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How should credit reserves be taken into account in determining the state of cessation of payments of a company?

In a decision dated November 29, 2016, the Commercial Chamber of the *Cour de Cassation* (French Supreme Court) further specified the conditions for the implementation of Article L.631-1§1 of the French Commercial Code that addresses the rules according to which credit reserves or moratoria granted to a debtor company should be taken into account in the assessment of said debtor company's possible state of cessation of payments.

This decision provides the opportunity to recall applicable rules and to stress that particular attention should be paid, in particular within corporate groups, to advances made to financially distressed group entities.

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In the decision commented herein, a French real estate company challenged the commencement of judicial liquidation proceedings and relied on the fact that its available assets included a sum of 180,000 euros contributed to it by one of its shareholders during the appellate proceedings. However, the release of this contribution – that had been put into escrow – was conditioned upon the reversal of the judgment that opened the judicial liquidation proceedings.

While the Court of Appeals had refused to take into account the escrowed sum in the calculation used to establish that the French real estate company was in a state of cessation of payments, the *Cour de Cassation* reversed this finding and held that this contribution constituted "*a credit reserve that should be included in the [French] real estate company's available assets*".

Pursuant to Article L631-1§1 of the French Commercial Code, "*the debtor, who establishes that his credit reserves or moratoria granted to it by his creditors are sufficient to enable him to meet his outstanding liabilities out of his available assets, is not in a state of cessation of payments.*"

It should be recalled that judicial receivership and judicial liquidation proceedings are available to any debtor who, being unable to meet his outstanding liabilities, is in a state of cessation of payments (Articles L631-1 and L640-1 of the French Commercial Code).

More generally, this decision raises the question of how credit reserves should be taken into account in the calculation that is used to establish that a debtor company is in a state of cessation of payments, which may be a critical issue, especially for corporate groups.

It provides the opportunity to recall the conditions in which such credit reserves or cash advances can be considered part of a company's available assets (I) or, conversely, part of a company's outstanding liabilities.

1. Credit reserves are considered as available assets

Ordinance n° 2008-1345 of February 18, 2008 for the reform of insolvency and bankruptcy law enshrined the concept of "credit reserves" in Article L631-1 of the French Commercial Code which, as mentioned above, stipulates that "*the debtor, who establishes that his credit reserves or moratoria granted to him by his creditors are sufficient to enable him to meet its meet his outstanding liabilities out of his available assets, is not in a state of cessation of payments.*"

However, the French legislator did not provide any legal definition of the term "credit reserve".

As such, the Commercial Chamber of the *Cour de Cassation* has been asked on several occasions to clarify the scope of the concept of "credit reserve" as an available asset of a financially distressed company, "*asset that enables it to meet its outstanding liabilities*"[1], such as additional financial aids granted by financial institutions, sums loaned by shareholders and/or corporate officers of the company, but also supplier's credits from their financial partners[2].

Concerning the conditions in which such sums may be considered as available assets, the Commercial Chamber of the *Cour de Cassation* first held in 2009 that "*the company's financial debts to the other companies of the group are part of such liabilities, even if […] the repayment of such debts has not been*

requested"[3]. In 2010, it ruled that "*a current account advance that is not frozen, or whose repayment has not been requested, constitutes an available asset*" and finally further clarified things in a decision dated November 16, 2010[4] in which, relying on the provisions set forth in Article L631-1 of the French Commercial Code, it ruled that a "*cash advance that is not frozen, or whose repayment has not been requested, constitutes an available asset*".

This November 2010 decision thus helped define the place that should be given to credit reserves in the available assets of a financially distressed company.

However, it should be specified that these advances or reserves can conversely, in certain circumstances, be considered as outstanding liabilities of the relevant debtor company.

2. Any "abnormal" financial support is to be considered as outstanding liabilities

The recognition of credit reserves as available assets is conditional on the purpose of the advanced sums, wherever such sums have the effect of disguising the debtor company's state of cessation of payment.

Indeed, the *Cour de Cassation* ruled in 2011 that sums paid in shareholders' current accounts were to be included as outstanding liabilities insofar as the continuation of the company' business activity "*was only possible through a cash position artificially maintained by the current account advances made by its parent company, such advances having merely delayed the acknowledgement of the state of cessation of payment*", and specified that the granted credit "*was indisputably artificial in nature and resulted from abnormal circumstances*"[5].

In that specific case, it is the artificial nature of the company's cash position and the abnormal circumstances in which sums were paid that led the *Cour de Cassation* to refuse including credit reserves into available assets.

As a result of this landmark decision, not only can the debtor company be found to be in state of cessation of payments but the judge may also, as permitted under French law[6], predate the date of cessation of payments and fix it on the date on which advances were paid (within a maximum of 18 months)[7]. Such a decision is not without consequences for the company, its corporate officers and its shareholders whose actions between that date and the commencement of the insolvency/bankruptcy proceedings (referred to as the "suspect" period) could, in certain circumstances, be challenged or trigger their liability.

As such, specific attention must be paid – in particular within corporate groups – to the circumstances in which advances are granted to finally distressed companies or companies that are structurally loss-making.

[1] Commercial Chamber of the *Cour de Cassation*, July 6, 2010, n°09-14937; Commercial Chamber of the *Cour de Cassation*, February 15, 2011, n°10-13625

[2] La Semaine Juridique *Entreprise et Affaires n° 6, February 9, 2012, 1102, Frédéric Arbellot*

[3] Commercial Chamber of the *Cour de Cassation*, March 24, 2009; n°08-12212

[4] Commercial Chamber of the *Cour de Cassation*, November 16, 2010; n°09-71.278

[5] Commercial Chamber of the *Cour de Cassation*, May 17, 2011; n°10-30.425

[6] Article L631-8 of the French Commercial Code

[7] Commercial Chamber of the *Cour de Cassation*, June 13, 1989, n°87-20204