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# Law Reform in France: The Incidental Benefit for Rescue Plans

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*Introduction*

The law of insolvency is anchored on the pillars of the law of 1984 and two laws of 1985.[1] Criticisms of the structure of insolvency proceedings led to a further reform law in 1994 which affected the law of 1984 and the first law of 1985, but left the law in relation to the professions largely untouched.[2] However, recent allegations that two administrators were involved in the disappearance of over FF 200 million from the coffers of companies which they administered, further revelations that a number of insolvency practitioners had used their position to further their own business interests as well as allegations of bad practice made as a result of investigations in a number of judicial districts,[3] have led to a crisis of public confidence and have prompted Elisabeth Guigou, the Garde des Sceaux, to announce a raft of wide-ranging reforms which would centre around four key issues: the reinforcement of penalties for supervising judges who misuse their influence for personal ends, the closer scrutiny of insolvency practitioners' accounts and a requirement that funds generated by companies in insolvency be deposited with the official deposit-taker as well as a greater role for public prosecutors in insolvency proceedings.[4]

Curiously, it is not this raft of reforms that will affect the central issue in insolvency procedures, the rescue plans, but an allied reform to company law, which itself is coming under pressure to reform, in particular due to the increasing influence of what is euphemistically termed in France "Anglo-Saxon" (i.e. Anglo-American) management methods. The watchword of the mid 1990s in France is now "Corporate Governance", and the Cadbury and Greenbury Reports, part of the reform to the structure and ethics of corporate management in the United Kingdom, have had an effect on French corporate thought.[5] An official report by Phillippe Marini,[6] titled "The Modernising of Company Law", contains a great number of recommendations as to reforms, in three broad themes, which may be briefly summarised as covering, first, the broad law applicable to companies, secondly, the management of companies and associated interests and, lastly, the

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[1]Law no 84-148 of 1 March 1984 (Prevention of Business Difficulties), Law no 85-98 of 25 January 1985 (Insolvency Procedures) and Law no 85-99 of 25 January 1985 (Insolvency Practitioners).
[2]Law no. 94-475 of 10 June 1994.
[3]This case, known as "l'affaire Sauvan-Goulletquer" resulted in the arrest of both partners in early 1997 on charges of fraud, illegal acquisition of interests in companies and abetting criminal bankruptcy. A journalistic enquiry published in Challenges (January 1998 edition) at p48 passim outlined some of the cases which have prompted public concern, included concerns about courts in Bobigny, Nanterre, Nice, Paris and St. Lô.
[4]Announced on 24 October 1997 during the General Conference of Commercial Courts in Paris.
[5]Some of the recent articles on this topic include: Couret A., Vers un nouveau droit des groupes Les Petites Affiches 1997.47.4; Chamy E., Transposition du Corporate Governance anglo-saxon en droit français Les Petites Affiches 1997.69.4; and a special issue of Les Petites Affiches 1997.55 titled Démocratie et transparence dans le gouvernement d'entreprise containing 10 contributions.
[6]Senator for the Oise département.

law relating to internal control and management duties and liabilities..[7] The first chapter, titled “Favouring freedom of enterprise”, predicates firstly, the creation of a more neutral legal regime which applies to corporate affairs and, second, the introduction of a more flexible company law system, including the harmonisation of tax treatments for partners in joint stock companies (‘*SARL’*) along the lines of advantages obtained by shareholders in share companies (‘*SA*’) and the harmonisation of stamp duty for the transfer of *SA* shares and *SARL* stock.[8] The reasons for the harmonisation are stated as being that tax consequences are directly linked to the choice of investment vehicle, which may result in an inappropriate choice of incorporation status for certain businesses. As there appears to be no justification for the disparity in treatment, the recommendation is to use the tax regime applicable to the transfer of shares to all such transfers, whether of shares or stock. The impact of this may be seen from a consideration of the tax rates which are at present applicable.[9]

*Taxation of Rescue Plans*

There are two types of rescue plan known to French insolvency legislation, the continuation plan, which provides for the continuation of business, and the sales plan, under which part or all of the business is sold as a going concern, with the remaining company shell and any surplus assets being liquidated.[10]

