



Corporate and Commercial
Structuring and financing private
equity & venture capital transactions

Luxembourg
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Introduction

The jurisdiction of choice for many private equity and venture capital investors/funds

Luxembourg has developed over the last two decades into a major hub for private equity and venture capital actors, both as regards to the location of their funds and as regards to the structuring and financing of their acquisitions.

Luxembourg maintains more than ever its commitment to the private equity and venture capital industry, modernising and offering new structures that are aligned with the need of sponsors. Recent examples include the complete reform of the company law in July 2016 (see reference 1) (the **New Law**), the introduction of an anglo-saxon type of partnership (SCSp) (see reference 2) and of the reserved alternative investment fund (RAIF) (see reference 3).

As regards the company law reform, it is worth pointing out that all existing Luxembourg companies are required to amend their articles of association to reflect the changes introduced by the New Law prior to 23 August 2018. During this period, the current legislation will remain applicable to all provisions of the articles of association while the New Law will apply to all matters not mentioned in the articles of association. After such period, any provision in the articles of association contrary to the New Law shall be deemed unwritten and the mandatory rules

under the New Law will apply. For any new company incorporated after 23 August 2016, the New Law shall automatically apply in its entirety.

One of the most flexible and attractive EU tax regimes

Luxembourg offers one of the most flexible and attractive legal framework and tax regimes in the EU with a strong and ever-expanding double-tax treaty network and attractive effective tax rates.

Tax benefits of investing through Luxembourg

- there is a wide participation exemption regime for dividends, capital gains and liquidation proceeds;
- there is no withholding tax on market conform interest payments made by Luxembourg companies;
- there are generally no statutory thin capitalisation rules although minimum equity may be required in some particular cases;
- in most cases, there is no Luxembourg tax on any gains arising on an exit realised by a Luxembourg non-resident investor;
- there is no withholding tax on liquidation proceeds;
- there are no CFC rules; and
- there is no stamp duty on the sale or issuance of shares.

1. Please refer to the client briefing on www.ogier.com, Luxembourg, Publications, "Luxembourg corporate law - modernisation 2016"

2. Please refer to the client briefing on www.ogier.com, Luxembourg, Publications, "New Luxembourg limited partnerships"

3. Please refer to the client briefing on www.ogier.com, Publications, "New Luxembourg RAIF structure likely to prove attractive"

Vehicle selection

Which type of companies to use?

The vehicles most frequently used to structure private equity and venture capital investments are:

Société à responsabilité limitée – private limited liability company (Sàrl) - when control over the share capital is required (the shares are not freely transferable)

One of the most commonly used vehicles for structuring an acquisition is the Sàrl. It is a private limited liability company, managed by a board of managers, for the benefit of its shareholders. It is characterised by a very high degree of flexibility and a very limited level of statutory prescription. It is thus easily tailored to the requirements of single investor or joint venture private investment. The Sàrl is check-the-box eligible.

Société anonyme – public limited liability company (SA) - when flexibility in terms of the variety of instruments that can be issued is required

The SA is a public limited liability company which is able (in contrast to a Sàrl) to make offers of shares to the public, to have a wider shareholder base and to provide a high level of confidentiality for its investors. As a public company, it does however operate in a more extensive statutory framework than a Sàrl.

Société par actions simplifiée – simplified public company (SAS) - when flexible governance is required

The SAS offers far more flexibility to the shareholders and managers than the SA. The SAS may be a suitable alternative to the SA or Sàrl for shareholders with special needs in respect of the balance of powers, shareholder relations and the

distribution of profits (for example start-ups or joint ventures).

Société en commandite par actions – partnership limited by shares (SCA) - when sponsors want to retain control over the management functions

The SCA is a corporate limited partnership with a share capital. This vehicle is frequently encountered in Luxembourg structures. Although a limited partnership (with one or more general partners/unlimited partners) the SCA is also subject to the same, more extensive, statutory framework as the SA. The SCA is check-the-box eligible.

Société en commandite simple – common limited partnership (SCS) - when tax transparency and structural flexibility are required (with legal personality) sponsors can retain control over the management functions

The principle which underpins the SCS is one of contractual freedom and the parties are free to contract on whatever terms suit them best from a commercial perspective. The partnership agreement can be tailored-made to the respective needs and objectives of fund promoters and investors.

Société en commandite spéciale – special limited partnership (SCSP) - when tax transparency and structural flexibility are required (without legal personality) - sponsors can retain control over the management functions

The SCSP is very similar to the SCS and most of the legal regime which governs it is identical. The one major difference between the two vehicles is that the SCSP does not have legal personality.

Sàrl, SA, SAS and SCA are typically organized under the Soparfi (*Société de Participations Financières*) or holding company regime. The Soparfi is not governed by any specific law but is a company incorporated under general Luxembourg law and will in principle be a fully taxable resident company subject to ordinary income tax that can take advantage of the participation exemption in Luxembourg and that is eligible to double tax treaty benefits.

The SCS and SCSP are fiscally transparent and are therefore not subject to tax and should not in principle be eligible to double tax treaty benefits. They can however represent an alternative when a fiscally transparent vehicle is required.

