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Structuring club deals

Clarification of the Amendement Charasse

Like in most European countries, France's tax consolidation regime plays a big role when structuring private equity transactions. Again like most European countries, France has a thin-capitalization regime that limits the tax deductibility of interest on related parties' debt.

But France is, to our knowledge, the only major European jurisdiction that has a specific anti-avoidance regime, the *Amendement Charasse* regime, which could disallow interest paid by a tax-consolidated group in the context of M&A transactions, even if the group abides by thin-capitalization rules and even if the group has not borrowed monies to fund the acquisition.

The anti-avoidance regime under the *Amendement Charasse* could be a constraint in situations where the sellers, whether they are individuals, industrial groups (in primary leveraged buyouts) or private equity houses (in secondary LBOs), reinvest alongside the acquirers in so-called club deals.

Adopted in the late eighties, the *Amendement Charasse* regime generated no case law and remained substantially unchanged for 15 years, a long time by French standards. This lack of jurisprudence tends to indicate that the French tax administration made little use of this anti-avoidance tool.

But the situation has changed. In late 2005 a lower court rendered a decision in a dispute related to *Amendement Charasse*. And the Amended Finance Bill for 2005 has amended the regime for the first time. It will be amended again by the Amended Finance Bill 2006, which will be adopted soon.

Amendement Charasse and control

As a general principle, when a French acquisition vehicle (BidCo) acquires a French target company (Target), finances the acquisition in whole or in part with debt and forms with Target a tax consolidation group, interest expenses incurred by BidCo (and the other group members) may be offset against Target's operating profits, subject to thin-capitalization rules.

However, under the *Amendement Charasse* regime, if: (i) BidCo acquires Target from BidCo's controlling shareholders; and (ii) Target is then included in BidCo's French tax group, a fraction of the financial charges incurred by BidCo's tax group is not deductible from its tax-consolidated income, even if the acquisition has not been funded by debt.

In the context of a leveraged buyout, coming within the scope of the *Amendement Charasse* might adversely impact the financial structuring of the deal, which generally assumes the tax deductibility of the financial charges borne by BidCo and its group.

The Amended Finance Bill for 2005 has amended the definition of control provided by *Amendement Charasse* to incorporate by reference the general definition of control under French corporate law. Once the changes to the *Amendement Charasse* regime became effective (that is, for fiscal years ending on or after January 1 2006), one or more persons will be viewed as controlling BidCo for *Amendement Charasse* purposes if they are controlling shareholders under French corporate law (the French Code de commerce). French tax authorities have not published any guidance on this new rule so far, but the modification should mean that the control test under the *Amendement Charasse* regime would perfectly mirror that under French corporate law, as interpreted by French commercial and administrative courts.

Under the French Code de commerce, a person is considered as controlling a company with respect to which the person:

- holds, directly or indirectly, the majority of the voting rights in the shareholders' meetings of the company;
- holds alone the majority of the voting rights as a result of an agreement entered into with other shareholders;
- enjoys de facto control, through his voting rights, the decisions taken at the shareholders' meetings of the

company; or

- have the power to designate or dismiss a majority of the members of the board of the company.

In addition, a person will also be presumed to control a company if he directly or indirectly holds more than 40% of the voting rights in the company and no other shareholder directly or indirectly holds a higher percentage (this presumption of control may be rebutted).

Two or more persons acting in concert are considered to jointly control a company when those persons *de facto* control the decisions made at the shareholders' meetings. This concept of joint control is the key issue whenever one or more sellers of Target shares reinvest as minority shareholders in BidCo.

Interpreting the provisions of the Code de commerce in this context is difficult. Characterizing the existence of joint control depends upon an application of law to facts, yet there is little case law dealing with the concept of joint control or providing guidance on how to apply these provisions. In light of this uncertainty, the terms of the shareholders' agreement between the sponsors in BidCo must be carefully reviewed to determine whether or not the minority shareholders who are reinvesting in the transaction could be seen as jointly controlling BidCo together with the new investors. Depending on the rights held by minority shareholders under the shareholders' agreement, this might be an issue even if the new investors hold more than 50% in BidCo.

In such a situation, minority shareholders would, however, be considered as jointly controlling a company only if and to the extent that: (i) they are acting in concert with the majority shareholder; and (ii) together with the majority shareholder they *de facto* control the decisions taken at the shareholders' meetings of the company.

