CLIFFORD
CHANCE

Client briefing
September 2011

France: Recognition of Trusts and Parallel Debt structures

In a landmark decision dated 13 September 2011, the French Supreme Court recognises trusts and parallel debt structures in International Financings.

In the famous Belvedere restructuring, the French Supreme Court has recognised trust and parallel debt structures governed by New York law in the context of filing of proof of claims within French safeguard proceedings.

Reinhard Dammann, partner in the restructuring group based in Paris, remarks *"Financiers and insolvency practitioners have been anticipating this ruling with great interest. The recognition of the trust structure and of the parallel debt mechanism as a matter of French law provides more legal certainty and will facilitate greater access for French debtors to international financings. With much uncertainty in the financial markets in the Eurozone at present, this decision is very timely."*

The first issue considered by the Supreme Court related to a New York bank who was acting as a trust agent on behalf of bondholders and had filed proof of claims for the amount of €375 million in the safeguard proceedings opened in France. (*For a brief refresher of the safeguard process and implications in relation to Belvedere, see "Safeguard plans and proof of claims" at the end of this briefing.)* The debtor argued that the filings should be rejected because the trust agent was not the legal owner of the bonds, but a mere proxy acting for the bondholders without the benefit of a formal proxy. The French Court rejected these arguments, thus recognising the trust structure which was governed by New York Law. This ruling is even more remarkable since France has not ratified the Hague Convention on the law applicable to trusts and on their recognition dated 1 July 1985.

Secondly, two other banks, acting as security agents under New York law, filed proof of claims in the same amount as the trust agent in their capacity as legal owners under the parallel debt mechanism. The French Supreme Court upheld their proof of claims, considering that it did not contravene French public policy. Thus, the concept of the parallel debt structure has now been recognised as a matter of French law.

Background

Belvedere is a producer of spirits, most famous for its Polish Vodka. It is based in the wine capital of Beaune, in the Burgundy region of France. It had issued bonds in the amount of €375 million. The bond documentation was governed by New York law. A US bank was appointed as trustee and the two other banks were appointed as principal and ancillary security agent respectively. Its seven Polish subsidiaries stood as surety for the bonds.

On 16 July 2008, the Commercial Court of Beaune opened safeguard proceedings in favour of Belvedere and its seven Polish subsidiaries. This decision was controversial since the bondholders challenged the finding that the centre of main interest was in France rather than in Poland. This did not succeed and proceedings have continued in France.

Key Issues

- **Recognition of Trusts**
- **Security Agent/Parallel Debt Mechanism works in France**
- **Impact on the French legal and international finance**

If you would like to know more about the subjects covered in this publication or our services, please contact:

Paris

Reinhard Dammann +33 1 44 05 51 51

Frédérick Lacroix +33 1 44 05 52 41

Thierry Arachtingi +33 1 44 05 52 92

Daniel Zerbib +33 1 44 05 53 52

Jonathan Lewis +33 1 44 05 52 81

Yann Beckers +33 1 44 05 54 78

Gilles Podeur +33 1 44 05 24 20

London

Adrian Cohen +44 20 7006 1627

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

Within the framework of safeguard proceedings, three proof of claims were filed with the official creditors' representative by the trustee and the security agents. The judge responsible for the case allowed these claims and the claims were subsequently upheld by the Dijon Court of Appeal in September 2010. In particular, the Dijon Court ruled that the proof of claims in the amount of €375 million should be accepted, since the trustee was not acting as a mere bondholder's proxy but rather as the owner of the receivables in accordance with New York law.

The Court also upheld the proof of claims filed by the two other banks acting respectively as principal and ancillary security agents, ruling that the parallel debt structure under New York law was not contrary to French international public policy rules.

Thereafter, the debtor filed a further challenge to the Commercial Chamber of the French Supreme Court.

Recognition of trusts as a matter of French Civil Law

The question before the Supreme Court was to ascertain whether the trustee was filing the proof of claims in its capacity as legal owner of the receivables pursuant to New York law (which was the governing law of the trust deed), or in its capacity as proxy, pursuant to French law. In other words, the Supreme Court was asked to recognise as a matter of French law, the effects of a New York trust, without recharacterising it as a proxy. The recognition of a trust structure has been the subject of much debate in French case law over the years. As a general proposition, French case law recharacterised trust agreements as proxies, because French law did not recognise the trust mechanism and the French government had not ratified the Hague Convention on trusts.

