

What you should know about the boost to the efficiency of Luxembourg pledges

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Over the recent months, the Luxembourg legislator has once again demonstrated its ability to adapt to an uncertain economic environment and to the use of new technologies, allowing Luxembourg to remain the jurisdiction of choice for creditors.

The Luxembourg law of 5 August 2005 on financial collateral arrangements, as amended (the **Collateral Law**) that has implemented in Luxembourg law the Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements in the most creditors' friendly way, has been amended by a law dated 20 July 2022 which entered into force on 24 July 2022 (the **2022 Law**) and more recently by the law of 15 March 2023 implementing under Luxembourg law Regulation (EU) 2022/858 of the European Parliament and of the Council of 30 May 2022 on a pilot regime for market infrastructures based on distributed ledger technology (the **2023 Law**).

Financial collateral arrangements over DLT financial instruments

The 2023 Law brings one single change to the Collateral Law but this modification is of key importance as it amends the definition of financial instruments contained in the Collateral Law to expressly cover financial instruments registered or existing in securities accounts maintained in or through secure electronic recording devices, including using distributed electronic registers or databases. Any legal uncertainty is hence removed and the creation, perfection and enforcement regime laid down Collateral Act shall hence apply to financial instruments booked in securities accounts located or deemed to be located in Luxembourg and kept using distributed ledger technologies (DLT).

With such change, Luxembourg becomes one of the first jurisdictions to explicitly recognize financial collateral arrangements over DLT financial instruments.

The changes brought by the 2022 Law mainly aim at modernizing certain enforcement methods contained in the Collateral Law and at bringing into law several well-established market practices previously confirmed by Luxembourg courts. These improvements confirm the attractiveness of Luxembourg collateral financial collateral arrangements in international transactions and strengthen even further their legal certainty to the benefit of secured creditors.

The key changes that we deem relevant are as follows:

Clarifications of the trigger events for enforcement of pledge agreements

The 2022 Law has helpfully clarified the possible trigger events for the enforcement of pledge agreements in order to clearly state that such enforcement event can be agreed between the parties and can be unrelated to the financial obligations secured. An enforcement event now means an event of default, or any other event **"whatsoever"** as contractually agreed between the parties on the occurrence of which the collateral taker is entitled to enforce its pledge.

The word "whatsoever" has been added in order to clarify that a financial collateral arrangement may be enforced on the occurrence of any event contractually agreed between the parties. Such trigger event is not limited to the non-payment of financial obligations (as is usually provided for in the underlying credit documentation) but can be any other event even if it is non-financial. The parliamentary discussions list some examples such as any particular elements relevant to the transaction or the breach of financial ratios.

Such possibility was already implied by the terms of the Collateral Law and confirmed by the Luxembourg courts in the highly commented *Courtepaille* case, where the Luxembourg Court of Appeal confirmed on 22 January 2020 that the enforcement of collateral pursuant to the Collateral Law can be done further to any event as agreed between the parties, which had in this case included an event of default linked to the breach of financial ratios. Bringing this change into law will however enhance the legal certainty as some secured lenders were still reluctant to enforce their pledge agreements absent any payment default.

Application of proceeds in the absence of due and payable obligations

The above described change is further supported by the changes made to Article 11 of the Collateral Law, which now states that in its paragraph 5, that where no financial obligations are due at the time of enforcement of the pledge, the enforcement proceeds shall be, unless otherwise agreed, applied to satisfy the relevant financial obligations, hence offering the flexibility to the parties to agree on the application of proceeds.

This clearly reinforces the concept that, contractually, the parties are free to determine the enforcement events, which may occur without any financial obligations being due. Before the 2022 Law, the Collateral Law was indeed silent on the application of payment proceeds absent any due and payable obligations which led to certain uncertainties as to whether an enforcement of a pledge was possible absent any acceleration of the debt.

Modernization of the enforcement methods of pledge agreements

Article 11 of the Collateral Law has been modified to (i) clarify and provide more flexibility for certain enforcement methods and (ii) encompass additional enforcement methods which are in line with a growing financial sector looking for diverse enforcement methods.

(i) Assignment by public auction: the involvement of the Luxembourg Stock Exchange is no longer required

In the case of an assignment of the pledged collateral by public auction, the involvement of the Luxembourg stock exchange is no longer mandatory. The Collateral Law now provides that the pledgee shall appoint among the bailiffs or notaries sworn the in Grand Duchy of Luxembourg an auctioneer in charge of operating the public action. The 2022 Law further introduces in the Collateral Law a detailed procedure for such public auction in case the parties choose this option and unless otherwise agreed between them. It is also worth mentioning that the new procedure factors any necessary public authorisations in case of enforcement of a pledge over the shares of a regulated entity.

