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The duty to inform in French contract law further to the 2016 reform of the French Civil Code

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QUESTION

The reform of the French Civil Code has formalized a general duty to inform during the pre-contractual phase (« *the party who knows information which is decisive for the consent of the other must disclose it to the other party* », article 1112-1). Should this reform be feared by investors looking to complete M&A transactions in France ? What will be the practical impact of such legal duty to inform on buyers and sellers in the context of M&A deals ?

SUMMARY

This reform formalizes the parties' duty of information prior to the execution of the contract which translates in a duty of information of sellers with regard to any potential acquirer on the one hand, and an obligation for any potential acquirer to obtain information during the pre-contractual phase on the other hand. The public order nature of these provisions makes it an important reform, which will lead to certain changes in M&A practices.

RÉSUMÉ

Cette réforme formalise un devoir d'information bilatéral des parties avant la signature du contrat qui se matérialise, d'une part, par un devoir d'information des vendeurs à l'égard de tout acquéreur potentiel et, d'autre part, par une obligation de tout acquéreur potentiel de s'informer pendant la phase précontractuelle. Le caractère d'ordre public de ces dispositions en fait une réforme d'importance, qui justifiera certains aménagements dans la pratique des opérations de fusions-acquisitions.

EXPERTISE

Ordinance n° 2016-131 of 10 February 2016 on the reform of the law of contracts, the general regime and the proof of obligations has amended an important part of the French Civil Code relating to the formation of contracts. This reform is all the more important as the pre-contractual phase has considerably developed these past years, with multiple exchanges and preliminary agreements between the parties prior to the execution of the definitive contract, notably in the context of an open bid process (letter of intent, indicative and binding offers, etc.).

Contrary to article 1134 (old) of the French Civil Code which limited good faith to the performance phase, article 1104 (new) of the French Civil Code now provides that « *contracts must be negotiated, formed and performed in good faith* ». The first article of the sub-section relating to « negotiations » in the French Civil Code (which includes article 1112-1) also reinforces the concept of good faith in the pre-contractual phase, with article 1112 stating that « *the initiative, conduct and termination of pre-contractual negotiations are free. They must imperatively meet the requirements of good faith.* » [1]

Good faith requirement allows the legislator to impose on a party a positive obligation provided by article 1112-1, being the communication to the other party of any information of key importance enabling it to give an informed consent. [2]

In this respect, French contract law remains committed to the principle of contractual fairness and differs further from

1. This new article reflects case law « *Manoukian* » (*Cass. Com., 26 nov. 2003, n° 00-10.243 et n° 00-10.949*) which had already extended the duty of good faith to the pre-contractual phase.
2. *N. Mathey, L'obligation de contracter de bonne foi s'invite dans la cession d'actions : Rev. sociétés 2005, p. 587.*

English contact law which does not recognise the duty of good faith, notably in the pre-contractual phase. [3]

Under English law there is no general implied duty to act in good faith when negotiating or performing a contract. This is a well-established principle and the English courts have been reluctant to imply such a concept into a contract, despite being recognised in other jurisdictions, as it could potentially conflict with the English law concept of individualism and self-interest. Imposing a duty which could be vague and subjective undermines the English law concept of contractual certainty. [4]

There are certain exceptions to this rule in limited situations. The duty of good faith will be implied into certain contracts. The case of *Yam Seng v International Trade Corporation* [5] suggested that a duty of good faith could, and should, be implied into commercial contracts. In the High Court, Legatt J held that there was a duty to be honest, which itself is part of the wider duty of good faith, which might arise in « *relational* » contracts which contain a « *high degree of communication [and] cooperation* » between the parties.

A. - Questions raised by article 1112-1 of the French Civil Code

« *The party which knows information the importance of which is key for the consent of the other must inform it as soon as, legitimately, the other party does not know this information or trusts its counterparty* » (1st paragraph of article 1112-1).

1° Scope of the legal duty to inform

Which information must be disclosed ?

At first sight, the condition relating to the knowledge of the information seems devoid of purpose as it is obvious that in order to communicate information, one must have knowledge of it.

The comparison with the wording initially provided in the draft ordinance is useful. Beyond information which is known by the obligor, the draft ordinance of February 2015 had indeed opted to incorporate in the scope of article 1112-2 information which the obligor « knows or ought to know ». [6] This choice of language is not neutral and restricts the information to be disclosed to that which is actually known. The obligor is therefore not obliged to acquire information in order to satisfy its disclosure obligation to the other party.

