

# LEGAL CONSEQUENCES OF BANKRUPTCY

## FRANCE

### TITLE 1. INTRODUCTION

#### ➤ Historical/aim

French bankruptcy law can be traced back to the creation of the French Republic at the end of the 18<sup>th</sup> century and the emergence of the modern French legal systems based on the Napoleonic Codes. Its evolution can be divided into three periods:

1<sup>st</sup> period: The Commercial Code of 1807 contained the first codification of legal provisions regarding merchants who were not capable of paying their debts. The focus of these provisions was clearly to punish the debtor and included incarceration, the sealing and confiscation of the debtor's assets and various civil and professional sanctions.

2<sup>nd</sup> period: A major shift in philosophy was introduced with the law of 1967 which sought to provide protection to creditors by assisting the company with its reorganization. If the debtor company had the possibility of being reorganized, the courts would establish a payment plan and allow the company to continue its activities, the goal being to protect the creditors. If the outlook for the debtor company was not positive, the court would order its liquidation. Only debtors who were guilty of intentional, grossly negligent or negligent conduct were subject to civil and criminal sanctions.

3<sup>rd</sup> period: More recently, the tendency has been to use the bankruptcy procedures as a way to protect debtors from their creditors and assist them in reorganizing in order to return to financial health.

The current system can be described as follows:

- 1) The law of March 1, 1984 regarding the amicable settlement of company difficulties has two primary objectives (article L.612-1 of the French Commercial Code). First, the law seeks to assist companies in avoiding the necessity of seeking bankruptcy protection through alert procedures. Second, the law facilitates the contacts between the debtor and its creditors to establish a reimbursement plan in order to avoid a bankruptcy procedure.
- 2) The law of January 25, 1985 regarding the reorganization and the judicial liquidation of companies prioritizes the objectives of bankruptcy policy in France (article L.620-1 of the

Commercial Code). The primary objective is to save the company and this is followed by protecting jobs and the activity of the company and finally, the reimbursement of the company's debts. The liquidation is ordered immediately only when the company ceases all activity or the reorganization and recovery of the company are clearly impossible.

➤ **Generalities regarding the procedure**

The bankruptcy procedure is open to merchants, registered craftsmen (“*artisans*”), farmers and legal entities. When the debtor is in default of payment (“*cessation des paiements*”) the courts will decide whether to begin a liquidation procedure (if the debtor has ceased all activity) or a reorganization (article L.620-2 of the Commercial Code).

The first stage of the bankruptcy procedure is the observation period which allows the court to determine the financial situation of the debtor. The duration of this period depends, in particular, on the size of the debtor and can vary from 4 to 20 months. At the end of this period the court makes its decision regarding the fate of the company. These decisions can be either to liquidate the company or to adopt a reorganization plan which would consist either of the sale of the company or a continuation plan.

In case of a continuation plan, the management remains in control of the company while a court ordered sale of the company requires the transfer of all the company's assets to a third party. However, in case of plan for the sale of the assets, nothing prevents the managers from subsequently owning or managing other companies. In case of liquidation however, the management are stripped of their management powers but they are free to start other businesses (unless the Court imposes other penalties).

## **TITLE 2. DEFINITIONS AND TERMINOLOGY**

Bankruptcy Proceedings (“*Procédure collective*”): The generic term defining the reorganization procedure and the judicial liquidation.

Creditors' Representative (“*Représentant des Créanciers*”): Officer of the court chosen by ruling of the Bankruptcy Judge who is in charge of the representing of the creditors' interest during the judicial reorganization.

Debtor (“*Débiteur*”): Person or legal entity who is the subject of the bankruptcy proceeding.

Default of payments (“*Cessation des paiements*”): The situation of the debtor who cannot meet his outstanding liabilities with current assets.

Judicial Liquidation (“Liquidation judiciaire”): This is ordered by the court when the company cannot successfully be reorganized. It entails the sale of the assets of the company to satisfy the company’s debts.

Judicial Reorganization (“Redressement Judiciaire”): The phase of the proceeding which covers from the observation period (“période d’observation”) until the final judgment on the fate of the company (sale of the company, continuation of its activities or liquidation).

Liquidator (“Liquidateur”): Officer of the court chosen by ruling of the Bankruptcy Judge who is in charge of the sale of assets in case of judicial liquidation of the company.

Observation Period (“Période d’observation”): Period beginning with the ruling opening the judicial reorganization during which the receiver prepares the economic and employment report as well as a draft reorganization plan for the company.

Personal Bankruptcy (“Faillite personnelle”): Forfeiture or restrictions on merchants, craftsmen or the management of legal entities which are in reorganization or judicial liquidation who are found liable for dishonest acts or gross negligence.

Receiver (“Administrateur Judiciaire”): An officer of the court chosen by ruling of the Bankruptcy Judge at the beginning of the bankruptcy proceeding. His mission is to either to oversee, assist or replace the debtor in the management of the company. He is also responsible for the preparation of a reorganization plan based on an economic and employment report (“bilan économique et social”).

### **TITLE 3. WARNING LIGHTS AND PREVENTION OF INSOLVENCY**

The goal of this phase is to detect any problems within the company as soon as possible in order to adopt measures to improve the situation of the company. There are two types of warnings : prevention through the use of information,  
warning procedures (“procédures d’alerte”)

#### **Chapter 3.1 Prevention through the use of information**

##### **□ Accounting Information**

- Obligation to maintain regular accounts: All persons and legal entities qualified as merchants have an obligation to maintain regular account and, at the end of the financial year, establish annual accounts.
- Obligation to file annual accounts and annual report: Limited companies (“sociétés par actions”), limited liability companies (“société à responsabilité limitée”) and partnerships (“société en nom collectif”) must file annual accounts and an annual report with the clerk of the

Commercial Court and are subject to criminal penalties in case of violation (articles L.232-23, L.232-22 and L.232-21 of the Commercial Code).

