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ARTICLE

Disproportionate Guarantees may be Counterproductive in France: Implications for Risk Mapping

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Synopsis

Guarantees are by nature designed to protect creditors against their debtors' failure to fulfil their obligations. In some instances, however, excessive protection may be counterproductive and detrimental to the creditors. French law indeed provides that a guarantee can become unenforceable if it is disproportionate either to the guarantor's fortune or to the secured debt, when the borrower is in financial trouble. There is thus a true creditor's dilemma: while seeking to protect their legitimate interests, creditors need to carefully appraise, depending on the borrower's financial situation, how and to what extent to secure the reimbursement of their claims or loans. French courts are the custodians of the aforementioned proportionality principle and ensure that it is complied with. Lenders therefore need to factor this principle into their risk mapping analysis.

The authors summarise the key points to consider under French law and propose an approach to address and reduce the risks to which lenders may be exposed. The suggested approach, however, has its limits since the last word will always rest with the courts and that case law is by nature evolving.

1. Introduction

There is a natural and intrinsic element of risk in loan operating activity, namely the possibility that a debt, including interest, will not be paid on its maturity date. In that respect, at a first glance it may be surprising that the French lawmakers have decided to add further uncertainty to lending activities by introducing the proportionality principle into secured loans. The rationale behind the proportionality principle is indeed straightforward: i.e. addressing over-indebtedness and credit resource waste. Consequently, lenders, and especially professional lenders, need to be cautious when providing funding because of the risks resulting from the proportionality principle interpretation.

The general civil law rule is that a personal guarantee granted by a guarantor must not exceed the secured debt. However, the guarantee contract will still be valid even if this rule is not complied with. The guarantor's obligation will simply be reduced to the amount of the debt level (part 3 of Article 2290 of the French Civil Code).[2]

There are however two deviations from this general rule, which must be taken into account.

The first deviation finds its source in French consumer protection law. In particular, Article L 332-1 of the French Consumer Code provides that 'a professional creditor may not rely on a guarantee contract concluded by a natural person whose obligation was, at the time of its conclusion, manifestly disproportionate to its property and income, unless the assets of that guarantor, at the time when the latter is called, enable it to meet its obligation'.[3] Two consequences can be drawn from the provisions of this article: (a) the guarantee is not reduced to the debtor's capacity to fulfil its obligation but becomes unenforceable against the guarantor, and (b) the guarantor is discharged not only with regard to the creditor, but also vis à vis other co-guarantors, if any, bound jointly to cover an event of default by the debtor.

The second deviation, resulting from the specific provisions of the French Commercial Code dedicated to insolvency rules, addresses the disproportion between a guarantee or a security interest and the amount of the secured debt (Article L 650-1 of the Code). Here, it is in the judge's discretion to decide whether to invalidate the guarantee or rather to reduce the base of the guarantee thus removing the disproportionality. Essentially, this regime aims both at protecting other creditors and penalising abusive crediting of the companies in financial trouble.

Notes

1 Nataliia is also admitted to the Kiev Bar in Ukraine.

2 The guarantee which exceeds the debt, or which is contracted under more onerous conditions, is not invalid: it is simply reduced to the extent of the principal obligation.

3 In French: '*Un créancier professionnel ne peut se prévaloir d'un contrat de cautionnement conclu par une personne physique dont l'engagement était, lors de sa conclusion, manifestement disproportionné à ses biens et revenus, à moins que le patrimoine de cette caution, au moment où celle-ci est appelée, ne lui permette de faire face à son obligation*'.

2. Creditors should not be optimistic about the revenues of physical persons acting as guarantors

French consumer law specifically provides for three conditions under which a professional lender loses its right to enforce a guarantee contract entered into by a nonprofessional natural person. A nonprofessional natural person in this regard, considering court practices, includes individuals acting as directors of companies who provide a guarantee for the company in which they hold that position.

