

The Brief

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French Legal News

Editorial¹

The French Legal News will be issued periodically to update you on recent developments in French law.

A number of significant reforms regarding corporate, financial and tax law were implemented in France in 2004. The reform of French securities laws, in particular the implementation of preferred shares, the introduction of Private Public Partnerships, the modernization of the securitization legal framework and the introduction of a legal framework governing the free granting of stock in an attempt to boost French employee profit sharing were important developments toward an implicit "Americanization" of French Law. A substantial tax law reform for 2004 designed to exempt capital gains arising from the disposal of shares as well as the entry into force of an EU Regulation creating the European corporation are also among the main developments.

This significant trend toward more "Anglo-Saxon" oriented reforms is expected to continue in 2005. Dominique Perben, the French Attorney General, announced in December 2004 the Government's intention to introduce the notion of Trust in France in the near future, a reform that has eluded France for 45 years. Gide Loyrette Nouel, and especially the New York Office with its broad knowledge of the use of the trust under the US law, will be closely involved in the drafting of this new law.

All of these reforms reflect the concern of French lawmakers to boost the French economy and lure back foreign investments by giving to French companies as much flexibility as their foreign competitors and by updating the French legal framework to the most recent financial instruments and financial transactions.

¹ Materials contained herein are of a general nature, are not intended to render legal advice, and should not be construed or relied upon as legal advice or legal opinion with respect to any of the matters addressed.



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FRENCH SECURITIES LAW IS MODERNIZED

On June 24, 2004, new legislation was adopted to modernize many aspects of French securities law.

The new rules are effective immediately, although a number of provisions will become enforceable only after an implementation decree has been adopted, the timing of which is uncertain.

This legislation is of great importance and is designed mainly to develop the Paris Market by modernizing the legal regime of French securities and easing share issuance and other capital increases.

1. Modernizing the legal regime of French securities

The new legislation has dramatically simplified the legal regime of securities in France through the creation of three types of securities:

- shares (including ordinary shares and preferred shares);
- securities giving access to the share capital;
- other debt instruments (in particular ordinary bonds).

This simplification is designed to clarify securities law in France and allow French companies as much flexibility as their European competitors. Especially noteworthy is the implementation into French law of preferred shares and the unification of the legal regime governing securities giving access to the shares.

(i) Creation of preferred shares

Besides ordinary shares, the new legislation has introduced a new type of shares called *actions de préférence* inspired for the most part by American preferred shares. In creating such preferred shares, French lawmakers have reduced the importance of the general principle of equality among shareholders (which was the keystone of French corporate law) and strengthened the freedom of contract principle.

Prior to the legislation, three categories of equity instruments different from ordinary shares co-existed: (i) priority shares, (ii) non voting rights without voting rights, and (iii) investment certificates. Each of these

was governed by a distinct set of rules, and they were seldom used due to their cumbersome legal regimes.

The regulation governing preferred shares supersedes the rules applicable to these three types of instruments. The creation of such preferred shares is aimed at giving more flexibility to French companies in determining the terms of the shares. Indeed, there are now many fewer restrictions on companies specifying the features of preferred shares (including preferred dividends, larger representation rights, larger information rights, limited voting rights, etc.). The new legislation even provides for the dissociation between the issuer of the preferred shares and the company with respect to which the preferential rights are created. Thus, preferential financial rights granted to the preferred shareholders may be based on the financial performance of a subsidiary or a parent company of the issuer (a parent company being defined for the purpose of this provision as a company holding 50% or more of the shares of the issuer).

(ii) Securities giving access to share capital

The new legislation creates a simple and unified regime applicable to all types of securities giving access to share capital. Prior to the new legislation, three types of securities giving access to share capital co-existed: (i) convertible bonds, (ii) exchangeable bonds, and (iii) bonds with warrants. They were all governed by different provisions. A set of rules governing other securities giving access to share capital (such as warrants) also existed. The combination of all of these regimes created confusion and uncertainty. The new legislation creates a unified regime governing all securities giving access to share capital.

The new legislation also specifies that it will now be possible to issue securities giving access to the share capital of a subsidiary or a parent company of the issuer, which represents substantial progress under French law and can be seen as a first step towards the implementation in France of the US reverse and forward “A” reorganizations.