Acting in concert

Under the French Code de Commerce, shareholders are viewed as acting in concert "when they have entered into an agreement with a view to buying or selling voting rights or with a view to exercising voting rights to implement a policy in relation to a company".

In a 2002 decision, the Cour d'Appel de Paris took a narrow view of the notion of concert. According to that case, majority and minority shareholders of a private company, whose relations are regulated by a shareholders' agreement, do not act in concert provided the minority shareholders limit their powers and actions to those necessary to protect their financial interests. In this case, the minority shareholders' veto rights were limited to extraordinary decisions such as rights offerings and changes in the bylaws of the company.

However, acting in concert has generally been viewed more broadly. The mere fact of having a shareholders' agreement regulating relations between majority and minority shareholders relating to the common treatment of the acquisition or disposals of the company's shares (including tag-along or drag-along rights) could qualify as acting in concert. *A fortiori*, any agreement providing for shareholders to reach an agreement or even to engage in a mere consultation before certain company decisions would generally be considered an agreement with a view to exercising voting rights to implement a policy in relation to the company.

Joint control

As mentioned above, shareholders jointly control a company if they act in concert and they determine the company's decisions taken at shareholder meetings.

There is to our knowledge no case law relating to the interpretation of the concept of joint control in the context of the Amendement Charasse. But French administrative and judicial courts have interpreted this concept in other contexts.

For example, in the 2004 TF1 decision, France's highest administrative court used the following test for assessing joint control: Under the shareholders' agreement between the majority and the minority shareholders, can the corporate strategy be set solely by the majority shareholders and its representatives or does it also require the approval of the minority shareholders? The court closely looked at both the letter and impact of the provisions contained in the shareholders' agreement, and found that the agreement granted minority shareholders veto rights on the main management and growth decisions, such as the annual budget's definition and the signing of the most significant contracts. The majority shareholder was entitled to: (i) buy the minority's shares out in the event of a deadlock; and (ii) appoint the company's CEO. The court still concluded that the majority and minority shareholders jointly controlled the company based on the fact that, as a practical matter, the majority shareholder needed the support of the minority shareholders to manage the company.

In 2005, the Cour Administrative d'Appel de Paris (Paris Administrative Court of Appeals) took a similar position and concluded that shareholders jointly controlled a company if all decisions relating to the company's corporate purpose required the minority shareholders' consent.

Lastly, in the 2005 *Hyparlo* case, the Cour d'Appel de Paris decided along the same lines as the administrative court decisions discussed above.

So French courts draw a distinction between two sets of veto rights granted to minority shareholders:

- Veto rights relating exclusively to a minority shareholder's protection of its financial investment, which are not controlling rights.
- Veto rights relating to ordinary course matters, which are controlling rights.

Shareholders' agreement and *Amendement Charasse*

When drafting a shareholders' agreement where one or more sellers of Target shares reinvest in BidCo as minority shareholders, and BidCo plans to include Target within its French tax consolidation, the negotiation of the shareholders' rights should take into account the potential tax constraint. Certain guidelines should be kept in mind:

The majority shareholders and lead sponsors should have the exclusive right to appoint the majority of the members of the boards at BidCo level and each level of the chain of ownership, and should also have the exclusive right to appoint and replace BidCo/Target's CEO.

Veto rights granted to reinvesting sellers as minority shareholders should be strictly limited to the protection of their financial investment, that is, rights to object to exceptional transactions that could have a detrimental impact on the value of their investment. For example:

- Transactions between Target and BidCo's majority shareholders (or their affiliates) outside the ordinary course of business;
- Very large acquisitions or disposals (when compared with the Target's size and with investments contemplated in the business plan);
- Exceptional capital expenditures not contemplated by Target's business plan;
- Raising large amounts of additional debt;
- Non-proportional cash distributions; or
- The liquidation, merger, issue of shares, or change in bylaws.

The changes to the *Amendement Charasse* regime by the Amended Finance Bill for 2005 tend to indicate that the French legislature and tax administration have recently decided to focus on this anti-avoidance regime. However, this reform is generally viewed as good news for taxpayers because it clarifies which control test the French tax administration will apply. The concept of control for French tax purposes had previously been autonomous and quite vague. Now it is in line with the corporate rules and will help the structuring of private equity transactions that include a reinvestment component.

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