Article 1112-1 also provides for a second explicit limitation with respect to information which falls within the scope of the obligation. Paragraph 2 of the article indeed specifies that « *this duty of information does not apply to the estimate of the value of the contract* ». This is consistent with the « Baldus » case law pertaining to fraudulent non-disclosure (*réticence dolosive*). [7] However, the fact remains that information impacting such value can still be in the scope of the legal obligation to inform.

What information is decisive for the consent of the other party ?

The decisive nature of the information for the consent of the other party appears to be the most subjective condition, even if one can readily assume that « relevant » information, notably in respect of the value of the target, but which is not « decisive » for the consent of the other party would be excluded.

Paragraph 3 of article 1112-1 nevertheless sets out a definition of such « decisive nature » by providing that it is any « *information that has a direct and necessary link with the content of the contract or the nature of the parties* ».

What is a « legitimate lack of knowledge » ?

For the party holding the information to be bound to communicate it, the other party must be unaware of such information in a « legitimate » way, or be in a relationship based on trust with that party.

This legitimacy will depend in particular on the nature of the party to whom the information is owed : is it an experienced professional, or a layman requiring more information ? It will also depend on the diligence of the other party in carrying out the transaction, being in itself the basis of a real obligation to investigate (V. infra B, 2°).

In the absence of an express provision in the contract, the other party will have to demonstrate, depending on the circumstances of the case, that it held itself to be in a relationship of trust with the obligor, such to rely on the obligor's assessment. This might be the case for a transfer between affiliated parties. [8]

In the draft ordinance, the section relating to defects in consent (*vices du consentement*) was preceded by a paragraph on the legal duty of information. This duty thus appeared to be an obligation aiming to prevent defects in consent. The drafters eventually chose to place this obligation in the section on the formation of the contract so that it may have a more general application.

The main innovation of the reform in terms of defects in consent is the recognition of fraudulent non-disclosure in article 1137 of the French Civil Code. [9] The parallel drawn between articles 1112-1 and 1137 of the French Civil Code is clear. The conditions around application of these two provisions are very similar : knowledge of the information by the obligor (implicit in fraudulent non-disclosure through the intentional concealment of information) and knowledge of the decisive nature of the information for the other party. [10] The difference is the condition relating to the legitimate unawareness of the other party. The intentional concealment of the obligor in the context of a fraudulent non-disclosure renders in some way the other party's lack of knowledge legitimate.

If the non-disclosure of decisive information results from an intention to deceive the other party, the applicable regime will be that of fraudulent non-disclosure. If, on the other hand, such an intention cannot be demonstrated, the other party may benefit from the protection given by the legal duty of information.

2° Regime of the legal duty of information

« *It is for the party who claims that disclosure of information was owed to it to prove that the other party owed such*

3. With the kind support of Camille Noirot, Solicitor (England and Wales), Gide Loyrette Nouel LLP (Gide London office).
4. New Law Journal, In good faith ? (7 August 2015), *http://www.newlawjournal.co.uk/content/good-faith-0*. Partnership, agency, contracts of insurance and agreements involving a fiduciary relationship.
5. [2013] EWHC 111 (QB). This case is of particular interest as it extends beyond the approach previously taken by the English courts. However, its limitations in terms of demonstrating a true shift toward recognizing an implied duty of good faith must be recognized. There is no indication the ruling in *Yam Seng* extends a potential duty of good faith in the course of pre-contractual negotiations.
6. Article 1129 of the draft ordinance of the Chancellery.
7. *Cass. 1re civ., 3 mai 2000, n° 98-11.381.*
8. *CA Paris 25e ch. 29 av. 1994 Reille c/ Bonnet : BRDA 1994, n° 11, p. 4 ; RJDA 1994, n° 1299, p. 999 ; Bull. Joly 1994, § 262 note A. Couret.* In this case, the transfer was made to the benefit of the nephew of the transferor. The Paris Court of Appeal stated that « *in light of the existing relationship of trust, she (the transferor) had no grounds to suspect the elements she was provided with* » and then concluded that the transfer was fraudulent.
9. Article 1137 provides that « *fraud (dol) is the fact that a contracting party obtains the consent of the other party through manœuvres or lies. Fraud (dol) also results from an intentional concealment of information by one of the contracting parties which it knows is decisive for the other party* ».
10. The « decisive information » of article 1112-1 (duty to inform) of the French Civil Code should nonetheless be analysed independently from article 1137 of the Civil Code (fraudulent non-disclosure), given the definition provided at paragraph 3 of article 1112-1 (« *information which has a direct and necessary link with the contents of a contract or the nature of the parties is of a decisive nature* »).

disclosure, and for such other party to prove that it has disclosed it.

