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Enforcement of security in insolvency in Luxembourg

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Standard Luxembourg security package

Luxembourg is one of the leading domiciles worldwide for international investment portfolio acquisition vehicles.

Acquisition financing is usually secured against the assets and cash flows of the target company as well as of the buyout vehicle.

In practice, given that a Luxembourg holding company generally does not have any operational activities, shares, receivables and cash in bank are the most important assets to cover.

Pledges are the common form of security for such movable property. They are governed by the Law of 5 August 2005 on financial collateral arrangements, as amended (the **Financial Collateral Act**), which transposed Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the **Collateral Directive**) into national law.

Methods of enforcement of security

One of the innovations of the Financial Collateral Act has been to facilitate the enforcement of pledges. It offers to the secured creditor the opportunity to enforce pledges without having to give prior notice to the pledgor. It further provides for the following enforcement procedures (in addition to the right to receive dividends and vote on the pledged shares):

- private sale at arms' length conditions (*conditions commerciales normales*);
- appropriation at a value as determined by an independent auditor;
- sale by public auction; and
- attribution in court.

Upon the occurrence of an event of default (which is to be interpreted broadly[1]) as agreed between the parties, the main methods used by secured creditors to realise or appropriate the collateral are the enforcement by means of private sale or the appropriation of the pledged assets.

The flexibility offered by the Financial Collateral Act to lenders was confirmed in 2017 by the Luxembourg District Court[2]. In particular, the court ruled that a Luxembourg pledge can be enforced by a creditor on the occurrence of a contractually agreed enforcement event, without requiring repayment or the need to accelerate the underlying debt obligations.

Private sale

Advantages:

- No liability of the pledgee: Where shares are pledged, the private sale of such assets has the specific advantage that the pledgee does not become the owner of the Company and does hence not have to assume any liability, even for a short period of time.
- No valuation required as a matter of law: The law does not require proceeding to a valuation of the pledged assets. The pledgee may conduct a full marketing process to demonstrate that the pledged assets have been sold at arm's length conditions. The pledgee would then have to contact several potential buyers and sell the pledged assets to the highest bidder. Reasons of certainty and prudence command however that an independent valuation is obtained to reduce the risk of challenge.

Disadvantages:

- Vagueness of the term "arm's length conditions": The main disadvantage of enforcement by means of a private sale is the vagueness of the term "at arm's length conditions" (*conditions commerciales normales*). As a guidance, a private sale would meet the "normal commercial test" when made at a price that a well-informed independent willing buyer would normally, under relevant market conditions and taking into account the information available at that time, accept to pay to a willing seller.

Appropriation

Advantages:

- No intervention of a formal authority (court or exchange): The appropriation is an out-of-court enforcement procedure. Considering that there is no formal authority to intervene, an appropriation is a cost efficient method.
- Valuation can be performed afterwards: The appropriation can be made either before or

after the valuation has been completed.

- Appropriation can be made by a designated third party: The pledged assets can be appropriated by the pledgee himself or by a third party (e.g. a special purpose vehicle wholly owned by the lenders).

Disadvantages:

- Intervention of an independent auditor in case of appropriation of collateral: According to the Financial Collateral Act, the secured creditor can appropriate the pledged assets at a price determined pursuant to the valuation method that is agreed upon between the parties.

In order to reduce the risk of challenge, generally the parties will decide that the valuation will be carried out by an independent external auditor (for instance, a *réviseur d'entreprises agréé*). Upon determination of the value of the pledged collateral, a set-off against the secured debts will be made (just as in a credit-bid process).

Enforceability of pledge agreement in insolvency situation

Disapplication of the insolvency rules

One consequence of the policy underlying the Financial Collateral Act's aim to enhance certainty for secured parties is the disapplication, in relation to the granting and the enforcement of security, of both Luxembourg and other jurisdictions' laws relating to bankruptcy, liquidation, reorganisation or similar measures.

The Financial Collateral Act provides that pledges are valid and enforceable against third parties, receivers, liquidators or similar persons notwithstanding a reorganisation, winding up proceedings or similar national or foreign proceedings. The assets subject to the pledge do not form part of the estate of the insolvent company.

