

Restructuring and insolvency in Luxembourg (part 1)

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INTRODUCTION

Luxembourg is one of the leading domiciles worldwide for international investment vehicles. This leading position has arisen from the combination of the following core factors:

- the flexibility of relevant companies law
- Luxembourg's pro-investment fiscal laws
- intra-group corporate financing techniques
- extensive double tax treaty network
- full EU single market access for investment of capital, as implemented by the EU Parent-Subsidiary Directive
- Luxembourg's acquisition finance legal framework

This has resulted in the domiciling of several tens of thousands of international investment vehicles in Luxembourg. The restructuring and the insolvency framework applicable in Luxembourg can become of central importance to acquisition finance.

This briefing summarises:

- out-of-court debt restructuring
- court-driven restructuring options
- ultimately, insolvency procedures.

OUT-OF-COURT DEBT RESTRUCTURING

Preparatory phase: Negotiating a standstill agreement

Once a default has occurred, the first step in many restructurings involves the borrower and creditors entering into a standstill agreement to maintain a stable position within which a substantive restructuring can be negotiated.

The key principles of such a standstill agreement are:

- the standstill period lasts until completion of the restructuring
- the payment of principal is deferred until the standstill period expires
- lenders agree not to accelerate loans, enforce security interests or initiate bankruptcy proceedings during the standstill period
- all lenders are treated equally in respect of obligations, repayments and provision of information, and they all undertake not to improve their position compared to the other lenders.

While agreement not to enforce existing contractual rights is generally accepted under Luxembourg law, it is uncertain whether contractual provisions prospectively prohibiting a debtor to file for bankruptcy are enforceable. If the criteria for a debtor to apply to insolvency proceedings are met, it is unlikely that a Luxembourg court would dismiss a petition filed in breach of the debtor's covenant. The remedy for the breach by the debtor of a non-petition covenant would be damages only. Although a debtor may often be expected to be pleased to comply voluntarily, if enforced reliance is required, a damages claim against a distressed debtor is of limited practical value.

Coordination phase: Creditors representation

While every creditor may be expected to action its own interest, a positive attitude towards negotiations and a certain level of coordination among them are crucial to ensure liquidity and that a uniform position of creditors is established.

Agency

In syndicated credit agreements, one of the lenders is usually appointed as agent of the banks and entrusted with the administration of the loan (the facility agent) and/or of the security granted in connection therewith (the security agent). Although certain decisions may be left to the discretion of the agent, in many cases it may be reluctant to act without preliminary

discussion and approval from other members of the lending group.

In order to avoid any blocking minority, to speed up and ease the decision-making process, European leveraged loan facilities generally contain provisions allowing a majority of lenders to take certain decisions. It is standard for the definition of "Majority Lender" to refer to 50 per cent or $66\frac{2}{3}$ per cent of the lenders' loans or commitments for matters (including acceleration) other than those relating to certain fundamental lender rights like changes to commitment amounts or the extension of the maturity date for instance, in which cases the unanimous approval of the lenders would be required.

Dealing with a dissenting creditor

Syndicated credit facilities may often result in lender groupings with diverse interests. In a restructuring process, borrowers or a specific group of lenders (eg. mezzanine lenders) may face refusal from one or more "hold-out" lenders motivated to seek an individual outcome. Unlike in the UK however, no cram-down procedure is available in Luxembourg. It is not possible to compel dissenting creditors to agree with the terms of an out-of-court debt restructuring plan.

A limited exception to this principle is provided for by article 1244 of the Luxembourg Civil Code, which enables a court, at the debtor's request and taking into account the debtor's position and the creditors' needs, to postpone or reschedule the payment of sums due (so called *délai de grâce*).

Another exception exists in relation to bondholders as a specific category of creditors. Majority bondholders may bind dissenting minorities for specific decisions like the postponement of one or more interest payment dates, the reduction of the interest rate or a change of the conditions of payment thereof, the substitution of bonds by shares of the issuer or the substitution of bonds by shares or bonds of other companies.

Implementation phase: Debt restructuring methods

Debt restructuring implies multi-lateral negotiations between the debtor and its creditors. The process is purely informal: it is a consensual deal disconnected from any kind of judicial intervention. Provided the debtor's underlying business is viable, it may be the most appropriate response to the financial difficulties of the debtor compared to the costs, finality, potential loss of value and relative inefficiency of a judicial insolvency proceedings. It can be achieved using the following methods:

Asset swap / debt-for-equity swap

In an asset swap, the creditor agrees to accept an asset of the debtor (such a inventory, receivables or intangible assets) as final settlement of the debt. In an debt-for-equity swap, the

debt is converted into and discharged for the issue by the debtor of equity (or similar) instruments like (preferred) shares or bonds plus warrants.

Under Luxembourg law, the conversion of all or part of a debt into equity requires the prior authorisation of the debtor's shareholders in order to: (i) increase the share capital by an amount equal to the value of the debt being converted (so that new shares can be issued) and (ii) enable the creditor to subscribe for the newly issued shares by means of the contribution in kind of the debt held by it.

Equity issuance following debt conversion requires that the statutory pre-emption right of the existing shareholders be waived.

The valuation of the debt to be contributed may also prove to be challenging given its distressed nature. Such valuation must be confirmed in an auditors' report, and a board of directors' report when the debtor is a public limited company (S.A - *société anonyme*) or a partnership limited by shares (S.C.A - *société en commandite par actions*). When the debtor is a private limited companies (S.à r.l - *société à responsabilité limitée*), the valuation can be made by the managers of the company only.