- Obligation to file forward looking management reports: Companies having at least 300 employees or annual revenues of at least 18.3 million Euros must also file forward looking management reports which indicate the future management of the company with regard to the available and future assets and debts owed, a financial breakdown describing the manner in which the resources of the company were used to meet its obligations, a provisional profit and loss statement and a financial plan to ensure that the foreseeable needs of the company will be adequately financed. (article L. 232-2 of the Commercial Code).
- **Prevention through public information requirements**
  - The commercial registry (“*Registre du Commerce et des Sociétés*”): was created to inform the public of the situation of all companies. All defaults of payment are automatically listed as well as any decisions regarding a reorganization or liquidation (commencement of proceedings, extension of the observation period, modification of the default date, liquidation order...)
  - Special registers: In addition to the commercial registry, the Clerk of the Commercial Court also keeps a register of protests for non-payment (“*Registre des Protêts*”) and maintains a general company lien index (“*nantissements du fonds de commerce*”) as well as a specific lien index for equipment, vendor’s liens and liens on public companies and leaseback agreements on movable property. Finally, there is a tax and social security lien index.

⇒ **These various indexes may be freely consulted by the public and by the courts.**

## **Chapter 3.2 Warning Procedures**

These procedures can be either mandatory or optional depending on the situation and can be initiated by either the statutory auditors (“*commissaires aux comptes*”), the company’s work’s council (“*comité d’entreprise*”) or the Commercial Court.

### □ **Warning made by the Statutory Auditor**

As a preliminary note, statutory auditors are mandatory in limited companies, limited partnership with shares and for all companies who meet the following criteria :

- Total book value of at least 1.5 million euros
- Pretax revenues of at least 3 million euros
- Average of 50 employees (articles L. 221-9, 222-2 and L.223-35 of the Commercial Code)

Also, it is important to note that the role of the statutory auditor is to certify that the annual accounts of the company are regular, sincere and provide an accurate picture of the activities and situation of

the company for the financial year and the financial situation and the assets of the company (article L. 225.235 of the Commercial Code).

- Criterion for commencing the warning procedure:

The statutory auditor must commence the warning procedure in case of « *knowledge of any fact which could compromise the ongoing status of the company* ». (articles L. 234-1 and L.612-3 of the Commercial Code). Any failure to call a meeting is a breach of the statutory auditor's duty to the company.

- The warning procedure:

The warning procedure has three phases :

1°) An information request to the Chairman of the Board of Director who has 15 days to respond,

2°) Invitation to call a meeting of the Board of Directors. If the Chairman does not respond to the information request, the statutory auditor will request that he call a meeting of the board of directors to discuss the relevant information. The Chairman has 8 days to call the meeting which must be held within 15 days of the statutory auditor's request. The statutory auditor must receive notice of the meeting and inform the Commercial Court of it.

3°) Report to shareholders. If, after the Board of Directors has taken action, the statutory auditor considers that the continuity of the business is still in danger, he is required to draft a special report to be presented to the shareholders and shareholders meeting that he will call. If, after this shareholders meeting, the statutory auditor is still not satisfied with the decisions made, he notifies the Commercial Court.

**⊢ We draw your attention on the fact that the warning made by the statutory auditor is mandatory who is subject to criminal penalties in case of violation.**

□ **Works Council Warning Procedure**

- Criterion for commencing the warning procedure

The works council may commence a warning procedure in case of « *knowledge of fact which negatively affect the situation of the company* » (article 432-5 §1 of French Labour Code).

- The warning procedure:

The procedure has two steps :

1°) The works council requests the company to provide information about the situation,

2°) If it is not satisfied with the response, the works council drafts a report which is addressed to the company. The works council has no power to call a shareholders meeting.

**↳ Contrary to the warning made by the Statutory Auditor, the Works Council warning is optional.**

**□ Warning Procedure for Shareholders and Partners**

• Criterion for commencing the warning procedure:

The criterion for commencing the procedure is the knowledge of « *any fact which could compromise the ongoing business of the company* » (article L.225-232 of the Commercial Code).

• Warning procedure:

This warning procedure may be brought by any partner other than the managing partner of a limited liability company (“*société à responsabilité limitée*”) (article L. 223-36 of the Commercial Code) or by one or more shareholders of a limited company holding in the aggregate more than 5% of the share capital (article L. 225-232 of the Commercial Code).

The procedure consists of submitting written questions to the board of directors at the most two times per financial year.

**□ Warning Procedure of the Chief Judge of the Commercial Court**

Since the law of 01.03.1984, the Chief Judge plays an essential role and has wide investigative powers.

• Criterion for commencing the warning procedure:

The criterion for commencing the procedure is the knowledge of « *any difficulty which could compromise the ongoing business of the company* » (article L.611-2 of the Commercial Code).

• Warning procedure:

The procedure is as follows: the Chief Judge is alerted of the situation by the directors of the company, the statutory auditor who was not successful in commencing a warning procedure or by public information. The Chief Judge then calls a meeting with the directors. He cannot force the directors to cooperate with the procedure. If the directors participate in the meeting and the Judge is not satisfied with their responses, he can request further information from the statutory auditor, employee representatives, public authorities, social security administration and other governmental bodies.

#### **TITLE 4. LEGAL POSSIBILITIES TO CONTINUE ECONOMIC ACTIVITIES**

When a company has financial difficulties but is not in default, it can seek either the assistance of the public authorities or implement its own reorganization plan.

## Chapter 4.1 Assistance of Public Authorities

The increase in the number of company failures and the repercussions that they create on the market have led the public authorities to intervene outside of the judicial procedures. This intervention can take three forms :

- reorganization committees,
- State aid,
- subsidies.

