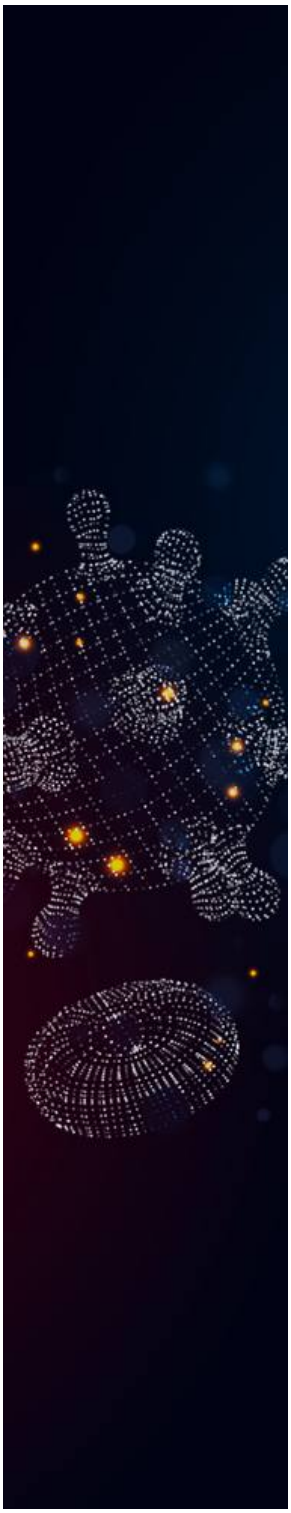

ARTICLE

PRIVATE EQUITY PLAYERS: HOW CAN HEALTH AND ECONOMIC CRISIS INCREASE THE DE FACTO MANAGEMENT RISK

Private Equity M&A | 10/04/20 | Julien Aucomte Virginie Desbois Coralie Foucault

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In the context of the current health, economic and social crisis, the temptation for private equity players to increase their involvement with the managers of their portfolio companies may prove to be significant. While this is in line with the legitimate desire of investors to assist their portfolio companies in managing this unprecedented crisis, in particular because the managers are facing high level of pressure, do not wish to act alone and are seeking help from their shareholders, this involvement must be properly assessed and defined in order to avoid the consequences associated with a *de facto* management qualification.

In this respect, various assistance measures are indeed offered by investors to the managers of their portfolio companies, whether within or outside the framework of a services agreement. These measures may range from the very regular reporting of information on the day-to-day situation of the portfolio companies and the difficulties encountered, or the provision to the portfolio companies of the investors' internal and external experts and advisors (who may, if necessary, act as an interface with the authorities) in order to assess and choose the government help schemes best suited to their situation; to more interventionist measures, such as providing advice on best practices, on how to manage their relations with suppliers, customers and employees or on the setting up of projections and monitoring on cash flow, credit or refinancing.

In "normal circumstances", investors already benefit most of the time from governance rights set out by the investment legal documentation. These rights, which very often consist of an enhanced right to information about the company's management, combined with a right of representation on the collective supervisory body and prior authorization of a certain number of transactions, restrict the management powers and thus the autonomy of legal managers. Depending on the scope of their governance's rights, the risk for the investor of being qualified as a *de facto* manager is thus already present.

Consequently, in the current circumstances and depending on their importance, the proposed measures to assist their portfolio companies, which are additional to the above mentioned existing control mechanisms, increase the risk of interference by investors in the management of their portfolio companies and thus the risk of qualification as *de facto* manager.

In the absence of a legal definition, the notion of *de facto* management, suggested by the authors and developed by the French judges, is characterized by two cumulative criteria (i) the existence of a positive act of management, on the one hand, and (ii) the exercise of a management activity by the *de facto* manager independently and freely, on the other hand.

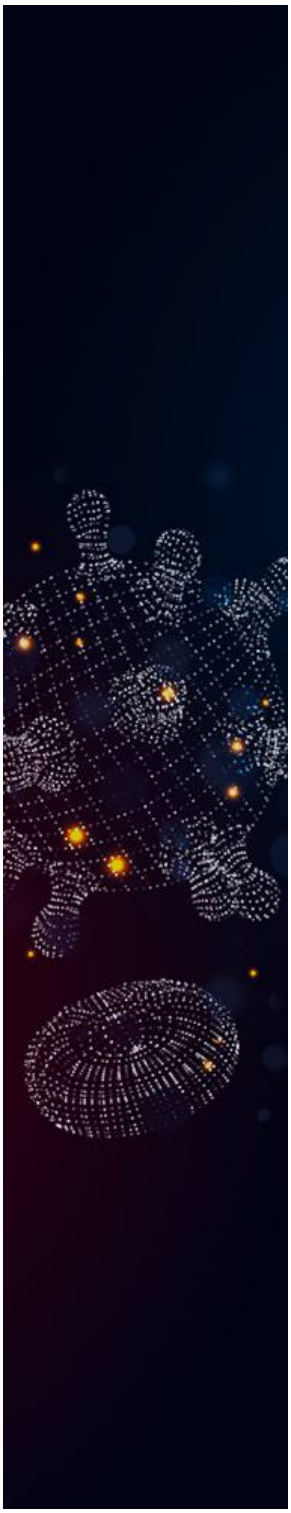
The management of a company must in fact be carried out by its legal managers, who are regularly appointed by the corporate bodies and who are the only persons empowered to manage, represent and bind the company. Any person who, without being legally vested with the functions of manager, interferes in the management, administration or direction of a company, by acting in a hidden or apparent manner, in place of the legal managers, would be qualified as a *de facto* manager.

