Luxembourg finance - Tailored acquisition finance

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International investment portfolio structuring

Introduction

Luxembourg is one of the leading domiciles worldwide for international, investment portfolio acquisition 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 position;
- 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; and
- Luxembourg's acquisition finance legal framework.

This combination of factors has resulted in the domiciling of several tens of thousands of international investment portfolio acquisition vehicles in Luxembourg. Private holding companies (*sociétés à responsabilité limitée* or *Sàrl*) are the principal vehicles used for this purpose.

Luxembourg acquisition finance - key factors

The following factors contribute to the success of Luxembourg *Sàrl* as acquisition finance vehicles:

- ease of creation and perfection of security
- certainty - substantial exclusion from insolvency risk
- ease of transaction management
- enforceability of multi-jurisdictional financing market norms
- ease of enforcement of security.

This briefing focuses on the attributes of Luxembourg acquisition finance for international investment portfolio structuring. It does not seek to discuss financing matters relating to vehicles other than *Sàrl* or relating to security over assets not commonly found in such structures. Any reference to such other vehicles or security interests is made for the purposes of comparison only.

Luxembourg situate assets commonly secured in such structures comprise Luxembourg company shares, bank accounts, and receivables. Such Luxembourg situate assets should be secured under Luxembourg law and the most common form of such security is by way of pledge (although security assignment and fiduciary contract security are also possible).

Luxembourg law on security interests over such assets was significantly updated in 2005 with the adoption of Law of 5 August 2005 on financial collateral arrangements (the Financial Collateral Law). In passing this Law to implement the EU 2002 Financial Collateral Directive, Luxembourg implemented a policy decision to modernise its security interests law across a wider spectrum than that solely required by the Directive, for the specific purpose of enhancing Luxembourg's role as a global domicile for finance vehicles. The result is the attractiveness for secured finance parties (and therefore for promoters seeking finance) of Luxembourg structures.

Security - ease of creation

One of the key policy aims of the Financial Collateral Law was to remove, to the maximum extent possible unnecessary complications in relation to the creation and enforcement of such Luxembourg security.

Thus, no particular formalities are required in relation to the creation of security by pledge other than that the attachment of the secured collateral must be capable of being evidenced in writing. In particular, there is no requirement that security be created by deed or notarial act or be subject to particular execution formalities. In practice, pledge agreements are commonly entered into in writing and executed by signature. There are no prescribed protocols relating to email exchange of contracts.

No stamp duty or similar tax or charge applies to the creation or enforcement of a specific pledge security interest over shares, bank accounts or receivables. Nor are there any public registration requirements.

Such security may be validly created between all types of natural and legal persons, irrespective of any form of categorisation.

Security may be created in respect of any type of secured obligations, whether of a payment or performance nature, including under credit facility agreements, vendor financing of sale and purchase agreements, delivery obligations of financial assets and obligations under derivative instruments.

Such secured obligations may include present, future, contingent or prospective obligations without any need to specifically identify the specific obligation in question. Third party obligations may be secured without any need to supplement these with a covenant to pay or guarantee, and may include obligations of a specified class or type arising from time to time.

Security by way of pledge may be created over a comprehensive range of financial collateral, including:

- all securities, shares and comparable corporate interests, participations in companies, units in collective investment schemes; securities giving a right to acquire, subscribe for or exchange shares, bonds or other instruments;
- bonds and other debt instruments, certificates of deposit, loan notes, term financial instruments;
- derivatives; contractual claims; receivables and cash at bank;

and whether the collateral is in a physical form or dematerialised, whether transferable by book entry, delivery, whether bearer or registered, negotiable or not and regardless of its governing law. Valid security may be created by pledge over all such financial collateral of the grantor, whether present of future, without need to specifically designate it.

The pledge will be enforceable against third parties in respect of future assets from the date of perfection by means of actual or statutorily deemed dispossession of such assets from the grantor.

Ease of perfection

In Luxembourg (as in many other jurisdictions) security created by pledge was originally a possessory security whose perfection and attachment to the secured collateral required the transfer of possession to the secured party. The Financial Collateral Law has significantly updated the concept of possession/dispossession in relation to pledge security over such financial collateral, whilst retaining the terminology of possession to describe perfection and attachment.

Perfection of pledge security over financial collateral therefore occurs on (and continues with) the deemed transfer of possession of the secured collateral to either the secured creditor or to an agreed third party custodian. Such deemed transfer of possession renders the pledge enforceable against third parties and is commonly effected under the Financial Collateral Law as follows:

- in relation to registered financial instruments whose transfer is effected by register entry, by noting registration of the pledge on the relevant register of the issuer;
- in relation to financial instruments transferable by book entry, by noting registration to an account with a custodian, whether in the name of the grantor, secured party or an agreed, third party, noting the pledge;
- physical delivery in relation to bearer instruments; and
- by endorsement of the pledge on negotiable financial instruments.

Market practice is to require a certified copy of the share register of the company in which shares have been secured, to be provided at completion noting the creation of the pledge following its notification to the company.

