial management, vol. 24, No 1; Spring 1995.
8 Such a court assisted procedure present the advantage to be a confidential non coercive procedure, in which a mediator is appointed on demand of the legal representative of the company to assist it in seeking an agreement with creditors. Entrepreneurs may alternatively opt for the conciliation proceedings, the purpose of which is also to enable a company to come to a restructuring agreement with its creditors, but which may not be confidential.
9 Article L.621-4 of the French Commercial code.
10 Article L.620-1 of the French Commercial code.
11 Law No 2005-845 enacted on 26 July 2005.
12 Recent statistics conducted by CMS Francis Lefebvre on 19 Mai 2009 show that warranties ceiling and duration has increased in 2008 in 23% of the M&A deals for the European market and in 9% of the French deals.
13 '*Défaillance d'entreprise: l'actionnaire et l'ancien employeur responsables à l'égard des salaries*' ; A. Szekely ; MdA No 39, March 2009, p. 29.
14 Tribunal de Grande Instance de Béthune, 24 June 2008, cited in '*Seller's liability for business facing financial difficulty*'; I. MacElhone, W. Maxwell and H. Bernhard; International Law Office French M&A Newsletter, Globe Business Publishing Ltd., 8 April 2009.
15 Bull case, 14 November 2007.
16 '*Corporate Restructuring: Finance in times of crisis*'; M. Blatz, K.-J. Kraus, S. Haghani; ed. Springer, 2006.
17 '*Les contrats à l'épreuve de la crise : les aspects corporate*' ; T. Gontard and N. Nevzi ; Revue Lamy Droit civil, July-August 2009, No 62, p. 54 et seq.
18 Prohibited by the article 1170 of the French Civil code.
19 '*Les contrats à l'épreuve de la crise : les aspects corporate*'; Ibid.
20 Case law No 06-14357, dated 26 September 2007.
21 '*Earn-Out Clauses: A User's Guide*'; I. MacElhone and K. Chabrières; International Law Office French M&A Newsletter, Globe Business Publishing Ltd., 25 February 2009.
22 Under certain circumstances, the appointment of an expert is legally required (article 1843-4 of the French Civil code). This provision applies to some specific transfers of shares and, in this case, the expert will not be bound by the price calculation method, which is defined in the by-laws.