Luxembourg case law on subordination provisions

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The Court of Appeal of Luxembourg issued a decision whereby it clearly upholds the validity of subordination clauses.

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1. Subordination under Luxembourg law

Subordination provisions originate in the Anglo-Saxon banking practice. Although in Luxembourg no specific legislation governs subordination provisions[1] and legal literature rarely refers to relevant cases, most legal practitioners advising on structured finance operations are familiar with the subordination mechanism.

Subordination provisions between creditors are commonly used in acquisition structures. Buyouts are leveraged by bank financing including senior and junior debt, which are generally contractually subordinated in an intercreditor agreement.

The Luxembourg corporate entities involved in these buyout structures[2] as borrowers or subordinated lenders shall enter into such intercreditor agreement together with the senior lenders.

The intercreditor agreement regulates the respective rights (receipt of payments, enforcement of security, etc.) and ranking of two or more funders in a financing. The subordinated funders entering the agreement (whether they are or not the debtor's shareholders) agree to defer payment of all or some of their claims until the more senior lenders are paid in full.

This type of subordination can be referred to as «specific subordination». The subordination agreement or intercreditor agreement is executed by all interested parties (the debtor, the senior creditors, the mezzanine creditors and the other junior creditors) and the debtor must comply with the order of repayment.

The other type of subordination is designated as «general subordination», whereby a creditor who ranks *pari passu* with other creditors agrees with one of its debtors to be placed in a lower priority for the collection of its debt. Such subordinated creditor agrees that it will have no right to receive or retain payment from the debtor until after all the other creditors have been paid in full, it being understood that such senior creditors are not parties to the subordination agreement.

General subordination clauses are frequent in intercompany loans or hybrid instruments, bond issues and securitization debt instruments.

In a «general subordination» situation, the subordinated creditor may in principle obtain the repayment of its loan when it is due and payable and the subordination mechanism shall only take effect when there is a competitive situation (*concours*) between the debtor's creditors, especially in the case of insolvency and bankruptcy proceedings.

In the absence of legal provisions and case law with that respect, legal authors[3] agree that subordination provisions should be valid in accordance with the

1. Even if Articles 63 (1) and 64 (1) of the Securitization Law dated 22 March 2004 authorize securitization vehicles to issue securities and debt instruments with subordination provisions.
2. Mainly as holding company, acquisition company or finance company.
3. S. Jacoby and M. Melhen, «Les clauses de subordination et de recours limité en droit luxembourgeois», in *Droit bancaire et Financier au Luxembourg*, Recueil de doctrine, Larcier, 2004, p. 915-938; F. Debroise, «Les accords sur le rang: hiérarchiser pour mieux partager», in *Droit bancaire et Financier au Luxembourg*, Recueil de doctrine Vol. 3, Anthemis – Larcier, 2014, p. 1349-1391.

concept of freedom of contract (*liberté contractuelle*).

The main reservation raised with respect to the validity of subordination provisions consists in the fact that they may violate the mandatory *pari passu* distribution principle (*principe d'égalité de traitement des créanciers*) provided by Article 2093 of the *Code Civil* (creditors who have no privilege provided by law must be regarded equally) and another principle that states that there are not any privileges or preferential rights without any formal legal provisions (*pas de privilège sans texte*).

The aim of the *pari passu* principle (*principe d'égalité de traitement des créanciers*) is to protect all the creditors and to avoid having the debtor's assets distributed unfairly and thus creating unfair disparities among creditors.

However, in case a creditor agrees to subordinate all its claims and rights against a borrower until another lender is paid in full, in other words, in case a creditor agrees to waive the benefit of its *pari passu* ranking, it shall not infringe such *pari passu* principle.

As a result, some creditors will become «senior» to the subordinated creditor but general unsecured creditors will still share the insolvent debtor's assets *pro rata* and will not be harmed or otherwise adversely affected by the subordination agreement.

2. Facts

A Luxembourg company («**LuxCo**») granted two loans (the «**Credit Agreements**») on 19 April 2001 (EUR 6.197.338) and on 30 August 2001 (EUR 2.478.935) to a Belgian company («**BelCo**»).

