Read this post online

Reform of the French Law Governing Security Interests: Order dated March 23, 2006

At the behest of the President and Minister of Justice, a working group was created in July 2003 in order to prepare a reform of the French law governing security interests.

Applicable general provisions governing French security interests were mainly found in the French Civil Code of 1804 and in a multitude of specific texts and special legal regimes applicable to certain categories of property or to specific situations. As a consequence security interest-related case law was fluctuant and uncertain.

In order to develop credit while offering a better security to lending creditors, it was urgent to reform French Security Law.

Pursuant to Article 24 of the Law dated July 26, 2005 known as the Law for Confidence in and Modernization of the Economy, the government decided to reform French law governing security interests through the adoption of a governmental order. It is however regrettable that the restrictions set forth by the aforementioned law did not allow the reformers to proceed with a complete overhaul. As such, sureties, pledges over financial instruments and the use of ownership interest in a trust as collateral were not addressed by the reform.

However, even though incomplete, this reform remains quite important.

From a formal point of view, the most important change is the creation of a new **Book Four of the French Civil Code** entitled "Security Interests", logically divided into two main sections concerning "Personal Sureties" and "Assets-Based Sureties".

I Personal Sureties

Even if the main changes brought forward by the Order dated March 23, 2006 principally concern assets-based sureties (II), some provisions deeply affect personal sureties.

1) Surety: the provisions governing sureties have been included in Articles 2288 to 2320 of the French Civil Code (said provisions used to be contained in Articles 2011 to 2043 of the same Code), without however being

amended.

Just like prior to the reform, the provisions governing sureties remain scattered between the French Civil Code and the French Consumer Code. Nevertheless, the inclusion of certain provisions in Book Four of the French Civil Code can let us suppose that further steps will be taken in the future to clarify and harmonize surety law.

2) Independent Guarantee and Letter of Intent: These two types of security by personal title, largely used by practitioners, were not governed by law and the parties were free to negotiate and agree to the terms and conditions of said documents. Now, they are codified in the French Civil Code (Articles 2321 to 2322). Although said codification did not bring forth any fundamental modification, it did result in the clarification and definition of their scope.

It is advisable to note that the independent guarantee, now governed by the French Civil Code, may not be issued as a guarantee for consumer credit (Article L. 313-10-1 of the French Consumer Code).

Moreover, the new Article 22-1-1, inserted in the Law dated July 6, 1989 to improve relationships between landlords and tenants, sets forth that the independent guarantee may only be used in place of the security deposit provided for in the lease, within the limits of two months of rent.

Concerning the letter of intent, the new Article 2322 contents itself with defining it as « *… the obligation to act or not act with the purpose of supporting the debtor in the performance of his obligation…* », without specifying whether or not the obligation of the guarantor constitutes an *obligation de moyen* (the obligation to implement or use, to one's best efforts, all necessary means in order to fulfill the obligation or achieve the result) or an *obligation de résultats* (the obligation to fulfill a specific obligation or to arrive at a specific result).

II Assets-Based Sureties

1. Movable assets-based sureties: the rules applicable to movable assets-based sureties have been completely redrafted and contain innovative solutions.

It must be noted here that French law distinguishes between two types of pledges: the "*gage*" which is a pledge on tangible movable property only and the "*nantissement*" which is a pledge on intangible movable property.

1.1 The gage (Articles 2333 to 2354 of the French Civil Code)

As explained above, the "*gage*" is a pledge on tangible movable property only.

- French Law establishes the principle of pledges without dispossession of the debtor: The principle of a pledge with dispossession, which constitutes a block in the development of credit notably by depriving the debtor from operating the pledged item, by limiting the debtor's capacity to obtain further credit on

the same assets and by excluding any other possible guarantees on future goods, remain however applicable.