*Continuation Plans*

A continuation plan provides for two alternatives for those wishing to acquire all or part of the company in question. The first alternative is the purchase of the existing shares or stock for a nominal value. This entails the assumption of business debts by the purchaser and the repayment of the creditors in accordance with the continuation plan. The sale may be arranged on an amicable basis directly with the shareholders or partners in the company or may occur following an order of the court in relation to directors being required to sell their shares.[11] The second alternative is for a reduction of existing capital followed by an increase, under which the newly issued shares or stock are subscribed to by the party wishing to acquire the company. This modification may occur either at the initiative of the existing shareholders or partners, or may be ordered by the court at the request of the administrator. The tax which falls to be paid in the case of a continuation plan is registration duty.[12]

<u>SA</u>

Registration duty is levied in cases of transfer of shares at a rate of 1% of the value of the shares.[13] The tax is levied on the registration of the deed which

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[7]The report, titled “La modernisation du droit des sociétés” can be obtained from La documentation française ISBN 2-11-003652-4 price FF.150.

[8]Action (shares in a société anonyme) and part sociale (stock in a company whose capital is not divided into shares, usually a société à responsabilité limitée) respectively.

[9]The rates quoted are those applying in 1997.

[10]For a general overview of corporate rescue plans, see Chapters 9-11, Sorensen & Omar, Corporate Rescue Procedures in France (1996) Kluwer Law International.

[11]Art. 22, Law no. 85-98 of 25 January 1985.

[12]Droit d’enregistrement.

[13]Art. 726, General Tax Code (Code Général des Impôts (‘CGI’)).

records the transaction, even if this deed is drawn up after the transaction occurs.[14] There is a ceiling fixed at FF. 20,000 per transaction. The transfer of shares by more than one party or to more than one party and also the transfer of the shares of more than one company, even if noted in the same document, constitutes a separate transaction and is taxed separately. This tax may legitimately be avoided where the transfer is executed in a country other than France, although the parties may need to be able to provide evidence of this fact. The tax may also be avoided where the transfer is not set out in any document, whether a single document or separate documents which together would constitute a transfer, which would prove the agreement of the parties as to the price or amount of shares to be transferred. Nevertheless, should for any reason registration of the transfer becomes necessary, for example so as to ensure performance of the agreement, parties to the transaction may wish to provide who will bear the costs of registration and the tax that may fall to be paid.

SARL

In cases of a transfer of stock, the rate is set at 4.8%, whether or not the transfer occurs pursuant to a deed. An exception is made for stock which represents capital contributions in kind, which is subject to any tax on the sale of the property the contribution represents.[15] In principle, if the deed is executed in a country other than France, the tax remains due if it relates to the transfer of stock in a French company. A transfer of stock in a foreign company is also taxable if the deed is executed in France.[16]

*Sales Plans*

A sales plan provides for the possibility of acquiring either the whole or part of the business. This entails the purchase of certain parts of the business free of any encumbrances. Although classified as a sale of assets rather than a sale of company shares or stock, the sale must be that of an entire commercial operation, defined to mean an ensemble of property, machinery, tools, employment and supply contracts etc. which is potentially viable as a separate unit. The law includes take-over terms so that the unit cannot be shut down and broken up for separate use or resale after purchase to discourage asset-stripping.

The tax that falls to be paid for the sale of a business and its goodwill or clientele is subject to a graduated tax which is levied as follows:

| **Tax on Sale of Business**[17] | |
|---|---|
| *Value of Sale* | *Amount of Tax* |
| less than 150,000 FF | 0% of value |
| 150,000 FF to 700,000 FF | 6% of value |
| over 700,000 FF | 11.8% of value |

The tax is calculated on the price of sale of stock, the value of the transfer of a lease and corporeal or incorporeal property which allows for the running of the

[14]Cassation commerciale, 7 December 1993, Lamy Fiscal at para. 1221.
[15]Art. 727, CGI.
[16]Francis Lefebvre, Fiscal 1997, para. 6422.
[17]Droit de mutation.

business. All these items must be inventoried with detailed cosigns, separately from any take-over agreement, on a form supplied for this purpose by the tax authorities, three copies of which must be deposited with the tax office which deals with the transaction.[18]

