

# France

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## MARKET TRENDS AND ACTIVITY

### 1. Please describe briefly the private equity market in your jurisdiction, in particular:

- The sources from which funds established to invest in private equity transactions (private equity funds) obtain their funding, such as institutional investors (for example, pension funds, insurance companies and banks), companies, individuals and government agencies.
- Market trends (for example, the role of hedge funds in private equity).
- Any proposed or pending regulatory changes.

The statistics provided throughout this article were published by the *Association Française des Investisseurs en Capital* (AFIC) (*L'activité du capital investissement en France en 2009*) and the *Autorité des Marchés Financiers* (AMF) (*Rapport sur la gestion d'actifs pour le compte de tiers en 2009*).

### Sources of funding

In 2009, the amount raised by the French private equity market dramatically decreased to EUR3.7 billion (as at 1 November 2010, US\$1 was about EUR0.7) from EUR12.7 billion in 2008.

Private equity funds' activity was closely linked to tax incentives resulting from the the Law for the promotion of labour, employment and purchasing power (*Loi en faveur du travail, de l'emploi et du pouvoir d'achat*) (TEPA law) and the development of special wealth tax (*impôt sur la fortune*) (ISF) funds. This resulted in a change in the relative proportions of funding sources. Individuals and family businesses have overtaken financial institutions as the main source of funding of private equity funds.

In 2009, the main sources of funding were:

- Private individuals and family businesses: EUR1.6 billion (compared to EUR3 billion in 2008).
- Banks: EUR653 million (compared to EUR2.9 billion in 2008).
- Insurance companies: EUR433 million (compared to EUR2.3 billion in 2008).
- Funds of funds: EUR430 million (compared to EUR1.5 billion in 2008).
- Pension funds: EUR 283 million (compared to EUR1.9 billion in 2008).

The decline in fundraising from institutional investors (down by 71%) is a result of a movement to safer assets in times of financial turmoil and a reflection of prudential rules under Basel II/III and Solvency II.

### Market trends

In a difficult economic context, the French private equity market invested more than EUR4 billion in 2009 in nearly 1,500 companies. While the amounts invested declined, the number of investee businesses remained relatively stable.

With over EUR3.7 billion collected by 77 management companies, fundraising fell by 71% compared to 2008 and was the lowest in the past five years. However, the fall was only 40%, if the three largest fundraisings in 2008, which represented EUR6 billion, are disregarded. While LBOs showed a fall of 80%, affecting the total amount of investments, investment was refocused on the creation and development of companies through venture capital and expansion capital. It is also the first year the French private equity industry recorded reductions in funds' sizes.

### Regulatory changes

There are currently no major regulatory changes on the horizon.

### 2. Please summarise any changes in the level of activity in recent years in relation to:

- Fundraising by private equity funds and hedge funds.
- Private equity investment in established, early stage and start-up businesses.
- Private equity financed transactions (for example, management buyouts (MBOs), management buy-ins (MBIs), leveraged buyouts and public to private transactions).
- Exits by private equity funds (that is, the realisations of the investments).

### Fundraising

In 2009, the private equity market raised EUR3.7 billion, a decrease from the EUR12.7 billion raised in 2008.

### Investment

The amounts invested in 2009 decreased by 59% compared to 2008, to EUR4.1 billion, while the number of investee companies remained stable at 1,469.

While investing in more companies in 2009 (779) than in 2008 (707), expansion capital grew in value from EUR1.65 billion in 2008 to EUR1.8 billion in 2009.

More than 80% of investments were made in small to medium-sized enterprises employing fewer than 250 people and realising less than EUR50 million of turnover.

Venture capital activity decreased from EUR758 million in 2008 to EUR587 million in 2009.

### Transactions

As a result of the credit crunch, the expansion capital segment was the main focus of private equity investors in 2009, representing 44% of the investments in value (compared to 17% in 2008).

### Exits

Exit conditions remained difficult in 2009 with nearly 800 companies being involved in divestment operations totalling EUR2.8 billion.

## TAX AND STRUCTURING

### 3. What tax incentive schemes exist to encourage investment in unlisted companies? At whom are the schemes directed? What conditions must be met?

There are no general tax incentive schemes, but the following legal structures dedicated to private equity investments have their own tax benefits.

#### **Fonds commun de placement à risques (FCPR) bénéficiant d'une procédure allégée (FCPR allégé)**

FCPRs *allégés* are the most commonly used structure and are the focus of this article.

