Luxembourg – Efficiency of financial collateral arrangements in case of insolvency in Luxembourg and abroad

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Luxembourg has developed a strong practice in structuring cross-border transactions through a wide range of investment structures. One of the most important vehicles is the company called "SOPARFI" which has been extensively used by the fund industry and PE firms for LBO structures to set up holding companies, acquisition companies and group finance companies. The resilience of these holding structures has been assessed now by a few years of hard refinancing and restructuring activity. Due to our secure legal framework, especially our law relating to financial collateral arrangements dated August 5, 2005 as amended on May 20, 2011 (the "Collateral Law") it is possible to state that these holding structures have easily passed the stress test. We may even say that our Collateral Law is now considered as the most efficient legal framework in the EU. This is due to the fact that it perfectly reflects the main goal of the Collateral Directive that consists in facilitating, accelerating and ensuring the enforcement procedure of collateral arrangements to help preserve financial stability. With respect to enforcement of security interests, Luxembourg will remain a strategic jurisdiction for the finance parties as the pledge over the shares of the holding company may give access to the control of the whole group.

The collateral law has solved remaining issues

One of the main issues that the Collateral Law has solved is related to the express recognition of the security trustee.

Pursuant to the provisions of Civil Law countries, it is generally assumed that the pledgee should be creditor of the secured obligations. This is not the case when a non-lending agent holds security interests for all the lenders. In the past, this issue was generally solved by creating a parallel debt in the pledge agreement, whereby the pledgor acknowledges a debt to the agent. Now, the Collateral Law expressly provides that a pledge can be granted to a fiduciary agent or a trustee on behalf of the creditors. Therefore, the creation of a parallel debt is no longer necessary.

In addition, contrarily to the past, the Collateral Law regulates the relationship between first ranking pledgees and more junior ranking pledgees.

The enforcement methods

Upon the occurrence of an event of default or an enforcement event, a pledge may be enforced without prior notice.

The Collateral Law's main strength relies on the broad range of enforcement procedures it offers to the pledgee. The two most efficient enforcement options it provides for are the appropriation and the private sale.

The appropriation of the pledged assets, in terms of timing, should be considered as one of the most appropriate enforcement procedures as it is an out-of-court appropriation.

Generally, when the security agent does not wish to become the owner of the pledged assets, the pledge agreement can provide that it shall be authorised to assign the right of appropriation to a third party appointed by it.

The Collateral Law provides that the appropriation shall be carried out at a price determined through a valuation process agreed between the parties. Therefore, the key and essential aspect consists in the freedom of contracting the valuation method. As long as the valuation method agreed between the parties is properly applied, it will be difficult to challenge the price of appropriation, except in case of fraud.

Appropriation clauses usually provide that (i) the shares shall be valued by an independent external auditor appointed by the pledgee; and that (ii) the shares shall be valued in accordance with standard practice evaluation rules based on the net assets of the company reflected in the most recent annual accounts and, if required, as adjusted in order to reflect the fair market value of these net assets.

Borrowers usually deem valuation an issue as they fear that the shares of their holding company might be underestimated. A solution to this potential problem could consist in ordering an independent valuation before an event of default occurs in order

to preserve their chances to challenge the price of appropriation afterwards. Nevertheless, when the shares are evaluated by the pledgee after an event of default, the expert will take the latter into consideration for the valuation, and, in practical terms, apply a discount on the value of the shares because of the default in any case.

Finally, in practice, this is the worst downside to the valuation operation from the borrower's perspective; the discount rate is determined by the expert and may vary depending on the expert's appreciation.

As mentioned above, the private sale of the pledged assets to a third party is also an efficient enforcement procedure and can be considered adequate in terms of timing.

The Collateral Law provides that the sale shall be carried out under "normal commercial conditions" (*conditions commerciales normales*). However, as it does not provide any interpretation keys with respect to what should be considered as a sale under "normal commercial conditions", pledge agreements sometimes provide for other English wordings such as "at arm's-length terms" or "at commercially reasonable terms".

The "normal commercial conditions" shall normally and solely apply to the determination of the price and the principle is to be reasonable without necessarily trying to obtain the best price for the pledged assets.