Comparing the different types of companies used in private equity and venture capital deals

A table reflecting the key features of the most common Luxembourg vehicles is annexed to this client briefing.

Constituting the vehicle

Involvement of a public notary

Luxembourg being a civil law jurisdiction, the SA, SAS, SCA and Sàrl must all be constituted by a formal deed, made before a Luxembourg notary. This notarial deed is the constitutional document of the vehicle, including a statement of all the characteristics of share classes. In order to carry out incorporation, the initial economic contribution of the founding investors must be unconditionally held by the vehicle at the moment of its incorporation with a value at least equal to the minimum required by Luxembourg law. Where this initial contribution/ subscription is made in cash, this cash sum, equal to at least EUR

12,000 in the case of Sàrl and EUR 30,000 in the case of SA, SAS or SCA, must be deposited with a (Luxembourg) bank account, in cleared funds, in advance of incorporation.

The SCS and SCSp, as an exception to this rule may be constituted either by a private, non-notarial instrument between their members, or by notarial deed. No minimum capital requirements apply in the case of the SCS or SCSp.

Involvement of an independent auditor

For contributions other than cash in a SA, a SAS or a SCA, an independent auditor (*réviseur d'entreprises agréé*) must issue a report on the nature of the assets contributed and the valuation method used. The report must confirm that the value of the shares issued, nominal and premium, is at least equal to the value of the non-cash contributions. It is important to note that the value reported on the report are those which will be reflected in the notarial deed. Such report is not required in the case of the contribution of a receivable held by the holder of a debt instrument (such as convertible bonds) against the company or for incorporation of reserves, profits or share premium to the nominal share capital.

It is worth mentioning that a similar report shall also be prepared in the case of a capital increase by way of a contribution in kind and if, in the first two years of the company's existence, the company purchases assets from a founding shareholder amounting to more than 10% of the share capital of the company. As an exception that rule, no report is required when the transaction is in the normal course of the company's business or is subject to control by a regulatory authority.

No similar requirements exist for a Sàrl, a SCS and a SCSp.

Timing / steps

It takes usually around two to three days to incorporate a new company in Luxembourg. Many of the delays experienced when setting up a Luxembourg company relate to the KYC procedures that are required to be complied with by Luxembourg lawyers, domiciliation agents, banks and notaries. The usual steps in setting-up a Luxembourg company are as follows:

- The first step consists in identifying a bank and a domiciliation agent (required if the client does not already have a place of business in Luxembourg to provide registered office services) who can also help with setting up a bank account in Luxembourg.
- The domiciliation agent and the bank will need to be supplied with AML/KYC information such as a notarised copy of the passport of the beneficial owner and a utility bill of that person.
- Next step would be the wiring of the share capital to the bank account with the bank issuing a certificate confirming the blocking of the capital on the bank account pending the incorporation of the company to the officiating notary who will incorporate the Company. Without that certificate stating that the funds are held in a blocked account, the notary cannot incorporate the company.
- Once the Company will be incorporated, the notary will issue a certificate confirming to the bank that the capital can be released, i.e. the blocking will be lifted.
- The Company will receive legal personality at the incorporation meeting. The registration and filing of the incorporation deed with the Company Register and the publication of the

incorporation deed with the RESA (*Recueil Electronique des Sociétés et Associations*) are to occur after the incorporation meeting.

Once set up, there are also ongoing practical requirements to consider. In particular, any change to the articles of association of a Sàrl, a SA, a SAS and a SCA, any capital increase or reduction (unless specific provision has been made for an authorised share capital), any merger or liquidation will require the involvement of a public notary and the passing of a notarial deed, which can take up to a couple of days to arrange.

The SCS and SCSp are generally constituted by a private instrument between their members (the limited partnership agreement) and no notary will need to be involved. Incorporation process is therefore generally relatively straightforward. It takes approximately one or two days to establish a SCS or SCSp, longer if a general partner has to be set-up first.

Substance

One growing issue when structuring a deal through Luxembourg is the requirement by foreign tax authorities of real substance for private equity and venture capital vehicles in order to benefit from the desired tax status. The required level of substance is determined primarily by the tax rules of the country(ies) where the assets are / will be located and will have to be considered on a case by case basis.

Substance is therefore more a matter of creating a tangible economic reality in Luxembourg than an exhaustive list of prescribed requirements. Factors focussed on by foreign tax authorities in assessing substance generally include: (i) active, Luxembourg-based employees, (ii) majority of directors being private individuals and Luxembourg tax resident, (iii) decision making process taking place in Luxembourg, (iv) specific Luxembourg office space and utilities, (v) accounting and specific company documentation being held at the company's Luxembourg office and (vi) company bank accounts being in Luxembourg with real cash movement passing through them,

Implementing the adequate level of substance comes at a cost. However, one of the more important reasons to structure private equity deals through Luxembourg in the first place is to benefit from certain tax advantages, which far exceed the costs of creating the tax substance.

