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Mismanagement by a manager who did not prompt the regularization of the shareholders' equity: Further clarification from the French Supreme Court

The liability of the manager of a company placed in judicial liquidation is often sought on the basis of Article L. 651-2 of the French Commercial Code which allows the court, in the event of mismanagement having contributed to the company's shortfall of assets, to decide that the amount of this shortfall shall be borne, in whole or in part, by said manager.

In a decision issued on September 8, 2021[1], the *Cour de Cassation* (French Supreme Court) has clarified the application of this Article to a manager who did not convene the shareholders to regularize the situation of the company, the shareholders' equity of which had fallen below half of the share capital.

In the case at hand, the shareholders of a limited liability company had acknowledged, during the ordinary general meeting held on August 10, 2011, that during the financial year ended in 2010, the shareholders' equity had fallen below half of the share capital.

At the extraordinary general meeting held on January 9, 2012, the shareholders had decided not to dissolve the company.

The company was placed in receivership on February 19, 2013 and then in liquidation on February 16, 2016.

The Versailles Court of Appeals ordered the manager to pay to the liquidator the sum of 120,000 euros as her

contribution to compensate for the company's shortfall of assets.

The manager appealed to the *Cour de Cassation* which held that mismanagement by the manager was not sufficiently characterized since the time period during which the situation of the company could be regularized had not expired on the day of the judgment that initiated the receivership proceedings.

The non-expiry of the two-year time period

The Versailles Court of Appeals held that the shareholders had not regularized the situation "**in breach of the provisions" set forth in Article L. 223-42 of the French Commercial Code** and that, consequently, mismanagement by the manager, who had not "*drawn the consequences* [of the] *failure to restore* [the shareholders equity to an appropriate level]" was established.

The Versailles Court of Appeals erroneously found that the provisions of this Article had been breached.

Indeed, it should be recalled that Article L. 223-42 of the French Commercial Code stipulates as follows:

"*If, as a result of the loss recorded in the accounting documents, the shareholders' equity of the company falls below half of the share capital, the shareholders must, within four months of the approval of the accounts showing this loss, decide whether the company should be prematurely dissolved.*

If the dissolution is not decided by the majority vote required for decisions resulting in an amendment to the by-laws, the company must, ***at the latest at the end of the second financial year following that in which the loss was recorded****, reduce its capital by an amount at least equal to that of the loss which could not be allocated to the reserve accounts, if, within this period, the shareholders' equity has not been restored to an amount at least equal to half of the share capital.*"

In addition, the last paragraph of Article L. 223-42 of the French Commercial Code specifies that these provisions "*do not apply to companies under safeguard or receivership proceedings*".

It was, therefore, not possible to find that the company had failed to regularize the situation as the two-year time period had not expired before the date of the judgement that initiated the receivership proceedings.

The Versailles Court of Appeals, although it did not expressly rule in this sense, seems to have retained the closing date of the financial year during which the loss occurred as the starting point of the two-year time period.

Yet, it is established that the time period to regularize the situation must be calculated from the closing date of the financial year during which the accounts which revealed the loss were approved, and not from the closing date of the financial year during which the shareholders' equity fell below half of the share capital[2].

In the case at hand, the *Cour de Cassation* – which held that the manager "*had a period of time expiring only at the close of the 2013 financial year*" (for a loss that appeared during the 2010 financial year and was recorded during the 2011 financial year) to regularize the situation –– thus correctly applied Article L. 223-42

of the French Commercial Code.

Absence of mismanagement

The Versailles Court of Appeals inferred from the shareholder's failure to regularize the situation the existence of mismanagement by the manager, who had not, according to the Court, "*drawn the consequences* [of the] *failure to restore* [the shareholders equity to an appropriate level]".

The *Cour de Cassation* noted that the Court of Appeals did not specify "*what the mismanagement attributed to* [the manager] *precisely consisted of*", since the two-year time period had not expired on the day of the judgment that initiated the receivership proceedings.

In this way, it recognized that mismanagement could have been established if the manager had not convened the shareholders to decide to restore the shareholders' equity and if the two-year time period had expired before the initiation of the receivership proceedings.

In this respect, the *Cour de Cassation* had already held that the fact of not asking the shareholders to carry out a capital increase necessary for the survival of the company constituted mismanagement likely to make the manager liable for shortfall of assets[3], this despite the fact that Article L. 223-42 of the French Commercial Code imposes this obligation on the company (and not on the manager).

This outcome is in line with previous rulings that tend to sanction business managers who do not scrupulously comply with the provisions set forth in Article L. 223-42 of the French Commercial Code.

For example, the Court of Appeals of Paris has ruled in the past that the fact that the manager did not ask the shareholders to decide on the possible continuation of the business operations constituted mismanagement that justified, on the basis of Article L. 223-42 of the French Commercial Code, that he be ordered to pay part of the company's liabilities[4].

In conclusion, it is important for business managers to ensure that applicable regulations are fully complied with, as the financial consequences can be serious if mismanagement is established.

We are at your disposal to assist you in the procedure to be implemented if the shareholders equity of your company has fallen below half of its share capital.

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[1] Commercial Chamber of the *Cour de Cassation*, September 8, 2021, 19-23.187

[2] Ministerial response No. 10735: Official Gazette French Senate Q October 29, 1971

[3] Commercial Chamber of the Cour de Cassation, July 12, 2016, 14-23.310

[4] Court of Appeals of Paris, February 17, 2009

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