French investors can benefit from a favourable tax regime applicable to investments in an FCPR *allégé*, subject to certain conditions, giving tax exemptions for income and capital gains derived from the ownership of the interest in an FCPR (for individual investors) or taxation at a low rate on the capital gains on the disposal of the interest in the FCPR (for corporate investors) (see *Question 5*). This favourable regime is available if the FCPR satisfies, in addition to the legal requirements (see *Question 11*), certain tax requirements (known as the tax quota). In summary, 50% or more of the FCPR's assets must be invested in shares or other securities giving access to equity in qualifying portfolio companies, that is, unlisted companies that:

- Are incorporated in a EU or European Economic Area (EEA) member state that has entered into a tax treaty with France containing a mutual assistance provision (excluding Liechtenstein).
- Carry out an industrial or commercial activity (within the meaning of French tax legislation).
- Are subject to corporate income tax under the standard rules or would be subject to this tax under the same conditions if its activities were conducted in France.

Companies listed on a regulated or semi-regulated (*marché organisé*) stock market with a market capitalisation of less than EUR150 million also qualify, provided that, for the purposes of the quota, no more than 20% of the assets of the FCPR constitute investments in these companies.

FCPRs may also indirectly hold investments in qualifying portfolio companies, through either:

- Holding companies organised in a jurisdiction in the EU or in the EEA, which have entered into a tax treaty with France containing a mutual assistance provision and that:
  - are liable to corporate income tax under standard rules or would be liable to this tax under the same conditions if their activities were conducted in France; and
  - have the main purpose of holding equity investments.
- An FCPR or another investment fund organised in the EU or EEA.

The legal and tax requirements must be met from the last day of the FCPR's second accounting period to the last day of the fifth accounting period following either:

- The FCPR constitution date.
- For an additional subscription after the closing of an initial 18-month subscription period (irrespective of complementary subscription for reinvestment purposes), the end of the accounting period during which the last subscription occurred.

After this date, the FCPR can enter into an irrevocable pre-liquidation period during which it is no longer required to meet the requirement.

Management companies (*sociétés de gestion*) must file every year with the French tax authorities a specific schedule evidencing the investments carried out by the FCPR in participations eligible for the 50% tax requirement (irrespective of whether the investors have elected for the FCPR favourable tax regime).

The management company can incur significant penalties:

- For failure to file this schedule.
- For attempting to hide the fact that the FCPR did not meet the tax requirements during the year.
- If the tax authorities determine that the FCPR has not complied with the tax quota with respect to a given year.

In addition to the legal and tax requirements, the French Monetary and Financial Code (FMFC) imposes risk allowance ratios and influence ratios which prohibit FCPRs from having more than certain percentages of their assets invested in the equity of an individual entity and from controlling the equity capital of a target company. These ratios vary depending on whether the FCPR is open to the public.

There is no maximum or minimum investment period for an FCPR.

(See also *Questions 4 and 5*.)

#### **FCPR contractuel**

The FCPR *contractuel* is an investment vehicle for qualified investors that aims to compete with the well-known UK and US limited partnership structure. This type of fund has the main following characteristics that differ from the FCPR *allégé*:

- It need not comply with legal and tax quotas (even though its investment policy must focus on unlisted companies), risk ratios or portfolio concentration restrictions and can invest in a wide range of assets.



- It can borrow under conditions determined only by the fund's bye-laws and can therefore make leveraged investments.
- The investors cannot request redemption until a set period determined by the fund's bye-laws. This period can exceed ten years.

The FCPR *contractuel* does not entitle its investors to the favourable tax regime applicable to the FCPR *allégé* (see *Question 5*).

#### **Fonds commun de placement dans l'innovation (FCPI)**

Individuals are entitled to a tax deduction equal to 25% of the amount invested in the FCPI up to EUR12,000 per person. In addition, individuals and corporate investors in FCPIs may benefit from the same favourable regime applicable to FCPRs, if a FCPI meets the conditions to qualify as an FCPR. To qualify for favourable tax treatment, at least 60% of the assets of the FCPI must be invested in securities of either:

- Non-listed companies.
- Companies listed on a regulated stock market or non-regulated stock market (for up to 20% of the assets of the FCPI), with a market capitalisation of less than EUR150 million and that are:
  - innovative (subject to specific and detailed conditions);
  - established in an EU member state, or in an EEA member state which has entered into a tax treaty with France containing a mutual assistance provision;
  - subject to corporate income tax;
  - held predominantly (directly or indirectly) by individuals;
  - staffed by fewer than 2,000 employees.

In addition, FCPIs must invest at least 6% of their assets in start-up companies with a capital stock between EUR100,000 and EUR2 million.

#### **Fonds d'investissement de proximité (FIP)**

Individuals investing in a FIP are entitled to the same tax credit as when investing in a FCPI (see *above*, *FCPI*). The FIP is subject to the same requirements as the FCPI, except that it must invest:

- In small and medium-sized companies located in areas close to the place of incorporation of the fund.
- At least 10% of its assets in companies that have been in existence for less than five years.

#### **Société de capital risque (SCR)**

An SCR benefits from an optional tax regime open to joint stock companies. Its shareholders (whether individual or corporate investors) are subject to a tax regime that is similar to the FCPR. Provided certain requirements are met, an SCR is exempt from corporate tax on income and capital gains realised from investments. An SCR's shareholder may also benefit from tax incentives. The Financial Markets Authority (*Autorité des Marchés Financiers*) (AMF) does not supervise SCRs.