2. Easing shares and bonds issuances

The new legislation removes many of the procedural constraints that formerly hampered listed companies in issuing new shares and bonds and which was seen as a substantial burden for French listed companies wishing to raise funds.

Briefly, the key provisions of the new legislation in this respect are:

- the cancellation of the rule known as the “10 out 20 rule” regarding the pricing issuance of new shares in the event that shareholders have waived preemptive rights. Under the 10 out 20 rule, the price of the issued shares had to be priced at a level at least equal to the average of the opening price of any 10 consecutive business days in the 20 business day period prior to the beginning of the transaction. This rule was a significant hindrance in issuing shares in a volatile or declining market. It will be replaced by new rules which will be provided in the upcoming implementation decree. It is expected that this decree will set a minimum price for the shares to be issued equal to the average price during the 3 business days preceding the transaction (eventually with the application of a 5% discount);
- the possibility of shareholders meeting to delegate to the board the power to issue annually up to 10% of the share capital without a legally mandated pricing constraint. This provision is mainly designed to ease the issuance of equity lines;
- the competence of the board to decide or authorize the issuance of non convertible bonds. The issuance of bonds will no longer require the authorization of the shareholders, which will ease and accelerate the bond issuance process.

THE PPP: A HOPEFUL SOLUTION TO BOOST PUBLIC INVESTMENT

By enacting the Private Public Partnership (“PPP”) Regulation, France has moved closer to the mainstream state contract legal framework, creating a system very similar to the UK’s PFI. The PPP Regulation allows the French state, a municipality or an agency (a “State Entity”) to grant an overall project to a private company (designing, building, maintaining, restoring, and even operating a facility) in exchange for regular payments spread-out over the length of the contract.

The purpose of the PPP Regulation is to encourage public investment in France at a time when European Union budget requirements (State indebtedness must not top 3% of the GDP) have become significantly burdensome.

Prior to the PPP Regulation, the State Entity had only two means of requesting the services of a private company.

First, a private company was granted an overall public service mission (financing, building, etc.) for which it assumed the risk in exchange for a long-term right to have final consumers pay for the service provided. The disadvantage of this so-called Public Service Concession was that the project had to be adapted to a public commercial use such as highway projects, but worked poorly for such projects as prisons or public schools.

Second, a simple contract by which the State Entity paid a price for the work performed within the framework of a specified mission (generally a construction project). The main disadvantage for the State Entity involved in this arrangement was that the payments had to be made at the latest upon completion of construction.

The new PPP is designed to overcome these shortcomings.

First, the State Entity will be allowed to pay in installments over a contractual period agreed upon by the parties. This should permit state agencies to embark on expensive, non-commercial projects (prisons, public schools) which otherwise might not be implemented. Furthermore, the scope offered by the PPP contract is broader than that provided by the Public Procurement Contract. The project manager is

not limited to building a facility but can also, for example, be responsible for managing or maintaining it for a long period of time.

Second, although project managers and construction companies will have to accept deferred payments, a larger scope of projects will result in a bigger market and, overall, more projects for those participants.

Finally, private banks will more readily participate in financing plans. Since payments are deferred and made in installments, the project managers and the construction companies will need to obtain interim financing from private banks. The collateral granted to secure the loans extended will be the receivable held by the project manager and the construction companies over the State Entity (generally regarded as AAA debt). Although not specifically provided for in the new legislation, we expect securitization schemes to tag on to those projects given the quasi certainty of payment that the receivable held against the State Agency would grant to the investors.

Unfortunately, such partnerships are permitted only when the relevant State Entity deems that the project could not be accomplished in any other way, or that the situation is an emergency. Obviously, it will be interesting to follow the actual compliance with this rather vague requirement.

FRANCE MODERNIZES ITS SECURITIZATION LEGAL FRAMEWORK

By promulgating the 2004 Financial Security Act, French legislators wish to make up for lost time in the area of securitization. The new regulation aims to bring more flexibility and liquidity to the French securitization market and make the French Securitization Vehicle suitable for synthetic securitization transaction.