Similarly, in relation to bank account security, the account bank will be notified of the pledge and will be asked to relinquish any rights of set off, combination of accounts or first ranking pledge in the respect of the account collateral which would otherwise apply in standard account bank terms and conditions.

Pledges over intra-group receivables are commonly perfected by joining the obligor of the receivable collateral to the relevant pledge agreement.

No government, notarial or other third party involvement is required for the perfection of such security. Secured lenders are not required to obtain any Luxembourg banking or other licence by virtue only of entry into finance documents with a Luxembourg obligor.

Ease of transaction management

The settled market view in Luxembourg is that there is no prohibition on a *Sàrl* granting security over its assets for the purposes of a financing transaction which includes the acquisition of shares in it. Although the section of the Luxembourg companies law statute (the Law of 10 August 1915 on commercial companies) relating to public limited companies (*sociétés* *anonymes*) and European companies (*sociétés européennes*) prohibits the granting of such financial assistance unless whitewashed (and such prohibition is expressly extended to incorporated partnerships limited by shares), the section of the statute relating to *Sàrl* does not contain any such prohibition.

This difference of treatment between public companies and private companies derives from the EU Second Company Law Directive and mirrors the approach in other EU jurisdictions such as the UK following the Companies Act 2006. There are no other provisions applicable to the *Sàrl* equivalent to the underlying English common law prohibition (now superceded for private English companies) on the grant of financial assistance as a maintenance of capital principle.

In approving any transaction, particularly one involving financial assistance, the Sàrl's directors (*gérants*) will need to act in accordance with their duties to act within the scope of their authority, in performance of the *Sàrl's* corporate objects (*objet social*) and in its best corporate interests (*intérêt social*). In doing so the directors (*gérants*) will need to also act as *bon père de famille* (as their duties were originally described). In a modern investment financing context, this requires them to act diligently, as a prudent business person would in the conduct of their own affairs, in applying the *Sàrl's* investment policy.

Whilst this clearly has parallels with English common law fiduciary duties, these are applied slightly differently in practice in relation to the grant of cross-group guarantees and/or security by *Sàrls*.

The general principle remains that such transactions must be for the corporate benefit of the *Sàrl* in question, which may be found for a parent supporting the provision of finance for its subsidiary in the expectation of enhanced economic benefit ultimately upstreaming to the parent. Similarly, a subsidiary may achieve funding on more advantageous terms through participation in a group financing and related security net.

It is an accepted principle that the requisite individual corporate benefit may also be identified where one group company approves a transaction in favour of another group company, in which the first is directly or indirectly interested but which transaction is not immediately advantageous for the shareholders of the grantor group company, where that transaction:

- is for the purposes of the common economic, financial or corporate interests of the group pursuant to the group's express investment policy, which is complimentary to the economic success of each relevant group company (not just the ultimate parent);
- does not on balance deprive the grantor of the net wider benefit it derives from its group participation, taking account of the obligation undertaken. This balance between the obligations undertaken and the benefit of group participation for the grantor needs to be viewed over a reasonable time period; and
- does not risk the insolvency of the grantor.

In practice, this may often give rise to contractual limitations of recourse under cross-group guarantees to a certain percentage of the net asset value of the grantor.

In a Luxembourg context it is important that the *Sàrl's* directors (*gérants*) identify and satisfy themselves in relation to corporate benefit. It is not necessarily helpful from either a legal or tax residency perspective to put such decisions to a shareholder (who may well not be Luxembourg resident) for prior approval.

Finally, in relation to transaction management and certainty of security, ownership of the secured collateral is statutorily presumed to vest in the grantor at the time of creation of the pledge, unless the secured party had prior written notice of the contrary. In the absence of such notice, no defect in the grantor's title to the secured collateral compromises the validity of pledge security created over it.

Flexible use of secured collateral

A high degree of flexibility is specifically provided in the Financial Collateral Law in relation to the use of the secured collateral subject to pledge security. Where that collateral carries a right to vote, for example shares, the right to exercise those votes is determined by the parties in contract. Similarly, the parties may agree that the secured party has a right of use (including a right to dispose of the secured collateral as if its owner) during the security period, subject to the obligation to replace any secured collateral disposed of with equivalent assets prior to the performance of the secured obligations. The priority date in relation to attachment of the pledge to such replacement collateral is deemed to rank and to continue from the initial perfection of the pledge notwithstanding such disposition and replacement.

Similarly, whilst perfected, the pledge security remains valid notwithstanding any contractual agreement to permit the grantor to continue to use the secured collateral. In relation to pledged bank accounts, for example, the right to use the credit balance of secured accounts may be agreed between the parties in contract. This secured account may either be closed, to be utilised by the grantor solely with the secured party's consent or in accordance with an agreed payment waterfall or alternatively may be controlled by the grantor for use for agreed permitted purposes under the facility agreement until closed by service of a blocking notice on and acceptance by the account bank. No control issues affect the validity of the perfected security although a secured party will clearly be aware of the risk of dissipation of unblocked account balances in practice.