The parties may neither limit nor exclude such duty.

In addition to the liability of the party concerned, the failure to comply with this duty to inform may result in the cancellation of the contract in accordance with the terms set out in articles 1130 and subsequent. » (4th, 5th and 6th paragraphs of article 1112-1 of the French Civil Code).

Can the legal duty of information be subject to any limitation ?

The public order nature is one of the major innovations of the reform [11] and the one which is most likely to raise challenges for practitioners. Any provision limiting the effects of article 1112-1 f the Civil Code may be considered invalid.

The penalty provided under article 1112-1 is defined by referring back to articles relating to defects of consent. A pre-contractual failure to inform may therefore result in the nullity of the contract if it amounts to a defect of consent, and more particularly a fraudulent non-disclosure.

Aside from intentional concealment, article 1112-1 provides a penalty for pre-contractual non-disclosure of information through the allocation of damages. [12]

B. - Impact of the French Civil Code reform on the practice of M&A transactions

1° The seller's duty to inform [13]

Under the law in force prior to the reform, certain provisions created a duty of disclosure owed by the seller during the pre-contractual stage. This is the case with respect to the guarantee against latent defects (*garantie des vices cachés*) as well as for fraudulent non-disclosure, which was recognised by the French courts. [14] Case law clearly imposed on the seller an obligation to provide the purchaser with « *exact and complete information about the financial situation of the company* ». [15]

This duty to inform led to a prohibition for the seller to give information which it could not ignore to be false, including for instance accounting information [16] (information subsequent to the closing date of the last available accounts) as well as legal information [17] (such as the existence of a litigation). This also imposed penalties on a seller who failed to disclose information relating to the exact situation of the company. [18] The duty to inform concerned any relevant information [19] which the seller knew or which it couldn't legitimately have been unaware of.

There were limits to this duty to inform. Such a duty were imposed on the seller only where the risks were certain and not only potential [20], and only to the extent that the purchaser did not have knowledge of the situation. [21]

In the case of a breach of this obligation, the purchaser could have a claim either for fraudulent non-disclosure (former article 1116 of the French Civil Code) or for tortious liability (former article 1382).

On the contrary, there is no pre-contractual obligation imposed on a party to act in good faith and disclose information under English law (other than with respect to specific types of contracts which may require good faith as a matter of law, such as insurance contracts, as referred to above). However, the duty of disclosure may arise from circumstances which occur during the negotiations. It was held in *Davies vs London and Provincial Marine Insurance Co* [22] that, although a contracting party may keep silence even as to facts which he believes would be « *operative on the mind of the other* », if such party makes a statement which he believes to be true, but which in the course of the negotiation he discovers to be false, he is bound to correct his erroneous statement.

On the other hand, the parties are free, under the English law concept of individualism, to expressly agree that they will act in good faith. [23] If the concept of good faith is expressly agreed between the two parties, there will be no objection from the English courts to an agreement to such obligation. It is becoming increasingly common for the express duty of good faith to be included in commercial contracts contemplating future negotiations between the parties to ensure honesty in the pre-contractual negotiating phase. What this obligation imposes in practice will be affected by the commercial context of the contract. One notable aspect of a duty of good faith is the obligation to disclose all material facts. [24]

What recommendations can be made to sellers ?

Firstly, it is important to be transparent as far as all the information which the seller knows and which would be decisive for the purchaser is concerned. The seller should provide to the purchaser access to a data room containing all the information known by the seller's management in relation to the target company. [25]

In the event that the seller is aware of recent information which does not appear in the last available accounts, it would be advisable for it to communicate intermediary accounts to the purchaser.

The duty to inform being restricted to information effectively known by the seller, it does not appear necessary for it to gather information from the management of the target company, which holds exhaustive information. Sellers should be particularly vigilant when the management of the target company is involved in the transaction, especially when meetings are organized with the management to prepare management presentations or answers to questions raised by the purchaser. Such involvement necessarily broadens the scope of information known by the seller and therefore the scope of its duty to inform.

