Evaluating France's introduction of the classes of affected parties mechanism

The system has proved to be effective in addressing companies with business difficulties, but areas of uncertainty remain, say **Laïd Estelle Laurent, Jean Delapalme,** and **Claire Blondel** of **Jeantet**

The French system for dealing with companies in difficulty comprises two categories of procedure:

- 'Amicable' procedures (namely, *mandat ad hoc* and conciliation), which aim to reach an agreement with the main creditors through confidential negotiations under the aegis of a third party appointed by the president of the court; and
- 'Collective' legal proceedings (namely, safeguard, accelerated safeguard, receivership, 'crisis exit', judicial liquidation), which are characterised, in particular, by restrictive measures for creditors:
- Suspension of legal proceedings against the debtor;
- Prohibition on the debtor paying claims arising prior to the opening judgment; and
- Continuation of current contracts, which cannot be terminated on the sole ground that the insolvency proceedings have been initiated.

There are several possible outcomes in insolvency proceedings:

- If the company can prove that it will be able to pay all its debts within a maximum of 10 years, a 'continuation plan' can be drawn up;
- If a continuation plan is not possible and the business can be sold to a third party, a sale plan will be considered; or

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- If the company cannot prove that it will be able to pay its debts over a maximum of 10 years, and if the business cannot be sold, the court will order the company to be wound up.

An order dated September 15 2021 transposing **Directive (EU) 2019/1023 of 20 June 2019** has significantly amended the rules for consulting creditors on the draft continuation plan, particularly in the context of an accelerated safeguard.

Until this reform, there were two ways of consulting creditors:

- Individual consultation – each creditor was consulted individually on the proposed terms and conditions. In addition, the proposed repayment terms should, in principle, be the same for all creditors.
- Consultation of certain creditors within committees – credit institutions and the main suppliers were brought together within two creditors' committees. Bondholders were also consulted collectively at the bondholders' meeting. The other creditors were consulted individually. This method of consultation was only possible for companies above a

certain size (more than 20 employees, more than €3 million in sales excluding tax, and more than €1.5 million in total assets).

In accordance with the requirements of the directive, the order dated September 15 2021 repealed the provisions relating to creditors' committees and replaced them with "classes of affected parties".

Firstly, consultation by class has been extended to all creditors, unlike the previous committees, which only involved credit institutions and the main suppliers.

Secondly, consultation by class is required in accelerated safeguarding, whatever the size of the company.

In other collective proceedings, the debtor can always request the constitution of classes, regardless of the size of the company.

Since the entry into force of the transposition order, insolvency practitioners have made frequent use of the new mechanism of classes of affected parties, which has already proved efficient (Part 1), even if its implementation has left some areas of uncertainty (Part 2).

Part 1: Effectiveness of the system

Section 1: The system

The new system of classes of affected parties in French law will be described by first discussing the fate of creditors (subsection 1), then that of shareholders (subsection 2).

Subsection 1: Treatment of creditors

Affected creditors

Article L.626-30 I. 1° of the French Commercial Code defines affected creditors as "creditors whose rights are directly affected by the draft plan".

In safeguard proceedings, the affected creditors are generally those listed by the debtor's auditor or, failing that, the debtor's chartered accountant and submitted to the court-appointed administrator when the proceedings are opened.

However, the French legislator has excluded from the scheme certain creditors whose rights are subject to special protection, such as employees and creditors benefiting from a trust.

Any other claimant arising prior to the opening judgment will be considered an affected party, including public entities, credit institutions, bondholders, and suppliers.

Class composition

It is up to the administrator appointed in the accelerated safeguard, safeguard, or receivership proceedings to decide on the composition of the classes. They have considerable freedom to do so.

However, the administrator must comply with the provisions of Article L.626-30 of the French Commercial Code, giving them the task of dividing, on the basis of verifiable objective criteria, the affected parts into classes representing a sufficient community of economic interest, taking care of:

- Separating creditors from equity holders;
- Among creditors, separating those having security from those who do not; and
- Respecting subordination agreements.

By way of comparison, in the US, under Chapter 11, a claim may be placed in a specific class if it is substantially similar to the claims in that class, assessed by similarity of nature or legal effect on the debtor's assets.

In England, the High Court uses a flexible approach, with each class grouping together members whose rights are similar enough to serve their common interest.

In France, the division into classes is justified by a "sufficient community of economic interest", a criterion that leaves room for interpretation.

Apart from the criteria set out above, there can theoretically be as many classes as there are creditors.

In some cases, the administrator will not hesitate, within the limits set by the law, to multiply the classes if it is likely that they will obtain a majority of favourable classes.

In the *Le Grand Cercle 95* case (Commercial Court of Pontoise, May 24 2024, RG 2024L00099), no fewer than 11 classes were created, including four classes reserved for service providers and suppliers of goods, when they were deemed essential.

In some cases, the court imposes class splits.

For example, in the *Orpea* case, the Versailles Court of Appeal ordered the splitting of the class of unsecured bank creditors to create a class dedicated to creditors with unsecured claims who also have preferential claims, which the court justified on the ground of a difference in economic interest in the adoption of the plan.

