

France: The Versailles Court of Appeal fine-tunes the duty of loyalty owed by Managing Directors

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A Managing Director of a French *Société Anonyme* has a statutory duty of loyalty towards the shareholders of such company. This principle was set in stone by a ruling of the French Supreme Court (*Cour de cassation*) in 1996. It has further been ruled that under this duty, a Managing Director (“MD”) must inform the board of directors and shareholders of any ongoing negotiations in relation to a proposed transaction affecting the shareholding of a company, even in the situation where such a company is in distress. Non-compliance with this duty may lead to the termination of a MD’s appointment and exclusion of his right to contractual compensation².

Factual background In early 2010, a major car-rental company (the “Company”) hired an experienced and senior MD with a view to turning around the Company. The latter had not been performing as expected and required a substantial cash injection and debt restructuring. Throughout the duration of his appointment the MD, who was also appointed to the board, signed various agreements with the Company, including:

1. a “*contrat de mandat*” (a written mandate) whereby he committed to use his best efforts to develop the Company’s business, to serve and act with loyalty, care and good judgment;
2. a share purchase plan agreement (“*plan d’actionnariat des dirigeants*”); and
3. put and call option agreements with the main shareholder of the Company.

In January 2012, the main shareholder of the Company, a major French Private Equity firm (the “Main Shareholder”) informed the Company’s management via one of its representatives on the board of directors, that it had started negotiations in respect of a significant debt refinancing program, and that it was therefore not considering a sale of its shareholding in the Company.

Nevertheless, the MD initiated conversations with one of the Main Shareholder’s key competitors and started preliminary discussions with various bankers and lawyers in relation to a change of control of the Company. He also publicly mentioned to several members of the management team that he did not believe in the Company’s strategy and the viability of its business model.

This apparently contributed to the spreading of negative and contradictory rumours in the market, at a time where the Main Shareholder was negotiating the debt refinancing.

As a consequence, the MD’s appointment was terminated in February 2012 for breach of his duty of loyalty towards the Main Shareholder. The Company also took the view that the MD was not entitled to benefit from the agreed termination package provided in the mandate because he had committed a “*faute grave*” (gross misconduct). Under the mandate, the *faute grave* was defined as a breach of a contractual obligation resulting in the MD being prohibited from further carrying out his functions in the Company (“*une faute grave rendant impossible son maintien dans les fonctions de directeur général*”).

Concept of duty of loyalty The duty of loyalty owed by the MD to the shareholders of a company was established by the French Supreme Court on 27 February 1996³ and has since been regularly upheld by French courts⁴. In most reported cases, the MD has been deemed in breach of his duty of loyalty when concealing his intentions to his fellow shareholders and the potential value of the company’s shares, in order to purchase them from the latter and later reselling a controlling interest in the company with a profit.

Until the decision by the Court of Appeal of Versailles had been handed down, it had not been determined by reported case law whether the duty of loyalty arises from the contractual relationship between a MD and the company or if it is a duty akin to a fiduciary duty which arises from the MD’s appointment⁵.

Court analysis At first instance, the Commercial court (“Tribunal de commerce”) of Versailles ruled in favor of the Company’s MD⁶, who was awarded €2,444,000 in compensation for his termination. The Commercial court deemed that the agreed

termination package could not be denied because the MD had not committed a “*faute grave*” (gross misconduct). This judgment was based on article 1134 of the French Civil Code which provides that valid contracts legally bind the parties.

On appeal, the judgment was overturned and it was held that:

- The fact that the MD was on the verge of starting negotiations in relation to a change of control of the Company and concealing this from the shareholders constituted a serious breach of his duty of loyalty to the shareholders. Circumstances in the present case were particular as the board of directors, during a meeting in January 2012, had specifically excluded considering the search for a potential purchaser of the Company’s shares, which was on the board’s initial agenda for that meeting.
- The Court further added that the MD had acted against the Company’s corporate interest but also that his behavior was:
 - contrary to the common interest of the Company and its Main Shareholder
 - disloyal and as such justified the immediate termination of the MD’s appointment and the denial of his right to compensation provided for by the terms of the written mandate.
- A MD does not have to derive a personal benefit from the proposed transaction in order to trigger a breach of the duty of loyalty.

The Court of Appeal based its judgment on articles 1833 and 1984 of the French Civil Code, which respectively provide that a company is created [and operated] in the common interest of its shareholders and that the MD acting on the basis of a mandate must act in the common interest of the shareholders.

An appeal to this ruling has been lodged before the French Supreme Court.

Practical considerations

- According to consistent case law, the MD of a distressed company has a duty to take any suitable measure in order to avoid a payment default or continuing an unprofitable activity⁷. Failing to do so may be qualified as acts of mismanagement (“*faute de gestion*”) and end up with the MD being liable for a part of the company’s outstanding debt, particularly in the event of a subsequent insolvency scenario. As

per the judgment of the Commercial court of Versailles, this was apparently raised by the MD (page 10 of the judgment) as a defense against the claim that he had committed a serious breach of his duty of loyalty.

- A breach by a MD of his duty of loyalty towards the shareholders may be qualified as a “*faute grave*” and therefore lead to his dismissal by the company and loss of the right to any contractual compensation, as per the provisions of his appointment.
- It may be necessary to formalize in writing, as in the present case, the conditions under which the MD would be deprived of his termination compensation.
- The duty of loyalty in itself does not prohibit the MD negotiating the potential sale of a company’s shares. Under that duty, his obligation is to disclose such negotiations to the shareholders in a timely manner prior to entering into such conversations and subsequent negotiations.
- The Court of Appeal took a stand in regard to the legal grounds of the duty of loyalty, as this ruling is based on both articles 1833 and 1984 of the French Civil code. By doing so, the Court of Appeal asserted that the duty of loyalty is both a contractual and a fiduciary duty, and is therefore in line with the French Supreme Court which stated that in the event no written contract is entered into between a MD and the company, the duty of loyalty arises, according to article 1833, from the MD’s obligation to always act in the common interest of the company and the shareholders⁸.
- The outcome of the decision of the French Supreme Court will certainly impact the drafting of compensation packages for MDs.

¹ With the contribution of Thomas Allain, élève-avocat

² Court of Appeal of Versailles, 1 July 2014, n°12/07800

³ Commercial chamber of the Cour de cassation, 27 February 1996, *Alary v. Vilgrain*, n° 94-11.241

⁴ Commercial chamber of the Cour de cassation, 6 May 2008, no 07-13.198; 12 March 2013, no 12-11.970

⁵ H. Le Nabasque, Le développement du devoir de loyauté en droit des sociétés: RTD com. 1999, p. 273

⁶ Commercial court of Versailles, 7 November 2012, n° RG 2012F00363

⁷ Commercial chamber of the Cour de cassation, 7 June 2005, n° 04-13.262; 31 May 2011, n° 09-13.975, n° 09-14.026, n° 09-16.522, n° 09-67.661

⁸ Rapport de la Cour de cassation pour 1996 : Doc. fr. p. 312