Change in case law regarding the transfer of criminal liability within the context of merger-absorption transactions

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On November 25, 2020, the French Court of Cassation operated a significant change in case law by deciding that the criminal liability of an acquired company, such as to give rise to a fine or confiscation measures, could now be transferred to the acquiring company in the context of a merger-absorption of public limited companies (*sociétés anonymes*) and, by extension, of simplified joint stock companies (*sociétés par actions simplifiées*) and partnerships limited by shares (*sociétés en commandite par actions*).

Although the scope of such judgment is only applicable under certain conditions, it aligns the position of French judges with European case law[1] and is part of a more general shift in France towards corporate accountability with respect to compliance and criminal liability. Indeed, French authorities now insist on the importance of assessing compliance programs and the criminal exposure of target companies, as well as the resolution or the self-disclosure of identified violations.

In practice, pre-merger due diligence with respect to compliance and criminal liability will be all the more necessary and the implementation of protection measures, beyond the usual representations and warranties, by the shareholders of the acquired company (other than the acquiring company) could become more systematic.

I. The criminal liability of companies in merger-absorption transactions completed prior to November 25, 2020

A merger-absorption transaction entails, in principle, the universal transfer of the assets of the acquired company to the acquiring company. This universal transfer of assets will have an impact on the criminal liability of the companies that are parties to the transaction. Thus, in the event that a criminal fine has been imposed on the acquired company and has not yet been paid as of the date of the merger, the fine will be automatically transferred to the acquiring company, which will then be in responsible for paying it.

However, the question arises as to whether the acquiring company must pay penalties imposed after the merger for acts committed by the acquired company that did not result in a final decision to impose a penalty prior to the transaction.

Prior to November 25, 2020, according to established case law, an acquiring company could not be prosecuted for acts punished under criminal law committed by an acquired company prior to the merger-absorption transaction[2], unless the acquiring company carried out fraudulent operations. According to French criminal courts, given that a merger-absorption transaction results in the dissolution of the acquired company and the termination of its legal personality, its criminal liability is simultaneously extinguished as a result; the application of the principle that penalties must be specific to the offender led to such conclusion. In line with this solution, an acquiring company could not be ordered to pay damages to the victim of the acquired company when the merger-absorption transaction was completed before the criminal court judge issued a ruling[3].

The principle of lack of transfer of the criminal liability of the acquired company to the acquiring company has however known some limitations in France with regard to the penalties imposed by administrative authorities (French Competition Authority (*Autorité de la concurrence*), French Financial Markets Authority (*Autorité des marchés financiers*), French Prudential Supervisory Authority (*Autorité de contrôle prudentiel et de résolution*), etc.). Acquiring companies were ordered to pay administrative penalties for acts committed by acquired companies prior to merger transactions, in particular for violations relating to competition[4], financial market[5], or tax regulations[6]. Nevertheless, in these situations, only financial penalties could be imposed on the acquiring company, excluding other sanctions, such as, in particular, a reprimand or the publication of the sanction decision.

II. The criminal liability of companies in the context of merger-absorption transactions completed after November 25, 2020

The judgment issued by the criminal division of the French Court of Cassation on November 25, 2020[7] leads to an

* The work is the authors' and the statements made therein are not necessarily those of the Firm or any one or more of its clients.

1 - Court of Justice of the European Union, 5 March 2015, No. C-343/13, JCP E 2015, 1171, note F. Barrière. European Court of Human Rights Report, 24 October 2019, Carrefour France v. France, No. 37858/14.

2 - In particular, French Court of Cassation, Criminal Division, 20 June 2000, No. 99-86.742; French Court of Cassation, Criminal Division, 25 October 2016, No. 16-80.366.

3 - French Court of Cassation, Criminal Division, 23 April 2013, No. 12-83.244.

4 - French Court of Cassation, Criminal Division, 28 February 2006, No. 05-12.138.

5 - French Supreme Administrative Court, 22 November 2000, No. 207697, Crédit Agricole Indosuez Chevreux.

6 - French Supreme Administrative Court, 3rd and 8th sections *et seq*., opinion, 4 December 2009, No. 329173, Rueil Sports.

7 - French Court of Cassation, Criminal Division, 25 November 2020, No. 18-86.955. In this particular case, proceedings were brought against a company for involuntary destruction caused by a fire which took place in 2002. Prior to being summoned before the correctional jurisdiction to be judged, the company against whom proceedings had been initiated was acquired by another company by means of a merger transaction which was completed in March 2017. The criminal court, as

important change in case law by considering that now the acquiring company can be criminally convicted to pay a fine or be subject to confiscation measures for acts constituting an offense committed by the acquired company prior to the transaction. In the current state of case law, this decision is only applicable (except in the event of fraud) to merger-absorption transactions falling within the scope of Council Directive 78/855/EEC[8], *i.e.*, to merger-absorptions of public limited companies (*sociétés anonymes*) and, by extension, of simplified joint stock companies (*sociétés par actions simplifiées*) and partnerships limited by shares (*sociétés en commandite par actions*). It remains to be determined whether this decision will be extended to mergers involving other corporate forms, notably when the acquiring legal entity is seen as the economic continuation of the acquired company – of which the business would continue after the merger – and not as a separate legal entity.

Although the French Court of Cassation only specifically targets merger by absorption transactions, mergers that lead to the creation of a new company, which also entail the universal transfer of the assets of the offeror companies to the newly created company and which are based on the same mechanism for dissolution without the winding-up of the company and on the same principle of continuity of the economic activity, could also be affected by this new case law. Case law will also have to confirm whether this could also be the case for other types of transactions, such as demergers or partial contributions of assets subject to the regime governing demergers, where the entity benefitting from the continuation of the economic activity could be in a similar situation to that of the acquiring company.

