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French Supreme Court rules out liability for undercapitalising companies

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Minimum share capital requirements have disappeared from French legislation over the last few years, leaving the *société anonyme* as the last and only commercial company with such a requirement, set by the French Commercial code at EUR 37 000[2], thereby increasing the need in practice to accurately determine the equity and debt financing required when starting operations.

In this regard, two decisions addressing the liability of the main shareholder and the Managing Directors (the "**MDs**") of commercial companies in the case of undercapitalisation, were recently rendered by the Commercial chamber of the French Supreme Court (hereafter the "**Supreme Court**"). In both matters, although based on different facts, the liability of shareholder and MDs, respectively, was not triggered.

In the first case, the unusual attempt by a subsidiary, not subject to any insolvency proceedings, to target the deep pockets of its parent company was dismissed by the Paris Court of Appeal.
In the second case, the court appointed liquidator of the company, which had filed for insolvency, obtained a ruling by the Bordeaux Court of Appeal sentencing the two MDs, who were also shareholders of the company, to assume personal responsibility for a part of the company's outstanding debts. The decision by the Court of Appeal was overruled in a short decision, setting a ground-breaking precedent.

I. SA Rhodia v SA Sanofi: the end of the saga[3]

a. Facts

In 1997, Rhône-Poulenc spun-off its entire chemical, fibres and polymers division to an existing fully-owned subsidiary named Rhône-Poulenc Fibres and Polymers, later renamed as Rhodia. The spin-off was carried out by way of the sale of the shares of the chemical division by Rhône-Poulenc to Rhodia, funded by a share capital increase in cash by Rhône Poulenc.

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As a consequence, Rhodia acquired assets but also liabilities associated with the transferred division, including pension liabilities and environmental liabilities. In 1998, Rhodia's shares were listed on the Paris and New York stock exchanges. A year later, Rhône Poulenc, after disposing of the majority of Rhodia's shares, merged with the German group Hoechst to create Aventis, which was later acquired by Sanofi Synthelabo, renamed *Sanofi* in 2011.

In 2005, Rhodia informed Sanofi of its intention to claim compensation for damages that it claimed had resulted from the transfer by Rhône Poulenc of liabilities and obligations as part of the spin off.

In 2007, Rhodia pursued a claim in tort against Sanofi before the Paris Commercial Court, claiming that it could not discharge the pension and environmental liabilities and related expenses due to an under-capitalisation by Rhône-Poulenc during the stage of its creation. Rhodia also claimed that Sanofi should have financially supported its subsidiary, given the lack of resources resulting from the structuring of the spin-off.

b. Decision

The Paris Commercial Court dismissed Rhodia's claim, holding that there was no proof of negligence or recklessness on the part of Rhône Poulenc during the creation of Rhodia. It was also confirmed that there was no duty owed by Rhône Poulenc to provide indefinite and unlimited support to a former subsidiary.

The Paris Court of Appeal took an identical stance and dismissed Rhodia's claim on all grounds, and this stance was approved by the Supreme Court on 12 May 2015[4]. The Supreme Court insisted and relied on the interpretation of the facts by the Court of Appeal on all grounds and its decision was based on three main arguments:

- Firstly, the Supreme Court acknowledged that Rhône-Poulenc contributed equity, through several share capital increases in cash and a discharge of debt, up to the amount of EUR 2.17 billion[5] to Rhodia. Hence, it ruled that Rhodia suffered no damages from its level of capitalisation, set by its former shareholder, Rhône-Poulenc.

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- Secondly, it further ruled that the Court of Appeal, based on its findings, rightfully held that Rhône Poulenc had shown no negligence or recklessness during the creation of Rhodia on the basis that i) there is no "good practice" governing the transfer of pension liabilities that Rhône-Poulenc should have complied with, and ii) the environmental liabilities did not overburden Rhodia, as the financial structure was considered sufficient by several experts and investment banks.
- Lastly, it held that the difficulties encountered by Rhodia were caused by the challenges faced in the chemical sector and a number of costly transactions (such as the acquisitions of Albright & Wilson and Chirex made by Rhodia in 1999 and 2000, respectively) rather than the pension liabilities or environmental liabilities.

c. Comments

A distinctive feature of the decision rendered by the Court of Appeal is that, rather than being based on legislation or existing case law, it is very factual and that Rhodia failed to provide adequate evidence. The meticulous emphasis placed on facts by the Court of Appeal greatly influenced the outcome of the Supreme Court's decision, as French civil procedure rules[6] solely allow the latter to control the adequacy of the decision subject to the appeal with French law. Facts are "evaluated without appeal" (*"appréciés souverainement"*) by the Court of Appeal and therefore cannot be subject to a new evaluation or interpretation by the Supreme Court. Consequently, the Supreme Court's decision was rather predictable as all the facts pointed towards the conclusion, according to the Court of Appeal, that Rhône-Poulenc did not under-capitalise its former subsidiary. On the contrary, Rhône-Poulenc contributed to its future success through healthy share capital increases and a major discharge of debt, which contributed to Rhodia becoming a major player in the chemical industry market.