Taking into consideration the financial difficulties of its debtor, LuxCo agreed to postpone the payment of outstanding interest of the Credit Agreements as of 2004.

Despite the fact that BelCo was financially recovering further to disposing of some assets, it was still defaulting under the Credit Agreements.

After several formal notices, LuxCo had to terminate the Credit Agreements in July 2007 granting, however, a 6 months' notice of termination in accordance with the Credit Agreements to BelCo.

On 18 January 2008, BelCo should have reimbursed the principal amount of EUR 8.676.273 owed to LuxCo together with EUR 122.841 of accrued interest.

BelCo objected to the Luxembourg lender that the Credit Agreements were subordinated and could not be repaid before all other existing loans granted by banks or credit institutions were settled.

Pursuant to a judgment dated 5 June 2009, the Court of First Instance (*Tribunal d'Arrondissement*) declared the lender's claim well founded and the respondent was ordered to pay the principal and interest on the Credit Agreements.

3. Court of Appeal decision

The borrower appealed against the decision on 9 July 2009 and criticized the Court for not having taken into consideration the subordinated characteristic of the Credit Agreements.

3.1. Preliminary remark: translation of the documents

The Court stated that documents handed into the debates must be translated into the languages provided by Article 3 of the law dated 24 February 1984 on the language regime (Luxembourgish, French or German).

In this case, a lot of contracts and documents submitted to the Court were in Flemish/Dutch, hence they were not taken into consideration and the judges were not in a position to rule on the issues raised by such documents.

3.2. Due to the existence of a bank debt, the Credit Agreements would not be payable

The appellant argued that the lender did not have the right to terminate the Credit Agreements so its claim was not admissible and unfounded.

The termination of the Credit Agreements shall be considered as null and void, the due date of the Credit Agreements shall be postponed (at least the loan dated 30 August 2001 with a 10 year repayment term) as long as a bank debt is outstanding.

The Credit Agreements provide that «*the present debt ranks immediately after all the other debts of the borrower existing as of the date hereof and in the future and due to the banks and other financial institutions. As a result, until the repayment date, the outstanding amount under this agreement may be considered by the banks and other financial institutions as due and payable to the lender only in case the bank debt has been paid off in full or the banks have been in a position to enforce their rights».*

It cannot be disputed that the Credit Agreements are subordinated debts.

A subordination clause can be defined as an agree-

ment by which a creditor, called «*hypographaire*» creditor, agrees to be repaid only after the repayment of one or several debts due by the same borrower to one or several other creditors.

The Court of Appeal held that subordination clauses, as other contractual provisions, shall meet the usual conditions of the validity of the contract[4] and it recognized that they cannot contravene the *pari passu* principle (*règle d'égalité des créanciers*) simply because the legal prohibition has not been infringed. Therefore, the debtor shall comply with the order of priority for the repayment agreement with the creditors.

The judges also stated that the parties may agree that a default under such subordination clause could lead to the acceleration of the loan maturity. The creditor could take actions against its debtor to obtain the repayment of its debt.

3.3. Existence of a previous bank debt

The Court held that the appellant supported wrongly that the loans granted by LuxCo were even subordinated to subsequent bank loans granted to BelCo after the termination of the Credit Agreements.

The judges ruled that entering into a bank loan agreement after the termination of the Credit Agreements was not likely to make such agreements unenforceable.

They stated that subordination only concerns bank loans granted before the termination of the Credit Agreements, otherwise, (i) the subordination clause could be considered nul and void because it is purely discretionary (*condition potestative*), the debtor could enter into any kind of loan agreement with any kind of financial institution regardless the terms and conditions of the loan and this would be sufficient to suspend the enforcement of the Credit Agreements, and (ii) the clause could be considered as a perpetual undertaking prohibited by law.

The Court pointed out that the Credit Agreements do not indicate as of which date the debts to which they are subordinated shall exist.