These three conditions, which are cumulative, are:

(a) an obvious/manifest disproportion ('*disproportion manifeste*') between the secured debt and the guarantor's property;

(b) this disproportion must exist at the moment of the guarantee conclusion; and

(c) the assets of the guarantor, at the moment when the latter is called further to the debtor's default, do not enable him/her to perform his/her obligation (Article L 332-1 of the French Consumer Code).

As often, the most interesting part of the rule of law is behind the curtain (read: behind the Code and in the court rooms). Thus, it is key to examine the criteria established by French courts to understand and appraise (i) when and to what extent a disproportion is or may be deemed manifest/obvious; (ii) what kind of property and income should be taken into account by a creditor to determine whether the guarantee will be enforceable, if required; and (iii) how the creditor can use the increase in the guarantor's revenues over time to enforce its rights at a later stage.

a. 'Manifestly disproportionate' does not mean 'resulting into the guarantor's insolvency'

The courts have considerable discretion in evaluating disproportion. The law provides that disproportion must be manifest. The issue is that the courts have not established a consistent test (quantitative criteria or benchmarks) which could be used to guide stakeholders in assessing what constitutes manifest disproportion.

As a result, it is not straightforward to predict in which case a guarantee will be considered as manifestly disproportionate.

Formally, the burden of proof is on the guarantor to evidence a claim of the manifest disproportion, but professional creditors should also be in position to anticipate and evaluate the respective risks.

We recommend considering three assessment instruments for risk mapping. They address the risk zone, the standard of evaluation and the level of the creditor's expected care.

Firstly, it is generally accepted that the risk zone lies in-between the two extremes. On the one hand, the fact that the guarantee exceeds the loan volume is not enough to state that there is a manifest disproportion; however, on the other hand, the guarantor does not need to become insolvent to claim the manifest disproportion.[4]

Secondly, in the absence of strict quantitative measures of what constitutes manifest disproportion, the standard is to appraise whether a qualified professional creditor is reasonably in a position to assess whether the guarantor can or cannot fulfil its obligation, if it were to fall due. The advice for a professional creditor, which is based on court practices, is to not be optimistic when evaluating the guarantor's fortune. For instance, the creditor must remain objective and attentive to the guarantor's personal situation and change factors which may impact the latter's income or assets. For example, in one case a guarantee was considered manifestly disproportionate because it was entered into by a natural person, acting as the debtor's director, who was in his seventies and who predictably retired shortly after signing the guarantee.[5]

Thirdly, the creditor is not obliged to verify the guarantor's fortune. It can rely on the latter's statements in the absence of any abnormal or unusual circumstances.[6]

It is noteworthy that the unenforceability of a guarantee has no direct relation with the professional creditor's duty to warn ('*devoir de mise en garde*'[7]) an unexperienced guarantor about the risks linked to the execution of the guarantee and related consequences for the guarantor, in particular the risk of over indebtedness (*surendettement*).[8] The liability associated with the noncompliance by the creditor of this statutory

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4 Code de la consommation. Annoté et commenté (2018). Dalloz – Art. L. 332-1 – Comm. I, p. 455.

5 Court of Appeals of Nimes, 1 February 2012 – 10/05166.

6 Commercial Chamber of the Cassation Court, 14 December 2010 – 09-69.807.

7 According to courts, a professional creditor's duty to warn applies exclusively to uninformed guarantors and borrowers (see for example, Commercial Chamber of the Cassation Court, 3 May 2006 – 04-19.315). The duty to warn is different from the professional lender's obligation to provide a guarantor on an annual basis with information in relation to the amount of the principal debt and interests. The lender's failure to comply with this statutory obligation results in the guarantor's discharge of the matured unpaid interests starting from the date when the last information has been provided until the moment when the respective notification was made (Articles L 333-2 and L 343-6 of the French Consumer Code). It is thus irrelevant for this case whether the guarantor has suffered any loss.

