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Distressed M&A transactions in France: a halt to liability claims against sellers?

The Commercial Chamber of the French Supreme Court ("*Cour de cassation*") has recently handed down a decision of particular interest for distressed M&A transactions: [Cass. com. 1er mars 2023, no. 21-14.787, FS-B.](#)

Alexandre Koenig, partner and head of the firm's restructuring and insolvency practice in France analyses the legal and practical consequences of this decision for sellers of French distressed companies.

Context

- As a general principle under French law, a shareholder of a limited liability company is limited to the amount of equity contributed to the subsidiary by said shareholder. The same applies in an insolvency context: the shareholder of a company placed in a French insolvency process is not, in principle, liable for the liabilities of the subsidiary, irrespective of its equity stake. There are, however, a certain number of exceptions to this non-liability rule in French case law, which some stakeholders tend to use to exert pressure on or try to seek the liability of shareholders of companies in an insolvency process in case one of its actual or former French subsidiaries end up in liquidation proceedings.
- Our experience of distressed M&A litigation notably reveals that, when the turnaround plan established by the buyer of a distressed company cannot be implemented under the conditions foreseen at the time of the sale, and ultimately leads to the liquidation of the target shortly after the sale, the crystallization of the target's liabilities and the dismissal of its employees can be a source of numerous disputes, involving notably the seller/former shareholder of the distressed company. This is precisely what happened in the case at hand.
- company's main customer. This project quickly proved to be a failure.
- On 21 November 2011, the target was placed in French receivership proceedings and its cashflow insolvency date was set at 31 July 2011 (i.e. at a date preceding the sale).
- The French target's rehabilitation proceedings were converted into liquidation proceedings on 9 May 2012. All the company's employees were dismissed in this framework on 30 May 2012.
- The sequence of events – which involved the insolvency process starting one month after the sale; the cashflow insolvency being set at a date prior to the sale; and the turnaround strategy being based on an ambitious increase of customer prices – led to cast doubt on the relevance of the buyer's plan to turn the distressed target's business around. The company's dismissed employees sought the liability of the seller based on tort law. They argued that selling a cashflow insolvent company without ensuring that the turnaround plan presented by the buyer included measures which were adapted to the target's situation and could avoid, at least in the short term, the start of an insolvency process, constituted in itself a wrongful act on the part of the seller.

Key facts

- On 18 October 2011, a German company sold its underperforming French subsidiary to a German buyer for one euro. The buyer's plan was to turn around the French target's business by, notably, renegotiating up to 30% of the prices charged to the
- On 27 March 2019, the employees won on first instance: the Civil Court of Fontainebleau held the seller liable and condemned it to pay the employees a significant amount of damages (Civil Court of Fontainebleau, RG no. 14/00867).

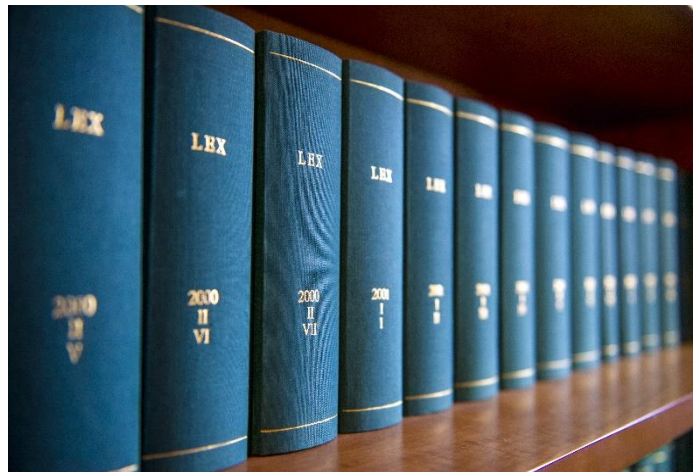
- On 4 February 2021, the Court of Appeal of Paris nullified the first instance decision and rejected the dismissed employees' claim (Court of Appeal, 4 February 2021, RG no. 19/07936). To do so, the Court notably held, based on the evidence produced by the parties, that the buyer appeared to be able to finance its projected investments at the time of the sale and that the seller could not be held responsible for the buyer's subsequent failure to comply with its plan.
- On 1 March 2023, on further appeal, the French Supreme Court confirmed the Court of Appeal's decision. The French Supreme Court notably held that: *"It does not follow from any text or principle that, when it sells the shares it holds in the share capital of a cashflow insolvent subsidiary, a parent company would be under an obligation to ensure, before the sale, that the buyer has a takeover project which guarantees the economic and financial viability of this subsidiary"*.

