Corporate Finance/M&A - France

How to Maximize Corporate Investment While Protecting Company Interests

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Raising Capital

In view of the financial crisis and the difficulty of obtaining bank loans, many companies have resorted to alternative solutions in order to maintain or increase their market presence. The credit crunch has caused many companies to finance their activities by raising new money.

In some cases recourse to private investment is the only option available to company managers to solve financial difficulties.

In this context, 2009 was marked by new investment opportunities as a significant number of privately and publicly held companies launched capital increases in order to raise cash.

Although opening a company's share capital to a third party may be contrary to the company's method of operation (such move may cause the company to lose its independence and bring about a new corporate governance structure), it can help to strengthen the company's equity or meet its debt financing obligations.

To enable future shareholders to invest successfully, participants in these kinds of transaction must be creative and use the most appropriate corporate combinations - usually by subscribing to a share capital increase after cancellation of shareholders' preferential rights or through the issue of convertible bonds or bonds exchangeable for shares.

The investor's primary goal is not to take effective control of the target, but rather to occupy a temporary shareholding position, with an exit strategy established from the outset and the objective to obtain potential capital gain upon exit.

In order to secure such investment, those that wish to protect their respective interests must set the terms and conditions of the relationship, in particular through an executed investment contract and a shareholders' agreement that will take effect upon closure of the transaction.

The investment contract describes the whole transaction. The shareholders' agreement governs shareholders' relationships during the partnership. It should cover the mechanics of the company's operation and all aspects of the relationship. The agreement must therefore be drafted with due care to limit the possibility of dispute between parties.

This update looks at key clauses to be considered for inclusion in a shareholders' agreement: those relating to corporate governance rules, shareholders' financial rights and the subsequent sale of shares.

Corporate Governance

As the investment is directly linked to company performance, the investor will seek to be involved in the company's management. It is increasingly common to include conditions under which shareholders, or the board of directors in the case of co-optation,(1) may appoint one or more representatives of the investor to the board of directors or supervisory board.

Investors' political rights go further, since the shareholders' agreement often includes genuine voting agreements. Voting agreements are used to obtain unanimous consent, quorums or qualified majorities for important decisions (eg, selection of managers, changes in activity or restructuring). However, such agreements are disputable since they may be in breach of the free exercise of shareholders' voting rights and in any case are unenforceable against third parties.

Article L242-9 of the Commercial Code states that it is forbidden to grant, guarantee or offer advantages to a shareholder to vote in a certain way. Nevertheless, case law reflects that shareholders' voting rights may be temporarily adjusted on the condition that this leads to no abuse of the right to vote (ie, the adjustment may not contradict the social interests of the company or be motivated by the desire to harm a party to the agreement). The Paris Court of Appeal has held that a commitment to vote favourably for a share capital increase is legal, since it is limited to a specific transaction, complies with the social interests of the company and is not fraudulent.(2)

Shareholders' Financial Rights

The shareholders' agreement may include financial rights which benefit the investor (eg, a preferred dividend). In such cases the shareholders' agreement provides for allocation of profits between shareholders and therefore derogates from the allocation resulting from their respective shareholding. Alternatively, the shareholders' agreement may include a clause to provide a minimum dividend guarantee to the investor, thus ensuring a minimum return on its investment.

However, such clauses must be cautiously drafted and become effective only when the company has profits available for distribution. The Supreme Court has held to be void:

"*[a] provision according to which a shareholder transfers to another shareholder the right to receive all the benefits in exchange for a lump sum, which effectively ensures under all circumstances the certainty of a profit, even if the company generates losses that would be entirely borne by the other partner*."(3)

Resale of Shares

When an investor takes a shareholding in a company, its main objective is usually not only to obtain dividends, but also to guarantee liquidity of the shares. Consequently, the investor requires that the shareholders' agreement specifically include conditions governing its exit from the company and rules governing the sale of its shares. The investor will sometimes require the founding shareholders to commit to an initial public offering.

The agreement may include several provisions in order to simplify the investor's exit - for example, a joint exit right which allows a shareholder to transfer its shares when another shareholder exits the company.

The shareholders' agreement may also include a clause stating that if a third-party offer is received and accepted by the majority of shareholders, the remaining shareholders are obliged either to purchase the shares of the shareholders that wishes to sell or to sell their shares to the third party.

The investor may also be granted a put option, which allows it to sell its shares to the founding shareholders on an agreed date and at a fixed price, or at a price determinable by a specific formula in the agreement. The founding shareholders then agree irrevocably to buy the shares.

Some liquidity provisions state that the parties can meet on a certain date to negotiate the sale of the investor's shares to a third party.

Other Issues

Investment in a publicly held company may raise certain issues. For instance, Article L233-10 of the Commercial Code states that persons that have entered into an agreement with a view to exercising voting rights to implement a common policy in relation to a company are considered to be "acting in concert". Under French takeover rules, when persons acting in concert comes to hold more than one-third of the target's shares or voting rights, they must launch a mandatory takeover bid.(4) Therefore, by entering into a shareholders' agreement, the signatories may be deemed to be acting in concert and consequently may have to file a public takeover bid.(5)

The content of shareholders' agreements can vary and should be adapted to the circumstances. However, they must ensure a proper balance between the several interests represented. The investment, other than its intrinsic value, is only as good as the terms of the contract that formalizes it.

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Endnotes

(1) 'Co-optation' is the nomination of a new director by board members, under certain conditions and on a temporary basis. The appointment is then approved by the general shareholders' meeting.

(2) Paris Court of Appeal, 5th ch C, June 30 1995, 93/27606, *Sté Metaleurop c v Sté Financière Delot et Cie*, JCP M E 1996, II, 795, note J-J Daigre.

(3) Cass com, October 18 1994, Dr sociétés 1994, comm 205, note H Le Nabasque.

(4) Article 234-2 of the general regulation of the *Autorité des Marchés Financiers* (French securities regulator).

(5) Cass com, October 27 2009, *Gecina c v Metrovacesa*.

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