8 As a general rule, the duty to warn is limited to the warning of the guarantor's risk of over-indebtedness resulting from the inadequacy of the guarantor's resources in consideration of his guarantee commitment. Recently, however, French courts added that a banker must also

duty consists in compensating the guarantor for the loss resulting from the commitment taken by the guarantor and not the discharge of the latter.[9] In practice, however, the remedy granted by a court can trigger partial discharge of the guarantor: a court may, of course, always leave only the symbolic euro to be paid by a guarantor.[10]

b. Guarantor's fortune: global revenues and debts

The key issue in detecting possible disproportion is the comprehensive understanding of the guarantor's fortune. The question, when this information is available and reliable, is then which assets constitute the base of the guarantor's fortune for the purpose of the creditor's assessment and whether it is the 'net' fortune, i.e without the guarantor's debts, which is to be taken into consideration.

As far as the assets are concerned, any asset owned, and any type of income earned, by the guarantor fall under the scope of his fortune. Furthermore, if a guarantor is married under the common property regime ('*régime légal de biens communs*'), the earnings (as well as the assets acquired after the marriage) of the spouse are part of the guarantor's fortune even though these earnings will not contribute to the performance of the commitment unless expressly agreed by the spouse.[11] It is a generally established practice to seek for the spouse's consent before the guarantee is executed.

Regarding the guarantor's debts, which may substantially impact his fortune, they must be factored into the assessment.[12] Thus, the global amount of debts and other guaranties existing at the time of execution of the guarantee must be identified and considered. Obviously, debts incurred as well as guarantees given thereafter have no retroactive impact.

As mentioned above, creditors must take a pragmatic and objective approach of the guarantor's fortune, which excludes optimism and speculation about the guarantor's future revenues. Neither the expected income resulting from the secured transaction, nor any potential success of the guarantor's business or career evolution constitute valid grounds which will be taken into account to mitigate the risks resulting from a disproportion between the guarantor's fortune and the guaranteed amounts at the time where the guaranty was entered into.[13]

As an exception, however, it has been ruled that the commitment of a director, as a guarantor, is not disproportionate to his assets and income in consideration of his ability to develop the company which he had founded and which is the borrower.[14] This solution, applicable to directors (i.e. natural persons) of companies which they control, does not apply to shareholders (here again, natural persons) when they do not hold a directorship position, or to any other related persons.[15]

c. When creditor's optimism nevertheless pays: how to use the guarantor's subsequent revenue increases

The law[16] provides that the disproportion has to be assessed twice: firstly at the moment of the contract conclusion, and secondly when the guarantor is called to pay. In practice, this means that if disproportion is detected when the guarantee is initially executed, then the professional creditor shall integrate the risk of its possible unenforceability if and when the guarantor is called to pay.

The guarantee contract, however, will not be deemed invalid merely because of its disproportion with the guarantor's fortune. Even though the guarantee may have initially been disproportionate, it can still be enforced if the guarantor's fortune has progressed since the date of its execution, and been brought to a level (in terms of proportions) enabling the guarantor to perform his obligation under the guarantee.

Procedurally, creditors bear the burden of proof. As such, they must bring conclusive evidence of the change in the guarantor's fortune and establish that (i) the initial disproportion is no longer relevant, and (ii) the guarantor has the means to fulfil its commitment.

d. Unenforceability does mean 100% discharge of the guarantor

If the guarantee is judged to be manifestly disproportionate with the guarantor's fortune, the latter's obligation becomes unenforceable.

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warn an uninformed guarantor of its straightforward exposure to guarantee payment, resulting from the obvious inadequacy of the loan to the borrower's financial capacity, even though the guarantor is in a position, considering its fortune, to meet its guarantee commitment (Commercial Chamber of the Cassation Court, 15 November 2017 – 16-16.790).