The enforcement procedures commonly used prior the implementation of the Collateral Directive, and which are still in force, are the public auction and the appropriation by a court order.

Compared to the appropriation and the private sale, the public auction is potentially more time consuming and it cannot be excluded that a third party, different from the pledgee, may win the auction and become the owner of the collateral.

As for appropriation by a court order, it is the most time consuming procedure and it is not commonly used.

Finally, it is worthwhile to mention that pledge agreements usually provide for the voting rights of the pledged shares to be transferred to the pledgee upon the occurrence of an event of default or an enforcement event. By exercising the voting rights of the pledged shares, instead of recurring to the enforcement, the pledgee can also take decisions in relation to the management of the company and control it.

Bankruptcy remoteness

Another main strength of the Collateral Law relies on the immunity that it grants to the enforcement of pledges against insolvency procedures.

In accordance with article 20 (4) of the Collateral Law, Luxembourg and foreign law provisions relating to reorganisation and liquidation procedures, attachments and situations of competition between creditors (or other similar measures) are not applicable to and do not affect the enforcement of pledge agreements.

According to the Collateral Law, the pledge and its enforcement are valid and enforceable at anytime against any third party, including receivers, liquidators, supervisors or other similar entities. The protection against insolvency procedures covers all types of situations such as composition with creditors or reorganisations affecting the pledgor. The pledge agreement shall not be challenged on the basis of voidability grounds in case it has been entered into during the preference or "claw back" period (*période suspecte*).

This protection is extended regardless the nationality or location of the pledgor and the Collateral Law sets aside any revocable action opened to a creditor in Luxembourg or in foreign jurisdictions.

Below is an analysis of all the potential situations covered by the Collateral Law:

Firstly, it covers a double Luxco structure, i.e. a Luxembourg company that has pledged its shares in another Luxembourg company. The pledgor is therefore a Luxembourg entity and the pledge agreement is governed by the Collateral Law which gives a full protection against Luxembourg insolvency rules.

Secondly, it covers a well known situation whereby the pledgor is a Luxembourg company but the pledge agreement is over the shares of a foreign law entity, and is consequently governed by foreign law. In this case, the insolvency proceedings of the pledgor will be governed by Luxembourg law but the enforcement of the foreign law pledge shall not be affected by the insolvent situation in Luxembourg.

Finally, the last possible situation it covers consists in a pledge agreement governed by Luxembourg law whereby the pledgor is a foreign entity and the insolvency proceedings affecting it are located abroad.

Restructuring

After having stressed the efficiency of the Collateral Law, we can conclude that the enforcement of security interests may be conveniently used to implement restructuring strategies.

The Luxembourg insolvency legal framework does not entail modern and efficient reorganisation procedures such as the "pre-pack administration".

In distressed situations, certain transactions that sponsors and lenders may envisage are not allowed because of the preference period (*période suspecte*) and the prohibition to give priority to certain creditors. Furthermore, the restructuring strategy and the possible transfer of the target group under a

brand new holding company could be jeopardised by the bankruptcy or liquidation of the initial holding structure. As a result, the enforcement of the Luxembourg share pledge shall be considered as a safe alternative to prevent the operations to be challenged.

The debt restructuring through the enforcement of the pledge may be done with or without the agreement of the initial borrowers.

In addition, the transfer of the group to a new structure may be done to a company controlled by the lenders, by the existing re-investing sponsors or by new investors. The transfer of the operating company under a new holding structure and the cleanup of the initial structure shall always be done taking into account the potential directors' liability and conflict of interest.

Finally, it is worthwhile to mention that the settlement of the tax status of the initial structure shall also be a matter of concern.

Double Luxco structure

Further to the "*Coeur Défense*" case law, the setting up of a double Luxco structure should prevent the paralysing of the lenders' recourse and the enforcement of the security interests.

The purpose of the structure is to:

- prevent the COMI shift of the Luxembourg companies;
- ensure that the shares of the Luxembourg companies remain located in Luxembourg, as article 5 of the EU Regulation 1346/2000 gives protection to a security interest located abroad;
- allow the lenders to enforce by appropriation a Luxembourg law share pledge granted by a Luxco; and
- take control of the Luxembourg company and sell the assets of the group.