International financing norms

The Financial Collateral Law expressly recognises that the contractual rights and proprietary interests of finance parties may be validly held and/or exercised by a facility agent and/or security trustee on their behalf, without requiring the principal obligations to be supplemented by parallel debt provisions which are required under other civil law systems, provided that the beneficiary finance parties (present or future) are known or capable of determination (which finance parties will be).

Choice of law, jurisdiction and enforcement are determined on the same basis as English law, under the EU Regulations on the law applicable to contractual obligations and the recognition and enforcement of judgements.

Contractual subordination, limited recourse and contractual set off are recognised financing tools.

The Financial Collateral law expressly recognises the ability to create different ranking pledges in the same secured collateral unless the first ranking pledgee has a contractual right to use and dispose (subject to an obligation to replace with equivalent collateral) the collateral under the security agreement.

In such cases, priority ranks from the date of perfection (unless varied in contract by an intercreditor agreement). Given the absence of public registration, the senior creditor's priority position is granted certain safeguards under the Financial Collateral Law.

Distinctive local provisions do apply in relation to security powers of attorney, guarantees and the compounding of interest. Please seek specific advice in individual cases.

Ease of enforcement

Enforcement may be carried out by the secured party by its private action, without requiring any Court order or the involvement of any public or judicial officer or notary. Thus, subject to applying valuation and the contractually agreed enforcement mechanism in good faith, control of the process and of key decisions in it remains with the secured party. The Financial Collateral Law has also disapplied the civil law requirement for a formal default notice (*mise en demeure*) to be served prior to enforcement, although the contractual facility agreement terms will often entail a notice of acceleration and demand in any event.

Unless varied by the finance documents, enforcement may occur as follows:

- by appropriation of the collateral, with a valuation method agreed in contract; or
- by private sale on normal commercial terms (ie on an arm's length basis) or
- by public auction.

Where appropriation occurs in relation to listed financial instruments, the applicable valuation is provided by the listed market price. In relation to units in open-ended collective investment undertakings with frequent net asset value calculations, the valuation is provided by such valuation per unit.

Valuation principles for certain other collateral, such as shares in a *Sàrl* can clearly be a key issue. Although the Financial Collateral Law does not itself prescribe a specific valuation methodology, other Luxembourg law requirements relating to contractual performance and enforcement in good faith, corporate benefit requirements at time of creation and principles of non-abuse of law are argued to support a position of fair market valuation on enforcement by appropriation.

One consequence of the policy underlying the Financial Collateral Law to enhance the attractiveness of Luxembourg as an international financial centre is to ease certain issues relating to enforcement of share security over *Sàrls*. The issue on enforcement historically arose from the original conception of the *Sàrl* as a quasi-partnership company (with limited liability). As such, the transfer of any shares in a Sàrl required the positive approval of the transferee by the other, remaining members. If unresolved, this could clearly have a disadvantageous effect on the ease of enforcement of such share security.

The Financial Collateral Law removes this requirement completely in relation to any transfer on enforcement (in whole or in part) of security granted over a *Sàrl's* entire issued shared capital pursuant to a single financing transaction. In other circumstances, for example security granted over some only of a *Sàrl's* shares, the approval of the other members by resolution of transfer(s) on enforcement may be obtained on an irrevocable basis and in relation to non-specified transferees, at the time of creation of the security.

Thus, control over enforcement may be ensured for the secured party, subject only, in the latter case of enforcement of security created over part only of the issued share capital, to a right of purchase of the shares transferred on enforcement for the other members of the *Sàrl* at the realisation price. In practice, this question only arises in the comparatively rare circumstances in an international financing context where the *Sàrl* in question is not a wholly-owned group holding vehicle and/or where only part of its issued share capital is secured.

Substantial exclusion of insolvency risk

Certainty for secured parties is also enhanced by the Financial Collateral Law's disapplication, in relation to the grant of such security, of both Luxembourg and other jurisdictions' laws relating to bankruptcy, liquidation, reorganisation or similar measures and from any civil, criminal or other judicial attachment or confiscation Court order. Thus, all legal risks of nullity of the security or unenforceability against third parties are disapplied except in relation to civil liability for conspiracy to defraud and in relation to an insolvency cause of action pursuant to a fraud on creditors.

Relevant Luxembourg security, its enforcement and agreed collateral valuation provisions in such structures is therefore binding on such insolvency office-holders, falls outside the bankruptcy estate of the grantor, may be enforced by the secured party despite any bankruptcy of the grantor, and, importantly, is not vulnerable to being set aside by reason of any hardening period (*période suspecte*) (subject as above).

The exclusion of non-Luxembourg law insolvency risks from application to Luxembourg law security (for example where granted by a non-Luxembourg obligor in respect of Luxembourg situate assets) is also recognised pursuant to the EU Insolvency Regulation 2000 which provides for the primacy of national, security interest laws applicable in the jurisdiction of the secured collateral over national insolvency procedures applicable to the grantor in such circumstances.

This briefing provides a general summary only of this area based on current law and practice in Luxembourg at April 2013 and is subject to changes therein. It does not purport to be comprehensive and is intended for information only. It does not constitute specific advice issued on a reliance basis. Such specific legal advice should be sought on each occasion.

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