A reminder of sellers' autonomy and contractual freedom

- From a corporate law standpoint, the French Supreme Court's solution is consistent with the legal principle of "autonomy and independence of legal entities". Since the shareholder of a distressed subsidiary is under no legal obligation to support it financially, it seems logical, a fortiori, that the seller of a distressed target should not be under any legal obligation to ensure that the buyer of said target has a takeover project that guarantees the target's economic and financial viability. This solution is also in line with the principle of "freedom to sell" that prevails in M&A transactions, according to which a seller is, in principle, free to choose its purchaser, subject to any applicable statutory or extra-statutory clauses restricting the transfer of a company's shares.
- From a contract law perspective, this solution also reflects the "freedom of contract", which implies that each of the parties to a sale contract is free to choose its counterpart, the price and the conditions of the sale, without the judge interfering in the transaction. In a similar way, it must be noted that the Supreme Court refused the claimants indirect invitation to apply, in the context of an out-of-court amicable sale of shares, criteria inspired by those provided under French law in the context of court-supervised sales conducted within the framework of an insolvency process (for instance, the provisions of article L. 642-5 of the French Commercial Code, which require the selection, by the Commercial Court supervising the judicial sale, of the takeover offer that "provides the best conditions for securing employment on the longest possible basis" and

"offers the best guarantees of performance"). By refusing to engage in such a route, the Supreme Court confirmed the clear difference in regime that exists between, on the one hand, out-of-court distressed M&A transactions conducted on the basis of general contract law and, on the other hand, distressed M&A transactions organized under the aegis of a court, which are based on the derogatory provisions and mechanisms of insolvency law.

- As a result, the French Supreme Court is also setting a clear limit on attempts to engage the liability of sellers of distressed companies. In the range of options available to corporate groups engaged in a strategic review of an underperforming French subsidiary, the sale route, even if still subject to certain uncertainties, is thus strengthened, which seems a *priori* opportune for all stakeholders in the current economic context characterised by a peak in business failures and insolvencies.



Practical implications for distressed M&A transactions

- The apparent generality of the principle forged by the French Supreme Court raises questions as to its scope and practical implications for distressed M&A transactions.
- It has notably been observed that, while it could have upheld the Court of Appeal's decision by relying on the findings of the appellate judges - which had in fact verified the relevance of the buyer's takeover plan, noting that it was financed and included the required investments - by ruling the way it did, the French Supreme Court seems to consider that the appeal judges should not even have attempted to verify the soundness of the takeover plan to rebut the dismissed employees' claim.

Should this mean that any sale of a subsidiary in difficulty could henceforth take place without any form of duty on the part of the sellers, which would find themselves automatically protected from any legal

recourse in the event the takeover actually turns out to be a failure and the target company is placed in liquidation proceedings just after the sale?

- Despite the generality of the principle established by the French Supreme Court and the publication of its decision in the French Legal Gazette, its scope should in our view be put into perspective in at least two respects:

1. Firstly, it should be noted that the French Supreme Court only answers the specific questions of law submitted to it and that, as it stands, the Court has confined itself to rejecting the claimants' undoubtedly over-ambitious argument based on an obligation consisting, ultimately, for the seller to ensure, prior to the sale, that the buyer's project "guarantees" the viability of the target. This obligation is not only non-existent under French statutory law, but also and above all impossible to implement in practice, as no-one can guarantee in advance that a turnaround plan, which is intended to be implemented by a third party in a potentially deteriorated economic climate, will unquestionably ensure the viability of a business.
2. Secondly, it should be remembered that many legal grounds, that have not been called into question by this French Supreme Court ruling (e.g. seller's recklessness; seller's fraud in evading its obligations, in particular with regard to the target's dismissed employees; abnormal intra-group transactions; de jure or de facto directors' liability for mismanagement, etc.) remain potential vectors for litigation. These grounds for litigation actually constitute, at the same time, both effective safeguards against potential abuses by dishonest sellers and a renewed call for the judicious use of the various legal and practical tools crafted by R&I practitioners to secure distressed M&A transactions, which remain as useful and relevant as ever.

