PACTE law liberalizes use of preferred shares to encourage financing of companies

By Luis Wolff Kono[1]

V1 – July 2019

Preferred shares of stock are a tool allowing business owners to achieve a number of business objectives, such as raising fresh capital, organizing a succession, or incentivizing employees. Preferred shares afford flexibility in defining voting, dividend and other rights more favourable to a category of preferred shareholders than to other shareholders.

Preferred shares were first authorized in France in 2004, as an exception to the traditional principle of equality among shareholders under French corporate law. Their use was however subject to many restrictions.

Article 100 of the new PACTE law[2] liberalizes the use of preferred shares, removing a number of prior restrictions on their use, with the aim of encouraging companies to use preferred shares as a tool to raise capital and achieve other objectives. The impact study for the new law[3] had noted that French companies have a strong need to reinforce their working capital to finance their development.

The new rules from PACTE law will apply only to preferred shares issued starting from the publication of the law on 23 May 2019.

I. Preferred shares as tool to achieve business objectives

Preferred shares allow business owners to open up the capital of their companies to new investors, while retaining an adequate measure of control. Preferred shares represent an alternative source of financing.

As an example, the owner of a company worth 200 000 € needs additional capital of 800 000 € to finance research and development and marketing activities. In the classic scenario of equal voting rights, the owner may hesitate to open the capital to new investors who would acquire control of the company. If the owner can create a category of preferred shares with multiple voting rights, however, she may retain control by issuing the preferred shares to herself, and obtain the additional financing from the investors, who would receive common shares.

As a variant of this example, a sophisticated investor intent on participating actively in the management of the company could become a preferred shareholder, together with the founder.

Preferred shares are also a useful tool in the transfer of a business to a successor, allowing the business owner to adjust voting and dividend rights over time according to the circumstances. For example,

---

[1] Luis Wolff Kono is a corporate and commercial attorney based in Paris, France. He is admitted in New York and New Jersey, USA. Email: luis@wolffkono.com. Internet site : http://wolffkono.com.

[2] LOI n° 2019-486 du 22 mai 2019 relative à la croissance et la transformation des entreprises (available at https://www.legifrance.gouv.fr/eli/loi/2019/5/22/2019-486/jo/texte)

[3] The impact study (in French) for the new law is available at http://www.assemblee-nationale.fr/15/pdf/projets/pl1088-ei.pdf.

©2019 Luis Wolff Kono. All rights reserved.

dividend rights can be transferred to a successor quickly, while voting rights are retained until the successor is more experienced in managing the business.

Yet another practical application of preferred shares is employee stock programs, where employees can enjoy financial benefits from owning company stock, while the business owner can retain an adequate level of control.

II. Fewer restrictions on use of preferred shares

The new law authorizes all share company types – "société anonyme" (SA), "société en commandite par actions" (SCA) and "société par actions simplifiée" (SAS) – to issue preferred shares with multiple voting rights. This authorization applies only to privately-held companies whose shares are not traded in a regulated market or multilateral exchange.

Previously only SAS companies could issue such multiple voting shares.

Under prior law, SA and SCA companies could issue double-voting shares (but not multiple voting) but a shareholder had to fully pay for the shares and be their owner of record in the company's register for two years prior to being entitled to double-voting rights. This meant that even if a shareholder received double voting rights, she could not exercise them immediately, and had to wait two years.

Under prior law, for publicly-listed SA and SCA companies, the double-voting rights were offered by default.

The increased flexibility afforded by the new law allows a business owner intent on retaining control to create a category of preferred shares with multiple voting rights for himself or herself, while issuing common shares to new investors.

Another possibility is that sophisticated investors with strong negotiation leverage and intent on having a high degree of control may demand preferred shares with multiple voting rights. The new liberalized legal framework allows for this and other possibilities sensible in each case.

III. Preferential right of subscription

The new law encourages the use of preferred shares by removing a prior administrative burden related to preferential rights of subscription ("*droit préférentiel de souscription*").

Preferential rights of subscription are rights of both common and preferred shareholders to subscribe to new shares issued by the company in a new round of financing. The existing shareholders are given an opportunity to participate in the round and subscribe to a portion of the new shares proportionate to their ownership of the company. For example, a 10% shareholder can buy 10% of the new shares, thus keeping her relative ownership level and not being "diluted" by the round.

Preferential rights of subscription are conferred by EU law, to protect shareholders against dilution of their ownership as the company grows and raises fresh capital.

©2019 Luis Wolff Kono. All rights reserved.

Although their basic rationale is commendable, preferential rights of subscription can create administrative burdens in companies' efforts to raise capital. They require the company to notify and afford each existing shareholder a right to subscribe to the new shares. Until all existing shareholders are consulted and decide, the financing round cannot proceed. This creates delay and in some cases, might even block the financing round.