#### **Organisme de placement collectif immobilier (OPCI)**

The OPCI is a legal structure introduced to increase private equity investment in real estate. OPCIs can:

- Be structured in the form of a *société d'investissement à capital variable* (SICAV) or a *fonds commun de placement* (FCP).
- Benefit from a simplified procedure for institutional investors.
- Be opened to foreign investors.

For French investors, OPCIs structured in the form of an FCP are tax transparent. Those in the form of a SICAV are taxed under standard rules (taxation of distribution by the OPCI and capital gains on sale of the interest in the OPCI).

#### **4. What legal structure(s) (domestic or foreign) are most commonly used as a vehicle for private equity funds in your jurisdiction?**

FCPRs are the most commonly used vehicle. They are supervised by the AMF. The rules that apply to FCPRs also apply to a large extent to FCPIs and FIPs.

#### **5. For each structure identified in Question 4, identify whether it is taxed, tax exempt or fiscally transparent (that is, tax is levied on the individual investors rather than the fund itself):**

- So far as domestic investors are concerned.
- So far as foreign investors are concerned.

FCPRs are fiscally transparent. The French tax authorities look through FCPRs to determine the type of income received by the investors.

#### **Domestic corporate investors**

French corporate investors are subject to corporate tax at the standard rate (33.33%, plus surcharges) on distributions from the FCPR (dividends, interest and capital gains), subject to any foreign tax credits that can apply. In the absence of distribution from the FCPR, French corporate investors are subject to corporate tax on a mark-to-market basis.

A favourable tax regime applies to French corporate investors who invest in an FCPR that satisfies the tax requirements (see *Question 3*).

If a corporate investor holds its interest in the FCPR for five years:

- The investor is in principle not subject to tax on a mark-to-market basis.
- Distributions from the FCPR other than dividends and interest (for example, the proceeds of the disposition of an investment) are treated (to the extent of the investors' funded commitments) as a tax-free return of capital and subsequently as capital gains.

- Long-term capital gains realised by a corporate investor on the sale or redemption of interests are subject to a 15% reduced taxation (plus surcharges) or are tax exempt if the FCPR has held 5% of the shares in qualifying companies for more than two years at the time of disposal. Long-term capital gains are equal to the amount of commitments paid in by the corporate investor for at least two years before the date of the relevant distribution over the aggregate amount of commitments funded by the corporate investor. The standard rate remains applicable to capital gains not eligible to long-term status. Similar provisions were recently introduced for capital gains received from funds of funds under certain conditions.
- Distributions of dividends and interest are subject to corporate tax at the standard rate.

### Domestic individual investors

French individual investors who invest in FCPRs satisfying the tax quota requirements (see *Question 3*) are exempt from income tax on:

- All distributions from the FCPR if they undertake, on subscription, to hold their interests for at least five years and to reinvest any distribution for the remainder of the five-year period.
- Capital gains on the sale or redemption of interests following the five-year period. However, social security contributions apply to these gains at an overall rate of 12.1%.

If the above requirements are not satisfied, the investors are subject to income tax at progressive rates on distributions from dividends and interest. Capital gains are taxed at an overall rate of 30.1%, including social security contributions (12.1%). If an individual investor owns more than 10% of the interests in the FCPR, capital gains are taxable as soon as they are realised by the FCPR, and not just on distribution by the FCPR.

### Foreign investors

Unless paid to entities located in a non-cooperative jurisdiction (*Etat ou territoire non-coopératif*) (see *below*), distributions from FCPRs to non-French investors deriving from dividends and interest paid by French portfolio companies are subject to French withholding tax at the rates of:

- Dividends: 25% (or 18% for EEA individual residents).
- Interest: 18%.

The withholding tax rates may be reduced under an applicable income tax treaty.

Non-French individual investors and non-French corporate investors are tax exempt on FCPR distributions derived from French-source capital gains, unless they:

- Hold, directly or indirectly, more than 25% of the share capital of the relevant company.
- Are located in a non-cooperative jurisdiction (see *below*),

When capital gains distributions from an FCPR are taxable in France, the applicable rate is 18% (income tax treaties may prevent France from applying this taxation).

FCPR distributions of French source income are subject to a specific tax regime when distributed to an entity established in a non-cooperative jurisdiction. These are defined as states or territories that meet all of the following criteria on 1 January 2010 (*Article 238-0 A of the FTC*):

- It is not a member of the EU.
- Its position on tax transparency and tax information exchange has been examined by the Organisation for Economic Co-operation and Development (OECD).
- It has not entered into an agreement with France for administrative assistance enabling information exchange for application of the parties' tax legislation.
- It has not signed such an agreement with at least 12 states or territories.