If the borrower is a listed company, and the creditor is acquiring more than 33⅓ % of the share capital of the company, the conversion of debt into equity could result in the obligation for the lender to a mandatory takeover bid, which may not be ideal. It could also give rise to market abuse issues if the creditor has had access to price-sensitive information about the company.

Refinancing

New or extended loan facilities may be made available by the existing lenders or by new lenders in order to support the recovery of the debtor. Such granting of fresh money is generally conditional upon the granting of additional security or the inclusion of adequate provisions in the intercreditor arrangements, to compensate for the increased risk incurred by those who provide new financing to a distressed company.

There is no special priority given by law, by way of preferential ranking debtor-in-possession financing to the repayment of this funding if an insolvency proceeding is nonetheless subsequently brought against the debtor. However, if finance is granted after the commencement of the insolvency proceedings however, the lender will be considered as being a creditor of the bankruptcy estate (*créancier de la masse*) and will be granted with a priority claim against the estate.

Modification of debt terms

The debt may be continued, but with modified terms in order to take into account the current financial situation of the borrower.

Usual concessions often include partial principal settlement, interest rate adjustments, payment extension and alteration of (too restrictive) covenants. These amendments do not constitute a novation of the existing debt. Fresh security interests are not required, provided the original security agreements are drafted so as to cover any future amendment to the secured finance documents.

Debt buy-back

Debt buy-back is the repurchase and discharge by a debtor (or its sponsor) of its own debt, whether discounted or at par. As this transaction will constitute a transfer under the terms of the loan agreement, the borrower will need to comply with any restrictions on transfers in the finance documents in particular, it must fall within the "permitted transferee" provision. Otherwise an amendment to the finance documents will be required. Alternatively the borrower or sponsor might consider the option of purchasing a funded participation by way of sub-participation with an existing lender.

Under Luxembourg law, the repurchase by a borrower of its own debt will result in the debt being automatically extinguished by way of set-off. This could create the risk of the transaction being re-characterised as a prepayment. The terms of the loan agreement that govern prepayments would then apply. These usually include a provision requiring amounts received from the borrower to be shared equally between the lenders. This would defeat the purpose of the lender selling its (distressed) claim. However, if the conditions of the debt purchase are sufficiently different from the terms of the loan agreement (eg. the debt is purchased at a significant discount), there are good arguments to dispute that the transaction qualifies as a prepayment. The payment to be received by the lender in consideration of the sale will be applied against the amount due under the transfer agreement rather to sums due under the loan agreement.

LEGAL RISKS IN OUT-OF-COURT RESTRUCTURING

Directors duties

Under Luxembourg law, the directors of a company may be liable for (i) the non-execution of their mandate, (ii) any misconduct in the management of the company's affair and (iii) any damages caused by their fault or negligence.

The performance by the directors of their duties is assessed in light of the company's best interest. They must safeguard the interests of the distressed company and preserve the business value. While doing this, the directors must also verify that the conditions for the opening of an insolvency proceeding, being the cessation of payments and the impaired ability for the company to raise credit, are not met. The Luxembourg Commercial Code requires that directors

file for bankruptcy with the commercial court within one month of the company having ceased its payments. Not filing for bankruptcy within this timeframe constitutes serious misconduct, which could lead the court to order the directors to bear all or part of the debts of the company.

Lender's risks related to the provision of new money

A lender can be held liable both towards the company and towards third parties if it acts in an imprudent or ill-advised manner in connection with a company in financial difficulties. This can occur if such lender knew or should have known that the company was on the verge of bankruptcy and the lender's actions have abusively delayed the date of cessation of payments or created a false impression of solvency towards third-parties. If liability is established, the creditor can be ordered by the court to reimburse the party suffering loss.

Voidable transaction risks

The debtor's contracts, including security agreements in certain circumstances, can be affected by insolvency procedures if they were concluded during the "suspect period" (*période suspecte*). Such period starts from the moment the company stopped paying its debts (*cessation des paiements*), though the exact date is fixed by the court (a maximum of 6 months + 10 days before the start of the insolvency procedure).

The following contracts are automatically null and void if concluded during the suspect period:

- contracts entered into by the insolvent company, if its obligations in such contracts are significantly more onerous than the obligations of the other party (similar to transaction at an undervalue risks in English law)
- any payment made by the insolvent company in respect of debts that are not yet due
- any payment made in kind (eg. asset transfer) by the insolvent company in respect of debts that are due (excluding cash and negotiable instruments)
- any security granted by the insolvent company to secure obligations incurred before the security contract was entered into (ie. for post consideration).

Additionally, any contract or payment can be annulled by the court if the other party had personal knowledge that the company was insolvent at the relevant time.

All out-of-court contractual restructuring in Luxembourg must mitigate these legal risks. Unlike the UK, there is no mechanism for the expeditious appointment of an administrator by a debtor and/or its creditors to quickly impose a binding moratorium on adverse creditor actions and/or effect a pre-pack business sale ensuring business (if not necessarily corporate) continuing survival.

In certain circumstances (depending on the facts and the structure), a similar result can however be achieved through the enforcement (by way of private sale or out-of-court appropriation) of a Luxembourg law pledge granted over the shares of the principal asset-holding company. The Luxembourg law on financial collateral arrangements expressly recognises the validity and enforceability of all financial collateral arrangements covered by it, even if entered into during the pre-bankruptcy “suspect period”, enabling the possibility for pre-pack-type enforcement transactions in Luxembourg.

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Meet the Author



Jad Nader

Partner

Luxembourg Legal Services

E: jad.nader@ogier.com

T: [+352 2712 2047](tel:+35227122047)

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