The new PACTE law addresses this concern by allowing companies to issue preferred shares without preferential rights of subscription more easily. The only condition to such issuance under the new law is that the preferred shares have limited financial rights to dividends and other distributions.

Previously, such issuance of preferred shares without preferential rights of subscription was also subject to an additional condition that the preferred shares could not have voting rights upon their issuance. PACTE law eliminated this additional condition.

This change aligns French law with the minimum requirements imposed by EU law with regard to preferential rights of subscription.

The increased ability to issue preferred shares without preferential rights of subscription will allow companies to raise capital more easily.

IV. Approval procedure for particular advantages

Preferred shares are a form of particular advantage ("*avantage particulier*") conferred on certain persons, namely preferred shareholders, which is subject to a special procedure requiring approval by shareholders. This approval procedure ensures that the contemplated particular advantages are in the best interests of the company and shareholders, and do not constitute an abuse.

The procedure includes the appointment of an outside auditor ("*commissaire aux apports*") who issues a report with an evaluation of the particular advantages, which the shareholders can consider in deciding whether to approve the particular advantages.

PACTE law clarifies the scope of the approval procedure, which applies not only when the recipient of the advantages is an existing shareholder but also when the recipient is a third party such as a new investor.

V. Buy-back ("*rachat*") of preferred shares

Companies can provide for the buy-back of preferred shares by the company under certain conditions. Buy-backs provide an exit option for preferred shareholders, and thus are an important consideration in the decision to invest in a company.

PACTE law liberalizes buy-back rules in companies whose shares are not traded in a regulated market, by making it possible for issuers and preferred shareholders to agree terms for buy-backs at the initiative of preferred shareholders.

Under prior law, buy-backs could only be made at the exclusive initiative of the issuer.

©2019 Luis Wolff Kono. All rights reserved.

PACTE law creates two possible scenarios:

1. For companies whose shares are traded in a regulated market, buy-backs can be made either at the initiative of the issuer, or at the joint initiative of the issuer and preferred shareholder (whose shares are being bought back).

2. For companies whose shares are not traded in a regulated market, buy-backs can be made either at the initiative of the issuer, or at the joint initiative of the issuer and preferred shareholder (whose shares are being bought back), or at the initiative of the preferred shareholder.

This second scenario allows for the flexibility to give a preferred shareholder the right to trigger a buy-back under conditions defined in the company charter, without having to obtain the company's consent. Companies and investors now enjoy this possibility to provide for an investor-triggered buy-back.

The initial bill for PACTE did not contain this modification of buy-back rules, which was added during the legislative review, for the purpose of reinforcing shareholders' exit rights, and thus encouraging their decision to invest in the first place.[4]

For companies, this possibility of a shareholder-triggered buy back creates the uncertainty about the timing of such buy back. Under prior law, this timing could be predictable, as the company took the initiative of the buy back. It was also possible previously to provide for "automatic" buy-backs upon the satisfaction of objective conditions.

Under the new law, with shareholders being entitled to trigger buy backs, company charters will need to define the conditions under which such buy backs can occur, so these conditions will need careful consideration and negotiation up front. Companies will push for as much detail as possible in these conditions, whereas shareholders will want to retain as much discretion as possible in calling for a buy back.

Companies will need to consider possible adjustments in their liquidity needs, to ensure sufficient funds are available to pay for shareholder-triggered buy backs. Even when triggered at the shareholder's initiative, buy-backs remain subject to certain legal conditions under pre-existing law, such as that buy-backs be funded out of distributable reserves.

Another condition under pre-existing law which will need to be respected, is that the company cannot possess more than 10% of its shares (or of a category of its shares). So this 10% cap limits the amount of preferred shares that can be bought back at the same time. If the total buy-back amount is greater than this 10% limit, the buy-back will need to be split into different phases.

For investors, they now have this option to consider negotiating with companies they invest in, as a way to give them a more controllable exit scenario, in which they can unilaterally trigger a buy back.

---

[4] Rapport de la commission spéciale au Sénat, n°415, du 27 mars 2019, p.18 (available at http://www.senat.fr/rap/l18-415/l18-415.html).

©2019 Luis Wolff Kono. All rights reserved.

In some situations, this option can lower the investment risks or provide for a quicker return on investment.

For bondholders and other creditors of the company, the possibility of shareholder-triggered buy backs presents a novel scenario and risk to be considered. As a buy-back may ultimately result in a reduction in the company's capital base, bondholders and creditors may need to negotiate new terms with companies borrowing from them. They also will need to pay extra attention to public filings to detect any buy-backs they may wish to challenge in court through the opposition procedure.

©2019 Luis Wolff Kono. All rights reserved.