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Credit Supply as a Cause of Insolvency in France

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Introduction

The banking industry in Europe and in France in particular has experienced difficulties in recent years with a noticeable rise in the number of occasions banks have been reported in trouble. These moments of crisis include facing liquidity problems, loss of customer confidence, being targeted in criminal and fraud investigations as well as facing take-overs.¹ In France, a code governs the relationship of a bank with its customers in the supply of credit and other services, which does much to regulate the banking sector and assist in the internal management and external control of bank business.² Banks nevertheless face problems with public perception and mistrust, particularly in an unfavourable economic climate, when banks determine largely through their credit activities the survival of businesses.³

One of the more preoccupying problems stems from the heart of a bank's activity, the giving of credit to customers. This is particularly so where through participation in financing a business or other close connexion, a bank becomes so closely enmeshed in the activities of its customer that it finds itself the object of sanctions if its behaviour is deemed to have contributed to the insolvency of the debtor. This may occur in two situations, firstly, where the bank has given or extended credit to the debtor beyond the capacity of the debtor to handle appropriately and, second, where the bank has improperly withdrawn credit facilities. Because of this dual liability, commentators view the business of granting credit as comparable to trying to navigate between Scylla and Charybdis.

The Nature of Credit

Four criteria distinguish the credit contract: its duration, the element of trust, the risk attached to the credit facility and the absence of a speculative element, despite the possibility that profit, in the nature of fees for services and interest may be charged.⁴ The credit is a combination of an obligation to pay a debt and a legal act as manifested in the contract granting the credit.⁵ The contract is normally constituted by the presence of the three elements: the transfer of a sum of money, whether by way of immediate loan or a future

¹There have been two noteworthy domestic insolvencies in recent years, that of Banque Majorel in 1992 and Banque Pallas Stern in 1994. The latter insolvency has seen one of the largest claims against former directors for alleged mismanagement. Other banks, including the Cr dit Foncier de France, which at the end of 1995 received a loan of FF. 20 billion from the Caisse des D p ts et Consignations, are known to be still facing difficulties.

²Law no. 84-46 of 24 January 1984 ('Law of 1984'). The framework for the banking industry in France was the subject of a comprehensive amendment law in 1996.

³See Watt, *The Spirit of Insolvency in France* [1996] 7 ICCLR 266 for a commentary on the views of the French with regard to banks.

⁴Lamy droit du financement, para 2516.

⁵Lamy, op cit. para 2517.

facility, the obligation to reimburse this sum at a date, which may be fixed or remain to be determined, and the charging of interest.⁶

The nature of a credit agreement is almost always commercial, especially where the loan is made for the purposes of a business, and also where the loan is for a commercial company although for a purpose unconnected with its business.⁷ The granting of credit, particularly with respect to the identity of parties to the agreement, the type of services provided, proof of the availability of credit and of the terms and conditions of the contract as well as the rights of third parties in the context of a credit agreement, is subject to normal rules governing credit agreement and contracts.⁸

*The Improper Extension of Credit*⁹

The Foundation of Liability

A bank is generally liable where it supplies credit to an individual or company for a purpose which is unlawful. This may include activities which are manifestly illegal, including fraud, fraudulent imports and exports, tax evasion, and trading in illicit substances and others, which are breaches of legislation or administrative authorisation. The supply of credit to an individual for the purposes of legitimate trading may attract liability where the individual had in fact no licence to trade in France, which is an unlawful act.¹⁰

In principle, there is also liability where for the purposes of legitimate activities, the bank lends itself to unlawful acts, including failing to observe the rules in relation to the granting of credit and, in an example before the courts, the acceptance of fictitious instruments for the purpose of factoring these.¹¹ There are problems with questions of evidence and implied knowledge on the bank's behalf, but the principle is clearly stated and banks should exercise caution where doubt exists as to the nature of the debtor's business activities.

One of the most important sources of liability arises in insolvency. A bank is liable in an insolvency if it knowingly supplies credit to a business that is in a situation, which can be qualified as being compromised.¹² This is on the basis that in granting credit in these circumstances, the bank is failing to exercise its discretion properly and is in fact allowing the debtor to disguise the reality of the situation from other creditors.¹³

Liability also attaches where the credit is in fact inappropriate for the purposes of the business and results in the business getting into difficulties. This may stem from the excessive terms or conditions attached to the loan, including

⁶Cassation criminelle, 3 May 1966, Bull. Crim. p299.

