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Banking - France

Repurchasing distressed debts: a solution to banks' problems?

Contributed by **NMW avocats**

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Introduction

Capital acquisition through the repurchase of distressed debts could provide a solution to the problems that banks currently face. Stricter banking regulation means that there is a need for additional capital. Banks are still suffering losses incurred in the ongoing financial crisis. When trying to find ways to strengthen their capital, some banks are tempted to transfer - either temporarily or permanently - the mortgage liabilities which are rapidly consuming their capital.

Generally, the restrictions on banks' lending capacity encourage them to transfer non-profitable liabilities in order to restore their lending capacity. This update examines how banks can overcome their current problems through the repurchase of distressed debts.

Debtor's perspective

A company has bought a property for a value of 100. It is financed by shareholder equity at 30 and a loan from the bank at 70. Due to financial difficulties, the property is now estimated to be worth 55. The loan has covenants which provide for the use of guarantees, notably where the value of the property is reduced. The debt is secured by a mortgage and a pledge on the shares of the company.

Even if it transfers the property, which is worth 55 compared to the original value of 100, the company cannot pay back its debt or the guarantees. The company could also be liable in the case of a management fault.

Creditor's perspective

A company is a debtor with a liability of 70, with a pledge on the company's shares which benefits the bank. The bank transfers the liability with a nominal value of 70 to another company for 60. The bank has two options:

- It can increase the interest rates; or
- It can transfer its non-profitable liabilities in order to meet its targets due to the restrictions on its lending capacity.

For an asset bought for 100 and now valued at 55, the bank would have to provide 15 (70 - 55). Consequently, the bank would be inclined to transfer the liability for 60. In this case, the bank would make a loss of 10 (70 - 60) and a corporate tax saving of 3 (10 x 33.3% = 3). The bank would limit its actual loss to 7 (10 - 3).

Transferee's perspective

The bank transfers the liability with a nominal value of 70 to the transferee company for 60. The debtor company then buys back the shares for €1 each from the company. The transferee company has therefore bought the liability for 60 with a nominal value of 70 and a current value of 55. The transferee company enforces its right from the pledge on the debtor company's shares and thus releases through this company a loss of 45 (100 - 55). The transferee company therefore makes a corporate tax saving of 15 through the debtor company (45 x 33.3% = 15). This solution is possible as, under French tax law, a deficit or potential losses are not questioned where there is a change of control, except where there is an abuse of law.

From an economic point of view, it is necessary to consider recent legislative amendments. The Financial Law 2011 imposes a cap on the use of deficits. The transferee controls the timeframe for tax losses, which are potential losses only for as long as the property is not transferred. Implementing a fiscal integration between the transferee and the debtor company allows the transferee to control the deficits directly at the appropriate time.

Analysis

This operation could present certain difficulties with regard to the monopoly of the banks, litigious redemption and guarantees.

Bank monopoly
Where a buyer of liabilities is an investor rather than a credit institution, it must be considered whether the repurchase of such liabilities is likely to breach the banking monopoly. No entity other than a credit institution is permitted to carry out banking transactions or to provide payment services on a regular basis; nor can any entity other than a credit institution receive equity from the public either immediately or for a term of less than two years.(1) Any person acting as an entity or on its behalf who ignores these bans may incur a penalty of up to three years in prison and a fine of up to €375,000. However, the Supreme Court has stated that transactions carried out by unauthorised persons in breach of the monopoly are not necessarily null and void.(2)

Banking transactions can be classified as follows:

- receipt of money from the public(3) in the form of a deposit with the right to use the money as long as it is replaced;
- credit transactions(4) such as the immediate or deferred availability of funds, or leasing transactions with a call option; and
- payment services,(5) which include the possibility for funds to be transferred and cash services.

The repurchase of distressed debts cannot be considered to be any of these three transactions. No equity is made available, except where a new loan is granted.

Litigious redemption
Litigious redemption is the possibility for the debtor of a disputed right to discharge the debt by reimbursing the transferee with the price of the transfer once the creditor has transferred its debt.(6) The debtor must pay the price of the transfer, any eventual costs and any interest. The transferee's consent is not required.(7)

The following conditions apply to litigious redemption:

- The right can be exercised only after being disputed – a procedure must be in place at the time of the transfer. The procedure must concern the substance of the case.(8) The litigation must still be ongoing at the time of the litigious redemption.(9)
- Redemption can be exercised only by a defending party.(10)
- There must be an actual transfer – for example, a transfer resulting partially from shares under the scission regime does not constitute a transfer allowing the use of litigious redemption.(11)

In this context, it is possible to transfer an asset in two ways:

- The transfer of several assets for a fixed price – as long as the assets can be individualised,(12) a transfer made for a fixed price calculated statistically and not on a case-by-case basis is not, in itself, enough to exclude the application of Article 1699 of the Civil Code.
- An earn-out by way of an additional price according to the result of the procedure – this is not uncertain as it is determined according to the collection of funds. The earn-out does not prevent the litigious redemption.(13)

Insolvency proceedings prevent the debtor from exercising the litigious redemption. A repayment or liquidation judgment means that the debtor cannot pay off any debts which arise before the judgment.(14) Similarly, the liquidator, which must act in the parties' collective interests, cannot exercise the litigious redemption.(15)

Covenants
Covenants are stipulations included in the loan agreement. They oblige the borrower to respect certain financial norms such as particular ratios and debt restrictions. Covenants can also prohibit the borrower from providing security and from taking out new loans without the agreement of the lender. If such stipulations are not adhered to, penalties include immediate reimbursement and readjustment of the tariff conditions. The effects of the covenant can always be limited for different reasons, such as declaring a debt and prohibiting the payment of debts which arise before the judgment (and thus freezing the immediate reimbursement).

No doubt such investments will become more common in the coming years due to the financial benefits that they offer to the lending parties.

For further information on this topic please contact Sarah Lugan at NMW avocats by telephone (+33 1 83 62 54 54) or email (slugan@nmwavocats.com).

Endnotes

(1) Article L511-5 of the Monetary and Financial Code.

(2) Cass Ass Plen March 4 2005, 524.

(3) Article L313-2 al1 of the Monetary and Financial Code.

(4) Article L313-1 of the Monetary and Financial Code.

(5) Article L313-3 of the Monetary and Financial Code.

(6) Article 1699 of the Civil Code.

(7) Cass Com December 19 2006, 04-15.818.

(8) Cass Com February 26 2002, 99-12228.

(9) Cass Com November 13 2007, 06-16965.

(10) Cass 1st civ January 20 2004, 00-20.086.

(11) Cass Com October 5 2004, 00-21955.

(12) Cass 1st civ June 4 2007, 06-16746 and Cass Com May 27 2008, 07-11428 07-11530.

(13) Cass Com November 13 2007, 06-16965.

(14) Cass Com October 12 2004 03-11615 and Cass Com February 14 2006, 04-13907.

(15) Cass Com May 9 2007, 06-11275.

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