A few years ago, this situation changed. In a decision dated 11 March 2005, the Paris Court of Appeal recognised a trust as such, with all its legal effects, without referring to the traditional method and having to resort back to a recharacterisation exercise. Therefore, the Court allowed trustees to start court proceedings to recover money in their own names but for the benefit of the beneficial owners, without having to disclose details of the individual beneficiaries.

In February 2007, the legislator introduced the "*fiducie*" into French Law but without implementing the Anglo-Saxon concept of beneficial owners and legal ownership. Consequently, the question arose as to whether French judge should recognise the legal ownership of a trust agent created under New York law.

This question is of particular importance in case of insolvency proceedings. Under French law, only the creditors or their specially appointed proxy can file a proof of claims. In the Belvedere case, the trust agent did not have a special proxy from the various bondholders since he was deemed the owner of the receivables as a matter of New York trust law. If the French judge had recharacterised the trust as a proxy, the filing of the proof of claims on behalf of the bondholders would have been inadmissible in the safeguard proceedings and the bondholders would have been unable to benefit from the provisions of the safeguard plan including any distribution of dividends. This is why the ruling of the French Supreme Court is of the upmost practical importance.

In its rulings, the French Supreme Court stated that the filing of the claims must be made pursuant to French insolvency law pursuant to article 4 of EC Regulation 1346/2000, but the question as to whether the trust agent was the owner of the receivable must be determined by New York law. Consequently, the French Supreme court recognised the trust as such without any recharacterisation.

Security Agent/Parallel Debt Mechanism works in France

The second issue at stake was the validity of the parallel debt mechanism. This mechanism, which is frequently used in international financings, consists of the creation of a parallel debt in the same amount of the same debt owed to the trustee, but with the security attached to it. Through this mechanism, the creditor of the parallel debt becomes the security agent, which allows him to foreclose over the secured assets for the benefit of the various bondholders.

In order to recognise the parallel debt structure within French insolvency proceedings, the security agent must file a proof of claims with details of the security interests. In the Belvedere case, the Court of Dijon held that this mechanism was comparable to joint obligations under French law and therefore valid, in accordance with public policy. The debtor challenged this reasoning on the basis that the filing of the parallel debt could lead to double payment in contradiction with public policy. In its ruling, the Supreme Court rejected this argument on the ground that the contract specifically provided that any payment made to the security agent would reduce the main debt accordingly.

What's next? The impact of the decision on international finance

This decision clarifies key questions raised in connection with international financings in favour of French corporations. Frédérick Lacroix, partner in our Finance and capital markets team in Paris comments "*The legal certainty that can be derived from this case is going to mean potentially greater access for French debtors in relation to international financings going forward. From an economic perspective, this could not have come at a better time*."

The recognition of the trust and of the parallel debt mechanism is likely to influence the French legislature which is presently contemplating an amendment of article 2328-1 of the French civil code introduced in 2007. Indeed, unfortunately, the reform of 2007 did not keep its promises as the legislator did not implement an Anglo-Saxon security agent structure. Following the Belvedere ruling, it would appear more likely that the French legislature will retain such a structure in order to increase the attractiveness of French law in the financial markets in the future.

Safeguard plans and proof of claims

By way of brief refresher, the purpose of the safeguard procedure is to facilitate the restructuring of a company which is facing insurmountable difficulties without being insolvent. In this procedure, management remains in place, but is subject to the supervision of a court appointed administrator. The restructuring proposals are set out in bespoke safeguard plan. In order to benefit from the plan, including the recovery of any dividends distributed pursuant to it, each creditor must file a formal proof of claim. However, even if such a proof of claim is filed, the enforcement of security is frozen during the whole duration of safeguard proceedings. It should be noted however, that creditors excluded from their rights in safeguard proceedings can still vote on the plan. Indeed, for companies exceeding specific thresholds in terms of employees or turnover, creditor committees are created for voting on the plan. These committees include all the creditors whose claims arose prior to the judgment opening safeguard proceedings, even those who did not file a timely proof of claims.

Pursuant to French law, only a direct creditor or a specially appointed proxy can file a proof of claims with the court appointed creditors' representative. In the Belvedere case if the trust had been recharacterised as a proxy, the proof of claims filed by the trust agent and the security agents would have been rejected and the bondholders would have been unable to recover any monies from the debtor.