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French Decision Enhances Need for Robust Pre-Acquisition Due Diligence

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In a ruling dated November 25, 2020,[1] the Criminal Division of France's highest court (the *Cour de cassation*) reconsidered its prior case law by establishing the principle of transfer of criminal liability in the case of "mergers by acquisition." In doing so, the *Cour de cassation* stated that in mergers by acquisition, the acquiring company could now be held responsible for offences committed by the acquired company prior to the transaction.

Before this reversal in case law, the *Cour de cassation* had long considered that Article L. 121-1 of the French Criminal Code – which establishes that no one may be held liable for any actions other than his/her own – prevented an acquiring company from being prosecuted and convicted for offenses committed prior to the merger by the acquired company, which was dissolved by effect of the merger. The court, which tended to draw parallels between a dissolved legal entity and a deceased individual, considered that at the time of a merger which results in the dissolution of the acquired company, the acquired company was considered to have lost its legal "personality," thereby resulting in the extinction of the possibility of prosecution under Article 6 of the French Code of Criminal Procedure. Accordingly, the acquiring company, which is a separate legal entity, could not be prosecuted for offences committed by the company it had acquired.

The change in direction by the *Cour de cassation*, preferring to rely on the "economic reality" rather than the anthropomorphic approach, occurs in the context of a broader European trend, which called for such reconsideration in order to recognize the consequences of legal entities whose forms may change, as long as the acquired company has been liquidated and its activity continues within the acquiring company.

In 2015, the Court of Justice of the European Union ("ECJ") ruled that a "*'merger by acquisition'* […] *results in the transfer to the acquiring company of the obligation to pay a fine imposed by final decision adopted after the merger by acquisition for employment law offences committed by the acquired company prior to that merger.*"[2] The ECJ considered that the extinction of such liability would be contrary to: (i) the very nature of a merger by acquisition as defined by Directive 78/855 (relating to the merger of companies), which considers that such operations result *ipso jure* in the transfer to the acquiring company of all the assets and liabilities of the company being acquired following a dissolution without liquidation; and (ii) the objective of protecting the interests of third parties in the context of mergers by acquisition, including those of the EU Member States, which could be harmed should a company use a merger by acquisition as a means of escaping the legal consequences of offences it has committed.

More recently, in a ruling of October 24, 2019, the European Court of Human Rights based its decision on the economic and operational continuity existing between the acquired company and the acquiring company, and ruled that "*the acquired company does not truly qualify as 'someone else' in relation to the acquiring company,*" so that the application of a civil fine for antitrust violations committed by the acquired company prior to the merger by acquisition does not infringe on the principle of the personal nature of the penalties.[3]

The shift in case law brings France more in line with these EU decisions and jurisprudence in some other jurisdictions, including the United States, which recognizing a theory of "successor liability" – that is, that a successor entity in the context of a merger or acquisition can be held liable for prior acts committed by the entity being acquired. In that respect, the *Cour de cassation*'s new position is not unprecedented. That being said, it constitutes a revolution under French law which must lead relevant economic actors to appreciate practical implications that it raises:

- <u>Need for Effective Due Diligence:</u> In recognizing that criminal liability can transfer from an acquired company to the acquiring company, French companies should now ensure that pre-acquisition due diligence is sufficiently robust to assess the risks associated with an acquisition, including latent risks that could present difficulties under relevant anti-corruption, economic sanctions, competition, human rights, or other laws sanctioning corporate misconduct. While such risks were already triggered given their possible civil consequences and /or the applicability of certain laws recognizing the criminal liability transfer principle, the possibility of potential sanction in the French courts for misconduct of an acquired entity will likely focus and enhance the need for such risk mitigation measures. All the more that in its 2015 ruling, the ECJ considered that its decision (to sanction an acquiring company for offences committed by the acquired company) could not be called into question by the argument that the transfer of an acquired company's liability for an administrative offence would prejudice the interests of the creditors and shareholders of the acquiring company, since "*an acquiring company is not precluded from conducting a detailed audit of the economic and legal situation of the company to be acquired before the merger by acquisition in order to obtain a more complete picture of that company's liabilities.*"   Only such due diligence will allow the acquiring company to be in a position to factor the risks of criminal sanctions into the acquisition and negotiate adjustments to the purchase price, disclosures and/or representation and warranty provisions, the drafting of which will require scrutiny to appropriately mitigate the risk and avoid being considered as invalid on the basis of the individual nature of penalties.
- <u>Implications for Acquiring Companies</u>: Since the ruling establishes that the acquiring company continues to operate in the place of the legal entity being acquired, the acquiring company benefits from the same rights as the acquired company previously had. As such, the acquiring company will be able to avail itself of any defense that the latter could have raised during the course of a proceeding.
- <u>Date and Scope of Applicability</u>: Given the scope and importance of this change in the law, and for the sake of legal predictability and certainty, this ruling only applies to mergers closed after the ruling of November 25, 2020 and falling within the scope of the Directive 78/855 as amended. Hence, this will only apply to mergers involving public limited liability companies such as French *sociétés anonymes* or *sociétés par actions simplifies*, and does not apply to partial transfers of assets for instance.
- <u>Sanctions Faced by the Acquiring Companies</u>: Acquiring companies held responsible for offences committed by the company that they acquired can "only"be ordered to pay a fine or be subject to confiscation measures, to the exclusion of other sanctions available under French criminal law, such as debarment from public procurement, the exclusion from public funding or dissolution of the company. However, where it is

considered that the merger was orchestrated to escape criminal liability, acquiring companies may still - as was the case before the *Cour de cassation*'s new ruling - incur any available criminal sanction, regardless the date of the transaction and/or the corporate form of the companies at stake.

With its November 25, 2020 ruling, the French *Cour de cassation* has not only reversed its position on an important principle of French criminal law, but also opened the door to the development of novel case law as additional types, forms, and contexts of mergers and acquisitions face scrutiny in a heightened enforcement environment.

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[1] C. Cass., Crim., November 25, 2020, no. 18-86955

[2] ECHR, ruling of C. Cass., Crim., November 25, 2020, no. 18-86955October 24, 2019, Carrefour France v. France, no. 37858/14

[3] ECHR, ruling of October 24, 2019, Carrefour France v. France, no. 37858/14

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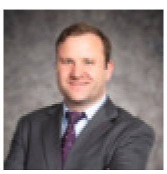

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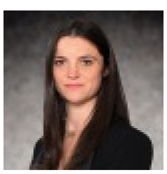

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