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The Recognition of Trusts and Parallel Debt Structures by the French Supreme Court

By

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INTRODUCTION

Belvédère, a French producer of spirits, issued bonds in the amount of €375m which were governed by New York law. Its seven Polish and French subsidiaries guaranteed the bonds. In addition, a security package was provided by Belvedère and its subsidiaries. A US bank located in London was appointed as trustee and depositary of the notes materialising the bonds while two other banks were appointed as principal and ancillary security agent under a parallel debt mechanism.

On 16 July 2008, the Commercial Court of Beaune opened safeguard proceedings in favour of *Belvédère* and its seven subsidiaries to prevent foreclosure over various security interests.

Within the framework of safeguard proceedings, the trustee and the two security agents each filed a proof of claim with the official creditors' representative in the amount of €375m.

The directors of *Belvédère* argued that the proof of claims filed by the trustee should be dismissed. According to them, the trustee did not act in its capacity as legal owner of the notes but as a mere proxy on behalf of the note holders, pursuant to French insolvency law, without having received a special power from each of the note holders.

Belvédère also alleged that the parallel debt structure was contrary to French principles of international public policy. Therefore, the debtor requested that the proofs in relation to the parallel debt claims in the amount of €375m each should also be rejected.

The bankruptcy judge allowed the claims and the Court of Appeal upheld this decision. The ruling of the French Supreme Court was awaited with great interest.

From a financial point of view, the stakes were considerable. Had the trustee been recharacterised as a proxy, the filing of the proof of claims for the benefit of the note holders would have been inadmissible thus preventing them from receiving any reimbursements of their notes within the debt restructuring under the safeguard plan.

From a legal perspective, the French Supreme Court had to consider three interesting questions: first, the court had to rule on a conflict of laws issue. Was the capacity of the trustee to file the proof of claim governed by contract law (*lex contractus*), ie New York law, or was it a matter of French law governing insolvency proceedings (*lex fori concursus*)?

The second question at stake was the recognition of the trust mechanism. So far, France has not ratified the Hague Convention of 1 July 1985 on the applicable law and the recognition of trusts. Consequently, the question arose whether the Supreme Court would nevertheless recognise the legal ownership of the trustee, rather than looking for an equivalent French institution, ie recharacterising the institution as a proxy.

The recognition of the trust structure and parallel debt mechanism as a matter of French law provides greater legal certainty and will allow French borrowers greater access to international finance. In the landmark *Belvédère* decision dated 13 September 2011 (Cass. com. no. 08-14949, JurisData no. 2009-050791), the French Supreme Court recognised trusts and parallel debt structures in international financings by French corporations. This decision clarifies key questions raised in connection with international financings by French corporations. It is also likely to influence the French legislature, which is presently contemplating an amendment of art 2328-1 of the French civil code that introduced the concept of security agent in 2007.

The third issue was the question of the validity of a foreign parallel debt structure under French private international law.

The ruling of the Supreme Court was of particular relevance since the French legislature is currently contemplating a reform of the mechanism of security agent of art 2328-1 of the French civil code.

I. THE RECOGNITION OF TRUSTS AS A MATTER OF FRENCH CIVIL LAW

A. The respective scope of the laws governing trust deeds and the insolvency proceedings

The first issue before the Supreme Court was a conflict of laws question. Which law determines the capacity of the trustee to file a proof of claims within French safeguard proceedings – French law being the *lex fori concursus* or New York law, the governing law of the bond issuance and of the trust deed?

The French Supreme Court held that the 'lodging, verification and admission of claims' must be made pursuant to French insolvency law in accordance with art 4.2(h) of European Insolvency Regulation no 1346/2000, but the question as to whether the trustee was the (legal) owner of the receivable must be determined pursuant to New York law as the *lex contractus* governing the notes and the trust deed.

This ruling is in line with the Supreme Court ruling of 15 December 2009 (Cass com no 08-14949, JurisData no 2009-050791) on the respective scope of the *lex loci concursus* and the *lex societatis* concerning the lodging of proof of claims. In this case the court ruled that the question as to whether the delegation of powers to lodge a proof of claim by a Dutch corporation was a question governed by French bankruptcy law. Dutch law (as *lex societatis*) was applicable to the question as to whether its directors validly represented the company.

B. The recognition of the legal ownership of the trustee without any recharacterisation

The second question in the *Belvédère* case to be decided by the Supreme Court was whether the trustee was filing the proof of claims in its capacity as legal owner pursuant to New York law (the governing law of the bond issuance and of trust deed), or in its capacity as proxy, pursuant to French law. In other words, should the trust be recognised as such or should it be recharacterised as proxy in order to fit in with an equivalent French legal institution.

The recognition of foreign trust structures has been subject of much debate in French case law and legal doctrine over the years. As a general proposition, French case law recharacterised the trust agreements as proxies, because French law did not recognise the trust mechanism and the French government had not ratified the Hague Convention on trusts.

