Corporate Finance/M&A - France

Seller's Liability for Business Facing Financial Difficulty

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On June 24 2008 a court decision outlined the exact measure of risk involved when a company undergoing reorganization aims to sell a branch of activity in economic distress.(1) The decision raises a number of questions relating to the extent of a seller's liability following the sale of a business facing financial difficulty.

Background

In 2005 the Samsonite group suffered a fall in market demand for hardside luggage, a product that was produced at its French production site. As a result, the group adopted a policy of outsourcing production abroad in order to reduce production costs and subsequently decided to sell its French site. In the first step of this sale, Samsonite transferred the branch to one of its subsidiaries by entering into a partial business transfer agreement. It then transferred the shares of the subsidiary to third-party purchasers. Several months later, the purchasers put the company into judicial liquidation. This led to the dismissal of employees, who later requested the cancellation of the partial business transfer and share purchase agreements. Samsonite agreed to make certain payments to the purchasers in order to help defray reorganization costs, but these payments were kept by the purchasers and were never used for the reorganization. Instead, the purchasers put the company into bankruptcy.

Decision

The court decided in favour of the employees, citing fraud as justification for its decision. It defined fraud as "the use of legal means to act in an illegal manner and to avoid applying the necessary rule of law". Thus, the fraud would be characterized by the transfer of a branch of activity, made unlawful by the seller's avoidance of its responsibility to pay shut-down costs by passing these costs on to the taxpayer. The acquisition of a company in economic distress was fraudulent because of the purchasers' misappropriation of funds paid by the seller which were intended to help defray reorganization costs. In the first instance the court aimed to demonstrate that fraud was committed by both parties, even though the court based its eventual decision only on the fraud committed by the purchasers.

The court first analyzed the seller's actions, criticizing Samsonite principally for its choice of buyer. Samsonite had several potential purchasers to choose from; some were industrial concerns with profitable businesses that had experience in the same sector. However, instead of choosing from among these companies, three individuals were chosen who, according to the judges:

- had no experience in the plastics industry;
- did not possess the funds necessary for the acquisition of the branch of activity or for the implementation of the reorganization; and
- presented a conversion plan for the site that had no solid basis.

The judges highlighted that the business plan presented by the purchasers consisted of one single page. The judges rejected Samsonite's argument regarding the various payments it had planned to make to the purchasers to help defray reorganization costs, arguing that these payments did not constitute proof of Samsonite's real motivation to ensure the survival of the transferred business because the assistance it had agreed to provide was insufficient. Moreover, Samsonite put no mechanisms in place to ensure that the payments it made to the purchasers would be used for reorganization costs. The court concluded that the continued existence of the transferred branch was superficial - the shutdown of the site was simply postponed. The court maintained that in completing the sale, Samsonite's sole motivation was to avoid bearing the costs of:

- possible dismissal of employees;
- any damage to the brand; and
- demolishing industrial equipment and the clean-up of the site.

The judges then addressed the purchasers' conduct. They stated that even if Samsonite had not assessed the extent of the flaws in the proposed reorganization project, the purchasers could ignore neither the weaknesses of the project nor the fact that there were no real prospects for the recovery of the company. Thus, the purchasers' sole motivation was to misappropriate the payments made by Samsonite that were intended to defray reorganization costs.

While the seller and purchasers acted differently, both were considered to have engaged in fraudulent behaviour. However, the judges cancelled the partial business transfer and share purchase agreements based on the fraud committed by the purchasers only.

Comment

Case law shows that the reorganization of a group through the transfer of a branch of activity in economic distress to a purchaser does not automatically release the seller from all obligations, particularly where subsequent judicial liquidation of the transferred business occurs. There are numerous precedents for such liability, the most famous of which is the *Bull Case*.(2)

For the seller, such a cancellation means that because of its retroactive effect, the shares transferred in the cancelled agreements are returned to the seller and the assets transferred in the business transfer agreement are returned to the original operating company. The most important consequence of this was the transfer of the employment contracts back to Samsonite, making it responsible for the cost of dismissal of the employees.

The question is whether the seller has a duty to ensure that the purchaser of a troubled business has a realistic restructuring plan and the ability to implement it.

This decision suggests that a seller has a certain duty to sell to a responsible buyer. Nevertheless, the importance of the *Samsonite Case* should not be overestimated.

First, even if the judges had specified the elements that could qualify Samsonite's conduct as fraud, they used only the fraud committed by the purchasers to justify their decision. Thus, despite the care and thoroughness they displayed in their arguments, they did not draw upon Samsonite's conduct when justifying their decision.

Moreover, the case involved the misappropriation of funds that Samsonite paid and which were destined to help in the restructuring, but were pocketed by the purchasers. The case indicates that a criminal investigation had been initiated. Nevertheless, the case suggests that a seller must be careful in choosing a purchaser and should take measures to ensure that any payments destined for restructuring are used for that purpose. Without such measures, judges may conclude that the aim of the transaction was not to transfer a branch of activity to a good-faith purchaser wishing to pursue its operation, but rather to dispose of an unprofitable business by handing it over to a third party that will put the company into bankruptcy and help the seller avoid the cost of dismissals.

Samsonite appealed the court's decision and the case is pending. Given the number of questions raised by this decision, the outcome of the appeal will be closely watched.

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Endnotes

(1) TGI Béthune, June 24 2008, RG 08/00832, *Mme X v Société Energy Plast, Bulletin Joly Sociétés*, December 1 2008, Number 12, p 998.

(2) November 14 2007, 05-21 239, Bulletin 2007 V, number 188.