

## The Limits on Shareholders' Freedom to Exercise their Right to Terminate the Managing Director in French Companies

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Dissatisfied shareholders, when they consider replacing the management team, should ensure that proper process is complied with. This is particularly true, in underperforming companies, where turnaround plans often require speedy action, including termination of the Managing Director. An unlawful termination and related subsequent litigation may add unnecessary trauma to the company's dire financial situation, on top of the many other issues it needs to address. The author reviews recent decisions by the Commercial Chamber of the French Supreme Court in relation to the duty of loyalty owed by the Managing Director to the company and vice versa and gives various examples of the sanctions and amount of damages awarded.

### A. The duty of loyalty, a two way concept

a) The Managing Director ('MD') of a French commercial company has a duty of loyalty towards the company and its shareholders. This duty has regularly been recognised by French courts.

For years, reported case law in relation to the duty of loyalty owed by the MD to the shareholders was essentially linked to situations where MDs had concealed their intention to sell their shareholdings in the company and the company's potential value, in order to purchase the shares held by other shareholders and thereafter to resell a controlling interest with a profit.

More recently the Versailles Court of Appeal<sup>1</sup> ruled that a MD cannot conceal from the board of directors and shareholders that he had initiated negotiations in relation to a proposed transaction affecting the shareholding of the company, even where the company was

in distress. The Versailles Court took the view that the MD's behaviour was disloyal and contrary to the company's and main shareholder's common interest. This decision was upheld by the French Supreme Court.<sup>2</sup> In the subject case, the MD's negotiations with other investors and bankers apparently contributed to spreading contradictory rumours in the market at a time where the MD knew that the main shareholder was negotiating the company's debt refinancing and was not planning to dispose of his shares in the company. As a consequence, the MD's appointment was terminated and he was deprived of his contractual termination package provided in a 'written mandate', i.e a separate agreement, because of the breach of his duty of loyalty and his gross misconduct prohibiting him from further carrying on his management position as per the separate agreement.

b) The company also has a duty of loyalty towards its MD.

Compliance by the company with this duty generally comes to the fore when termination of the MD's position has been decided. Under French law, termination of a MD's position will be deemed in breach of the company's duty of loyalty and unlawful,<sup>3</sup> where the termination is decided 'brutally', i.e with no prior notice and information as to the reasons for the termination before this issue is put to a vote by the relevant corporate body.

For example, the Supreme Court<sup>4</sup> recently upheld a decision by the Paris Court of Appeal, which had ruled that termination of a MD in a simplified joint stock company (*société par actions simplifiée*) did not comply with the company's duty of loyalty when it exercised its right to terminate the latter's position, because:

### Notes

- 1 Anker Sørensen, 'The Versailles Court of Appeal Fine-tunes the Duty of Loyalty Owed by Managing Directors', (2015) 12:2 *International Corporate Rescue*.
- 2 French Supreme Court, Commercial Chamber, 5 July 2016, No. 14-23904 – known as the *Europcar* case.
- 3 The lawfulness of the termination may however vary depending on the legal form of the company. For instance, termination of the MD of a private limited company (Sarl) is subject to different rules than those applicable to MDs in public companies (SA) and simplified joint stock companies (SAS).
- 4 Supreme Court, Commercial Chamber, 22 November 2016, No. 15-14.911 F-D; this matter was referred back to the Paris Court of Appeal for determination of the amount of damages resulting from non-compliance with the adversarial principle, which was the only head of claim upheld by the Supreme Court. In its initial decision, the Paris Court of Appeal had awarded a single indiscriminate amount by way of damages across a number of heads of claim.

- The vote by the shareholders was obtained on the basis of a report setting out various grievances against the MD; and
- The company later amended its grievances and presented other reasons for termination, when the MD subsequently challenged his termination in court.

The Court of Appeal considered that the MD, per the company's by-laws terminable *ad nutum* i.e. without just cause and without indemnity,<sup>5</sup> had nevertheless not been put in a position to properly argue and make appropriate representations in relation to the grievances put forward after the shareholders' vote.

However, a contrasting position was taken by the Supreme Court in another recent decision.<sup>6</sup> In circumstances where the MD of a simplified joint stock company, accused of poor management and accounting manipulation, had been terminated by a decision of the main shareholder, the Supreme Court held that the freedom to terminate enjoyed by the relevant corporate body cannot be deemed faulty as the grounds for the decision were not subject to any judicial control.<sup>7</sup>

## B. The scope of shareholders' right to terminate the MD

To mitigate trouble and minimise the risk of litigation and having to pay damages to dismissed MDs, foreign shareholders of French companies need to be aware of the fact that:

- i) MDs of French companies can be freely terminated. This is known as the '*principe de libre révocation*', i.e. the unfettered freedom to terminate, which is a public policy rule. Clauses to the contrary, preventing or limiting the freedom to terminate are deemed null and void (*toute disposition contraire est réputée non écrite*).

In this regard, for example, clauses have been deemed null and void where:

- the amount of damages contractually payable in case of an MD termination (i) disincentivises termination as incompatible

with the company's size or financial situation<sup>8</sup> and (ii) runs contrary to the principle of free termination of MDs; and

- a shareholder contractually commits to buy the MDs' shares for very significant consideration, in the event of the latter's termination, contrary<sup>9</sup> to the principle of free termination.