### □ Reorganization committees

In France, these committees exist on the departmental level (CODEFI), the regional level (CORRI) and on the interministerial level (CIRI). Their mission is to examine the causes of the company's problems and implement out of court reorganization measures in order to protect the employees of the companies from redundancy.

### □ The heads of financial services commission

These commissions exist in each of the French departments. They examine the situation of farmers, merchants, professionals and any legal entity which is late on payments of taxes, or social charges. They study the feasibility of a payment plan to cover the outstanding charges and are responsible for its adoption. If the plan is not followed, the commission officially acknowledges this and the company is, for all practical purposes, obliged to file for bankruptcy.

### □ State aid

This includes public loans under various conditions, cooperative loans where the public body acquires an ownership interest in the company or subsidies, though the latter are rarely given.

## Chapter 4.2 Extra-judicial reorganization measures

There are two extra- judicial reorganization measures:

- The independant preliminary bankruptcy (“*mandat ad hoc*”),
- The amicable settlement procedure (“*procédure de règlement amiable*”).

The goal of these measures is the establishment of a contractual arrangement under the auspices of a conciliator and under the authority of the Court which allows companies who are in difficulty but not yet in default to find an agreement with its creditors and avoid the opening of a bankruptcy proceedings.

### □ **The independent preliminary bankruptcy (“*mandat ad hoc*”)**

*§1 Comprehensive description of the regime as well as its underlying philosophy*

This solution involves the naming of an independent receiver («*Mandataire ad hoc*») who intervenes before the need for a formal bankruptcy proceeding.

The goal of this practice is to use an objective third party (“*Mandataire ad hoc*”), under the supervision of the Court, to deal with the difficulties that the debtor company is facing. Its advantages are its flexibility with regard to procedure and duration.

This practice originated in the 1980’s (the Commercial Court of Paris began using this procedure for real estate foreclosures) and was codified, in a limited manner, in the law of 01.03.1984 (article 35) amended by the law of 10.06.1994 which became articles L. 611.3 et seq of the Commercial Code.

*§2 Classification of the procedure among branches of law, competent jurisdictions, overview of the procedure followed before these jurisdictions, implications of international private law*

- Competence:

The procedure is started upon request by the legal representative of the debtor company and falls within the competence of :

- The President of the Commercial Court for all commercial entities (article L.611-3 of the Commercial Code).

The Commercial Court has competence over all commercial or craftsman enterprises. The judges of these Courts are not professional magistrates but rather business people. The Paris Commercial Court has a chamber specialized in the prevention of enterprise difficulties.

- The President of the Civil Court (article L.611-5 of the Commercial Code) for individuals.

The Civil Court has competence over all private law legal entities. The judges are professional magistrates.

- Initiative of the request:

The procedure begins with a request submitted to the President of the Commercial Court or to the President of the Civil Court by the legal representative of the legal entity. The request must include an description of the difficulties that the company is facing, the proposed measures to be taken and an explanation of why the independent receiver solution is more adapted to the case at hand.

The Courts may not commence this type of proceeding *sua sponte*. It is however, common practice for interested parties (creditors, works council, etc.) to join with the legal representative on the request. Several debtor companies who form a group of companies may also join together to make a common request.

*§3 Criteria to benefit for the regime (the origins of the criteria: legal, case- law, practice must be specified)*

The debtor cannot be in default of payment, otherwise bankruptcy proceedings **must** be commenced.

*§4 Specification of the possible initiators of the procedure*

As mentioned above, this procedure may be used with regard to any commercial entity or individual. It may be initiated by the legal representative of the legal entity. Creditors together or with other interested parties can join in on the request.

*§5 Restructuring plan (if applicable, who must file it, where, must it be voted by creditors, is there a court intervention, etc...)*

It is possible to implement a reorganization plan under the supervision of the independent receiver which takes the form of an agreement between the debtor company and all of its creditors. The goal of this plan is to avoid the debtor falling into a situation of default.

**► It is important to emphasize that this procedure is contractual in nature and its success depends on the ability of all the parties involved to reach a consensus.**

*§6 Administration of the procedure (who manages the assets of the individual or the company, the role of the different actors in the proceedings: creditors, debtor, State, appointed manager, court, etc...)*

- Appointment of the receiver by the President of the Court:

The independent receiver is usually chosen from the list of court approved receivers but this is not a requirement (lawyers, statutory auditors,.... could be appointed).

- Time period of his mission:

The Commercial Court set the time period for the mission (there is no limit provided for in the law). His mission may be renewed by the Court.

- Scope of mission:

The scope of the mission is freely set by the Commercial Court based on the request which is submitted to him. Thus, the missions are varied and cover a wide range of activities (assistance management which is in a deadlock, resolving a punctual problem or a problem with bankers, partners, business associates). The independent receiver may not, however, participate in the management of the debtor company and, therefore, the management's powers are not affected.

*§7 The degree of protection of the actors implied in the procedure: public investors, creditors (secured and unsecured, preferential or not, shareholders, stakeholders...), as well as the way to carry out this protection*

The role of the independent receiver is to assist the interested parties in reaching a common agreement. This agreement does not provide any particular legal protection to any of the parties involved (company, creditors, shareholders).

*§8 Termination of the procedure*

3 solutions are possible:

- 1) No agreement is reached: the debtor will have to make a declaration of default of payments if it is in default.
- 2) If an agreement is reached, the agreement suspends for its duration all actions by all parties to the agreement regarding debts which are covered by the agreement.
- 3) In case of breach of the agreement reached between the debtor and its creditors, the only recourse available to the creditors is to seek the termination of the agreement (article 1184 of French Civil Code). No legal provisions cover the consequence of the termination of the agreement. In fact, the debtor will probably have to make a declaration of default of payments if faced with circumstances which place him in default of payment.