However, it is obvious that the bankloan agreements that are entered into after the termination of the Credit Agreements shall not trigger the consequence that such termination is to be considered as null and void.

It is worth noting that the items submitted into evidence by BelCo, especially the bank documents, were drafted in Dutch language and in the absence of translation the Court stressed several times that it was not able to analyze them in details.

In addition, the appellant offered into evidence several documents to prove the existence of a bank debt before the termination of the Credit Agreements but the Court maintained that those documents were not relevant enough to establish a valid bank loan at that time.

Finally, the Court has held that the bank loan with KBC dated 2 February 2008, which was the only one recorded in the annual accounts of BelCo, had been granted after the 6 months' notice and the termination of the Credit Agreements.

As a result, the judges did not see evidence that BelCo had a commitment to a bank, either to KBC or to any other financial institution, upon termination of the Credit Agreements.

3.4. Validity of the early termination of a fixed-term credit agreement

In order to counter the repayment claim, BelCo also alleged that the termination of the credit agreement dated 30 August 2001 was not valid.

The appellant requested that the credit agreement dated 30 August 2001 be considered as a 10 year fixed-term credit agreement so that an early termination would not be possible.

According to the Court the parties may of course include a fixed-term provision in the agreement but exceptions from the rule shall be permitted. The appellant's interpretation would lead to a denial of any possibility of an early termination. Such interpretation is not in line with the will of the parties as they clearly expressed their intentions to allow an early termination in the Credit Agreements. In addition, the possibility of an early termination is not legally inconsistent with the fixed-term provision.

The Court also found it surprising that the appellant had waited until 2010 to dispute the termination of the Credit Agreements, which occurred in 2007.

The judges also noted that the credit agreement dated 30 August 2001 had become due and payable since 30 August 2011, therefore, in any case, the date had expired and repayment was due.

Finally, the Court concluded that BelCo did not provide the evidence of a bank debt on 17 July 2007, which was the date of termination of the Credit Agreements and, as a result, it could not invoke the subor-

4. Article 1108 of the *Code Civil*.

dination clause for bankloan agreements entered into after the termination of the Credit Agreements.

The judges found that the Court of First Instance was fully entitled to hold that the Credit Agreements shall be considered as subordinated and that LuxCo had validly terminated them.

3.5. Other questions ruled on by the Court

The Court also denied the appellant's motion for dismissal, alleging that LuxCo had made a new request for enforcement of the Credit Agreements, which was not originally included in the writ of summons.

For the Court, the request has the same object and shall be considered as an additional argument.

The judges also rejected the appellant's challenge with respect to the accrued interest. The appellant finally declared having paid it off in its entirety.

4. Comment

In the case at hand, the Court ruled that the subordination provisions of the Credit Agreements were not efficient, notably because the appellant was not able to provide evidence of a bank debt existing at the time the subordinated Credit Agreements were terminated.

However, the recognition of the validity of subordination provisions by the Court of Appeal will certainly be of considerable importance for the practitioners.

Legal literature usually suggests that subordination provisions shall be considered as valid under Luxembourg law but in the absence of specific legislation in that respect, such judicial confirmation is invaluable to the financial center.

The subordination clause included in the Credit Agreements refers to a «general subordination» even though LuxCo, as a creditor, is not subordinated to all present and future creditors but subordination is limited only to banks and financial institutions as creditors.

The subordination provision is also to be considered as a «partial subordination» because payment of interest was definitely permitted under the Credit Agreements (in «complete subordination» clauses the subordinated creditor is not authorized to receive any payment until the superior debt is paid in full).

As to legal proceedings, the claimant here is not a senior creditor (bringing an action against its debtor or a subordinated creditor) who challenges, for instance, the validity of an early repayment of the subordinated loan in breach of the subordination clause. Instead, in our case, the debtor is the one to challenge the judgment ordering him to repay the subordinated loans and the subordination provision is used by the debtor as a legal argument to prevent the repayment which, according to him, should have been postponed.

However, it is the rights of the subordinated creditor which have been preserved in the reference decision.