9 Commercial Chamber of the Cassation Court, 15 November 2017 – 16-16.790.
10 Commercial Chamber of the Cassation Court, 8 November 2011 – 10-23.662.
11 Commercial Chamber of the Cassation Court, 6 June 2018 – 16-26.182.
12 Civil Chamber of the Cassation Court, 22 May 2013 – 11-24.812.
13 Commercial Chamber of the Cassation Court, 4 June 2013 – 12-15.518.
14 Civil Chamber of the Cassation Court, 4 May 2012 – 11-11.461.
15 Commercial Chamber of the Cassation Court, 6 February 2007 – 04-15.362.
16 Article L 332-1 of the French Consumer Code cited above.

In that respect, French courts understand the scope of unenforceability rather extensively. Firstly, the guarantee is unenforceable as a whole and not only for the portion of the 'excessive' commitment which means that the guarantor will be totally discharged from its duty to pay.[17] Secondly, the guarantor will be discharged not only with regard to the creditor, but also with regard to any other(s) guarantor (s).[18] This means that in the case of joint guarantees, the joint guarantor who has performed his obligation vis à vis the lender, further to the debtor's failure, will not be able to claim performance from the discharged guarantor.

3. Whether or not the borrower is in financial trouble, lenders should not take disproportionate guarantees

The French Commercial Code in its Article L650-1 provides that 'in case of insolvency (safeguard, insolvency or liquidation), creditors cannot be held liable for the damages linked to the granting of credit facilities/loans/financial support to the debtor, unless: fraud, obvious involvement/interference by the creditor in the debtor's management, or if disproportionate guarantees (including security in rem), are established'. Furthermore, 'when creditors' liability is established, guarantees taken at the time of the credit facility/loan/financial support is granted, may either be voided or reduced by the judge'.[19]

This specific regime provided for by the insolvency section of the French Commercial Code is substantially different from the regime provided by French consumer legislation. For instance:

(i) The creditor does not necessarily need to be a professional lender. For example, it can be a commercial company (including but not limited to suppliers or shareholders) providing financial support to the debtor company (which may be a client or a subsidiary) on a non-systematic basis, by extending payment conditions or granting intercompany funding;

(ii) Secondly, the disproportion must exist with regard to the secured debt and not with regard to the guarantor's fortune. In addition, the disproportion does not need to be manifest; and

(iii) Thirdly, the risk of voidance or reduction by the judge of the guarantee or security interest as per the aforementioned article of the code may arise provided that the granting of the financial support by a creditor is deemed faulty ('*concours fautif*').[20] This further criterion of a 'faulty financial support' has been developed by case law: according to French courts, financial support may be deemed faulty if it serves the creditor's interests rather than supporting the borrower's activity,[21] is inappropriate, excessive or granted to borrowers in so dire financial trouble that their recovery is fatally impaired.

Obviously, it can be difficult to draw a clear line between a creditor's excessive behavior and his rational considerations to secure his claim.[22] For instance, a lender should not consider granting a loan even if the transaction may generate a profit, when he can assess that the borrower will not be in a position repay it on its maturity date, but nevertheless decides to grant the loan because solvent third parties are providing guaranties in support of the loan. The question, under Article L 650-1 of the aforementioned code, will then consist in determining whether these guaranties are disproportionate with regard to the secured debt. If the guaranties in question are not disproportionate, a faulty financial support *per se* will not trigger the application of Article L 650-1. In this scenario the borrower's managing director or management team may face charges of mismanagement and be held liable for the debtor company's shortfall of assets as per Article L 651-2 of the French Commercial Code.[23] The professional lender may nevertheless not escape this scenario unscathed and may be held liable, but on the basis of

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17 Commercial Chamber of the Cassation Court, 28 March 2018 – 16-25.651.