Practically, the courts rely on a range of indicators to determine the existence of interference in the management of the company by these persons and thus of a *de facto* management, which is not presumed[1]. The taking of a simple precautionary measure or of a one-off or isolated measure cannot be regarded as such.

The qualification of *de facto* manager has serious consequences in practice. Indeed, as for legal managers, the liability incurred by *de facto* managers may be civil (outside of any collective proceedings, or within this framework[2]), criminal (with an assimilation to the legal manager for most offences), social (on the basis of co-employment, for example, even if the conditions laid down by French case law for such a qualification are strict[3]) or fiscal[4].

However, while the *de facto* manager is incurring the constraining effects attached to the status of legal manager, it does not benefit from the rights attached to this status. Thus, the *de facto* manager may not represent the company vis-à-vis third parties or receive (pursuant to the French Company law) compensation or remuneration for its management. Moreover, as regards the civil liability of the *de facto* manager, the action will be subject to ordinary law. Thus, the legal representative of the company, the shareholders and third parties (such as contractual and commercial partners), may seek the liability of the *de facto* manager, subject to the demonstration of a personal loss[5] and a causal link. In this respect, the *de facto* manager will not benefit from the shortened limitation period of 3 years applicable to liability actions on the basis of company law. Concerning the condition of "fault detachable from duties", the demonstration of which is required from a third party in order to engage the personal liability of the legal manager, the question of its application to the third party's action against the *de facto* manager is not clearly settled.

For all of these reasons, investors which are currently increasing their presence and support within their portfolio companies during this exceptional period, are advised to be graded and measured in their involvement. Under no circumstances should the legal managers be deprived of the management of the current crisis within their company or of



their usual management autonomy.

In this regard, the following recommendations, among others, should be followed:

- Issuing opinions or advice to the company's legal managers, provided they are not mandatory instructions or recommendations.

- Let the legal directors take the management decisions and, in any case, have the last word (subject to and within the framework of their legal autonomy and the provisions of the articles of association).

- Not to appear as the interlocutor of the company in the management of its relations with its commercial partners, the authorities or its employees.

- Pay particular attention to the content of the exchanges between the investor and the legal managers as well as the internal notes prepared by investors, which must show that the investor is fulfilling a supervisory or advisory role as opposed to a management or executive role.

- Pay particular attention to the reporting of information from the company to the investor, which must not reveal excessive interference by the investor in its management.

- Materialize, where applicable, the provision of assistance services provided by the investor to the portfolio company during this exceptional period by executing an agreement in order to delimit and frame the scope of the services and thus formalize the fact that the services do not involve any interference in the management of the company, which continues to be managed autonomously by its legal managers, and is limited to advice and assistance. However, the conclusion of such an agreement specific to the current period, in the absence of the prior existence of a general service agreement, should be assessed and used sparingly, in so far as it should not appear as an indication of increased investor involvement in the management of his portfolio company and on a specific subject, going beyond its supervisory role, particularly if the service is provided free of charge (or at low cost). Thus, the conclusion of such an agreement does not dispense from compliance with the other recommendations referred to above.

In conclusion, the right balance will have to be found at all times between (i) the legitimate (and often requested) assistance that investment funds wish to provide to their portfolio companies in order to ensure their sustainability and limit the consequences induced by the crisis we are facing and (ii) the need for independent management by the legal managers of these portfolio companies.

[1] The following have been qualified as d*e facto* acts of management: investors who did not confine themselves to carrying out technical research or finding financial restructuring solutions but, going beyond an advisory role, exercised management power by placing the board of directors in a state of dependency, submitting its decisions to the results of their research and opinions (Cass. Com, 6 February 2001, no. 98-15.129); or the actions of the majority shareholder, who had day-to-day power of control over the company's operations and the decisions of the management by co-signing all the company's banking transactions (CA Paris, 24 January 2017, no. 16/03136). Conversely, simply giving an advisory opinion or exercising influence at the company's general meeting is not sufficient to qualify a *de facto* management situation.

[2] If his mismanagement contributes to the asset shortfall. In addition, the collective proceedings initiated against the company may be extended to its de *facto* manager, on the ground of the fictitious nature of the company or the confusion of assets, or the de *facto* manager may have personal sanctions imposed on him.

[3] In any event, there is a trend in case law in favour of the possibility, on the basis of ordinary tort liability, for an employee to incur the liability of a shareholder who has interfered in the management of his employer (i.e. a company in which the shareholder holds a shareholding interest) and who, through its fault, has contributed to the damage suffered by the employee (often the loss of his job).

[4] For example, the *de facto* manager may be held liable, on a joint and several basis, for the payment of the company's tax debts if it has committed fraudulent actions or serious and repeated violations of tax obligations.

[5] Shareholders cannot exercise the *ut singuli* action (which enable them to act in the name and on behalf of the company) against the *de facto* manager.