Secondly, the seller could attempt to limit in a preliminary contract (such as a process letter countersigned by the purchaser) the information that it would consider to be decisive for the consent of the purchaser, by reference to the type and materiality of the information disclosed to the purchaser. Information which does not fall in such type of

11. It should be recalled that the provisions resulting from the reform are of a supplétive nature, except for the public order provisions, of which article 1112-1 of the French Civil Code is part.
12. *M. Fabre-Magnan, Le devoir d'information dans les contrats : essai de tableau général après la réforme : JCP G 2016, 706.*
13. It is reminded that both parties have a general duty to inform. This note presents, for clarity purposes, one after the other the seller's duty to inform the purchaser and the purchaser's duty to make enquiries.
14. For instance, *CA Paris, 25e ch., sect. B, 12 oct. 2001 : Bull. Joly Sociétés, p. 95, § 19, note A. Couret.*
15. *CA Paris, 9 juill. 1987 : Bull. Joly 1987, p. 779, § 318, note L. Faugérolas.*
16. *CA Grenoble, 30 avr. 1991 : Dr sociétés 1991, comm. 433.*
17. *Cass. com., 15 juill. 1992 : Dr. Sociétés 1992, comm. 210* (with respect to a litigation).
18. *CA Versailles 13e ch., 17 juin 1987, Edey c/ Quentin et Girard, syndic : Bull. Joly 1987, n° 10, p. 779, § 318, note Faugérolas* ; the court : « *considering that, by its reluctance to disclose the exact situation of the company, M. Quentin persuaded M. Edery to enter into a transaction which he would not have contemplated under these terms had he been aware of the reality ; that, through the functions it held at the management of the company, this error is evidently intentional ; that it therefore amounts to fraud resulting in the nullity of the agreement* ».
19. *De l'obligation d'information dans les contrats, Essai d'une théorie, LGDJ 1992.*
20. *V. Th. Massart, L'obligation d'informer et le devoir de se renseigner en matière de cession de parts sociales et d'actions : Bull. Joly Sociétés 2004, n° 1, p. 113.*
21. *CA Paris, 10 janv. 2003 : RJDA, 2003/5, p. 445, n° 502.*
22. (1878) 8 ChD 469 at 475.
23. Practical Law Company : Contracts : good faith (accessed on 13 October 2016), *http://uk.practicallaw.com/w-003-1201 ?q=good+faith#null.*
24. Practical Law Company – Good faith and commercial contracts : playing fair (26 March 2015), *http://uk.practicallaw.com/2-603-0189#null.*
25. We can consider that such duty also covers key information relating to the target's business sector.

information or which are non-material would therefore be excluded from the scope of article 1112-1.

Thirdly, with respect to the requirement as to the legitimacy of the seller's lack of knowledge, the share purchase agreement could provide that the purchaser acknowledges that the information which is crucial for its consent were provided by the seller or, that the purchaser entered into the agreement considering all the representations and warranties that were made and which cover the information which is decisive for its consent.

As the nature of the parties is taken into account, the seller may also request that the purchaser confirms that it is a professional [26], or that it is appropriately assisted by advisors having the capability to inform its consent, in particular by carrying out proper due diligences of the target company. Besides, the seller could request an acknowledgment from the purchaser to that there is no « relationship of trust » between them.

These recommendations seek to objectivise the duty of information, in particular by defining the scope of the information which is key for the consent of the purchaser. The courts will decide whether or not such recommendations are compliant with the public order nature of article 1112-1.

2° The purchaser's duty to make enquiries

The provisions in force prior to the reform imposed on the purchaser a duty to make enquiries during the pre-contractual stage [27], in accordance with the principle of « *emptor debet esse curiosus* » (« the purchaser must be inquisitive »).

The determination of the scope of such a duty was made on a case by case basis [28]. The duty was in particular based on the severity of the seller's breach [29], on whether or not the purchaser is a professional [30] or on how readily available the given information was. [31]

In particular, the purchaser was required to obtain information, failing which any error on its part was considered to be inexcusable, depriving it of protection. Thus, the courts have held that the purchaser's negligence rendered the error « inexcusable », which was a ground to reject a claim for indemnification. [32]

Causes limiting or excluding the application of representations and warranties reinforced this duty of the purchaser with respect to the information referred to in the clause. The exclusion of a representation which relates to a specific liability should indeed draw the attention of the purchaser. [33]

The breach of such an obligation by the purchaser is in itself a reason to qualify its lack of knowledge as illegitimate, in particular when the purchaser is a professional, such capacity implying a positive requirement to make enquiries and excluding fraudulent non-disclosure in the event the seller breaches its duty to disclose information. [34] Other jurisdictions considered that fraudulent non-disclosure by the seller rendered the purchaser's lack of knowledge excusable, even if the later had acted in an imprudent manner. [35] Therefore, only the legitimate lack of knowledge of a purchaser which has complied with its obligation to make enquiries, or which has suffered a fraudulent non-disclosure on the part of the seller, would be admissible.