*§9 degree of information on the development of the procedure towards creditors (e.g access to court files, etc...)*

The confidentiality of the procedure is not covered in the law. Nevertheless, the authors acknowledge that, in practice, it is confidential and only creditors who agree to participate in the proceedings are kept informed of their progress.

*§10 Costs related to the procedure, if applicable (e.g fees trustee, receiver, etc...)*

The independent receiver's remuneration is set by the Commercial Court after his mission is completed and is paid by the debtor company.

*§11 Competence, knowledge and functioning of insolvency (bankruptcy) courts*  
Please see §2

*§12 Publicity conditions, if applicable (e.g newspaper, official gazette)*

There are no provisions for the public notification of the outcome.

**¶ In conclusion, the independent receiver procedure provides the debtor company and its creditors with a practical and flexible means of resolving any difficulties the debtor company may be having in a contractual framework before a more structured, complicated and costly bankruptcy proceeding is necessary.**

The debtor company can also use the amicable settlement procedure in an attempt to solve the problems the company is facing and, as a result, avoid filing for bankruptcy.

□ **The amicable settlement procedure (“*procédure de règlement amiable*”)**

### *§1 Comprehensive description of the regime as well as its underlying philosophy*

This procedure has its origin in the law of 01/03/1984 which became articles L. 611-3 et seq. of the Commercial Code. The Commercial Court of Paris began using this procedure for real estate foreclosures in the 1990s.

The goal is the establishment of a contractual arrangement under the auspices of a conciliator and under the authority of the Court which allows companies who are in difficulty but not yet in default.

### *§2 Classification of the procedure among branches of law, competent jurisdictions, overview of the procedure followed before these jurisdictions, implications of international private law*

The procedure is started upon request by the legal representative of the debtor company and falls within the competence of the President of the Commercial Court for all commercial entities (article L.611-3 of the Commercial Code) or the President of the Civil Court (article L.611-5 of the Commercial Code) for private law legal entities. The Courts may not commence this type of proceeding sua sponte.

We remind you that the judges of the Commercial Courts are not professional magistrates but rather business people. The Paris Commercial Court has a chamber specialized in the prevention of enterprise difficulties.

On the other hand, the judges of the Civil Court are professional magistrates.

The proceedings begin with a request submitted to the President of the Commercial or of the Civil Court (according to the type of debtor) and contains:

- a description of the legal, financial and economic difficulties which have led to the request,
- the proposed corrective measures,
- the delay in the payment of debts which would allow the company to return to a sound financial situation,

The participation of all creditors is not necessary. Only the principal creditors are invited to participate meaning only those who are owed significant amounts or hold important guarantees or liens on the company. In practice this usually means banks and primary suppliers.

The following documents are submitted with the request (article L.611-4 of the Commercial Code):

- a provisional financing plan and balance sheet,
- the current debt situation and a proposed payment schedule with the list of the principal creditors,
- summary of the company's recorded liens,
- the annual accounts, financing table, status of current and available assets and debt.

### *§3 Criteria to benefit for the regime (the origins of the criteria: legal, case-law, practice must be specified)*

Article L.611-3 of the Commercial Code provides, “*the procedure is open to all commercial or craftsman enterprises which, **without being in default of payments**, are experiencing legal, economic or financial difficulties or has needs which cannot be met by a financing scheme adapted to the enterprise’s possibilities*”.

Article L.611-5 of the Commercial Court provides “*a matter can be brought before the President of the Civil Court at the request of the representative of any private law legal entity.*”

#### *§4 Specification of the possible initiators of the procedure*

As mentioned above, this procedure may be used with regard to any commercial entity or private law legal entities. It may be initiated by the legal representative of the legal entity with creditors or other interested parties joining in on the request.

*§5 Restructuring plan (if applicable, who must file it, where, must it be voted by creditors, is there a court intervention, etc...)*

The amicable settlement suspends for the duration of the settlement agreement any court proceedings seeking paying of debts owed to a creditor of the debtor company (article L.611-4 of the Commercial Code).

Also, the settlement can be approved by the President of the Court.

If the amicable settlement is reached with all the creditors, the Court must approve it. This is not the case if some creditors do not take part in the proceedings, in which case the Court has the option of approving it and can grant additional time for the payment of debts owed to creditors who did not participate in the proceedings. (article 1244-1 of the Civil Code).

The effects of this approval are not provided for in the law. Legal experts consider that the approval of the Court acts as a court order which can be immediately enforced against the parties.

*§6 Administration of the procedure (who manages the assets of the individual or the company, the role of the different actors in the proceedings: creditors, debtor, State, appointed manager, court, etc...)*

- Appointment by the President of the Court:

The conciliator is named by the President of the Court on the basis of the Court’s opinion that the person has the requisite qualities to successfully complete the mission. In practice, the Court names court-approved receivers or experts but may also appoint lawyers, statutory auditors....

- Duration of his mission:

The conciliator’s mission lasts three months and may be extended to four on the proposal of the conciliator. The relatively short period allowed for the mission makes it necessary, in practice, for the

debtor to first name an independent receiver (“*mandataire ad hoc*”, as described above) in order to have time to reach an agreement. The independent preliminary bankruptcy (“*mandat ad hoc*”) will thereafter be replaced by an amicable settlement procedure so that the conciliator has the Court approve the restructuring agreement.

- Scope of his mission:

The Court sets the exact mission of the conciliator based on the request made by the parties; the goal being to emphasize the restructuring of the company through an agreement with the principal creditors.

The conciliator may not, however, participate in the management of the debtor company and, therefore, the management’s powers are not affected.

