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Insights

VENDOR DUE DILIGENCE AND CRIMINAL LIABILITY OF THE ACQUIRING COMPANY

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The acquiring company, whatever its form, may be held criminally liable for acts committed by the acquired company prior to the merger.

In a judgment of 22 May 2024, published in the Bulletin and in the Lettres de Chambre (Crim. 22 May 2024, FS-B, no. 23-83.180), the Criminal Division of the Court of Cassation has extended its case law begun in November 2020 by extending to all types of companies the transfer of criminal liability from the absorbed company to the absorbing company in the event of a merger-absorption transaction.

Until the end of 2020, the Criminal Division of the Court of Cassation - adopting a strict interpretation of the principle of the personality of penalties - consistently refused to accept that, in the event of a merger-absorption, the acquiring company could be held criminally liable for offences committed by the acquired company[1], on the grounds that *"the merger (...) causes the acquired company to lose its legal existence"*. The merger resulted in the dissolution of the acquired company, which lost its legal existence and could no longer be held criminally liable. The public prosecution of the company was therefore extinguished[2] . The dissolved legal entity was assimilated to that of a deceased natural person, pursuant to article 6 of the French Code of Criminal Procedure. Similarly, the absorbing company, a separate legal entity, could not be held liable for acts committed by the absorbed company.

In a decision dated 5 March 2015[3], the Court of Justice of the European Union (CJEU) had initiated a development in this area by ruling that Article 19 of Council Directive 78/855/EEC of 9 October 1978, now Article 19, paragraph 1, of Directive 2011/35/EU of 5 April 2011, on internal mergers of public limited liability companies, should be interpreted as follows: a merger by acquisition entails the transfer to the acquiring company of the obligation to pay a fine imposed by final decision, after that merger, for breaches of employment law committed by the acquired company before that merger.

In a ruling handed down on 25 November 2020[4], the Court of Cassation made a major change in its case law by accepting that a merging company could henceforth be sentenced to a fine or

confiscation (*i.e.,* exclusively patrimonial sentences) for offences committed prior to the merger by another merged company.

However, this transfer of criminal liability was limited to mergers that met the following three cumulative criteria:

- the companies involved in the transaction are public limited companies, simplified joint stock companies or partnership limited by shares falling within the scope of Directive 78/855/EEC of 9 October 1978, codified by Directive 2011/35/EU of 5 April 2011;
- all the assets and liabilities of the company being acquired are transferred to the acquiring company; and
- the merger takes place after the judgment of 25 November 2020.

In the case of other types of company, only cases of fraudulent evasion of the law led to the possibility of prosecution of the acquiring company. Thus, if the merger was motivated by the need to put an end to proceedings against the absorbed company, the absorbing company could still be prosecuted without the aforementioned conditions being met, in addition to the fact that all existing penalties (and not just property and criminal penalties) could be applied.

However, there was no general principle of transferring liability from the absorbed company to the acquiring company in the event of a merger.

In its ruling of 22 May 2024[5], the Court of Cassation confirmed the solution established by the ruling of 25 November 2020 and extended it to limited liability companies that were merged after 25 November 2020, thereby establishing as a general principle the transfer of liability in the event of a merger.

In this case, in June 2021, the Criminal Court sentenced several limited liability companies (SARLs) in June 2021 to pay a fine of €30,000 for various breaches of the Town Planning Code in connection with the operation of a campsite, committed in 2015.

During the appeal proceedings, on 30 September 2022, two of the SARLs convicted at first instance merged. However, in April 2023, the Court of Appeal upheld the convictions of the companies, imputing the conviction of the absorbed company to the absorbing company.

The acquiring company appealed to the Court of Cassation, arguing in the first place that the principle of the individual nature of penalties, expressed in article 121-1 of the French Criminal Code, under which "*no one is criminally liable except for his own actions*", prevented the acquiring company from being convicted for acts constituting an offence committed by the first company[6] and that there are only two circumstances in which the acquiring company can be convicted of criminal offences for acts committed by the acquired company prior to the transaction:

- where the merger transaction, entered into after the judgment of 25 November 2020, involves public limited companies and therefore falls within the scope of Council Directives 78/855/EEC of 9 October 1978 and 2011/35/EU of 5 April 2011; and
- when the purpose of the transaction, regardless of the date and form of the company, is to avoid criminal liability on the part of the absorbed company and thus constitutes fraud.

However, as the companies in this case were limited liability companies and not public limited companies, the applicant did not fall within the scope of the Directive and, furthermore, there was nothing to show that the transaction constituted fraud whose sole purpose was to shield the absorbed company from criminal liability.

Relying on Article 121-1 of the French Criminal Code, Article L.236-3 of the French Commercial Code and Article L.1224-1 of the French Labour Code - according to which all employment contracts in force on the date of the transaction continue between the acquiring company and the employees of the acquired company - the Court of Cassation dismissed the appeal.

On the one hand, it notes that *"the economic activity carried out within the company (...) continues within the company that benefited from this operation and that, as a result, the economic and functional continuity of the legal entity means that the acquiring company cannot be considered to be distinct from the acquired company"*. As a result, the acquiring company may be criminally convicted for acts constituting an offence committed by the acquired company prior to the transaction.

The Court of Cassation also states that "*as the absorbed legal entity is continued by the absorbing company, the latter, which enjoys the same rights as the absorbed company, may rely on any defence that the latter may have raised*".

In so doing, the Court of Cassation adopts a pragmatic position in view of the economic reality of merger transactions, even though this is contrary to the letter of Article 121-1 of the Criminal Code.

In addition, the Court of Cassation emphasised that although it had not yet had the opportunity to rule on the consequences for public prosecution of a merger involving a limited liability company, its doctrine had been reasonably foreseeable since its ruling of 25 November 2020[7] and deduced from this that this principle should apply retroactively to the companies being prosecuted. This point has been the subject of much criticism in view of the need to ensure legal certainty for litigants.

One thing is certain: with this ruling, the Court of Cassation is contributing to the increasing criminalization of the activities of legal entities.

This means that extra vigilance is required in the case of mergers and acquisitions.

On the one hand, it is essential to pay greater attention to criminal risks during pre-acquisition audits, so as to be able to control them, measure their consequences and assess the costs likely to arise from them.

On the second hand, following the merger, it is important to retain as much information as possible in order to be able to defend the merged company in court, if proceedings are brought, in respect of the acts for which it may be held liable on behalf of the merged company.

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[1] Cass. crim, 20 June 2000, n°99-86.742; Cass, crim.14 Oct. 2003, n°02-86.376; Cass. crim, 9 Sept. 2009, n°08-87.312

[2] Cass. crim. 18 Feb. 2014, no. 12-85.807

[3] CJEU 5 March 2015, aff.C-343/13 Modelo Continente Hipermercados SA c/ Autoridade para as Condiçoes de Trabalho

[4] Cass. Crim, 25 November 2020, no. 18-86.955

[5] Cass. Crim 22 May 2024, no. 23-83.180

[6] Article 121-1 of the Criminal Code

[7] Cass. Crim, 25 November 2020, no. 18-86.955

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MEET THE TEAM

Claire Lavarde

Paris

claire.lavarde@bclplaw.com
+33 (0) 1 44 17 77 65

Julie Pereira

Paris

julie.pereira@bclplaw.com
+33 (0) 1 44 17 77 93