- *The pledge's base is enlarged* as pledges may now be granted over future movables.
- *Enforcement procedures as well as the methods for enforcing the pledge are greatly simplified*. As such,

(i) The pledge without dispossession is enforceable against third parties by publication in a special registry, the terms and conditions of which shall be regulated by a soon-to-be published decree. The order of registration on the pledged item, therefore, will determine which creditor(s) have priority.

(ii) The *pacte commissaire(*)* is no longer prohibited: during the creation of the pledge, the parties to the contract may agree that in the event of the debtor's default, the pledgor shall become the owner of the good without going through a legal procedure.

(*) The "pacte commissoire" is an agreement entered into at the same time as the principal obligation (generally a loan), which provides that in the event of non performance of the obligations by the debtor who pledged a movable property or an instrument, the creditor shall automatically and without recourse to a court of law, become the owner of said pledged property or instrument.

The use of the *pacte commissaire* is still prohibited in consumer credits. Moreover, initiating bankruptcy proceedings to attempt to preserve a company will thwart the *pacte commissaire.*

1.2. The Nantissement (Articles 2355 to 2366 of the French Civil Code)

As explained above, under French law, the "*nantissement*" is a pledge on intangible movable property only.

Among the various existing intangible movable assets, the Order dated March 23, 2006 addresses only the pledge over receivables.

Assignments of receivables as guarantees governed by the *Loi Dailly* (*) did not become widespread (which is regrettable). Additionally, the French Civil Code does not address the pledge over currencies or financial instruments. The pledge over financial instruments remains governed by Article L. 431-4 of the French Monetary and Financial Code.

(*) The Law 81-1 dated January 2, 1981, called the *Loi Dailly* (French Monetary and Financial Code, Article L. 313-23 et seq.), instituted a special and simplified mechanism for the assignment of professional receivables for the sole benefit of banks. The assignment takes place by simply providing the bank a statement listing the receivables to be assigned. Once the bank stamps a date on said statement, the assignment becomes enforceable against third parties. The bank notifies the debtor of said assignment, and the debtor then pays to the bank the payments owed on the assigned receivables on the due dates.

The formalities to be performed in connection with a pledge have been *simplified* as now it is sufficient to sign

a private document and there is no need to register the same.

Moreover, the enforceability against third parties becomes effective on the signature date appearing on the pledge documentation. A simple notification (rather than service by a court bailiff) is enough to render the pledge *enforceable against the debtor* (the form of the notification is not detailed, but it is specified that it is advisable to send said notification by registered mail). Finally, it is now possible to pledge future receivables.

2. Immovable assets-based sureties

2.1 *The Mortgage* (*Articles 2413 to 2488 of the French Civil Code*)

The government is keen on modernizing this type of security interest, notably to develop the mortgage credit. As such, the principal innovations are as follows:

- Unless the building constitutes the principal place of residence of the debtor, the mortgage creditor may now enforce the mortgage *by requesting the court to order that the building reverts to him as payment.* This attribution by the court is automatic as the judge does not rule on the merits of the request. The assessment of the building's value is done by an expert, either agreed upon by the parties or designated by the court.
- *The mortgage's base now includes improvements* made to the building.
- The mortgage may guarantee a *future detereminable credit.*
- The mortgage is *automatically transferred* in the event the mortgaged immovable is assigned.
- The introduction of the refillable mortgage (Article 2422 of the French Civil Code) which allows the use of the same mortgage to guarantee successive credits, within the limit of a maximum fixed amount and with less strict publicity requirements.

2.2 The creation of the *prêt viager hypothècaire* permits the owner of real estate property to borrow money without selling said property. The lender will be reimbursed after the death of the borrower, with the proceeds derived from the mortgaged property.

This new provision also permits consumer credit institutions to capture, in complete security, an aging clientele who owns immovable assets.

For more information, please visit us at www.soulier-avocats.com.

This material has been prepared for informational purposes only and is not intended to be, and should not be construed as, legal advice. The addressee is solely liable for any use of the information contained herein.