Voting procedures

Within each class, members vote on the draft plan by a two-thirds majority of the votes cast.

As a result, it may happen that a creditor representing only a small percentage of the voting rights within their class is the only one to vote and consequently represents 100% of the votes cast.

The vote may be replaced by a memorandum of understanding if it is signed by affected parties representing at least two thirds of the votes. The plan was thus adopted in the form of a memorandum of understanding signed by all the affected parties in the *Electro Holding* case (TC Paris, September 12 2022, No. 2022024000).

Outcome of the vote

Class voting can lead to two situations:

- All classes voted in favour of the draft plans; or
- At least one class voted against, in which case the court may impose the draft plan on the dissenting classes, subject to a number of criteria designed to safeguard the interests of the dissenters to a certain extent.

Subsection 2: Treatment of shareholders

The class system introduced by the 2021 order requires the creation of separate classes for creditors and holders of capital.

Furthermore, if it appears that the holders of capital have divergent economic interests, the administrator will set up several classes of holders of capital.

The question arose as to how convertible bondholders should be allocated.

In the *Orpea* case (Nanterre Commercial Court, May 12 2023, No. 2023M02419), the court held that holders of convertible bonds exchangeable for new or existing shares are creditors and not holders of capital, until such time as they have converted their bonds.

Section 2: Efficiency

The mechanism of classes of affected parties was quickly applied in major cases.

The effectiveness of the system is due to the great flexibility given to the administrator, not only in composing the classes, but also in drawing up personalised repayment proposals. The draft plan may provide for different treatment for each class of affected parties.

The effectiveness of the system is also, and above all, due to the court's ability to impose the plan on the affected parties who

voted against the draft plan, through a mechanism of 'cross-class cram-down'.

Measures may also be imposed on holders of capital: in the *Arc Holdings* case (Lille Commercial Court, August 1 2022, No. 2022012570), holders of share warrants had the choice of subscribing to the planned capital increase or having a capital reduction followed by a capital increase imposed on them, resulting in the dilution of their rights, with silence constituting acquiescence to the dilution.

By comparison, in an individual consultation, only uniform repayment terms can be imposed on creditors by the court.

However, there are limits to the sacrifice that can be made by the parties involved in a class.

Creditors:

- Creditors of the same class must be treated equally and in proportion to their rights;
- The plan must respect subordination agreements;
- Even when the plan is adopted unanimously by the classes, the court must check that each creditor who voted against the plan is not treated less well under the draft plan than under an alternative solution if the plan is rejected; and
- The plan's proposals must respect the principle of 'absolute priority' for the senior classes who voted against.

Equity holders:

- The plan can only be compulsorily applied if the company is automatically eligible for the affected party classes (€40 million net sales or €20 million net sales and 250 employees);
- The plan can only be enforced if the holders of capital would not be entitled to any payment in an alternative scenario in the absence of the adoption of the plan;
- Preferential subscription rights are retained in the event of a capital increase for cash; and
- The plan does not provide for the compulsory sale of shares.

For all:

- In insolvency proceedings, the parties affected may submit a draft plan competing with the one drawn up by the debtor and the administrator, although the question arises as to whether this option is feasible in terms of timeframe and level of information; and
- Lastly, regardless of the outcome of the class vote, the mechanism gives the court considerable discretion, enabling it, in particular, to refuse to adopt a draft plan in which the interests of creditors are deemed to be excessively prejudiced.

Nearly three years after the introduction of classes of affected parties in French law, the initial results are certainly positive.

It has been observed that creditors are often prepared to make major sacrifices, fearing a court-ordered liquidation that would be less favourable to them.

In practice, the court rarely has recourse to cross-class cram-down, and only uses it to override the opposition of bank creditors who also benefit from a state guarantee and who fear that a favourable vote would cause them to lose this guarantee.

While the effectiveness of the system is indisputable, practice has revealed several areas of uncertainty.

Part 2: Areas of uncertainty

Section 1: The main areas of uncertainty where improvements can be made

Voluntary exclusion of creditors

One of the main uncertainties raised by the new system relates to the possibility of voluntarily excluding certain creditors from the classes of affected parties.

This uncertainty arises from the legal definition of affected creditors as those "whose rights are directly affected by the draft plan".

Based on this definition, it could be argued that the debtor and the administrator can unilaterally decide to exclude certain creditors from the affected party class arrangements.

Such an interpretation would call into question the collective nature of safeguard and receivership proceedings, which, by their very nature, concern all creditors.

It is true that the new article D.626-65 5° of the French Commercial Code sows doubt by specifying that the draft plan must include "the parties that are not affected by the restructuring plan, as well as a description of the reasons why it is proposed not to include them among the parties concerned".

However, the Versailles Court of Appeal in the *Horizon Steglitz* case (March 14 2023, No. 23/00519) closed the door on such an analysis, ruling that the sole purpose of Article D.626-65 5° of the French Commercial Code was to enable the administrator to report the existence of creditors legally excluded from the classes.

