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Private equity in France: Preferred structures and protection mechanisms available to investors

In the unprecedented context of the health crisis created by the COVID-19 pandemic, private equity transactions slowed down sharply. Many funds have opted for a strategy aimed at focusing on their existing investment portfolio and supporting their investments to meet increased cash flow requirements.

This crisis also provides an opportunity to take a look back at a particularly dynamic year in 2019 for the French private equity investment market and to identify trends, both in terms of the investment methods hitherto favored by investors (1) and in terms of the protection afforded to investors (2).

1. Preferred structures for investment in private equity deals

Private equity funds usually invest in deals by way of subscribing for ordinary shares (*actions ordinaires*) and/or preferred shares (*actions de préférence*). Preferred shares, which can grant their owners specific rights (such as multiple voting rights, prior access to information, priority dividend rights, etc.), are widely used in practice. However, the issuance of preferred shares can prove (i) costly as an independent statutory auditor will have to be appointed, and (ii) complex insofar as special meetings of preferred shares' holders shall be convened to approve any modifications related to the rights conferred by preferred shares.

It is also very common for private equity investors to subscribe for hybrid securities of the target company in addition to subscribing for ordinary and/or preferred shares. Hybrid securities have developed considerably over the last years in France. They are particularly suited to investments made in tranches. Indeed, the use of hybrid securities allows the immediate payment of a first investment tranche while scheduling the payment of the next tranche. The investment often takes the form of the issue of share subscription warrants (*bons de* *souscription d'actions* or "BSAs") consisting in a warrant of the target company allowing the investor to subscribe for a certain number of company shares at a specified price by conversion of its BSA during the next round.

Investments in hybrid securities often also take the form of subscriptions for convertible bonds (*obligations convertibles* or "OCs") or bonds redeemable in shares (*obligations remboursables en actions* or "ORAs"). The use of convertible bonds or bonds redeemable in shares allows the target company to have funds available right away without immediately diluting the other shareholders. For the investor, the bonds allow a yield negotiated in advance thanks to the application of an interest rate. In addition, with OCs, the investor has a choice as to repayment: repayment in cash or repayment through the allocation of shares.

2. Protections generally available to investors

Private equity investors usually rely on the protection granted by the articles of association of the target company and the transactional documents, including inter alia the share transfer agreement and the shareholders' agreement. The articles of association and the transactional documents usually provide for various protection mechanisms, notably in relation to:

- the governance of the target company,
- the transfer of shares (including without limitation preemptive rights, prior approval, tag-along and drag-along provisions, "bad-leaver" provisions, etc.),
- the principle of non-dilution (ratchet mechanism),
- non-competition and non-solicitation provisions.

Aside from the above clauses, private equity investors are also granted representations and warranties (*garantie d'actif et de passif*) in connection with the shares being sold, pursuant to which they shall be indemnified by the seller in the event of breaches of the seller's representations, warranties and covenants. Specific indemnities are usually included for employment, taxes and customs, environmental issues, etc.

To secure its indemnification obligations under the representations and warranties agreement, the seller is usually required to provide a guarantee. The most efficient guarantee is a first demand guarantee provided by a bank as it is independent from the representations and warranties agreement. This guarantee can also be in the form of a joint and several guarantee provided by the seller or a bank. Apart from these guarantees, an alternative solution usually consists in placing a portion of the sale price in an escrow account.

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Although a rebound cannot be ruled out in the coming months, French funds will certainly continue to be cautious. It is likely that they will have to carefully review their investment methods and the protective measures available to them. This will also translate into greater attention being paid by funds to the negotiation of force majeure, hardship and material adverse change clauses in order to enhance the legal certainty of their investments.

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