⁷Cassation sociale, 14 January 1960, D.1960.jur.p384.

⁸Lamy, op. cit. paras. 2531-2547.

⁹Soutien abusif du crédit.

¹⁰CA Paris, 26 May 1967, JCP éd G 1968.II.15518.

¹¹Cassation commerciale, 9 July 1987, GP 1987.2.pan.p211.

¹²Cassation commerciale, 26 April 1994, RJDA 10/94 No. 1050. This liability is a species of tortious liability based on Art. 1382, Civil Code.

¹³Lamy, op. cit. para. 2554.

credit repayment terms, interest rates and penalties.¹⁴ These are also factors which may be extremely important in the case of new businesses. Liability may also result from failure to supervise the use to which the credit is put if this condition is attached to the supply of credit, which is often a clause applicable to banking services and overdrafts.¹⁵ In all the above instance, a bank will also be liable to any third party involved in the transaction, for example a guarantor whose guarantee is subsequently called in.

The Bringing of a Suit

The action against the bank at fault is normally brought by the creditors' representative. Proof of whether a bank is aware of the situation must be brought by the party making the allegation.¹⁶ It is nevertheless open to the judges hearing the case to make a finding that, given the state of facts and evidence, the bank was to be regarded as being perfectly aware of the perilous situation of the debtor.¹⁷ In addition, the judges will normally decide on a case by case basis whether the particular credit and its terms or conditions were appropriate for the business concerned.

A causal link between the fault attributable to the bank and the insolvency must be shown.¹⁸ If the insolvency is shown to result from the action of a third party, such as one of the company's debtors failing to make payment, or if the bank's contribution to the insolvency is negligible, then the bank will escape liability.¹⁹ One of the most important consequences of a finding of liability is that the bank will not be able to set-off or net sums arising from all transactions with the debtor, as liability by the bank is not to the debtor personally or to the creditors at large, but to the insolvency.²⁰ Indeed any sums paid which result from a finding of liability will be used by the administrator for the purposes of continuing the business and, it being the case, to extinguishing company debts.²¹

Defences to Liability

A bank may not claim that granting the credit was merely a delaying tactic while it sought to distance itself from the contract.²² This said, a bank may raise several defences to an allegation of improper supply of credit. These include the information defence, the agency defence, the public authority defence and, curiously, a defence of participation in insolvency proceedings.

Under the information defence, the bank may claim that it was not properly informed or entitled to be informed of the situation in which the debtor was to be found. This is especially so if the bank wishes to avoid any accusation of

¹⁴Cassation commerciale, 7 February 1983, RTD Com 1983.446.

¹⁵Cassation commerciale, 18 May 1993, Bull. Civ. IV No. 190.

¹⁶Cassation commerciale, RJDA 3/92 No. 237.

¹⁷Cassation commerciale, 1 February 1994, Bull. Civ. IV No. 39.

¹⁸Cassation commerciale, 24 March 1992, JCP éd E 1993.pan.240.

¹⁹Cassation commerciale, 2 May 1983, D.1984.IR.89.

²⁰Cassation commerciale, 28 March 1995, JCP éd E 1995.pan.710.

²¹This does not mean that the amount is ring-fenced for creditors.

²²Cassation commerciale, 5 December 1978, JCP éd G 1979.II.19133.

being involved in the management of the company, for which liability could also attach under the terms of the law on insolvency. Nevertheless, banks are required to be vigilant and liability may attach if it is held that it would be reasonable to presume that the bank could not have been unaware of the situation.²³ Similarly, it may be held that the bank had the necessary information or means at its disposal and ought to have made enquiries, in default of which liability will attach.²⁴

It is normally the case that a bank is responsible for the actions of its employees.²⁵ Under the agency defence, however, the bank may allege that the actions of a particular employee were completely outside the remit given to him and not in the normal course of his functions. A bank must show that the debtor knew and approved of the employee's actions, as the illicit act can not engender liability unless entirely for the benefit of the debtor, which would not be the case if the debtor was ignorant of the situation.²⁶