*§7 The degree of protection of the actors implied in the procedure: public investors, creditors (secured and unsecured, preferential or not), shareholders, stakeholders...), as well as the way to carry out this protection*

Legal experts consider that the commencement of these proceedings are, *ipso facto*, an acceptance by the Court that the company is not in default of payment since the sine qua non condition for the amicable settlement is that the debtor not be in default. As a result, no agreements reached within the framework of the proceeding are subject to being held void during the suspect period (“*période suspecte*”).

For information, the suspect period covers the time from the notification of default of payment until the final judgment ordering the restructuring or liquidation of the company. By setting the date of default, the Court is fixing the duration of the suspect period which cannot exceed 18 months. Certain acts of the debtor during this period are void (for example, payment of debts which are not due, gratuitous acts for the transfer of real or personal property).

Court decisions consider, however, that the Courts can change, a posteriori, the default date before or during the conciliation period, leading to the possible voidance of certain agreements made during the suspect period.

*§8 Termination of the procedure*

There are three possible solutions:

- 1) The parties reach an agreement which is either approved or not by the Court,
- 2) No agreement is reached and the debtor must make a declaration of default if it is not capable of make payments on its debt,
- 3) If an agreement is reached and a party subsequently breaches it, the remedies available in the Civil Code for breach of contract will be applicable (article 1184 of the Civil Code); this would mean the termination of the agreement. In addition, article L.621-3 of the Commercial Code

provide the remedy of starting bankruptcy proceedings in case of breach of a **financial** obligation under an amicable settlement (the law does not specifically provide any remedies in case of non execution of another obligation).

*§9 degree of information on the development of the procedure towards creditors (e.g access to court files, etc...)*

This is a strictly confidential proceeding. Any person who by his status, profession or activities has knowledge of an amicable settlement has a duty of confidentiality (article L.611-6 of the Commercial Code). The penalty in case of violation of this confidentiality is up to one year prison and fines of up to 15,244 Euros. (article 226-13 of the New French Criminal Code).

*§10 Costs related to the procedure, if applicable (e.g fees trustee, receiver, etc...)*

The remuneration of the conciliator is set by the Court in accordance with the requesting party and is paid by the debtor company.

*§11 Competence, knowledge and functioning of insolvency (bankruptcy) courts*  
Please see §2

*§12 Publicity conditions, if applicable (e.g newspaper, official gazette)*

There is no publication of the proceedings due to their confidential nature. (please see §9)

### **Conclusion:**

Despite a constant increase in the number of preventative measures taken, they remain under-utilized. Before the Paris Commercial Court, 74 such procedures were started during the period from January to August 2001 (15 conciliators and 59 independent receivers) as opposed to 28 during the year 2000 (9 conciliators and 19 independent receivers).

However, we note that 50% of companies who recover as a result of a restructuring procedure were submitted, prior to the bankruptcy proceeding, to an independent receiver or a amicable settlement procedure.

As a result, even if the restructuration plan fails, these preventative measures are beneficial for the debtor company.

## **TITLE 5. LEGAL CONSEQUENCES OF BANKRUPTCY AND POSSIBILITIES FOR A FRESH START**

The restructuring and liquidation procedures in French law are governed by the law of 25/01/1985 as modified by the law of 10/06/1994 (articles L.620-1 et seq. of the Commercial Code).

The 3 objectives of this law placed in order of importance are:

- Saving the company,
- Allow the continuation of the activity and protect the employees,
- Settle the debts of the company (article L. 620-1 of the Commercial Code)

## **Chapter 5.1. Bankruptcy procedure**

When a debtor is in default of payment, the Court in charge of the matter will order either the restructuring of the company, in an attempt to save the company, or its liquidation which results in the complete stoppage of the company's activity.

- The restructuring procedure seeks to allow the company to continue its activity during the reorganization. After an observation period during which the debtor company continues its activity and certain obligations are imposed on the company's creditors, the Court will decide the final outcome for the company which is either the restructuring (as on ongoing concern or through the sale of the company) or the liquidation of the company if no reorganization is possible. The continuation of the company's activities takes place under the direction of the same management but the Court may order modifications to the company's shareholdings to allow the entry of new shareholders. The transfer plan is intended to ensure the maintenance of the viable activities of the company, the management is taken over by a new legal entity, the third party liquidator (*«tiers repreneur»*).
- The liquidation of the company is immediately ordered by the court and takes effect immediately (without a prior commencement of bankruptcy proceedings) when the debtor has ceased all activity or when the restructuring is clearly impossible (article L. 620-1 of the Commercial Code). In this situation, the management is prohibited from operating the company and a liquidator is named to sell the companies assets to pay its creditors.

□ **Standing of the debtor** (article L.620-2 of the Commercial Code)

Bankruptcy proceedings may be opened against the following (article L.620-2 of the Commercial Code) :

- Private legal entity, whether or not it exercises a commercial activity,
- Persons:
  - merchants
  - craftsmen
  - farmers
- Individuals who attempted an amicable settlement but failed (in case of breach of a **financial** obligation under the settlement agreement).

## ❑ **Cases for the opening of the procedure**

### ✓ **Default of Payment (article L.621-1 of the Commercial Code)**

This situation exists when the company can no longer « *meet its debt obligations with its available capital* ». The « available capital » is defined as the assets which can be liquidated within a few days. The « debt obligations » are the debts which are due and payable by the company.

This is the most frequently case of opening of the procedure.

The debtor is required to make a declaration of default within fifteen days of the cessation of payments under penalty of civil damages including personal bankruptcy (please see chapter 5.4 about penalties).

### ✓ **Breach of the terms of the amicable settlement (article L.621-3 of the Commercial Code)**

Since 1994, the Court may, but is not required, to commence bankruptcy proceedings in case of breach of an **financial** obligation under the settlement agreement.

### ✓ **Breach of the terms of the continuation plan (article L. 621-82 of the Commercial Code)**

If the debtor fails to comply with the reorganization plan, the court orders the cancellation of the plan and the commencement of a liquidation procedure against the debtor.