18 Mixed Chamber of the Cassation Court, 27 February 2015 – 13-13.709.

19 In French: *Lorsqu'une procédure de sauvegarde, de redressement judiciaire ou de liquidation judiciaire est ouverte, les créanciers ne peuvent être tenus pour responsables des préjudices subis du fait des concours consentis, sauf les cas de fraude, d'immixtion caractérisée dans la gestion du débiteur ou si les garanties prises en contrepartie de ces concours sont disproportionnées à ceux-ci. Pour le cas où la responsabilité d'un créancier est reconnue, les garanties prises en contrepartie de ses concours peuvent être annulées ou réduites par le juge.*

20 This criterion is not straightforward, however, as it does not follow literary from the article's provision and was established by the court practice (see for example, decision of the Cassation Court as of 27 March 2012 N 10-20.077).

21 Generally, there is a difference made between abusive and ruinous support. Abusive support suggests that a lender knows that the borrower will not be able to repay but supports him, misleading thus the third parties about the true financial position of the debtor (see in this respect Commercial Chamber of the Cassation Court, 3 October 2000 – 97-21.154). Ruinous support implies that the credit and interests are too high for the borrower to be repaid in the view of its resources and profitability (see in this respect Commercial Chamber of the Cassation Court, 22 March 2005 – 03-12.922).

22 Recent court practice explicitly acknowledges a creditor's legitimate interest to obtain a guaranty for an operated loan (Commercial Chamber of the Cassation Court, 8 March 2017 – 15-20.288).

23 Directors may be held personally liable in case of mismanagement, if the latter contributed to the debtor company's shortfall of assets.

different legal grounds, i.e if he failed to warn an uninformed guarantor.[24]

As the three conditions mentioned above (i to iii) are cumulative, absence of at least one of them forecloses the application of Article L 650-1 of the French Commercial Code. However, when the financial support is not faulty, but disproportion between the guarantee or a security interest and the secured debt can be established, the general rule and sanction provided by Article 2290 of the French Civil Code may be applied. Alternatively, if the guarantor is a physical person and the disproportion is manifest, Article L 332-1 of the French Consumer Code may also apply instead.

The key questions to be considered here and addressed below are the relevance of the debtor's financial situation at the time where the facility/financial support was granted and the circumstances under which the disproportion can be established.

a. Advocated approach: the debtor's financial standing does not matter

For Article L 650-1 of the French Commercial Code to apply, the borrower must be subject to one of the above mentioned insolvency proceedings.[25] It is not, however, required that the financial support be granted after the commencement of these proceedings.

Some authors consider that the aforementioned article is applicable only when the financial support was provided to the company at a time where it was in financial difficulties.[26] The rationale behind this approach is that to apply Article L 650-1 of the French Commercial Code there needs to be a causal link between the faulty financial support and the debtor company's shortfall of assets. Put otherwise, the creditor's support will be faulty if it is granted to a borrower in a financial situation, deemed fatally impaired ('*situation irrémédiablement compromise*'). Faulty financial support, when granted is thus harmful as it may artificially mislead third parties on the borrower's financial standing. The same authors argue that when a debtor is in good financial health when the loan is disbursed and later becomes insolvent due, for example, to changes in market dynamics or as a result of a major client loss, the creditor's support cannot be deemed faulty. The absence of faulty support is implicitly presumed by these authors if a borrower faces no financial trouble at the time when the loan was granted.

This rather restrictive approach does not follow directly from the text of the article, and these arguments even though they may be deemed coherent and comprehensive are not, however, widely shared by French practitioners and academics. Moreover, there is still no position of the Cassation Court in this respect.[27] Therefore we take the view that taking excessive guarantees from companies with no financial difficulties may present a risk in terms of Article L 650-1 of the French Commercial Code.

b. To be 'manifestly disproportionate' or simply 'disproportionate'

Similarly to the 'manifest disproportion' in the French Consumer Code, the disproportion referred to in Article L 650-1 of the French Commercial Code has no legally established criteria.