Under the public authority defence, a bank may also allege that there was sufficient backing for the company by the public authorities which did not lead the bank to assume that the situation was compromised. This is especially the case if the company in question is considered by the authorities as being a vital business, when public subsidies or other support may be given, in which case a bank would have no reason not to continue furnishing credit. Given often close links between business and politics, a bank in this situation may have no option than to participate in a rescue plan or ease restrictions on credit.²⁷

The insolvency proceedings defence may arise where the bank has participated in the financing of a company subject to pre-insolvency or insolvency proceedings. This will be the case where the mediator in voluntary arrangements, which also benefit from a moratorium, has negotiated with creditors, the most important of which will undoubtedly be financial institutions, to waive existing debt and extend further facilities for the purposes of company reorganisation. In this instance, as also when a judicial administrator of a company in insolvency requests the continuation of credit facilities to keep the business functioning, it is rare that liability will be found.

Consequences of Liability

If found liable, the contribution of the bank is equal to the difference between the results of the insolvency proceedings in the instant case and what they would have been if the bank had not contributed to artificially prolonging the life of the company.²⁸ There may be two distinct contributions that the bank is required to make. Firstly, it may be required to contribute to the collective loss

²³Cassation commerciale, 22 July 1980, Bull. Civ. IV No. 317.

²⁴Cassation commerciale, 18 January 1994, BRDA 94-4 p10.

²⁵Art. 1384 al. 5, Civil Code.

²⁶Cassation commerciale, 27 June 1995, cited at Lamy, op. cit. para 2561.

²⁷Cassation commerciale, 9 November 1993, Bull. Civ. IV No. 384.

²⁸Cassation commerciale, 11 October 1994, D.1994.IR.240.

suffered by all the creditors. Secondly, it may be required to meet any individual claims arising from losses individual creditors have suffered.

The collective loss has been defined to be worth the value of the difference between the value of the declared debts and the dividends payable as a result of the procedure. The courts have held that this also includes any depreciation on the debts suffered by the creditors and any loss of interest.²⁹ Individual loss was previously defined as including losses directly attributable to the fact of insolvency, including loss of liquidity due to the debt which would have been recovered in ordinary trading circumstances being now subject to insolvency proceedings. The definition after case-law consideration now states that individual loss must relate to facts occurring independently of the insolvency, for example refusal by the bank to honour cheques or bills of exchange drawn by the insolvent company prior to the onset of insolvency.³⁰

*The Improper Withdrawal of Credit*³¹

There are two other points at which liability may arise for a bank in the situation of supplying credit to the debtor company. First, where the bank wrongfully withdraws credit, which may be one of the key factors in prompting the debtor to enter insolvency proceedings. Second, where during insolvency proceedings, the bank, whose contract continues by virtue of the provisions of the law on insolvency withdraws from the contract or fails to continue with the contract, which could compromise the success of insolvency proceedings.

Pre-Insolvency

(i) General Law

All contracts have to be examined to ascertain what terms they employ to offer either party the opportunity to escape being bound to continue performing the contract. Clauses contained in any such contract are subject to the general law relating to contractual terms, including any rules relating to unfair or excessive terms.³²

The law distinguishes between fixed-term contracts and unlimited contracts. In the case of fixed term contracts, the contract naturally comes to an end at the expiry of the term. Premature termination will entitle the other party to damages, unless it can be shown that the termination is entirely due to the other party being in breach of its promises.³³ Case-law has held that grave loss of trust by the banker in the client and the fact that the debtor is in a financially irremediable situation will entitle the banker to terminate the facility early.³⁴ These are also solutions which are found in banking law noted below.

²⁹Cassation commerciale, 25 November 1986, D.1987.jur.88.

³⁰Cassation commerciale, 19 December 1995, D.1996.IR.p48.

³¹Rupture abusive du crédit.

³²Law no. 95-96 of 1 February 1995.

³³Cassation commerciale, 4 June 1991, No. 846-D.

³⁴Cassation commerciale, 28 March 1985, RJDA 10/95 No.1122.