French source dividends or interest distributed or paid to entities located in non-cooperative jurisdictions are subject to French withholding tax at a rate of 50%. The tax is applied to dividends or interest distributed or paid through a financial institution established in a non-cooperative jurisdiction regardless of the tax residence of the effective beneficiary (that is, whether a French investor or a non-French investor) as well as to dividends or interest distributed/paid directly to non-French investors established in non-cooperative jurisdictions. The 50% withholding tax applies from 1 March 2010.

If established in a non-cooperative jurisdiction, non-French investors can be subject to a 50% withholding tax on French source capital gains distributions, regardless of the ownership percentage held by the FCPR in the French portfolio company. This withholding tax applies from 1 March 2010.

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## 6. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as not being tax transparent (in so far as they invest in companies in your jurisdiction)? What parallel domestic structures are typically used in these circumstances?

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French source investment incomes flowing through foreign partnerships, when paid to non-French tax resident investors, are in principle subject to French withholding tax on interest (at 18%) and dividends (at 25% or 18%) (see *Question 5, Foreign investors*), while capital gains can be tax exempt, subject to conditions.

Following late 1990s case law, French tax authorities are now inclined to analyse the tax transparency of foreign partnerships based on their intrinsic characteristics under the applicable foreign law. This allows the application of the look-through treatment for dividend and interest, and improves the French tax treatment of income flowing through foreign partnerships. This was confirmed in administrative guidelines released in early 2007.

French tax authorities now consider that foreign shareholders of a foreign partnership are entitled to benefit from the treaties between France and their country of residence, to the extent that:

- French source passive income (for example, interest and dividends) is concerned.

- The foreign partnership is located in a country that has entered into a tax treaty with France containing a mutual assistance provision.
- French source passive income is regarded as income of the shareholders both in their country of residence and in the country of residence of the partnership.
- The foreign shareholder is not a partnership.

No withholding tax is due from a French shareholder in a foreign partnership for income derived from the partnership if the shareholder is not active in its management.

If those conditions are not met, the tax status of foreign limited partnerships is generally analysed by the French tax authorities according to French domestic principles. Foreign partnerships are generally not considered to be tax transparent since they have legal personality (in particular with respect to limited partners' shares). In addition, since they are not subject to tax, they are not entitled to the application of treaties, unless the relevant treaty provides otherwise.

In practice, this analysis may vary, depending on the facts and circumstances, as certain tax treaties give favourable tax treatment for foreign partnerships investing in France. The France-US and France-UK double tax treaties provide specific rules recognising tax transparency in certain situations.

## LICENSING AND REGULATION

### 7. Are a private equity fund's promoter, principals and manager required to be licensed?

FCPRs have no legal personality and must be managed by a *société de gestion de portefeuille* (management company) registered with the AMF. Management companies are regulated under the French Monetary and Financial Code (FMFC) and the AMF Regulations (*Règlement général de l'AMF* and *Instruction n°2008-03, 8 February 2008*).

Since 1st July 2010, management companies must ensure that their managers (financial managers making investment decisions) and promoters (members of the management team responsible for funds' marketing and investor relations) have the appropriate qualifications and expertise as well as a sufficient level of knowledge to perform their work.

Under the AMF Regulations, these key persons must either:

- Take an exam certified by the AMF.
- Be subjected to a formal procedure within the management company to practise as fund managers or promoters (which may be verified later by the AMF).

The sponsor of the private equity fund does not need to be licensed.

### 8. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

FCPRs are not regulated as investment companies although their management companies are.

Each management company must appoint a person responsible for compliance and internal control (compliance officer). The compliance officer must hold a professional card provided by the AMF.

The compliance officer must:

- Ensure that the Code of Ethics (*Code de déontologie*) promulgated by AFIC and the *Association Française de Gestion Financière* (AFG), is complied with.
- Verify compliance with procedures and rules of good practice for all aspects of relations with investors.

The management company must implement regular follow-up and audit procedures for its portfolio activities.

The FCPR must appoint an officer to liaise with Tracfin, the French administrative service dealing with money laundering. This person:

- Must be internal to the management company.
- Must not be involved in the portfolio management activity.
- Can also be the compliance officer.

The management company's activities are regulated by the AMF and monitored by statutory auditors. An FCPR's assets must be held by a custodian separate from the management company. The custodian also ensures the validity of the management company's decisions and is jointly liable to third parties, including investors.

The promotion and the marketing of an FCPR (or any other form of fund, including foreign equivalents) are considered in France as *démarchage* (unsolicited contact in relation to the sale of financial products).

FCPRs can be marketed only by those authorised to engage in *démarchage*, for example:

- Registered financial investment advisers.
- Credit institutions.
- Investment and insurance companies of sufficient standing.

### 9. Are there any restrictions (for example, nationality, age and number) on investors in private equity funds?

FCPRs open to the public and their organisational documents (the *règlement* and *notice d'information*) must be approved by the AMF before the first closing of the fund.