However, this does not mean that MDs cannot agree on and benefit from a compensation package in the event of termination of their position. Nor does it mean that they can be removed without any restriction whatsoever, nor that they cannot be awarded damages if termination is carried out in breach of the statutory rules that govern termination.

- ii) The rules or legal regime which apply to termination of MDs depends on the legal form of the subject company and vary from one form of company to another. For example, the two decisions of the Supreme Court, referred to above,<sup>10</sup> were made in relation to simplified joint stock companies. French company law provides that termination of MDs in simplified joint stock companies is freely determined by their by-laws. As such, termination may be decided at any time and with no just cause (*juste motif*) as in the above decisions (provided due process is observed). Alternatively, depending on the by-laws, termination may require just cause.

The legal regime is different in other companies:

- private limited companies (*société à responsabilité limitée – Sarl*) where termination of the MD (*gérant*) requires just cause<sup>11</sup> unless provided otherwise in the by-laws,<sup>12</sup> failing which the MD may be entitled to damages, or
- public companies (*société anonyme – SA*) where termination of the *Directeur Général* also requires just cause, unless the *Directeur Général* also holds the office of chairman of the board (*Président du Conseil d'Administration*) and unless the by-laws provide otherwise.

### Notes

- 5 Today, this concept essentially means that the revocation can take place at any time, even if it is not on the shareholders' or board meeting agenda.
- 6 Supreme Court, Commercial Chamber, 8 November 2016, No. 14-29770.
- 7 '*...ne saurait être tenu pour fautif le libre exercice par l'organe statutaire de la société du droit de révocation, dont les motifs échappent à tout contrôle juridictionnel*'.
- 8 Supreme Court, Commercial Chamber, 6 November 2012, No. 11-20.582.
- 9 Paris Court of Appeal, 28 March 1995, RJD 6/95, No. 726.
- 10 Under footnotes 4 and 6.
- 11 Article L 223-25 of the Code of Commerce.
- 12 This opinion, which appears in numerous text books, is based on the similar but not identical provisions of the civil code, applicable to termination of MDs of civil real estate companies and related case law. There is however an ongoing debate as to whether the by-laws of Sarls may overreach the just cause criteria.

Just cause is not defined by the code of commerce. However, just cause has been held to cover (i) poor management performance, (ii) behaviour, not wrongful per se, but which is incompatible with shareholders' development strategy, and (iii) a breach of the by-laws or non-compliance with statutory rules.

iii) Criteria common to all types of French companies, when considering termination of their MD and compliance with their duty of loyalty towards the latter, is that:

- The MD must be informed of the shareholders' intention to discuss/vote on the MD's termination and the reasons for such decision, so as to be in a position to prepare his arguments prior to being heard and make appropriate representations before and during the shareholders' vote. If this so called adversarial principle is not complied with, the termination may be deemed wrongful and the company held liable in damages to the MD. In this respect, the Commercial chamber of the Supreme Court<sup>13</sup> recently ruled, on the basis of a key provision of French tort law,<sup>14</sup> that a right to terminate without just cause does not mean a right to terminate without giving any reason whatsoever; and
- Termination must not occur in circumstances which undermine the MD's reputation or honour (*dans des circonstances*

*vexatoires*), which presents another area capable of giving rise to a claim in damages by the MD against the company.

### C. The costs of wrongful termination

French courts award damages to MDs when they are wrongfully terminated.

The damages are generally calculated based on the damage suffered (*préjudice subi*) by the MD linked to the circumstances in which the MD was terminated. However, the assessment of damages does not include the loss of a chance to remain in the position for a longer period, nor the consequences of termination on the MD's personal situation,<sup>15</sup> leaving only a few heads of claims for compensatory damages:

- Any lack of compliance with the adversarial principle;
- Any vexatious circumstances of termination; and
- Any lack of just cause, when this is a condition provided for in the by-laws or by statute.

Damages for wrongful termination awarded to MDs are accordingly relatively low. They rarely exceed a few hundred thousand Euros,<sup>16</sup> in addition to the MD's contractual termination package, when it is owed depending on the leaving conditions, and consideration for the acquisition of his shares or other voting or financial rights in the company.

## Notes

13 Supreme Court, Commercial Chamber, 14 May 2013, *Astérop c/ Mr G*, No. 11-22845

14 Article 1382 of the civil code, which after a recent reform and renumbering of the code is now article 1240

15 Supreme Court, Commercial Chamber, 3 March 2015, No. 14-12036, '*la révocation abusive n'ouvre droit à réparation ni du préjudice résultant de la révocation, ni même du préjudice constitué par la perte d'une chance de conserver ses fonctions, mais seulement du préjudice causé par la circonstance constitutive d'abus considérée en elle-même*'

16 Paris Court of Appeal, 3 October 2013, *Ms P. v Foncia*. This decision was appealed and the French Supreme Court, Commercial chamber 10 February 2015, referred it back to the Paris Court of Appeal for retrial and a ruling was made on 18 October 2016, No. 15/18421, according to which the damages initially awarded (250 K€) were cancelled.