### ✓ **Penalties against managerial misconduct (articles L.624-4 et L.624-5 of the Commercial Code)**

Bankruptcy proceedings may be opened against a manager of a legal entity if the officer/director who was found liable for all or the debts of the company regarding the reimbursement of debt does not pay them (article L.624-4 of the Commercial Code) or if the officer/director commits one of the following acts (article L.624-5 of the Commercial Code):

- misappropriation of corporate funds;
- interested transactions;
- self dealing
- etc.

## ❑ **The commencement of the procedure**

### ✓ **The debtor**

The debtor is required to make a declaration of default within 15 days of the cessation of payments (article L. 621-1 of the Commercial Code) under penalty of civil damages including personal bankruptcy (article L.625-5 of the Commercial Code) or the assumption of the company's debts (article L. 624-3 of the Commercial Code).

✓ **Creditors**

Any creditor, regardless of the amount owed, may file suit in bankruptcy against the debtor (article L.621-2 of the Commercial Code). In practice, such requests originate with banks and the social security authorities.

✓ **The Public Prosecutor**

Though this is possible, it rarely occurs in practice.

✓ **The Court**

This possibility is design to avoid the continuation of a loss generating business when the debtor and its creditors fail to act.

□ **Competence of the Court**

✓ **Competence over the person (article L. 625-5 of the Commercial Code)**

The Commercial Court has subject matter jurisdiction over debtors who are merchants, and craftsmen as well as all commercial companies by their structures (« *société anonyme* », « *société à responsabilité limitée* », « *société en nom collectif* ») or by their purpose (« *sociétés civiles* »),

The Civil Court has jurisdiction over all other cases including non-commercial companies.

✓ **Territorial Compétence (article. 1er decree of 27/12/1985)**

This is based on the place where the debtor's registered office is located or, if the company's registered office is not in France, then its principal place of business.

□ **Elements of the Court Order commencing the Procedure**

The Court order calls either for the restructuring of the company which allows the company to continue its activities and its reorganization or the liquidation of the company which stop immediately the activity of the company. It also set the date for the cessation of payments and appoints the parties who will oversee the procedure.

✓ **Set the date for the cessation of payments**

In general, the date for the cessation of payments is the date of the Court order but the Court is free to set any date which up to 18 months prior to the date of the commencement of the procedures.

✓ **Entities involved in the procedure**

- The Insolvency Judge (« *Juge-Commissaire* ») who is responsible for the efficient treatment of the matter and the protection of the interests of all the parties (article L.621-12 of the Commercial Code). He oversees the work of the receiver and the creditors' representatives and

participates in the drafting of the economic and employment report of the company. He has wide investigative powers which enable him to interrogate the statutory auditors (who are normally bound by professional secrecy rules), banks, social security administration and the tax authorities to get an idea of the situation of the company (article L.621-55 of the Commercial Code). He also makes many decisions with regard to the admission of debts, the management of the company during the observation period, the sale of assets and redundancies.

In case of judicial reorganization :

- The Receiver (« Administrateur Judiciaire ») : drafts a restructuring plan during the observation period and participates in the management of the company as provided in the Court order commencing the proceedings (please see chapter 5.3)
- The Creditors' Representative (« Représentant des Créanciers ») is responsible for the study and description of the debts of the company.

In case of judicial liquidation :

The Liquidator is responsible for overseeing the sale of the debtor's assets in order to cover the company's debts.

#### ✓ **Notification of opening of the Proceedings**

The opening of the proceedings is published in the Commercial Registry for companies and merchants, in the Professions Registry for craftsmen and also in the legal advertisements journal.

## **Chapter 5.2. Legal effects of the initiation of bankruptcy procedures**

Please see Chapter 5.3

## **Chapter 5.3. Legal effects of bankruptcy as such**

The commencement of a bankruptcy proceeding has effects on both the creditors and debtor and opens the observation period at the end of which the Court will rule on the fate of the debtor: either a restructuring or the liquidation of the company.

### □ **Effects on Creditors**

The settling of debts is third on the list of priorities of the law of 25/01/1985. As a result, creditors are not in an enviable position.

## **A. Judicial Reorganization**

1°) **During the observation period** :

All actions started by creditors are suspended and all debts are frozen. Moreover, the commencement of bankruptcy proceedings does not cause the payment of outstanding debt to be accelerated.

✓ **Suspension of ongoing matters (article L.621-40 of the Commercial Code).**

All Court proceedings involving debts which arose prior to the commencing of the bankruptcy proceedings are suspended and all further actions are restricted. These proceedings include any action seeking a Court order for payment of any debt and any action for the termination of a contract for default of payment. Moreover, the enforcement of any prior judgment is suspended

✓ **Freezing of debts (article L. 621-24 of the Commercial Code)**

The debtor is prohibited from paying any debt which arose prior to the commencing of the bankruptcy proceedings and interest accrual on prior debts is suspended.

✓ **No acceleration of payment (article L.621-49 of the Commercial Code)**

The Court order opening the bankruptcy proceeding does not cause the acceleration of payment of outstanding debts. Any contractual clause which purports to accelerate payment is deemed null and void.

At the end of the observation period, the Court renders its decision on the fate of the company (restructuring or liquidation).

**2° In case of continuation plan :**

If a continuation plan is adopted, a payment plan is put into place to spread the reimbursement of debt over a period not exceeding ten years.

**3° In case of transfer plan :**

Creditors are reimbursed from the proceeds of the liquidation of the debtor's assets according to their rank and priority.

**B. Judicial Liquidation**

The payment of creditors is made from the liquidation of the assets by the Court appointed receiver.