FCPRs restricted to qualified investors (investors or companies making certain levels of investment, such as states, banks and insurance companies) and their organisational documents must be notified to the AMF within one month of the fund's first closing.

Qualified investors can only transfer their shares to other sophisticated qualified investors. The management company must ensure (under money laundering provisions) that the shareholders act for their own account.

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#### 10. How is the relationship between the investor and the fund governed? What protections do investors typically seek?

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Drafting the fund's bye-laws is the prerogative of the management company and the custodian. Potential investors usually negotiate general amendments of the bye-laws and individual arrangements with the management company, including:

- Key persons.
- No-fault divorce.
- Management fees.
- Investors' committee.
- Disclosure of information.

Any individual arrangements between the management company and any particular investor must be disclosed to other investors so that they can seek to benefit from the same arrangements.

An amendment to the bye-laws after the first closing generally requires the approval of a qualified majority of the investors.

The private placement memorandum (*notice d'information*) is given to each potential investor for the purpose of providing preliminary information about the fund.

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#### 11. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

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An FCPR *allégé* can only invest in:

- Financial instruments.
- Shareholders' loans (subject to requirements set out below) in the form of a current account.
- Shares in a *société à responsabilité limitée* (SARL).
- Interests issued by financial entities organised under French or foreign law and whose main purpose is investing, directly or indirectly, in companies whose equity securities are not listed for trading on a regulated stock market.

Direct investment in real estate is not allowed.

To qualify as an FCPR *allégé*, a fund must comply with the following legal requirements (known as the legal quota), the FCPR must invest 50% or more of its assets in shares or other securities giving direct or indirect access to equity in unlisted qualifying portfolio companies.

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## INVESTMENT OBJECTIVES

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#### 12. What are the most common investment objectives of private equity funds?

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The investment policy of private equity funds must be set out in their bye-laws. Typically, funds seek long-term capital gains. The investment policy for achieving these gains and the projected investment period vary across the range of private equity investments.

There is no legal maximum duration for funds. The average life of a fund is generally from eight to ten years. This duration corresponds to a full investment cycle (seeking an investment, carrying and realisation) and the investors cannot request their redemption until a set period of not more than ten years has expired.

Private equity funds' performance is expressed in terms of gross internal rate of return (*taux de rentabilité interne brut*) (IRR), that is, the rate of return before accounting for management charges, carried interests and cash flows. The IRR is the annual discount rate used so that the value of positive cash flows (that is, income and gains resulting from divestments or estimated values) equals the value of negative cash flows (that is, investments).

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## INTERESTS IN PORTFOLIO COMPANIES

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#### 13. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? What are the relative advantages and disadvantages of each? Are there any restrictions on the issue or transfer of shares by law?

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There are a range of financial instruments through which private equity funds can hold direct or indirect equity and debt interests in a portfolio company. Private equity funds can:

- Purchase ordinary shares with standard voting and financial rights.
- Be issued preferred shares with flexible voting and financial rights, which supersede all former types of available preferred shares (*Ordonnance of 24 June 2004*).
- Be allocated free shares by the company.
- Get indirect access to equity through being issued instruments without voting rights such as equity warrants.
- Be given direct or indirect access to equity through bonds or bonds to which equity interests are attached.

Pre-emptive rights and other restrictions on the transfer of shares are commonly found in the bye-laws or shareholders' agreements.

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## BUYOUTS

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#### 14. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

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Auction sales are common but are not governed by any specific regulations. Standard contractual law principles apply.



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**15. Are buyouts of listed companies common (public to private transactions)? If so, which legislation and rules apply?**

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Public to private transactions are subject to specific stock market rules (*règlement général de l'AMF*) under the supervision of the AMF and are not uncommon in France.

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**16. What are the principal documents produced in a buyout?**

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The following principal documents are typically produced:

- Confidentiality agreement.
- Information memorandum.
- Letter of indication of interest.
- Binding letter of intent.
- Share purchase agreement including representations and warranties of sellers (and purchasers) and indemnification commitments and non-competition/non-solicitation undertakings.
- Mezzanine loan facility agreement or an agreement for the issuing of bonds.
- Shareholders' agreement.
- Inter-creditor agreement.
- Security package (for example, share pledge agreement, pledge over an ongoing business concern agreement and assignment of receivables).

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**17. What forms of contractual buyer protection are commonly requested by private equity funds from sellers and/or management?**

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Private equity funds investing in a company typically require representations and warranties from the sellers and (to a lesser extent) the management. The scope of these and the level of security the fund receives are a matter for negotiation and depend largely on the extent of competition for the target and (where applicable) the success of the parties in navigating the auction process.

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**18. What non-contractual duties (for example, of confidentiality and employment) do the portfolio company managers owe and to whom (for example, when approaching possible investors in relation to an MBO)?**

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Managers of portfolio companies have the same obligations to the company and its board (or boards) as in any other French company. The obligations depend on the form of the company, but are similar to the principles of fiduciary duty applicable in common law countries, for example, managers:

- Cannot engage in other business activities that would interfere with their employment.