*Motivations for Change*

Although the Marini Report outlines the case for tax harmonisation, the real pressure for change may have come from the tax authorities, for whom this disparity has had enormous impact, chiefly due to having to react to attempts by entrepreneurs to avoid paying the higher rate by changing the incorporation status of their companies. The Supreme Court gave comfort to these often ingenious manoeuvres in a case late in 1996.[19]

The facts of the case were as follows. Shares in Sojibe SARL, a limited company in which undivided stock, were held jointly by four partners. Following a breakdown in relations between two of the partners, a decision was made in November 1987 to transform the company into a SA, which was carried out pursuant to resolutions of an EGM in December 1987. At the same time, the share capital was to be increased from FF.100,000 to FF.1,000,000, the balance of capital being made up by a contribution from Sogra (Granulats de Ranteil). The partners then proceeded to sell their shares to Sogra, the transfers attracting the going rate for tax.[20] The tax authorities then assessed Sogra, which in the interim had been taken over by RMC France. for payment of stamp duty on the transfer of stock at the higher rate and sought to recover the duty, together with interest and penalties for late payment. RMC France appealed to the tax authority concerned, the regional director for taxation in Toulouse, to have the decision reconsidered, which was not granted. An appeal to have the decision overturned before the Tribunal de Grande Instance at Albi, heard on 22 June 1994, was also rejected. RMC then sought judicial review of the decision before the Supreme Court.

The tax authorities argued that the purpose of the transformation of the company from a SARL to a SA, coming as it did following a decision to sell the company to Sogra, had its sole purpose the avoidance of stamp duty, both transactions being linked by the fraudulent intent of the parties involved. This was an abuse of law.[21] RMC France argued that the transactions were not made exclusively with tax savings in mind, but had the advantage of being able to resolve the problems which led to the breakdown in relations between the partners, of protecting the financial and tax status of one of the partners within the SA and, furthermore, of giving the company the benefits of SA status, which were not inconsiderable.

The Supreme Court considered that the transformation of a SARL into a SA was, if made in a regular manner following a decision of the majority of partners, a decision to be treated as having several effects and was a transaction necessarily distinct from any subsequent decision by the partners to sell their shares. The Supreme Court held that, in order for there to be an abuse of law, the whole

[18]Art. 719, CGI.
[19]Cassation commerciale, 10 December 1996, Les Petites Affiches 1997 no. 60 at p.10.
[20]1% of the share value for each transaction between two parties, limited to a maximum of FF.20,000 per transaction.
[21]'Abus de droit', controlled by Article L.64 of the Book of Fiscal Procedure.

purpose of the manoeuvre had to be to get the company back to its original position, through a transformation followed by a transfer or sale, followed itself by a transformation. As this did not occur in the present instance, the court in Albi was in error and the case was remitted for consideration to the Tribunal de Grande Instance at Pau.[22]

*Summary*

This decision by the Supreme Court represented quite a restrictive interpretation of the relevant article of the Book of Fiscal Procedure and dealt a severe blow for the tax authorities, literally hampering their ability to act, even in situations where there are suspicions of a tax avoidance scheme, as it is open to companies to argue that the motives for any transformation, which may be opaque to the authorities and thought of after the event, were quite legitimate and in keeping with the statement of principle outlined in the case. The Supreme Court did not lay down a general test of what constituted a further transformation and the factors which would engender suspicion as to the motives for the transactions to which the company is subjected. Although it can be said that proof of situations constituting abuse of law is likely to be more difficult to obtain, the situation from both perspectives is quite unclear and any transformation, however innocent, may attract the unwanted attention of the tax authorities.

Now that there are proposals to harmonise the differential tax rates for the transfer of shares and stock, the incentive to transform companies in this way is likely to disappear. The only differences which will remain are in the taxation rates between continuation and sales plans, which may have an effect on the choice of plan. There is no reliable data, however, to suggest that administrators of insolvent companies or supervising judges are any less likely to consider sales plans over continuation plans on the basis of the cost of taxation involved, as it is common practice to require the author of a continuation plan and the offeror, in the case of a sales plan, to subscribe to a clause in the agreement by which any costs incidental to the adoption of the plan and transfer of company assets are to be borne by the author or offeror.[23]

**28th May 1998**

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[22]In France, the court which rehears a matter remitted by the Supreme Court is always another court within the same judicial district.

[23]See Sorensen & Omar, op. cit. Appendix Four at p306 and p310.