The problem relates to the fact an Anglo-Saxon trusts agreement creates a dismemberment of property into legal and beneficial ownership that is unknown in French civil law. Therefore, when considering the legal effects of a trust in France, French judges did not recognise this concept of ownership under the trust. Applying the theory of equivalences, French judges were looking for the closest similar French institution and qualified the trust as a proxy.

A few years ago, this situation changed.

In a decision dated 11 March 2005, the Paris Court of Appeal recognised a trust as such (Rev crit DIP 2005, p 627 note E Fohrer), with all its legal effects, without referring to the traditional method and having to resort back to a recharacterisation exercise. Therefore, the court allowed trustees to start court proceedings to recover money in their own names but for the benefit of the beneficial owners, without having to disclose details of the individual beneficiaries.

On 19 February 2007, the legislator introduced the *'fiducie'* into French law but without implementing the Anglo-Saxon concept of beneficial owners and legal ownership. The new article 2011 of the French civil code allows for the transfer of assets into a trust estate that is held by a trustee for the benefit of one or more beneficiaries. However, most of the commentators on the reforms believe that the beneficiaries of the trust are not the beneficial owners of these assets. They do not have a right *in rem* but only a claim to obtain the transfer of the ownership of the assets pursuant to the terms and conditions of the trust deed. This being said, some authors think that the French legislator has implicitly introduced the concept of fiduciary ownership into French law.

In 2009, Senator Philippe Marini proposed an amendment of article 2011 in view of introducing the concept of fiduciary ownership. In his view, this amendment was only clarifying the existing law. On 19 October 2009, the amendment was voted by parliament but, unfortunately, was invalidated by the Constitutional Court on procedural grounds, but not on the merits. Therefore, the debate is still ongoing.

Consequently, in the *Belvédère* case the question arose as to whether French judges should recognise as such the legal ownership of a trustee created under New York law.

This question is of particular importance in cases of insolvency proceedings. Under French law, only the creditors or their specially appointed proxy can file a proof of claims. In the present case, the trustee did not have a special proxy from the various note holders since he was deemed the owner of the receivables as a matter of New York trust law. If the French judge had recharacterised the trust as a proxy, the filing of the proof of claims for the benefit of the note holders would have been inadmissible in the safeguard proceedings and the note holders would have been unable to benefit from the safeguard plan including any distribution of dividends.

In its ruling, the French Supreme Court stated that the filing of the claims must be made pursuant to French insolvency law, but the question as to whether the trustee was the owner of the receivables must be determined by New York law. It therefore recognised the trust without any recharacterisation.

C. Trust and *lex rei sitae*: towards a reconciliation of conflicts?

The *Belvédère* ruling can be viewed as a very important step towards the recognition of trust agreements in France and anticipates the ratification of the Hague Convention on trusts.

This being said, the question arises as to whether it would be possible to have a trust agreement governed by a foreign law over assets which are located in France.

In the *Belvédère* case, this question was not relevant since the notes were located in England.

Traditionally, French case law considers that all questions relating to right *in rem* statutes are exclusively governed by the *lex rei sitae* (*See* the jurisprudence *Kantoor de Mas*, Cass Req, May 24, 1933, S 1935, 1, p 257 note H Batiffol). Consequently, if an asset is located in France, French law is exclusively applicable to determine the content of all rights *in rem*, including security interests. But the acquisition of a right *in rem* could be governed by the *lex contractus* (*See* Cass civ, July 21, 1987, D 1988 somm. p 345 note B Audit). For example, the creation of a trust is governed by the *lex contractus*. This conflict of laws rule is also set forth in art 6 of the Hague Convention on trusts.

That being said, according to the traditional case law mentioned above, French law governs the question of the content of the ownership of the assets held in trust that are located in France. As a matter of fact, since French law (arguably still) ignores the Anglo-Saxon concept of beneficial and legal ownership and in light of the traditional overriding effect of the *lex rei sitae* over the *lex contractus*, it would appear impossible, even after the *Belévèdere* ruling, to include French assets into a trust estate that is governed by English law.

Consequently, if the receivables were located in France (The question of the location of receivables in French private international law is not obvious if they are not incorporated into bonds or notes (*See* for this question R Dammann, Travaux du Comité Français de Droit International Privé 2008/2010 p. 17), it would appear advisable to use a French law device. This question is of particular importance in international financings for the management of security interests by a security agent.

Biog box
Reinhard Dammann's expertise is in insolvency law with a particular emphasis on international and cross-border restructurings. As a recognised specialist he has published a number of articles in the general and specialist press and is a regular speaker at seminars and conferences in particular on European regulation on insolvency proceedings.