- Cannot disclose confidential information relating to the company to third parties.
- Must provide full reports to the company's directors and respond to their requests for information about the company's business.

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**19. What terms of employment are typically imposed on management by the private equity investor in an MBO?**

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Rights and obligations of the management are typically governed by their employment contracts and a shareholders' agreement.

Managers usually undertake to:

- Devote full time to the company and not to compete with the business.
- Remain with the company for a minimum period.
- Enter into put and call arrangements where the circumstances of their leaving the company govern the price to be received by them for their shares (good leaver and bad leaver provisions).

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**20. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company (for example, representation at board level)? Are such protections more likely to be given in the shareholders' agreement or company bye-laws?**

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Mechanisms allowing a fund to oversee and obtain some measure of control over the activities of their portfolio company include:

- Entering into voting agreements or holding preferred shares with veto rights.
- The right to appoint board members with voting rights or observers with no voting rights.
- Requiring representation on monitoring bodies, the prior approval of which is required on certain issues.
- Imposing reporting obligations on managers, with prior consultation on certain decisions.

These mechanisms can be provided in either bye-laws or shareholders' agreements, both of which have advantages and disadvantages.

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**DEBT FINANCING**

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**21. What percentage of finance is typically provided by debt and what form does that debt financing usually take (for example, term loans, working capital facilities, convertible loans and bonds)?**

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Leverage ratios (debt-to-equity) in France have historically been lower than in other jurisdictions both because of financial assistance constraints and French banks' reluctance to accept high levels of debt, although debt levels are higher today than in the past. External debt provided in a leveraged buyout (LBO) in France (not including debt provided directly or indirectly by shareholders) is typically about 60% of the total acquisition price, but can vary

significantly depending on the cash flow capacity of the target. The current financial and banking turmoil has led to a significant reduction of the leverage ratio.

Typically, external debt financing is provided through:

- **Senior debt.** Taking the form of a term loan, this represents the largest part of the debt financing. The loan is typically secured by:
  - a pledge over the shares in the target company;
  - an assignment of the indemnities that can be paid by the sellers under the share purchase agreement; and
  - an assignment of key man insurance covering the main officers of the target company.
- **Mezzanine debt.** Subordinated to the senior debt but benefiting from a higher interest rate, mezzanine debt is generally, but not always, coupled with financial instruments giving access to the share capital of the company (such as bonds with equity warrants or *obligations à bons de souscription d'actions* (OBSA) and convertible bonds).
- **Working capital.** The working capital facility is generally a revolving loan secured by an assignment of receivables, and is used to finance the activity of the target company.

Over time, but mainly in the context of large LBOs (over EUR1 billion), the use of the following has developed:

- Collateral debt obligations that are considered as senior debt.
- High yield bonds (HYB), the maturity of which is generally later than senior debt (commonly ten years for HYB as compared to seven to nine years for senior debt).

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## 22. What forms of protection do debt providers typically use to protect their investments, in particular through what types of:

- **Security?**
- **Contractual and structural mechanisms (for example, covenants or subordination)?**

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Historically, the only protection generally available to lenders was a pledge of the target shares. Over time, however, other mechanisms have been developed (see *Question 20*).

Additionally, a subordination and ranking agreement is often signed between the various lenders governing their payment priorities and the ranking of security among the senior debt and the junior debt.

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## 23. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

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A company cannot advance funds, grant loans or give security for the subscription or purchase of its own shares by a third party (*Articles L.225 to 216, French Commercial Code*). Any breach of this provision, which applies to both shareholders of the company

and third parties, entails civil and criminal sanctions, including the loans or the security being declared void.

As a result, the target company cannot generally provide guarantees or security in respect of debt contracted to finance the acquisition of its shares.

It is generally considered that the prohibition does not preclude distributions of dividends made to the holding company to reimburse acquisition loans, although a careful analysis of the facts and circumstances is necessary to ensure that these distributions are not abusive.

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## 24. What is the order of priority on insolvent liquidation? Are certain debt providers given priority over other debt providers? Are debt providers given priority over other stakeholders by law or is priority purely a matter of contract and company constitution?

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Priority is a matter of law. In the event of liquidation or sale of the whole of the business under insolvency law, the creditors of the company rank broadly as follows:

- A statutory portion of employees' wages.
- Costs of the proceedings.
- Secured creditors with a right of retention.
- Creditors entitled to a super priority lien.
- Additional wages.
- Tax and social security claims.
- Secured creditors.
- Unsecured creditors.
- Preferred shareholders (including holders of preferred shares).
- Common shareholders.

Priority rights can be supplemented by contract, for example, as between the senior and junior lenders under the subordination agreement.

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## 25. Is it possible for a debt holder to achieve equity appreciation through conversion features such as rights, warrants or options?