Finally, it is important to highlight some specific measures that can be taken and some contractual provisions to implement the double Luxco structure and secure the lenders.

The Luxembourg features of the Luxcos must be preserved: (i) Luxembourg resident directors must be appointed; (ii) the board meetings must be held in Luxembourg on a regular basis; (iii) at least some agreements entered into by the Luxembourg companies must be governed by Luxembourg law; and (iv) the Articles of the Luxembourg company may also include the prohibition to transfer the registered office abroad.

Furthermore, the pledge agreement and the articles of incorporation may provide that the bearer shares of the Luxembourg company will be deposited at a Luxembourg custodian bank or that the shareholders register is kept under escrow with the domiciliary agent.

The pledge agreement may also provide the possibility to enforce in anticipation the pledge over the shares of the Luxco in case of a trigger event.

Finally, the transfer of voting rights with respect to the Luxembourg company shares may be provided, even before the enforcement of the pledge, in order to replace the board of directors of the company.

Improvement of the legal framework

The Luxembourg legislator took the opportunity of amending and thus improving the Collateral Law on May 20, 2011 further to the modifications undertaken in the Collateral Directive. One of the main improvements provides that the pledgor can irrevocably waive in anticipation any right of subrogation or recourse it may have. The latter is an issue which is commonly raised in case of debt restructuring and, for instance, when the pledgor is dispossessed from its shares pursuant to the enforcement of the pledge, it is subrogated in the rights of the pledgee and has a claim equal to the value of the shares against any other debtor or guarantor of the secured obligations. Thus, upon enforcement, the pledgee takes control of a group that could become itself debtor of the initial pledgor.

Prior to the amended Collateral Law, this issue was usually contractually addressed although this type of waiver was not totally in line with the general principles of the Civil Code.

In addition to validating the above mentioned waiver, the other main contributions of the amended Collateral Law consisted in (i) confirming the right of the original debtor of pledged receivables to irrevocably waive any right of set-off it may have against the pledgor; and (ii) providing that the appropriation of the pledged assets may occur before the valuation process.

Whereas, prior to the amendment of the Collateral law, it was agreed that the appropriation of the pledged assets was subject to the completion of the valuation process, waiting for the completion of a time consuming valuation process was not in line with the Luxembourg legislator's goals. Consequently, it has been provided that the pledgee may appropriate the pledged assets at a price determined before or after their appropriation. As a result, the appropriation may occur before the valuation process.

Finally, the amended Collateral Law confirmed that the pledgee may have the pledged assets appropriated by a third party, such as a nominee, designated by the agent.

Last but not least, it has been also expressly confirmed that the bankruptcy remoteness does not only apply to security interests governed by the Collateral Law but extends to security interests governed by foreign laws.

The Luxembourg Courts have also backed up the principle of legal certainty asserted by the Collateral Law.

Many decisions concern the sale of pledged assets under "normal commercial conditions". It has been decided that:

- the pledged assets must not necessarily be sold at their real value but at a price that reflects their nature and the applicable market conditions;
- if there is no market, it is not possible to determine a fair market value and the sale may be made on the basis of the best offer received; and
- there is no obligation to postpone a sale to a later stage in order to wait for better market conditions.

The most important decisions relate to the effectiveness of enforcement, especially the confirmation that:

- the enforcement of pledge agreements cannot be stopped by summary proceedings;
- the bankruptcy and competition remoteness of enforcement shall be considered as a mandatory provision of the Collateral Law; and
- the enforcement of a pledge agreement may not be challenged; only actions for liability are available afterwards.

Finally, it has been also decided that:

- the appointment of a receiver (*séquestre*) or an administrator (*administrateur provisoire*) is restricted as long as the enforcement complies with the conditions provided in the pledge agreement; and
- criminal seizures (*saisies pénales*) are not applicable to pledge agreements.

We may say that our legal framework has been strongly supported by the legislator and the Courts and, as it has successfully passed the stress test, it will certainly create a sound environment for restructuring and new acquisitions. Globally, it will be one of the best assets of the financial centre for the future.

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