In cases where contracts are expressed as running for an indefinite duration, there is built in to the contract the implied term that either party has a right to withdraw unilaterally from the contract. In certain circumstances, the decision to withdraw may be considered as wrongful, especially if it is made with an intention to do harm to the business.³⁵ Proof must of necessity be brought by the party alleging the fault and evidence of this intention must be forthcoming, although it is submitted this is likely to be a rare occurrence.

Contracts which have no set term are subject to proper notice being given, defined to mean clear notice given reasonably in advance of the date services are to cease.³⁶ What is proper notice is a finding within the discretion of the court and will depend on the circumstances, including the state of relations between the parties and whether previous warnings had been given. Where a contract does not provide that reasons need be given, a bank is not required to state why the contract is being terminated, though the decision to terminate must be sufficiently unequivocal.³⁷ For that reason, a bank's letter merely stating that the credit facility was under review due to the debtor breaching certain loan conditions and expressing the need for the debtor to bring himself back within the conditions was held not to be sufficient evidence of an intention to withdraw facilities.³⁸

(ii) The 1984 Banking Law

Contracts for the supply of credit are considered to be contracts of a personal nature.³⁹ Hence, they are also subject to an exception, permitting a banker who has lost trust in the client to refuse to perform the agreement unless the other party is in a position to fulfil their obligations. It seems that a simple loss of trust will not entitle the banker to terminate the contract and damages are due for any breach deemed unlawful.⁴⁰ Notice must be given although no period has been fixed by the law, although practice has settled on sixty days for overdrafts and thirty days in the case of discounted or factored debt. A notice period should be mentioned in the initial contract or other standard documents commonly used in practice.⁴¹ Termination of a contract by any other means will put the banker at fault and entitle the client to claim damages.⁴²

In a limited number of circumstances, termination of the credit contract may be performed without notice if the client has committed unlawful or fraudulent acts, such as issuing cheques without funds being available or despite a legal prohibition as well as producing false accounts and other falsified documents.⁴³ Notice may also be foregone if the client is in a financially

³⁵CA Paris, 13 March 1985, GP 1986.1.som.

³⁶Cassation commerciale, 20 October 1982, D.1983.IR.466.

³⁷Cassation commerciale, 18 May 1993, Bull. Civ. IV No. 189.

³⁸Cassation commerciale, 2 November 1994, RD Bancaire et Bourse 1995.17.

³⁹Intuitu personae.

⁴⁰CA Amiens, 4 October 1991, RPC 1992.314.

⁴¹Lamy, op. cit. para. 2606.

⁴²Cassation commerciale, 19 November 1985, GP 1986.1.pan.

⁴³Article 60, Law of 1984 which reads:

hopeless situation, incapable of remedy. A difficulty arises with this exception, as it is a delicate task to ascertain whether the debtor has reached an impasse in its financial arrangements that will not permit of a solution. Generally, a clear indication will be that the debtor has filed a declaration of cessation of payments, the formal precondition to the opening of insolvency proceedings.⁴⁴ However, a bank may well find itself too late to present the debtor with notice of termination given that the effect of any purported termination will be subject to the provisions of the law on insolvency.

(iii) Consequences of Liability

If the termination of the contract is deemed lawful, the only likely dispute will be over whether cheques issued by the debtor prior to this event will be honoured where they are presented after the date termination. Case-law states that the bank is obliged to pay if the total amount of the cheques is within the overdraft limit.⁴⁵ This is also the case where the bank has represented to third parties that an overdraft facility exists and would meet the amount for which the cheque is drawn.⁴⁶ If termination is unlawful, one likely consequence will be that the courts will order the facility restored, so that the parties will be in the status quo ante even if litigation is likely over the credit contract.⁴⁷

Failure by the bank to keep to the terms of its contract will provide grounds for liability in contract as well as in tort, where the effect of termination is to cause harm to other parties, including other creditors, guarantors as well as directors of the subsequently insolvent debtor if an action is brought against them for a contribution. A causal link must be shown between the bank's actions and the loss.⁴⁸ The rules as to the bringing of a suit are similar to those outlined previously under the topic of improper extension of credit.