On the contrary, under English contract law, there is no positive obligation on the buyer to learn about the target company prior to acquisition. The buyer is free to act, or fail to act, without breaching any pre-contractual obligation unless such an obligation is expressly agreed.

However, English law recognises the principle of 'caveat emptor' (or 'buyer beware'), that the buyer, and the buyer alone, shall be responsible to check all information for quality and suitability purposes prior to completing a purchase or acquisition. [36]

What recommendations can be made to buyers ?

Firstly, the buyer will need to show that it acted diligently during the due diligences, by ensuring that the scope of the information actually reviewed covers that which is instrumental to their consent. It should be particularly vigilant where those audits are carried out on the basis of due diligence reports prepared by the vendor (or its advisers). When subject matters which are excluded from the scope of the reports are of crucial importance or when the materiality threshold applied by the vendor is too significant, the purchaser is responsible for covering the scope of information which was not covered by such reports.

The buyer should also take care in specifying in any reliance letter that the fact that they place reliance on the vendor's due diligence reports does not amount to an acknowledgment that the information contained therein is the only information which is decisive for its consent.

Secondly, concerning the legitimacy of its lack of knowledge, the buyer could request an agreement from the vendor in the purchase contract as to the fact that the audit carried out does not release the vendor of its legal duty to provide information. In addition, the buyer may also specify, as the case may be, the particular circumstances in which the audit was carried out (limited time, disorganization, etc.) which could support the legitimacy of its lack of knowledge.

If applicable, the buyer may state that it is not a professional in the same speciality so that the « presumption » of knowledge attached to such capacity could not be invoked against it. Depending on the circumstances, it may also establish in the purchase contract the particular relations existing between the buyer and the vendor which would help to demonstrate a relationship of trust, thus providing legitimacy to the buyer's lack of knowledge.

While practitioners will try to elaborate a framework around this legal duty to provide information, the « good faith concept » will most likely remain the guiding principle to determine if a given information falls or not within the scope of the legal duty to provide information set out in article 1112-1 of the French Civil Code.

Mots-Clés : Réforme du droit des contrats

26. With respect to transfer of securities, courts consider that agreements which exclude a guarantee against latent defects are valid if the purchaser has the same specialty as the seller. Cass. com., 8 October 1973, n° 71-14322 : « it was a sale between professionals operating in the same area of expertise and such sale without guarantee had been agreed by the professional purchaser with full awareness of the risks which it accepts to bear ».
27. *V. P. Jourdain, Le devoir de « se renseigner » : D. 1983, chron. p. 139.*
28. *V. P. Mousseron, L'obligation de renseignement dans les cessions de contrôle : JCP E 1994, 362.*
29. *Cass. com., 10 juill. 1989 : Dr. Sociétés 1989, comm. 268 ; RTD civ. 1988, p. 336, n° 2, obs. J. Mestre.* In this case, the French *Cour de cassation* considered that the fact that the purchaser did not ask for the auditor's opinion did not matter as the seller had intentionally presented false accounts.
30. *CA Paris, 16 avr. 1992 : JCP E 1992, I, 172, n° 6* (the court : « *Considering that companies ALPHA and CHARTER HOUSE had been made aware of the tense financial situation of company EDGETEK, which made their involvement necessary, but that they had been misled as to the size of its revenues, that as professionals they were not under an obligation to question the accounts provided to them and to proceed to further verifications* »).
31. *V. M. Fabre-Magnan, op. cit., p. 199, n° 257 s.*
32. *CA Versailles, 17 juin 1987 : Bull. Joly Sociétés, p. 852, § 349.*
33. *V. P. Mousseron, L'obligation de renseignement dans les cessions de contrôle : JCP E 1994, I, 362, n° 21* : « it was subject to a stronger obligation to make enquiries with respect to such liability ».
34. *Cass. 3e civ., 24 oct. 1972 : Bull. civ., III, n° 543* (the court : « *that it seems absurd that being an estate agent experienced in such business, he has agreed to commit without having made due enquiries, and that the trial judges, who consider that he was not subject to manœuvres aimed at misleading him, can consider that he was not the victim of a fraud* « .
35. *Cass. 3e civ., 21 févr. 2001 : JCP G, 2001, I, n° 330, spec. no 10 à 14, obs. A. Constantin. – Cass. soc., 1 avr. 1954 : JCP G 1957, II, 8384, note Lacoste.*
36. Definition of 'caveat emptor' (accessed 13 October 2016), *http://dictionary.law.com/Default.aspx ?selected=158.*