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Mezzanine debt and junior debt holders commonly receive instruments that are convertible into shares, such as convertible bonds, warrants or other securities.

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## PORTFOLIO COMPANY MANAGEMENT

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### 26. What management incentives are most commonly used (for example, shares, options and ratchets) to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

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The following incentives are commonly used:

- Shares (subject to good and bad leaver provisions).



## PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATIONS

### Association Française des Investisseurs en Capital (AFIC)

**Head.** Hervé Schricke (Executive Director)

**Address.** 23, rue de l'Arcade  
75008 Paris  
France  
**T** +33 1 47 20 99 09  
**F** +33 1 47 20 97 48  
**E** [info@afic.asso.fr](mailto:info@afic.asso.fr)  
**W** [www.afic.asso.fr](http://www.afic.asso.fr)

**Status.** The AFIC is a non-governmental organisation.

**Membership.** The AFIC has more than 280 active members and 200 associate members from all related private equity businesses.

**Principal activities.** The AFIC is an independent, non-profit organisation created in 1984 that represents and supports the private equity industry.

**Published guidelines.** The following publications are available on the AFIC website:

- The AFIC activity report for 2009.
- The International Private Equity and Venture Capital Valuation Guidelines (developed by AFIC, the British Venture Capital Association and EVCA).
- Ethics of Private Equity and Venture Capital.
- Private Equity & Venture Capital: A Guide for Institutional Investors.
- Funds of funds: A Guide for Institutional Investors.
- The Code of Ethics Private Equity Investment Management Companies.
- Information sources. See website above.

**Information sources.** See website above.

### Autorité des Marchés Financiers (AMF)

**Head.** Thierry Francq (General Secretary)

**Address.** 17, place de la Bourse  
75082 Paris Cedex 02  
France  
**T** +33 1 53 45 60 00  
**F** +33 1 53 45 61 00  
**W** [www.amf-france.org](http://www.amf-france.org)

**Status.** The AMF is a French independent public body with legal personality and financial autonomy.

**Principal activities.** The AMF's remit is to:

- Safeguard investments in financial instruments and in all other savings and investment vehicles.
- Ensure that investors receive material information.
- Maintain orderly financial markets.

The AMF also lends its support to financial market regulation at the European and International levels.

**Published guidelines.** The following publications are available on the AMF website:

- The AMF General Regulation.
- AMF Instructions and Recommendations.
- AMF monthly reviews.
- AMF annual reports.
- The *Rapport sur la gestion d'actifs pour le compte de tiers en 2009*.

- Share options (which do not require initial investment but are subject to vesting conditions).
- Equity warrants (*bons de souscription d'actions* (BSAs)) (which involve minimal investment and good leverage, but risk being treated as salary) (see *Question 27*).
- Shares with equity warrants (*actions à bons de souscription d'actions*) (managers must make a financial commitment, but the risk of being treated as salary is reduced).
- Preferred shares (these provide management with flexible voting and financial rights).
- Founders' warrants (*bons de souscription de parts de créateurs d'entreprises* (BSPCEs)) (these are subject to specific eligibility conditions but are tax efficient) (see *Question 27*).
- Convertible bonds (*obligations convertibles*) (managers have more security but the terms of reimbursement must be negotiated with the lenders).

- *Plan d'épargne actions* (PEA) (see *Question 27*).
- Salary bonuses (not tax efficient).

### 27. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

The various tax reliefs on the incentives referred to in *Question 26* are:

- Beneficiaries of share options can benefit from a favourable tax regime provided they hold the options or shares for a minimum period of four years. The acquisition gain is taxed at 42.1% on the part of the gain below EUR152,500, and 52.1% for the part of the gain at and above EUR152,500, including social contributions (12.1%). A 30.1% rate for the part of the gain below EUR152,500, and 42.1% rate for the part of the gain at and above EUR152,500, can be available if an additional two-year holding period is completed.

- The capital gain on sale is taxed at 30.1% (including social security contributions) and the share option beneficiaries are subject to an additional 2.5% social contribution on their acquisition gain. The employer is subject to a specific 10% social contribution paid on grant of the share options, based on either:
  - the fair value of the options; or
  - 25% of the value of the shares deriving from the options.
- An equity incentive scheme allows French companies to distribute shares to their employees and their legal representatives in France, without requiring payment from them. Such shares benefit from a favourable tax and social security regime similar to the share option regime, provided certain conditions are met.
- BSAs are warrants to acquire shares at a predetermined price. Capital gains realised on the sale of the shares acquired as a result of the exercise of the warrants (the difference between sale price and subscription price plus BSA price) are taxable at the standard capital gain rate of 30.1% (including social contributions). Special attention is required in pricing the warrant to minimise the risk of the French tax authorities recharacterising the gain as salary rather than capital gains.
- BSPCEs are warrants protected by a specific tax regime. BSPCEs can be granted to the managers or employees of certain French companies which:
  - are unlisted joint stock companies (or joint stock companies listed on a regulated market in a country which is a member of the EEA if the market capitalisation does not exceed EUR150 million);
  - have been in existence for fewer than 15 years;
  - are subject to corporate income tax and at least 25% of the share capital of which is held by individual investors, directly or indirectly through a company held at least at 75% by individuals.
- The price at which the shares of the company can be acquired through the exercise of the BSPCE must be at least equal to the issue price set in the last share capital increase during the six months preceding the issue of the BSPCE. A capital gain realised on the sale of the shares acquired as a result of the exercise of the BSPCE (the difference between sale price and subscription price) is taxable at the rate of 30.1% (including social contributions), provided that the beneficiary has been employed by the company for at least three years on the date of the sale of the shares (otherwise the rate is 42.1%).
- The PEA regime allows French resident individuals to invest, within limits (that is, EUR132,000 per person and EUR264,000 for a couple), in securities issued by listed or non-listed companies established in France and other member states of the EEA (excluding Liechtenstein) that are subject to corporate income tax (or to a similar tax in their countries). The scheme allows qualifying investors to benefit