It is generally accepted that with regard to a professional lender, the reasonable level of guarantee or security interest to secure a loan shall cover (i) the credit amount together with the interests and (ii) the possible debt collection expenses.[28]

It is of key importance here to make a clear distinction between a creditor's wrongful intentions, and a creditor's legitimate interests in protecting his right to be repaid in full and on time. In practice, when a borrower is not in financial difficulties and can provide a perfect track record and show a constant repayment discipline on other loans, a creditor has no objective reason to take excessive guarantees. However, when a company is in financial difficulties, or may face financial difficulties in the near future because of a declining market or intense competition, a guarantee provided, for example, by its director, may not inspire much confidence. Thus a more substantial security package may be needed to make the creditor feel more secure and consent to providing the requested loan.

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24 The approach is pretty similar to that as discussed earlier in the part concerning a manifestly disproportionate guarantee under Article L 332-1 of the French Consumer Code. The liability for disregard of the duty to warn results in lost profit compensation for the taken guaranty commitment, and not in damages for faulty financial support (For the recent court practice: Commercial Chamber of the Cassation Court, 20 June 2018 – 1-27.693).

25 Preventive proceedings, such as '*mandat ad hoc*' and '*conciliation*' are not included in the scope of these proceedings.

26 J. Etter and S. Gobin 'Sûretés consenties en garantie d'un crédit et proportionnalité', (2015) 5 *Revue de Droit bancaire et financier. Etude 15*; J. Moury, La responsabilité du fournisseur de 'concours' dans le marc de l'article L.650-1 du code de commerce D. 2006, p. 1743.

27 The only thing that we do know for the time being is the Cassation's court approach to calculation of the damages under Article L 650-1 of the Code of Commerce. They are equal to the difference between the amounts of the asset shortfall at the date the judge rules and the amount of the asset shortfall at the date the faulty support was granted (see in this respect, Commercial Chamber of the Cassation Court, 22 March 2016 – 14-10.066 and 14-14.980). The Court ruled that the financial rescue, granted at the moment when the borrower experienced considerable financial difficulties, has put off the insolvency proceedings and caused the increase of the asset shortfall depriving other creditors (eventually, not secured creditors) of being repaid.

28 La responsabilité pour soutien abusif de l'article L.650-1 du Code de commerce: la fin des incertitudes. *Recueil Dalloz*. (2012) 22. 1455-1459.

In this respect it should be taken into consideration that multiple guarantees and security interests are evaluated cumulatively, not separately, in consideration of the debt volume. Without any arithmetic criteria, it is difficult to estimate an overrun ratio which would definitely make a court to rule on disproportion. A guaranty will certainly be deemed disproportionate if its value is twice the loan together with the interests,[29] but the lower ratios will need to be assessed on a case by case basis.

4. Closing remarks

The risk assessment is particularly important for the secondary loan market development in France and more specifically in the context of the European Commission's proposal for a directive on credit servicers, credit purchasers and the recovery of collateral.[30]

In order to cope with the disproportionate guarantee risk, lenders need to have an overall vision of the credit operation context and a pragmatic analysis of all related details.

The best strategy for lenders is to develop a dynamic risk map covering all mentioned elements and legal considerations should not be superseded by economic rationale when making decisions on financial support and securing repayment with guarantees.

An adequate risk analysis and solution may be provided by using artificial intelligence resources. From the efficiency standpoint, this kind of solution can largely supplant the traditional methods of risk assessment. It should be noted though that these solutions may trigger personal data protection concerns, particularly for the lenders who have not yet fully deployed the measures required under the General European Data Protection Regulation.

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29 Commercial Chamber of the Cassation Court, 10 May 1994 – 92-15.881.

30 The Proposal No. 2018/0063 as of 14 March 2018 is designed to provide banks with an efficient mechanism of out-of-court value recovery from secured loans. It shall also establish a harmonised legal framework for the secondary markets where banks can sell their non-performing loans to investors and make use of specialised credit services.

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