Luxembourg restructuring and insolvency: a guide to security

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In this article, partner Bertrand Géradin and managing associate David Al Mari from Ogier's Restructuring and Insolvency team in Luxembourg provide a high level summary of the enforcement mechanisms related to share pledges in Luxembourg. This article first appeared in Chambers Expert Focus Guides.

Luxembourg is a prominent global hub for acquiring international investment portfolios. Typically, the financing for these acquisitions is secured by leveraging the assets and cash flows of both the target firm and the acquisition vehicle. In Luxembourg, where holding companies usually lack operational activities, the key assets available for collateral are shares, receivables, and bank deposits.

What is the standard Luxembourg security package?

Pledges, serving as a common means of securing movable assets, are regulated under the Financial Collateral Act (the Act of 5 August 2005 on financial collateral arrangements, as amended). This legislation enacted the provisions of the European Union's Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the "Collateral Directive") into local law.

How is security enforced?

The Financial Collateral Act provides secured creditors with the advantage of enforcing pledges without the necessity of prior notification to the pledgor. Notably, the occurrence of an event of default triggers this enforcement, with a broad interpretation that does not mandate an actual default in repaying the secured loan or the immediate acceleration of debt obligations. This broader interpretation was reinforced by amendments to the Financial Collateral Act in 2022.

Such events of default, as mutually agreed upon by the involved parties, might include scenarios like violations of specific financial ratios. Upon the occurrence of such events, secured creditors commonly employ methods such as executing a private sale under market-standard conditions or directly appropriating the pledged assets to realise or take ownership of the collateral, as elaborated in the subsequent sections.

Private sales at arm's length

The advantages of a private sale include the following.

- Absence of pledgee liability: in the context of share pledges, a private sale of such assets is advantageous as the pledgee avoids becoming the owner of the company, thereby circumventing any associated liabilities.

- No legal mandate for valuation: the law doesn't necessitate the valuation of the pledged assets. However, the pledgee is permitted to undertake a comprehensive marketing strategy to substantiate that the sale of the pledged assets was conducted under market conditions. This involves approaching multiple prospective buyers and transferring the assets to the highest bidder. Nonetheless, for the sake of certainty and out of an abundance of caution, obtaining an independent valuation is advisable to minimise the possibility of legal disputes.

The key disadvantage of a private sale is the ambiguity in the definition of "market conditions". The Luxembourg District Court provided a broad interpretation of this concept in 2010 (District Court, 20 May 2010, Commercial Judgment 705/2010). Market conditions are understood as being reflective of the prevailing supply and demand during the enforcement of the pledge, considering the information available at that time, the unique attributes of the pledged assets, and the pertinent market dynamics. In scenarios lacking a regulated market for the asset sale, the most favourable offer that can be secured, given the nature of the pledged assets and the market circumstances, is deemed acceptable.

Asset appropriation

The advantages of asset appropriation include the following.

- Independent of formal authorities: asset appropriation operates as a direct enforcement mechanism, bypassing the need for court or exchange involvement. This absence of formal authority intervention makes appropriation a cost-effective approach.

- Flexible valuation timing: the security agreement terms dictate the timing of the valuation, allowing for appropriation to occur either prior to or subsequent to the valuation process.

- Option for third-party appropriation: the pledged assets may be appropriated directly by the pledgee or by a third-party appointed by the pledgee, such as a special purpose entity entirely controlled by the lenders.

The key disadvantage of asset appropriation is the requirement for a third-party valuer. Under the Financial Collateral Act, the secured creditor is permitted to appropriate the pledged assets at a value determined by a mutually agreed valuation method. To mitigate legal risks, the security agreement typically specifies the valuation professionals, often an independent external auditor (eg, a réviseur d'entreprises agréé) or a well-regarded investment bank. Following the valuation, the pledged collateral's value is offset against the secured debts, akin to a credit-bid process.

What is the enforceability of a security agreement in an insolvency situation?

Disapplication of the insolvency rules

A key benefit of the principles outlined in the Financial Collateral Act, aimed at bolstering certainty for secured parties, is the exclusion of various insolvency-related statutes, both within Luxembourg and from other legal jurisdictions. When it comes to the establishment and realisation of security interests:

- pledges maintain their validity and enforceability against third parties, including receivers, liquidators, or similar entities, regardless of the initiation of reorganisation, winding up, or equivalent proceedings, whether under national or foreign laws;

- assets pledged under such agreements are not considered part of the insolvent company's assets, shielding them from being drawn into the insolvency estate; and

- the Financial Collateral Act also asserts extraterritorial influence by ensuring that the insolvency-remote nature of these arrangements extends to financial collateral agreements made by Luxembourg entities under foreign laws, provided these agreements exhibit essential characteristics akin to those outlined for financial collateral under the Financial Collateral Act.

In the context of a reorganisation procedure

With the enactment of the Act of 7 August 2023 on business preservation and modernisation of bankruptcy law (the "Reform Act"), effective from 1 November 2023, Luxembourg's insolvency legislation has undergone significant changes. Under this reform, financially distressed debtors are now able to seek business reorganisation through either amicable settlements or court-led procedures, benefiting from a payment moratorium on certain obligations.

Despite these changes, pledges subject to the Financial Collateral Act are predominantly insulated from these proceedings, retaining their validity and enforceability. Nonetheless, the payment suspension introduced by the reorganisation process can negatively impact the acceleration of secured debts, indirectly affecting the execution of pledges. To mitigate this issue, it is advisable to stipulate within the relevant security agreements that the initiation of reorganisation procedures (or the request to commence such proceedings) under the Reform Act constitutes an event triggering enforcement. This provision ensures the pledge can be enforced even in cases where legal constraints prevent the acceleration of the secured debt.

Claw-back rules, fraud and immunity of security agreements

Contracts of a company may be impacted by insolvency proceedings if they are entered into during the critical period known as the "hardening period" (période suspecte) and the ten days leading up to it. This period commences when the company ceases to meet its payment obligations, with the actual onset date determined by the court, retroactively applicable up to six months before the initiation of insolvency proceedings.

Contracts enumerated in Article 445 of the Luxembourg Commercial Code are deemed void if executed within the hardening period. Moreover, any agreements or payments made during this period are susceptible to annulment by the court, especially if the counterparty was aware of the company's insolvency. Furthermore, the court holds the authority to invalidate any action or payment that infringes upon the rights of creditors, regardless of when it occurred.

Despite these provisions, security agreements under the Financial Collateral Act are shielded from both local and international insolvency actions, including any claw-back regulations, such as annulment due to fraud. However, in cases involving the formation of the security agreement and the enforcement of the pledge, the pledgee might bear personal liability towards any creditor who incurs losses as a result (Court of Appeal, Fourth Chamber, 16 May 2018, Judgment 63/18).

The Financial Collateral Act further stipulates that a security agreement is considered legitimate and enforceable against third parties if it is established either before the commencement of winding-up actions or the implementation of collective measures, or after these events, provided the pledgee can demonstrate a lack of awareness or a reasonable inability to be aware of such proceedings or measures.

Nevertheless, this protection is not absolute. The Luxembourg receiver retains the right to question the legitimacy of the security agreement before appropriate courts. In instances of fraud or abuse of rights concerning the enforcement event, the receiver may also contest the enforcement of the pledge (Court of Cassation, 16 December 2021, Judgment 157/2021).

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