II. SECURITY AGENT AND PARALLEL DEBT MECHANISM WORK IN FRANCE

A. The parallel debt mechanism is compliant with French principles of international public policy

The third issue at stake in the *Belvédère* case was the validity of the parallel debt mechanism governed by New York law. This mechanism, which is frequently used in international financings, consists of the creation of a parallel debt in the same amount of the same debt owed to the creditors but with the security attached to it. The parallel debt is not an accessory of the main debt but an independent obligation. Through this mechanism, the creditor of the parallel debt becomes the security agent, which allows him to create and register the security interest in its own name and foreclose over the secured assets for the benefit of the various creditors.

As demonstrated in the *Belvédère* case, the trust structure and parallel debt mechanism are complementary devices that are frequently used in international financings. The security agent holds the parallel debt and manages the security in its own name but for the benefit of the trustee and therefore, for the benefit of the various note holders. As shown in the *Belvédère* case, the security agent is not necessarily a trustee. In case of realisation of the security, he distributes the collected funds to the various creditors in accordance with the terms and conditions of the inter-creditor agreement.

In order to render the parallel debt structure and the security interests opposable towards French insolvency proceedings, the security agent must file a proof of claims with the representative of the creditors indicating in detail the security interests that are guaranteeing the reimbursement of the receivables arising out of the parallel debt.

In the *Belvédère* case, the Court of Dijon held that this mechanism was comparable to joint obligations under French law and therefore valid, in accordance with public policy. The debtor challenged this reasoning on two grounds: first, the filing of the parallel debt could lead to double payment in contradiction with public policy; second, since some subsidiaries of *Belvédère* did not constitute any security interest in favor of the security agents, their obligations under the parallel debt were arguably null and void because without cause. *Belvédère* pleaded that the very existence of the parallel debt was only justified by the constitution of securities in favor of the security agent.

The Supreme Court rejected the first argument on the ground that the contract specifically provided that any payment made to the security agent would reduce the main debt accordingly. In other words, there was no risk of double payment and, consequently, the mechanism was complying with the principle of equal treatment of creditors.

With respect to the second argument, the court took the view that the operation and the existence of the cause for the parallel debt structure needed to be examined in light of the whole financing agreements. Consequently, the fact that some parallel debt obligations were not secured did not constitute a sufficient reason to justify the voidance of the parallel debt structure.

Following this ruling by the French Supreme Court, the question arises as to whether it would be possible to create a parallel debt structure governed by French law. The answer seems positive, although the *Belvédère* decision does not address this point.

That being said, the amendment of art 2328-1 of the French civil code is likely to resolve this issue, increasing the attractiveness of the security agent under French law.

B The reform of article 2328-1 of the French civil code

According to practitioners of international financings, French law was viewed as not being as attractive as Anglo-Saxon law devices. The reform of 2007 introduced the mechanism of a security agent into art 2328-1 of the French civil code. The goal was to ease the management of security interests granted in favour of creditors thus avoiding the disadvantages of the proxy regime. However, according to the most commentators, art 2328-1 failed to introduce a true trust mechanism and therefore, the security agent remained a proxy acting on behalf of the various creditors. Furthermore, the scope of art 2328-1 was rather narrow and did not include personal guarantees.

In order to resolve this problem, it has been suggested that the common law 'fiducie' structure of art 2011 of the French civil code could be used. This was rejected as being too cumbersome to work in practice. Indeed, in case of an assignment of secured receivables, it would have been necessary to enter into an amendment to the original *fiducie* agreement, identifying the new beneficiary who must be registered with the tax authorities.

In light of the *Belvédère* ruling assuring the efficiency of the trust structure, it becomes even more urgent for the legislator to amend art 2328-1 of the civil code in order to propose a similar attractive trust mechanism.

Therefore, the French legislator is presently contemplating an amendment of art 2328-1 of the code civil introducing a trust mechanism pursuant to which the security agent would be able to constitute, register, manage and foreclose the securities interests, including personal guarantees, in its own name but for the benefit of the creditors.

The key provision of the new law would be the introduction of a trust estate. The security agent would hold the security interests in his own name in a trust estate separated from its own assets and liabilities. Consequently, such a trust structure would protect the interests of the beneficiaries in event of an insolvency of the security agent. The regime would also include the ability to replace the security agent which would be very flexible and similar to the mechanisms currently used as a matter of English law.

Under the new system, the security agent would not be the holder of the receivables itself but only the (legal) owner of the security interests. So whilst this would avoid the competition of proofs between the trustee and security agents as the role is effectively merged into one, it would not of itself enable the security agent to file proofs on behalf of the beneficiaries. Consequently, each creditor as beneficiary of the trust structure would have to lodge a proof of his claim within the insolvency proceedings. To this extent, each creditor could of course grant a special proxy to the security agent to do this on its behalf. It is hoped that the new legislation will therefore firmly establish the trust structure, and make France even more competitive in terms of international financings. ■

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