Such changes render the enforcement of a pledge by way of an assignment by public auction (which was until then not used in practice) much more efficient and attractive, although it is likely that most pledgees will still favour the fast and cost efficient enforcement by way of appropriation or private sale.

(ii) Financial instruments admitted to trading

Before the entry into force of the 2022 Law, it was foreseen in the Collateral Act that financial instruments could be sold on a stock exchange which raised certain questions as to whether only financial instruments listed on a regulated market were covered.

In case of sale of the pledged collateral, the pledgee may now assign such financial instruments on any trading venue on which they are admitted to trading which includes either Luxembourg, European or third country regulated markets, multilateral trading facilities and organised trading facilities.

The 2022 Law also introduced certain clarifications regarding the value at which financial

instruments may be appropriated. Financial instruments admitted to trading on a trading venue can, unless the parties have otherwise agreed, be appropriated at the market price of such financial instruments.

Introduction of new enforcement methods for units or shares in a collective investment undertaking

The 2022 Law introduced additional enforcement methods for pledges over shares or units in collective investment undertakings. A secured lender can now either (i) appropriate the shares and units in a collective investment undertaking either at their market price where such instruments are admitted to trading on a trading venue or at the price of the last net asset value published by or for this collective investment undertaking, provided the last publication of the net asset value does not exceed one year or (ii) request the redemption of the pledged units or shares at their redemption price in accordance with the constitutional documents of the relevant collective investment undertaking. The latter option could prove really useful for pledgees who are not in a position to easily appropriate or sell the shares or units or who are not able to hold such units or shares. With such new enforcement method, the relevant pledgee will be able to access cash amounts by simply requesting the redemption of the relevant units/shares.

Enforcement of a pledge over insurance contracts

Regarding pledges over insurance contracts, the pledgee shall now have the right to exercise all the rights arising under the pledged insurance contract, including, in the case of a life insurance contract or a capital redemption operation, the right to surrender, or request the insurance undertaking to pay any sums due pursuant to the insurance contract. This is a very interesting addition to the Collateral Law as it is now set in stone that pledges over insurance contracts are covered by such law as there were still certain debates among practitioners on this matter.

Given the growing importance of the fund finance industry in Luxembourg and the generalized use of pledges over undrawn commitments in subscription financings, a similar clarification could have also been helpful for such pledges. The changes made to the Collateral Law should however bring some comfort to the practitioners as the same approach is used in practice for such pledges (i.e. exercise of the rights attached to the pledged claims).

It should finally be noted that pledges over life insurance contracts still need to comply with the provisions of Articles 116 and 117 of the Luxembourg law of 27 July 1997 on the insurance contract, as amended under which a life insurance contract may only be pledged by an endorsement executed by the policyholder, the pledgee and the insurer and with the consent of the relevant beneficiary (in case the latter has already accepted the benefit of the life insurance contract).

Clarifications on the insolvency robustness of Luxembourg pledge agreements

The 2022 Law has also provided some further clarity on insolvency procedures in order to ensure a smooth enforcement process unfettered by insolvency procedures or similar procedures. Indeed the 2022 Law has added "*national or foreign*" to the various reorganisation measures as well as "*a winding-up proceeding or a similar proceeding*" to the list of measures which do not affect enforcement proceedings pursuant to the Collateral Law.

Inapplicability of sequestration measures

The 2022 Law further strengthens the robustness of financial collateral arrangements governed by Luxembourg law by adding the sequestration to the measures that do not apply to financial collateral arrangements governed by the Collateral Law. This new provision goes against a decision of the Luxembourg *Cour de Cassation* of 16 December 2021 which allowed such conservatory measure in the event of allegation of fraud or abuse of rights in the enforcement of a pledge. The parliamentary work of the 2022 Law specifies that such change is in line with the general goal of the Collateral Law which aims at ensuring a swift and smooth enforcement of financial collateral arrangements. This is a welcome addition to the Collateral Law which renders Luxembourg financial collateral arrangements even more bullet proof than they already were.

Conclusion

Although most of these changes mainly reflect the current market practice, they are welcome amendments to the Collateral Law as they confirm the creditors friendly features and robustness of such law and reaffirm the market leading place of Luxembourg as a jurisdiction of choice for secured lending but also to innovative projects using distributed ledger technologies. The additional layer of legal certainty brought by these changes will undoubtedly prove really useful to creditors looking at restructuring options in an uncertain economic environment and Luxembourg legal practitioners have already seen a recent uptick in the use of double Luxco structures.

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