from an exemption of income tax on the income (capital gains and dividends) derived from these securities, provided the income remains invested in the PEA for at least five years. This income is subject only to social security contributions, at the rate of 12.1%.

## EXIT

### 28. What forms of exit are typically used to realise a private equity fund's investment in a successful company (for example, trade sale, initial public offering (IPO) and secondary buy-out)? What are the relative advantages and disadvantages of each?

A successful exit can be realised through:

- **IPO.** This is a logical exit for a prosperous company, as the growth of the company should enable further fundraising and, if successful, the IPO can enhance the reputation of the company. However, timing of the IPO must be considered carefully.
- **Trade sale.** A trade sale (sale to a competitor) is very common. Synergies between buyer and target can lead to a higher purchase price. However, it can also lead to the replacement of the incumbent management if it is opposed to the sale.
- **Secondary or tertiary LBO.** Depending on prevailing market conditions, this can be an interesting alternative to an IPO or trade sale.
- **MBO.** An MBO may be appropriate if the management wishes to keep control of the company. However, it may not have the financial capacity to fund the acquisition alone.

### 29. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Exit from an unsuccessful company can take one of the following forms:

- Sale of the private equity fund's shares (at less favourable financial conditions), reimbursement of convertible bonds or shareholders loans. Potential acquirers can include recovery funds, which are becoming more common.
- Amicable liquidation of the company. This is only possible where all creditors and other claims can be paid or settled on a negotiated basis.
- Judicial winding-up of the company. Where there are disgruntled creditors and alleged management errors, there is a serious risk of claims by creditors against management and shareholders exercising control over the target.



## CONTRIBUTOR DETAILS



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**Qualified.** Paris, France, 1992

**Areas of practice.** Corporate; private equity.

#### Recent transactions

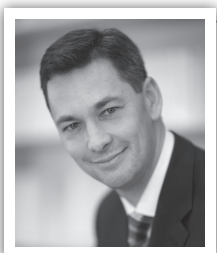
- Advising the investment teams of Natixis Investissement Partners and iXEN Partners in connection with the sale by Natixis Private Equity of its Private Equity portfolio to AXA PE, purchase of the management company and raising of a new fund.
- Advising a listed private equity firm managing funds of funds in France and emerging markets in its acquisition of a fund of funds management company from a financial services group.

**Qualified.** Paris, France, 1995

**Areas of practice.** Tax.

#### Recent transactions

- Advising an international group regarding reorganisation of the group throughout Europe.
- Advising and assisting a company specialised in the management of financial assets in connection with various investments.



### OLIVIER GENEVOIS

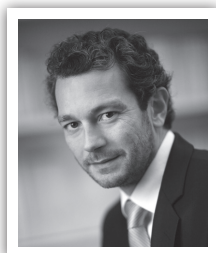
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**Qualified.** Paris, France, 1995

**Areas of practice.** Corporate; private equity.

#### Recent transactions

- Advising the investment teams of Natixis Investissement Partners and iXEN Partners in connection with the sale by Natixis Private Equity of its Private Equity portfolio to AXA PE, purchase of the management company and raising of a new fund.
- Advising a listed private equity firm managing funds of funds in France and emerging markets in its acquisition of a fund of funds management company from a financial services group.

**Qualified.** Paris, France, 1998

**Areas of practice.** Tax.

#### Recent transactions

- Advising Chéreau Holding SAS, a company controlled by the members of the Executive Board of Jean Chéreau SAS in connection with the financing of the latter company's takeover. The acquisition was financed by equity contributed by investment funds and by a loan made by Banque Scalbert Dupont-CIN, Caisse Régionale de Crédit Agricole Mutuel de Normandie and Banque Commerciale pour le Marché de l'Entreprise.
- Advising Crédit Mutuel Arkéa in connection with the acquisition of Monext. Monext holds a leading position in the processing of electronic payments.