□ **Effects on Debtors**

**A. Judicial Reorganization**

1° **During the observation period :**

The debtor continues to exercise its control over the assets and management of the company except with regard to the mission of the Court appointed receiver (article L.621-23 of the Commercial Code). Acts of day-to-day management of the debtor are considered valid with regard to third parties acting in good faith.

The Court appointed receiver will be assigned one of three missions (article L.621-23 of the Commercial Code):

- oversight of the debtor's management and approval after the fact ;
- assistance in the management limited to the double signature for approval of actions which are not part of the day-to-day management of the company ;
- representation of the debtor including management of the company (except for day-today activities with third parties acting in good faith).

Also, certain actions require the approval of the Insolvency Judge :

- redundancies during the observation period,
- delays in payments which could be authorized by the Insolvency Judge with the approval of the creditor seeking payment in order to release property legally held (article L.621-122 of the Commercial Code),
- any acts outside of the usual activity of the company : granting mortgages or liens, payment of debt which arose prior to the commencing of the bankruptcy proceedings.

### **2°) In case of continuation plan :**

The adoption of a continuation plan ends the mission of the receiver and the company is no longer under bankruptcy protection. The company becomes once again « *in bonis* » (i.e it is no longer subject to bankruptcy proceedings and is able to dispose freely of its assets). The company regains its power to undertake any activities except with regard to any undertakings agreed to in the framework of the continuation plan and any legal obligation, including the non-transferability of certain assets.

### **3°) In case of transfer plan :**

In case of a Court decision to transfer the business assets, the management is taken over by a new legal entity, the third party liquidator (« *tiers repreneur* »), and the debtor company is dissolved. (article 1844-7 7° of the Civil Code).

## **B. Judicial Liquidation**

The Court order of liquidation nominates a Liquidator whose mission is to sell the assets of the company to settle the debts. At the end of this mission, the bankruptcy procedure will be officially closed for insufficiency of assets if all debts cannot be settled with the assets of the company (which is normally the case) or for settlement of all debts of the company.

- If the debtor is an individual, he is removed from the management and control of the assets (article L.622-9 of the Commercial Code) and he must cease his commercial or craft activity.

At the end of the procedure, the individual debtor may begin a new commercial activity even if his prior debts were not settled due to insufficiency of assets. The only exception to this rule is with

regard to activities which may not be exercised by persons who were the subject of personal bankruptcy or fraudulent bankruptcy.

- If the debtor is a legal entity, the liquidation entails the cessation of the activity of the company and, when the liquidation is finished, the entity loses its legal status and is removed from the companies register.

The management of the legal entity has no powers since the company is represented by the Liquidator. When the entity is liquidated, the management may engage in new commercial activities under they were restricted from doing so by the bankruptcy court (see chapter. 5.5)

#### **Chapter 5.4. “Excusability” following bankruptcy**

The individual who was the subject of a judicial liquidation and the management of a legal entity which was liquidated can freely undertake new commercial activities unless the Court imposed specific restriction on them. (see chapter 5.5).

#### **Chapter 5.5. Responsibility of the Company’s management in case of bankruptcy of a limited liability company**

Civil or pecuniary penalties as well as criminal sentences can be imposed on the management of a legal entity or on an individual (merchant, craftsman) in bankruptcy as provided for in the law of 25/01/1985. The pecuniary sanctions have no effect on the individual’s ability to continue his activities within the entity or on the ongoing nature of the entity itself. However, if civil or criminal sentences are imposed, the guilty party may not participate in or manage the company. This does not, however, have any effect on the operations of the company itself.

##### **A. Pecuniary sanctions**

The two monetary penalties which are provided for in the law of 25/01/1985 are the reimbursement of debt (“*action en comblement de passif*”) and the involuntary bankruptcy of the company officer/director. These sanctions do not prohibit the continuation of the activities of the company or the individual to continue in a management role within the company.

##### **□ Reimbursement of debt (« *action en comblement de passif* »)**

In cases of mismanagement which contributed to the insufficiency of the assets of the company, the legal representatives of the company (officers and directors named in the articles of incorporation or by decision of the governing bodies of the company) or the representatives in fact (those parties who

are not legal representative but have assumed and exercised this role in practice) can be ordered to reimburse all or part of the debtor company's debts (article L.624-3 of the Commercial Code).

« Mismanagement » is not defined by the law but subject to a wide interpretation by the Courts. Some examples of « mismanagement » are the omission of making the declaration of default within the fifteen day limit, continuation of a loss-making activity and irregular or misleading accounting practices.

This proceeding does not prohibit the accused party from continuing his activity with the company.

The Courts also often try to extend liability to the management so that these individuals contribute to the reimbursement of the debts of the company. 60% of all such actions are for a value of more than 760 thousand Euros and 40% are for more than 3 million Euros.

#### □ **Involuntary bankruptcy**

This is possible if the officer/director who was found liable for all or the debts of the company regarding the reimbursement of debt (« *action en comblement de passif* ») does not pay them (article L.624-4 of the Commercial Code) or if the officer/director commits one of the following acts (article L.624-5 of the Commercial Code):

- misappropriation of corporate funds;
- interested transactions;
- self dealing
- etc.

An involuntary bankruptcy proceeding is independent of the bankruptcy proceeding of the company. The debts imposed on the officer/director include not only his own debts but also those of the company.

The date of cessation of payments is the same as the date in the order of the Court opening the bankruptcy proceeding.

#### **B. Civil Penalties**

The civil sanctions provided for in the law of 25/01/1985 are personal bankruptcy and prohibition from participating in the management of a legal entity. Once again, these penalties have no effect on the continuation of the debtor company's business.