The subordination clause provides that the Credit Agreement ranks after «*all the other debts of the borrower existing as of the date hereof and in the future and due to the banks and other financial institutions*». In addition, until the repayment date of the Credit Agreements, the latter are to be considered as «*due and payable to the lender only in case the bank debt has been paid off in full or the banks have been in a position to enforce their rights*».

The Court ruled that even if the Credit Agreements do not provide information on the date from which the debts to which they are subordinated shall exist, bank loans entered into after the termination of the Credit Agreements should not prohibit the further enforcement of the Credit Agreements.

The rationale for this rule arises from the prohibition of perpetual undertaking[5] and, most of all, from the fact that the subordination mechanism could be considered as null and void because purely discretionary (*condition potestative*), i.e. when the existence of the obligation/undertaking only depends on the sole will of the debtor.

The conditional obligation is valid when it depends upon the will of the debtor and the will of a third party or the occurrence of any event (*condition mixte*)[6].

In our case, the existence of a bank debt would necessarily involve a third party i.e. the bank which would have to enter into a loan agreement.

However, the Court did not consider that the intervention of the bank would alter the discretionary nature of the obligation of the debtor.

Indeed, the Court held that the debtor could enter into any kind of credit agreement with any kind of financial institution regardless of the conditions of the agreement and this would be sufficient to suspend the enforcement of the Credit Agreements.

5. See D. Boone, «*La durée maximale des contrats en droit privé face à l'évolution du droit des obligations*», in Bull. Cercle F. Laurent, 2000, IV, p. 60 and following.

6. O. Poelmans, *Droit des obligations au Luxembourg, Principes généraux et examen de jurisprudence, Les dossiers du Journal des tribunaux Luxembourg* n° 2, Bruxelles, Larcier, 2013, p. 390.

In other words, by obtaining any kind of credit from any financial institutions on a regular basis (which actually could be the case in the ordinary course of business) BelCo could theoretically escape the repayment on a perpetual basis.

The fact that BelCo submitted into evidence a lot of bank documents which were, most of the time, not relevant or not even comprehensible to the Court, probably heightened the perception that the debtor wanted to avoid repayment by any means.

Therefore, the limits to the possibility for the debtor to postpone the repayment of the subordinated credit agreement are (i) the valid termination of such agreement (in our case the Court held that it had been validly done on 17 July 2007) or (ii) the repayment date of the subordinated agreement as provided in the agreement (in our case 30 August 2011, finally the Court held that, in any case, the date had expired and repayment was due).

Another argument of the appellant to dispute the repayment obligation is that the 10 year fixed-term credit agreement would not allow an early termination.

This statement seems quite weak as the Court emphasized that it was not in accordance with the provisions of the Credit Agreements and the clearly expressed will of the parties.

The major interest of this decision remains the express recognition of the validity of subordination provisions.

The Court gives a definition of the subordination clause[7] making reference to the absence of specific legal provisions and the Anglo-Saxon origin of the banking practice. It confirms that, like any other contractual provisions, the subordination clause shall meet the usual conditions of the validity of contracts[8] which are the consent among parties, the capacity to enter into the agreement, a subject matter that exists and is the object of the undertaking and a lawful purpose of obligation.

The Court confirmed that it is agreed that a subordination clause shall not contravene the *pari passu* principle (*règle d'égalité des créanciers*) simply because the legal prohibition has not been infringed.

It follows logically that the judges state that the debtor shall comply with the order of priority for the repayment agreement with the creditors.

Even if a Luxembourg court had already recognized a group of subordinated creditors[9] by this decision the validity of subordination is now clearly established by the Court of Appeal.

This case law is in line with legal literature and it will definitely help improve the legal certainty with respect to creditors' rights.

7. «*An agreement by which a creditor, called «hypographaire» creditor, agrees to be repaid only after the repayment of one or several debts due by the same borrower to one or several other creditors*».
8. Article 1108 of the *Code Civil*.
9. *Tribunal d'Arrondissement Luxembourg*, 15 May 1998, n° 338/98.