Moreover, the transfer of criminal liability will only apply to merger-absorption transactions completed after November 25, 2020, given that the change will not apply retroactively, except, however, to fraudulent cases.

Moreover, only fines and confiscation measures may be imposed on the acquiring company, excluding other penalties such as, in particular, dissolution, prohibition from engaging in certain activities, exclusion from public procurement or the publication of the sanction decision. However, in the event of a fraudulent transaction, the acquiring company shall be subject to any type of sanctions (and not only a fine or confiscation measures), regardless of the date of the transaction or the corporate form of the companies involved.

Lastly, as the decision creates criminal liability for the acquiring company, the latter will be able to benefit from the same defense mechanisms as those that the acquired company could have invoked (such as the exception of nullity or the statute of limitations, for example).

III. Impact on merger-absorption transactions

The transfer of criminal liability in the context of a merger-absorption transaction poses a significant risk for the acquiring company, its shareholders and its creditors. Indeed, most mergers include certain unknown aspects given that it is often difficult to carry out, prior to the completion of the transaction, a full assessment of the criminal risk and the consequences for its assets, considering that the insurance policy of the acquiring company does not cover the risks of the acquired company, unless otherwise stipulated[9].

The acquiring company and its shareholders can protect themselves by inserting a warranty or indemnifying clause in the merger agreement. Such clause does indeed allow them to obtain compensation for the damage resulting from being sentenced to a fine or confiscation measures imposed after the completion of the merger. However, this solution only makes sense if the shareholder of the acquired company (debtor of the obligation to warrant and indemnify the criminal liability) is not the acquiring company itself. The question then arises as to the retained compensation mechanism (payment in cash or dilution of the share capital of the acquiring company) and its amount depending on whether the compensation is paid to the acquiring company or to its original shareholders.

The acquiring company will also be encouraged to conduct enhanced due diligence with respect to the acquired company prior to the merger. Such due diligence should allow it to gain in-depth insight into the situation of the acquired company and to assess the criminal risk associated with the transaction, including the financial risk, the reputational risk and the consequences of an entry of the conviction of the acquiring company in its criminal record[10]. The task will be all the more difficult because the ramifications of criminal law today relate to a wide range of aspects of the life of the company: competition, tax, environment, employment, finance, compliance (fight against corruption, compliance with international economic sanctions, anti-money laundering and terrorist-financing measures for the companies that are subject to such obligations, prevention of market abuse, etc.).

This change in case law supports a thorough approach to compliance due diligence, which often historically has been limited to a brief overview of the target company's existing policies and procedures pre-signing, particularly in non-regulated sectors. Compliance due diligence must include an appropriate risk-based review of the target's risk profile, mitigating controls and recent or ongoing incidents of non-compliance, among other matters, to be performed to the extent possible prior to the transaction or, in any event, following the transaction as part of the integration phase. In its January 2020 guidelines dedicated to anti-corruption due

approved by the Court of Appeal, requested additional detailed information in order to research whether the merger-absorption transaction had not been fraudulent, on the basis that in such case the acquiring company could be held criminally liable. The acquiring company intervening in the case then submitted an appeal in cassation, on the grounds that the principle that offenses and penalties must be specific to the offender is opposed to any criminal proceedings against it.

8 - Council Directive 78/855/EEC of 9 October 1978 concerning mergers of public limited liability companies, consolidated more recently by Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017.

9 - French Court of Cassation, Civil Division, 3rd, 26 November 2020, No. 19-17.824: "*the liability insurance of the acquiring company, taken out prior to the merger, is not intended to guarantee the payment of such debt, when the insurance contract covers, unless otherwise stipulated, the liability of the insured company, sole beneficiary, excluding any other party, even subsequently acquired by the insured company, from the guarantee granted by the insurer based on its assessment of the risk*."

10 - For example, despite the fact that, as mentioned above, the exclusion from public procurement cannot be imposed as a main penalty (except in the event of a fraudulent transaction), it could be an indirect consequence of the conviction of the acquiring company given that article L. 2141-1 of the French Public Procurement Code provides that a company finally sentenced in connection with certain criminal offenses (in particular relating to corruption) is automatically excluded from public procurement procedures for a period of five years.

diligence for mergers and acquisitions, the French Anti-Corruption Agency (*Agence française anticorruption*, AFA) already emphasized the need to perform due diligence on the target company's anticorruption framework in order to identify any ongoing criminal proceeding or potential misconduct[11]. The AFA also urged companies to put an end to any potential offenses they identify as soon as possible and to take any necessary corrective measures. The AFA further highlighted the benefits of reporting any misconduct identified to the judicial authorities, given that self-disclosure is now considered by the French National Financial Prosecutor's Office (*Parquet National Financier*, PNF) as a favorable factor to obtain a Judicial Public Interest Agreement (*Convention Judiciaire d'Intérêt public*, CJIP)[12]. Although there is no detailed incentive mechanism for self-reporting criminal matters in France, a French ministerial circular dated June 2020 urged the PNF to further develop such a framework[13]. The ruling of the French Court of Cassation could be a useful contribution to this end.

11 - AFA, Practical Guide – Anti-corruption due diligence for mergers and acquisitions, January 2020, pages 11 – 13.

12 - AFA, PNF, Guidelines on the implementation of the *Convention judiciaire d'intérêt public* (Judicial Public Interest Agreement), June 2019, page 9.

13 - French Ministry of Justice, Criminal policy circular on the fight against international corruption, 2 June 2020, page 8.