#### □ **Personal Bankruptcy (« *Faillite Personnelle* »)**

The officers/directors of the company may be subjected to civil sanctions in the following cases :

- if the situation of the company calls for an extension of the restructuring or the liquidation to include the assets of the management (article L.625-4 of the Commercial Code),
- in the cases set forth in article L.625-5 of the Commercial Code: violation of a restriction on management, self dealing, sale of product below their acquisition price,
- if the officer/director did not pay debts of the company which were imposed on him by the Court.

The declaration of personal bankruptcy, which has a legal effect for at least 5 years, entails a prohibition against operating, managing, or controlling, directly or indirectly any commercial or craft enterprise, any agricultural concern or, more generally, any legal entity having a commercial purpose. It also includes a loss of civil rights and ineligibility before the Commercial Courts. (article L. 625-2 of the Commercial Code).

#### □ **Management Prohibition** (« *interdiction de gérer* »)

Either as part of a personal bankruptcy ruling or independently, the Court may order a prohibition on any management, oversight or control, direct or indirect, of any commercial or craft enterprise or any legal entity. (article L.625-8 of the Commercial Code).

#### **C. Criminal penalties : Fraudulent bankruptcy** (« *banqueroute* »)

Fraudulent bankruptcy is a criminal penalty provided for in the law of 25/01/1985 (article L. 626-2 of the Commercial Code) which prevents the guilty officer/director from participating or managing a commercial enterprise but has no impact on the continuation of the debtor company.

This sanction is possible in the following cases :

- fraudulently obtained funding or sold assets below their value with the intention of avoiding the commencement of bankruptcy proceedings ;
- misappropriation or embezzlement of the company's assets
- etc.

The maximum sentence is five years prison and 75.000 Euros in penalties (article L. 626-3 of the Commercial Code) and the Court may also order the personal bankruptcy and/or a prohibition on management against the defendant officer/director (article L.626-6 of the Commercial Code).

#### **CONCLUSION OF TITLE 5 :**

In conclusion, current French bankruptcy law is not favorable to creditors. As discussed above, the three priority of the law, placed in order of importance, are 1) save the company, 2) avoid

redundancies and 3) settle the debts of the company. Some sources argue that the law does not take into account the economic realities of the market and is too ambitious as it is difficult to reconcile its three objectives.

Furthermore, much criticism has been raised against the various Court appointed bankruptcy specialists. They have been involved in many financial scandals, have accused of having powers which are too wide and of being subject to the influence of the Courts.

In practice, about 90% of bankruptcy cases end in the liquidation of the debtor company. Between 1996 and 1999, continuation plans or Court supervised sales of the debtor companies accounted for only 6.7 to 7.9% of all bankruptcy proceedings.

The statistics for the years 2000/2001 are as follows :

- 88.9% liquidations
- 2.4% court supervised sales
- 8.7% continuation plans

When faced with such negative numbers, the main conclusion to draw is that more preventative measures should be utilised. For the moment, these preventative measures are rarely used in general and almost exclusively in Paris. Their usage should be developed in both Paris and the rest of France.

## **TITLE 6. PROSPECT AND RECOMMENDATIONS**

Various reforms are currently being considered by the French legislature.

### **□ Reform of the Commercial Courts**

Currently, the Commercial Courts are made up businessmen who are chosen to act as judges. The reform would entail the naming of professional judges to sit on these Courts along side the current non-professional judges. The Bankruptcy Courts will be presided by one professional judge. No specific legislative action has been taken, for the moment, in this regard.

However, this draft legislation has resulted in many strikes by the judges of the Commercial Courts.

### **□ Reform of Bankruptcy Proceedings**

Changes have been proposed to the Law of 01/03/1984 regarding prevention and amicable settlement in order to enhance the preventative measures available to companies by reinforcing the role of the statutory auditor in the warning procedure and an increased role for the Clerk of the Commercial Court.

This reform also includes the intention to increase the role of the public prosecutor in the amicable settlement procedure and especially with regard to the oversight of the activities of the receiver named

in an independent preliminary bankruptcy proceeding. However, the increased role of the public prosecutor could act as a deterrent to the management to begin the voluntary preventive measures.

Changes have also been proposed to the Law of 25/01/1985 including a more restrictive definition of liquidation to avoid the abuse of this solution, a simplified liquidation procedure for companies with limited assets and a reinforced role for the public prosecutor during the observation period.

#### □ **Project to reform the professions related to the Bankruptcy proceedings**

This reform was introduced by a Decree dated 29/12/1998 and entails:

- Enhanced oversight of the activities of Liquidators and Receivers,
- Oversight of each Liquidator and Receiver every two years (instead of 4),
- Enhanced role for the Statutory Auditor,
- Reinforcing the obligations of the Liquidator : drafting of a report to be submitted to the public prosecutor and the Insolvency Judge upon request at any time and all funds received must be immediately deposited on an account at the Caisse de Dépôt et Consignations.

### **TITLE 7. STATE OF KNOWLEDGE**

#### **Lois :**

- Law n° 84-148 of March 1, 1984 as amended by law of June 10, 1994 regarding the amicable settlement of company difficulties,
- Law n° 85-98 of January 25, 1985 as amended by law of June 10, 1994 regarding the reorganization and the judicial liquidation of companies.

#### **Ouvrages :**

- GUYON Yves : Droit des affaires Tome 2 : Entreprises en difficultés- Redressement judiciaire- Faillite Economica (2001),
- SOINNE Bernard : Traité des procédures collectives Editions LITEC,
- SAINT ALARY- HOUIN : Droit des entreprises en difficulté Editions MONTCHRESTIEN .

#### **Répertoires :**

- LAMY Droit Commercial (redressement et liquidation judiciaires),
- Dictionnaire Permanent des Difficultés des Entreprises (Edition Législatives),
- JURISCLASSEUR Procédures collectives.

#### **Publications :**

- L'entreprise en difficulté en France (octobre 2001) Deloitte & Touche.