The question remains open, as the Court of Cassation has not yet ruled on the matter.

However, even if the Court of Cassation were to go against the Versailles Court of Appeal, the court's power to reject a plan that excessively affects the interests of the parties affected by the exclusion of certain creditors from the collective discipline should make it possible to guarantee the correct interpretation of this text.

Differences between certified and definitive liabilities

The system of classes of affected parties requires the debtor to communicate, in addition to the usual list of creditors provided for in Article L.622-6 and intended to invite creditors to declare their claims, a list of creditors certified by its auditor or, failing that, its chartered accountant.

In practice, these liabilities are rarely the final liabilities for which the plan is adopted.

However, the liabilities certified by the debtor are, within the meaning of the text, the liabilities on which the insolvency administrator must base the composition of the classes and the determination of the voting rights of each affected party.

In practice, this difficulty crystallises when it comes to disputed claims, whether as plaintiffs or defendants; i.e.:

- Claims that are the subject of ongoing proceedings and for which the amount of the claim has not been entered in the financial statements;
- Claims that are disputed by the debtor; or
- Later claims that are intended to be paid under the plan and that, by assumption, have not yet arisen at the time the certificate is drawn up when the proceedings are opened.

Regarding disputed claims, the Paris Court of Appeal recently reaffirmed the principle, established for plans subject to individual consultation, that all claims, even disputed ones, should be taken into account when the plan is adopted (May 30 2024, No. 24/00177).

This decision reinforces the uncertainty in so far as it indirectly implies that creditors who are not called at the stage of consultation by class must nevertheless be taken into account at the stage of adoption of the plan.

'Best interest test' and valuations

Under the 'best interest test', each creditor who voted against the draft plan must receive at least as much under the plan as it would receive in the event of liquidation, a sale plan, or another solution.

This test therefore requires several valuations to be drawn up by an independent third party, who will, in principle, be appointed by the administrator at the start of the procedure.

However, the concrete assessment of the situation of creditors in each scenario is not obvious.

Regarding the comparative scenario of a 'sale plan', it seems uncertain how realistic such a valuation would be in the absence of any offer(s) from potential candidates. This would mean issuing a call for tenders for each case, with the costs that this entails and the variation in the procedural timetable if a bid is submitted. In practice, administrators tend to indicate in their report to the court that a sale was not a viable option in the case in point (see, in particular, the Commercial Court of Pontoise, February 10 2023, RG 2022L01806, *Unhycos*; the Commercial Court of Pontoise, May 24 2024, RG 2024L00099, *Le Grand Cercle 95*).

In addition, the text only considers the 'sale price' when assessing the situation of creditors, even though creditors are also paid out of the debtor's available cash, debt recovery, and any other residual assets included in the scope of the post-sale judicial liquidation.

Regarding the comparative scenario of a judicial liquidation, the main difficulty concerns creditors with security interests, who, in this capacity, are classified as preferential creditors for the assessment of liquidation distributions.

However, in the context of a genuine liquidation, certain security interests prove ineffective, with the result that their holders are treated no better than unsecured creditors.

In their case, the assessment of the best interest criterion should generally lead to a consideration of them as unsecured creditors and a requirement for them to waive large amounts of debt, because of the low value of their lien base.

In Belgium, Italy, and the Netherlands, the decision has been made to consider creditors as holders of security only up to the fraction of their claim guaranteed by the lien. In France, this clarification has not been incorporated into the classes system but could be linked to the concept of economic interest to justify the splitting of their claim.

Section 2: Possible remedies to remove these uncertainties

In the US, creditors may challenge the classification of claims and the treatment proposed in the restructuring plan before the bankruptcy court. In England, creditors can also challenge the composition of classes and the terms of the plan in the High Court.

The above-mentioned areas of uncertainty in the French system, combined with the significant sacrifices that may be imposed by the court on creditors and equity holders, have already fuelled, and will continue to fuel, litigation in French insolvency law.

In France, although certain measures are not subject to appeal, such as the authorisation given by the judge to form classes below the thresholds or the voting procedures decided by the administrator, appeals are available throughout the process:

- A creditor or equity holder wrongly considered by the administrator to be an affected party may lodge an appeal within ten days of being notified;
- An affected party who has voted against the plan, if it considers that the best interest test has been incorrectly applied, may refer the matter to the court, which will then establish, or have established, an appropriate valuation; and
- Each affected party may appeal against the judgment adopting the plan.

Final thoughts on the system of establishing classes of affected parties

The mechanism for consulting creditors and shareholders in classes of affected parties has considerably strengthened French law on dealing with business difficulties, which is now on a par with neighbouring systems.

Although inspired by American and English systems, the French system has unique features, particularly in terms of the criteria for classifying and processing claims and rights.

The areas of uncertainty – such as the voluntary exclusion of affected parties, the application of the best interest test, and the absolute priority rule – can easily be improved, firstly through case law, which will become increasingly abundant, and then through legislation, to ensure the efficiency, fairness, and stability of insolvency proceedings, thus guaranteeing France's attractiveness for foreign investors.