As set forth in the 1989 law, the French system is organized through an entity called "Fond Commun de Créance (FCC)", a mutual-debt fund organized as a co-ownership. The FCC is a pass-through entity which is not a legal person. The FCC is run by a managing company which must either be: (i) a credit institution authorized to do business in France, or (ii) any institution duly authorized by the French Minister of the Economy. The management company is generally responsible for representing the FCC and managing it. The custodian monitors the managing company and looks after the collection of the receivables purchased by the FCC.

The former system needed improvements in two main areas.

The FCC could only issue units and not bonds. The characterization of units is quite difficult for foreign investors given the fact that it is neither a debt instrument nor an equity instrument. Many institutions need to be able to classify their investments either as debt or equity. This ambiguity made it difficult for US investors to know whether or not they were in compliance with Rules 144 and 144A.

FCCs are now authorized to issue debt instruments besides the units they usually issue. This will bring the FCC closer to a common "special purpose vehicle", avoiding the establishment of foreign intermediate entities for this purpose. The decree specifies that FCCs would be allowed to issue bonds and negotiable debt instruments which can be either governed by French Law or by another foreign law.

Similarly, the FCC could use derivative instruments for hedging purposes only to cover its own exposure for the receivables acquired.

FCCs are now allowed to be the counterparty to any entity which desires hedging. This paves the way for synthetic securitization in France (when bonds are

issued not based on a pool of assets but merely on a risk transferred to the FCC). The decree provides some limitations such as maximum leverage, compliance with management objectives or specific approval of investment managers by the French Financial Market Authority.

Two others points increase the flexibility of such a vehicle. FCCs are now allowed to enter into repurchase agreements and temporary purchase or sale security agreements and to assign any security before its stated maturity.

This new regulation will create a different legal framework for French securitization. FCCs should become more attractive for EU-based issuing vehicles for cross border structure finance transactions by providing international investors with an alternative to the traditional foreign SPV.

EMPLOYEE PROFIT-SHARING: FRENCH LAWMAKERS EASE THE GRANTING OF FREE STOCK

In order to stimulate employee profit-sharing, the Finance Bill for 2005 has created a privileged tax and social security regime with regard to the granting of free stocks by a French company.

Prior to this new law, the granting of free stock was not governed by any specific regulation and its tax and social security cost were prohibitive.

The new regulation provides that the extraordinary shareholders' meeting can authorize the board to grant free stock to employees. The beneficiaries of the free stock can only be (i) employees of the company or of related companies and (ii) officers (i.e. the chairman and chief executive officer, the general manager, and management-board members; but not directors or supervisory-board members except in special circumstances)².

Although it is not specifically provided for in the current law, in our view, this new regime should apply to free stock granted by a US parent company to the employees of its French subsidiary.

Specific rules are provided with regard to the acquisition and sale of the stocks freely granted:

- Employees eligible to participate in the free granting are first granted a right to acquire free stocks. The acquisition of the stocks becomes definitive after a certain period of time as established by the extraordinary shareholders meeting (this period cannot be less than 2 years after the date of granting) (the "Acquisition Date").
- Once the stocks are acquired, the employees are prohibited from selling their stocks during a period (which cannot be less than 2 years) set by the shareholders' meeting.

² Note that free stock may not be granted to an employee or officer who holds more than 10% of the company. In addition, the amount of stock freely granted cannot exceed 10% of the outstanding stock of the company.

Thus, the period between the granting of the right and the sale of the underlying stock cannot be less than 4 years. This regime is in line with preferential tax stock option plans in France.

Provided the above conditions are met, the consequences of the granting of free stock are the following:

(i) From a tax perspective:

- no tax is levied either at the time of the granting of the right or at the Acquisition Date;
- taxes are only levied at the time of the sale of the stock freely granted. The gain (equal to sale price) is divided in 2:
 - the acquisition gain (equal to the value of the stock at the Acquisition Date) is subject to tax at a rate of 41%;
 - the sale gain (i.e., the difference between the sale price and the value of the stock at the Acquisition Date) is subject to tax at the specific rate of 27%.

Thus, from the employee perspective, the granting of free stock is more advantageous than the granting of stock options as the employee does not have to pay the exercise price.

(ii) From a social security perspective, the granting of free stock complying with the above-mentioned rules is not subject to any social security contribution, either for the employees or for the granting company.