Practical recommendations for buyers and sellers of French distressed targets

- Our experience of post-acquisition litigation reveals that an optimal management of the above-mentioned risks requires not only to set-up a financial, contractual, employment and tax structure tailored to the specific features of a distressed M&A transaction, but also to adopt, at every stage of the process, a truly "pre-litigation" approach. To put it simply, this means that both the seller and the buyer must not only carry out minimum due diligence to

ensure that the turnaround plan envisaged for the distressed target is serious, and objectively feasible, but must also be able to provide proof of the steps taken to this end.

- The preparation and conduct of the bid process for the selection of a buyer should therefore be the first opportunity to pre-establish evidence of the appropriate steps taken by each party involved in the event of future disputes. On the seller's side, having recourse to a competitive bidding process (organised for transactions above a certain size, under the aegis of an investment bank), providing candidates with the information they need to carry out high-quality legal and financial due diligence (with a particular focus on the origin of the target's difficulties), and having the buyer's turnaround plan and its underlying assumptions reviewed and validated by a specialist audit firm will notably be very useful in this respect.



- At each key stage of the process, conducting a regular analysis of the project's main risks is highly recommended. This will depend on the quality of the bids received, the financial strength of the bidders, the extent of any re-organisation required prior to the sale, and/or the conclusions of the various parties involved in the project. The risk assessment should allow the parties involved in the transaction to arbitrate between, on the one hand, the business necessity to smooth the M&A process in order to get the deal closed in an accelerated timeframe imposed by the distressed situation and, on the other hand, the need to formalise and document the actions being taken to ensure the success of the transaction. This will ensure, on the basis of the objective information available at the time, that the buyer is serious, reasonable and has established a turnaround plan that appears in line with the target's corporate interest.

- In principle, the degree of prudence and nature of due diligence required should be inversely proportional to the financial strength and track record of the encompassed buyer. Where the buyer is a foreign investor, the traditional use of an ad-hoc vehicle specially set up for the acquisition raises the question of obtaining guarantees as to the identity of the shareholders and the capitalisation of the acquisition vehicle. The absence of such guarantees could indeed prove problematic for the seller in the event the target company enters into a French insolvency process shortly after the sale as a result of the acquirer's failings. In such a case, if the new, defaulting shareholder ends up being an "empty shell", the target company's liquidator and employees will have a strong incentive to increase pressure and, if necessary, take legal action against the seller.
- The higher the risks identified, the more advisable it is to resort to French preventive proceedings (ad-hoc mandate, conciliation) at the earliest stage possible. If used wisely, these proceedings are both suitable for negotiations relating to the sale itself (e.g. bid process, setting-up, review and validation of a turnaround plan for the target, negotiations with the target's creditors, etc.) and useful for providing proof of the steps taken in this context, with the ad-hoc agent or conciliator acting as an independent third-party reporting to the court on the steps taken to organise the sale. Approval of the agreement by the court is an additional security factor.

Conclusion

In the present case, one may notably observe that the incorporation of the French target's sale into a court-approved conciliation agreement would have put an end to any debate as to the cashflow insolvency date of the target (which, by law, cannot be set at a date prior to the court-approval of a conciliation agreement) as well as to the viability of the purchaser's project (that the Court supervising such proceedings would have had specifically verified in its approval decision).

The configuration of the case would therefore have been much different, which would mechanically have reduced the interest, for the claimants, in initiating 9-year litigation proceedings against the seller, which have, ultimately – save for the scientific interest of the French Supreme Court's decision at hand – mainly generated significant costs for the parties.

Key contacts



Alexandre Koenig

Partner

T: +33 1 44 15 82 09

E: alexandre.koenig@shlegal.com