During Insolvency

The law on insolvency has opted for the continuation of business as one of the priorities in insolvency, the others being the maintenance of employment and the repayment of creditors. To allow for the continuation of business, the law provides that the administrator may elect whether to continue any contracts current at the time insolvency proceedings are opened. This rule applies to all types of contracts, irrespective of whether they contain a

“All services to be supplied under an unlimited contract by a bank to a customer may only be reduced or withdrawn by the serving of written notice within the time-limit fixed at the time the contract is signed. Whether a contract is for a fixed-term or is unlimited, a bank need not observe any time limit if the customer behaves in a reprehensible manner or is in a financial situation incapable of remedy. Failure to observe these conditions will render a bank liable for damages”.

⁴⁴Cassation commerciale, 25 February 1992, PA 15 February 1993, p.8.

⁴⁵CA Paris, 19 March 1979, RTD Com. 1979.778.

⁴⁶Cassation commerciale, 22 October 1991, RJDA 6/92 No.616.

⁴⁷Cassation commerciale, 3 December 1991, RJDA 1/92 No.63.

⁴⁸CA Paris, 5 December 1990, Banque 1991.657.

personal element, and thus to contracts for the provision of banking services.⁴⁹

Only the administrator has the power to choose. A bank may not elect unilaterally to terminate any such contract but must formally enquire of the administrator whether the contract is to continue. The administrator is required to reply within a month. If he fails to reply to a formal notice within that period, the contract is considered terminated as of right. Nevertheless, before the expiry of the one-month period, the administrator may obtain a further grace period for consideration by applying to the supervising judge. This period must not exceed two months.⁵⁰ In practice, the decision whether or not to continue services will be subject to negotiations between the parties as the administrator will need to rely on the support of the creditors, including any financial institutions, for any rescue plan.

The fact that the administrator is the only party entitled to act is not without consequences for the bank which may wish to withdraw from the contract. A bank whose contract is continued by the administrator is required to fulfil its part of the bargain, irrespective of any breaches of condition or warranty or failure to perform by the debtor prior to the judgment commencing the observation period.⁵¹ If the bank fails to continue facilities, the administrator may apply to the supervising judge for the necessary order.⁵² This is despite the fact that the bank may well have served the requisite notice before insolvency proceedings were instituted.

In any case, where either the administrator continues the contract or the supervising judge orders the bank to continue supplying the debtor with banking services, the continued provision is subject to payment for these services be made as and when performed.⁵³ All contracts, once performance is continued, give rise to the same obligations on the part of the administrator and the bank and any breaches will give rise to liability. This also includes the possibility of terminating the contract if any of the Article 60 requirements are met.⁵⁴ Nevertheless, a bank may not purport to terminate a contract during insolvency for causes which arose prior to the opening of proceedings.⁵⁵ Notice to the administrator of any action the bank intends to take is a must.

Summary

The situation of French banks in the insolvency of their debtors is quite delicate, even possibly precarious. Quite frequently, banks are in the unenviable position of having to recoup a substantial debt, which may be difficult to collect, although bolstered by a guarantee or security. Less frequently, they may be involved when courts question the very heart of the

⁴⁹Cassation commerciale, 8 December 1987, JCP éd G 1988.II.20927.

⁵⁰Art. 37 al. 1, Law no 85-98 of 25 January 1985 ('Law of 1985').

⁵¹Art. 37 al. 3, Law of 1985. Cassation commerciale, 28 June 1994, BRDA 94-19 p6.

⁵²Cassation commerciale, 21 December 1987, Banque 1988.237.

⁵³Art. 40, Law of 1985 (payment for services during insolvency a priority).

⁵⁴Cassation commerciale, 2 March 1993, RTD Com. 1993.553.

⁵⁵Cassation commerciale, 28 June 1994, PA 24 April 1995 p8; Cassation commerciale, 1 July 1997, Rev. de Droit Bancaire no 8 p65.

bank-customer relationship and invite banks to explain the rationale behind their lending decisions. This is especially the case when commitment to a particular line of credit results in the debtor becoming overburdened and risking insolvency and also when credit is withdrawn leading the debtor inevitably to a situation of insolvency. It is said that in France the existence of liability for causing insolvency results in a reluctance by bank officials to commit themselves to decisions that may have consequences for the institutions they represent and possible repercussions on their own careers.

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