Interestingly the Supreme Court stated twice in its decision that the Court of Appeal had rightfully considered, based on its findings and analysis of the facts, that Rhône Poulenc had not disregarded Rhodia's interests, nor breached its duty of care and prudence (*"ses obligations de prudence et de diligence"*) when Rhodia was created[7].

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This repeated statement in relation to such a duty owed by shareholders at the creation of a company, which was amongst the arguments developed by Rhodia, seems to set a standard for the control to be exercised by the lower courts when ruling on similar issues.
Although the Court of Appeal and the Supreme Court did not give any indication as to the legal nature of the above mentioned duty, it is very likely that it is not an absolute obligation (*"obligation de résultat"*), but a so called *"obligation de moyen"*, which is characterised by the fact that a failure to obtain a result does not in itself equal a breach of the obligation.

This decision also puts an end to a decade of claims and proceedings initiated by Rhodia against its former shareholder in different jurisdictions and countries, thereby ending a litigation saga[8].

II. No liability for mismanagement by the MDs of a company incorporated with insufficient equity to fund its operations

a. Facts

During the creation process of a limited liability company (*"société à responsabilité limitée"*), the two founders agreed that the share capital of the new company would be contributed in cash for EUR 10 000 by one of the founders and contributed in kind for EUR 190 000 by the other. The company was later placed in liquidation and the court appointed liquidator claimed in two separate proceedings that the statutory MDs had mismanaged the company and were liable on the grounds of article L. 651-2[9] of the French Commercial code for the company's shortfall of assets (*"insuffisance d'actif social"*).

b. Decision

After a very detailed and fact based presentation, the Court of Appeal[10] overruled the judgment of the Commercial court[11] and judged that the fact, that both MDs had contributed insufficient capital to the company at its creation, as an act of mismanagement under article L. 651-2 of the French Commercial code. The court subsequently held that the two MDs were liable to cover, in different proportions, a part of the company's shortfall of assets.

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The Supreme Court, in its ruling, which expressly refers to article L. 651-2 of the French Commercial code, overturned the ruling of the Court of Appeal and held, apparently for the first time, that the contribution of sufficient equity to a company during its creation phase is an obligation of the shareholders of that company, and as such cannot be considered as an act of mismanagement by MDs.

c. Comments and conclusion

This decision is ground-breaking as it puts an end to a contrary line of case law[12] in respect of an MD's liability to sufficiently capitalise a company at its constitution.

One question is whether the Supreme Court would have reached a different conclusion in this case, if the claim had been brought against the shareholders rather than against the same persons in their legal capacity as MDs. In such an event, would the shareholders have been deemed to have complied with their duty of care and prudence required as per the Rhodia v. Sanofi decision?
This question may be of even greater interest considering that a number of companies, heavily leveraged at their creation, are currently subject to severe financial difficulties, which may have been predictable given the aggressive structuring of their business plans and financing models at the outset.

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1 The author would like to thank his trainee, Thomas Allain, for his enthusiastic involvement in the preparation of this article.
2 Article L. 224-2 of the French Commercial code
3 In respect of this case, the reader can refer to the article published by the same author analyzing the decision rendered by the Paris Court of Appeal on 17 September 2013: *SA Rhodia v SA Sanofi: Maternity Obligations do not Extend to Funding the Offspring in Spin-offs*, International Corporate Rescue, Volume 11, Issue 2, 2014.
4 Commercial chamber, Rhodia v. Sanofi, n° 13-27.716
5 The Court has inconsistently and erroneously referred to EUR 2.17 million on page 5 and EUR 2.18 billion on page 8 of its decision, whereas the combined amount of the share capital increases and discharge of debt is in fact EUR 2.78 billion (i.e two share capital increases of EUR 609 million and EUR 650 million and a discharge of debt of EUR 1.52 billion).

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6 Article 604 of the French Civil procedure code

7 Here, the Supreme Court erroneously refers to the "*creation*" of Rhodia. The term "*creation*" is inaccurate, as the company previously existed under the name Rhône Poulenc Fibres et Polymers and was apparently incorporated almost ten years prior to the spin off. Obviously, the Supreme Court may have referred here to the time of the spin off and the start of the operational existence of Rhodia – for more information on this aspect please refer to the author's prior article "*Maternity Obligations do not Extend to Funding the Offspring in Spin-offs*"; ICR, Volume 11, Issue 2, 2014, page 75.

8 For more details about the previous proceedings, please refer to the author's article: *SA Rhodia v SA Sanofi: Maternity Obligations do not Extend to Funding the Offspring in Spin-offs*, ICR, Volume 11, Issue 2, 2014, page 73.

9 This article is the French equivalent of section 214 of the UK Insolvency Act 1986 (wrongful trading) and enables French courts to hold statutory and *de facto* directors liable for the shortfall of assets in case of a court ordered liquidation, when the directors have committed acts of mismanagement which have contributed to such shortfall.

10 Bordeaux, Second Civil Chamber, 21 November 2011, RG : 10/01945

11 Angoulême, 10 December 2009, RG 2008X01139, Hirou v. Ribette & Ollard

12 Commercial Chamber of the Supreme Court, 23 November 1999, n° 97-12834 ; 27 May 2003, n° 00-14981; Rouen, 20 October 1983