The Financial Collateral Act further gives an extraterritorial effect to the above principle by extending the insolvency remote effect to any financial collateral arrangement, or any similar guarantee, granted by a Luxembourg-based entity when such financial collateral arrangement is governed by a law other than Luxembourg law.

Set-off arrangements

The Financial Collateral Act provides that set-off arrangements are valid and enforceable in the event of insolvency proceedings even if the relevant claims are not liked, provided that the agreement containing the set-off provision is valid.

Enforcement of a pledge over bank accounts

Enforcement of a pledge over bank accounts typically takes the form of the blocking of an account (to the extent that it is not yet blocked prior to an enforcement event) and the right for the collateral holder to take control of the account (including the right to demand direct payment or transfer of the amounts standing to the credit of such an account).

Enforcement of a Luxembourg share pledge as restructuring method

Claw-back rules

In principle, company's contracts, can be affected by insolvency procedures if they were concluded during the suspect/hardening period (*période suspecte*) and the preceding 10 days.

The suspect 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 prior to the start of the insolvency procedures).

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

- contracts entered into by the insolvent company, if its obligations are significantly more onerous than the obligations of the other party;
- any payment made by the insolvent company in respect of debts that are not yet due,any payment made by the insolvent company in respect of debts that are due, unless it was paid in cash or made by bills of exchange; and
- any security granted over an asset of the insolvent company to secure obligations contracted before the security contract was entered into.

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

If made during the suspect period, out-of-court restructuring arrangements are thus at risk to be declared null and void.

However, security agreements governed by Financial Collateral Act benefit from an immunity against Luxembourg or foreign insolvency proceedings. In addition, the Financial Collateral Act provides that a security agreement is validly constituted and enforceable against third parties, if concluded (i) before the decision is rendered on the opening of winding-up proceedings or the taking effect of a collective measure or (ii) thereafter such date, if the pledgee could prove, either that it did not have any knowledge of, or that it could not reasonably have any knowledge of the existence of a decision on the opening of winding-up proceedings or such a collective measure.

"Quasi pre-pack"

Pre-pack sale is a commonly used restructuring tool in the UK. It entails the sale of a company's business and/or assets which has been arranged in advance of the company entering into administration and will be closed shortly after the appointment of an administrator over the company.

The benefits of this method are, inter alia:

- the possibility to avoid – as much as possible – loss of value of the company's business and assets;
- the ability to realise a sale of the company's business and assets within a short period and the confidentiality of the prepared sale through pre-pack administration;
- the involvement of a receiver at an early stage as a result of which the receiver is in a better position to collect as much information as necessary;
- the possibility for potential buyers to have more opportunities to perform due diligence and a successful sale through a pre-pack will generally result in the preservation of jobs and value as much as possible; and
- the value of the company as a going concern will be significantly higher than the sale of the company's business and assets in regular insolvency proceeding.

Because of the execution risk resulting from the application of Luxembourg claw-back rules during a restructuring process and due to the fact that in Luxembourg, an administrator cannot be appointed out of court by a debtor and/or its creditors, it is not possible to pre-agree a sale of business in advance in insolvency proceedings in Luxembourg.

As mentioned above, financial collateral arrangements covered by the Financial Collateral Act are valid and enforceable, even if entered into during the pre-bankruptcy suspect period.

An effect similar to the UK pre-pack sale could then be obtained by implementing a "quasi pre-pack" through the enforcement (by way of private sale or out-of-court attribution) of a Luxembourg pledge agreement over the shares of the holding company. Even though untested at this stage, this possibility could prove useful for the implementation of loan-to-own strategies in Luxembourg.

[1] In an order of the First Judge of the District Court of Luxembourg sitting in summary proceedings matters, (N°356/2015, 15 July 2015), the judge concluded that that the Financial Collateral Act allows a lender to enforce a pledge in the event the borrower did not comply with certain financial ratios, even if the secured debt was not yet due and payable.

[2] District Court, July 12 2017, Commercial Judgment 897/2017

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