CAPITAL GAINS ARISING FROM THE DISPOSAL OF SHARES WILL BE EXEMPTED FROM ANY TAXATION AS OF 2007

French lawmakers are about to cancel the taxation of capital gains arising from the sale by French companies of stakes in French or foreign companies.

The Amended Finance Bills for 2004 provide that the current capital gain tax rate for companies will decrease from 19% to 15% in 2005, to 8% in 2006, and finally to 0% in 2007 (by way of compensation, as of 2007, 5% of the capital gain should be added to the taxable income).

By enacting this exemption, French lawmakers are trying to lure back French companies that had moved their headquarters to other European tax jurisdictions such as the Netherlands or Belgium where the tax burden was lower, and generally to make France a favorable jurisdiction for the creation of holding companies.

Thus, the tax regime for a French company holding interests in the US will be the following:

- **Regarding dividends distributed by the US subsidiary:** provided that the French company holds more than 5% of the share capital of the US subsidiary, dividends distributed to the French company will be 95% exempted in France under the domestic participation-exemption regime (which is virtually equivalent to the dividend received deduction regime under US tax law) and will only be subject to a 5% or 15% withholding tax in the US under the treaty.
- **Regarding the sale of the US shares:** provided that the shares are held for at least two years, the sale of the shares by the French company should not be subject to any taxation in the US and as of January 1, 2007 will be 95% exempted in France.
- **Regarding the thin capitalization rules:** the financial expenses incurred by the French company to acquire the shares of the subsidiary will be tax deductible. In addition, also note that, to date, there is no positive debt-to-equity ratio defined under French law (in fact, a debt-to-equity ratio is only defined with regards to direct shareholder loans, and as such, in practice it is seldom applied³).

France is therefore now becoming a very competitive and attractive jurisdiction for holding companies.

³ Note that French lawmakers may introduce a new law in the Finance Bills for 2006 that attempts to strengthen French thin cap legislation. This new measure could provide a debt-to-equity ratio for indirect shareholder loans. (In fact, the new rules would be quite similar to the US rules provided under Section 163 (j) of the Internal Revenue Code).

THE EUROPEAN CORPORATION: MIRAGE OR GIANT LEAP TOWARD THE CREATION OF A UNIFIED EUROPEAN REGULATION?

The 30 year-old European Union project to create a "European Corporation" became a reality on October 11, 2004, with the entry into force of the new EU Regulation establishing the "*Societas Europaea*" ("SE"). French lawmakers have not as yet enacted a regulation that would make this new form of corporation a part of French national law. However, it is expected that they will do so soon.

The two main advantages to the creation of an SE are (subject to the pending modification of the tax laws of the various EU countries): (i) the ability to transfer freely the headquarters of EU companies throughout the EU without having to dissolve and recreate the existing company⁴ and (ii) the simplification of merging EU companies (still today a difficult task). The new corporation may also be listed on a regulated market.

However, the SE is not for everyone.

First, an SE can only be created as: (i) the outcome of a merger of two companies established in different countries of the EU, (ii) a subsidiary of an already existing SE or, (iii) a JV of two companies established in different EU countries.

Second, the rather stiff minimum share capital amount (120,000 Euros) along with rigid corporate governance standards clearly indicates the European legislators' desire to limit the use of such corporations to large conglomerates with European-wide stakes. This lack of flexibility prevents the SE from being a proper form for organizing JVs.

Third, for so-called "SE Holdings" (the EU Regulation makes a Byzantine distinction between SEs which are holding companies and SEs which are merely "subsidiaries"), employees must be "involved" in the process of creating a holding. The extent of this involvement is not yet defined, but this again reinforces the idea of large groups with organized unions.

In summary, the *Societas Europaea* is a timid but first step in the unification of European corporate law for large visible groups. Even if SEs do not supersede or replace current national regulations on such issues as shareholders' interests, taxation, litigation and liability which for the most part will remain within the scope of national regulations (usually the EU country of incorporation of the SE and where it conducts business), it will nevertheless be interesting to observe its practical impact on the practice of corporate law in Europe.

⁴ Note that the French 2005 Finance Bill provides that a move from a country of incorporation will no longer trigger any adverse tax consequences. France should be followed by others EU members .

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