Structuring the investment

Thin capitalisation

Luxembourg tax law does not provide for formal thin capitalisation rules applicable to holding activities. However, the Luxembourg direct tax authorities have developed an administrative

practice whereby a debt-equity ratio of 85/15 is considered as a safe harbour for the financing of share capital participations. The latter ratio assumes a market interest rate on the debt portion whereas interest-free shareholder debt is considered as equity for the purposes of the debt-equity ratio. Borrowings for on-lending purposes are disregarded for the computation of the above debt-equity ratio but may be subject to other minimum capitalization rules, such as for intra-group financing. Under current tax practice laid as down in the Circular Letter n°164/2 dated 28 January 2011, Luxembourg companies engaged in intra-group financing activities must generally have a minimum equity at risk equal to at least the lower of either: (i) 1% of the nominal value of the receivable refinanced or (ii) EUR 2 million (or equivalent) in order to substantiate their real presence in Luxembourg.

Contributing the equity

Equity may be contributed to a Luxembourg company in cash or, by way of assets transfer. In relation to asset transfer, almost any tangible or intangible assets may be contributed, provided that such assets are capable of credible and reliable valuation. Eligible intangible assets include securities, debt claims, goodwill in a specific business and intellectual property rights.

Where shares in an SA, SAS or SCA are issued partly paid up in consideration of an undertaking to make a contribution of assets, such assets must be fully transferred to the vehicle within five years. In relation to an SA, SAS or SCA, the valuation of an equity contribution of assets must be supported by an up-to-date valuation report from an independent auditor. This contribution-in-kind report requirement does not apply in relation to a Sàrl but the valuation

of the assets must be certified to the notary incorporating the company. No report is furthermore required when the contribution in kind consist in a receivable held by the holder of a debt instrument against the Company.

Equity may also be contributed in the form of share premium attaching to specific shares or in the form of capital surplus contribution (i.e. capital contribution without the issuance of shares), with a great level of flexibility. Any share premium or capital surplus contribution shall be fully subscribed for and paid up.

Sweet equity contributions (*apports en industrie*) can also be made to the extent that the shares issued in consideration are not considered as share capital from an accounting perspective and are not transferable. Such shares will benefit from governance and/or economic rights as set out in the articles of association.

Equity contribution without issuing shares

An alternative way of making or increasing equity contributions to a Luxembourg company (of any description) is by means of an "account 115 contribution". This involves a contribution of value to the vehicle which is recorded to a special account/reserve in the company's books and records which is characterised as equity but which does not involve the issuance of shares. The absence of share issuance removes the requirement that otherwise often applies to make such transactions by way of notarial deed. This mechanism therefore provides a highly flexible way of ensuring a company's equity that can be actively managed so as to ensure on-going compliance with required debt-equity ratios and can therefore facilitate active portfolio management.

The corporate requirements to make such contributions are: enabling provisions in the articles of association; ordinary (non-notarial) shareholders resolutions or board resolutions; and implementation by the directors. A short form contribution agreement may also be required depending on the nature of the contribution.

Financing instruments

Depending on the legal form, the proposed strategy in terms of economic and voting rights, a Luxembourg company can be financed through a variety of equity, debt and hybrid instruments. Here are the different instruments typically used by Luxembourg companies outside external financing, ordinary shares and intragroup loans:

Asset-tracking shares

Where a vehicle makes multiple investments with a commercial requirement for asset-correlated investment returns to different classes of investors then asset-tracking classes of shares and "account 115" equity contributions are entirely acceptable. Such asset-tracking mechanisms are contractually binding absent insolvency. Insolvency-proof compartments have statutory recognition in the case of Luxembourg securitisation vehicles or specialised investment funds. In relation to unregulated, investment holding vehicles, insolvency-proof compartmentalisation is not statutorily recognised. If differential, asset-specific leverage is envisaged then structural asset ring-fencing may be advisable.

Alphabet shares

Also frequently encountered in the Luxembourg market is the use of alphabet shares. This technique involves the issuance of several classes of shares whose economic rights are not correlated to only certain portfolio assets, but rather apply to a pool of assets as a whole and/or to specific investment periods. The use of a number of classes of alphabet shares of this nature allows the vehicle to redeem individual classes of those shares at appropriate points in time so as to effect transfers of value, by means of redemption payments to shareholders, following the receipt of value from the underlying asset pool. Such redemption payments do not attract a withholding tax under Luxembourg law, if properly structured.

Redeemable shares

Redeemable shares may be issued, subject to the following statutory requirements: redemption is authorised in the articles prior to issue of the redeemable shares; shares to be redeemed must be fully paid up; and redemption can only be funded from distributable profits and reserves or the proceeds of a new issuance of shares made for the purposes of the redemption. When funded from distributable reserves/profits, a figure equal to the redemption price must be recorded in a non-distributable reserve in the accounts of the company. Any redemption premium may only be paid where it will not cause the company's net asset value (as set out in its most recent annual accounts) to fall below its subscribed share capital plus non-distributable reserves.

Mandatory redeemable preference shares

In common with many other jurisdictions, the equity in a Luxembourg investment holding vehicle can be structured so as to provide preferential distribution rights to certain share classes. Such rights may take the form of mandatory redeemable preference shares which may bear a fixed or variable, preferred, cumulative dividend right. Such shares would often be redeemable at the option of the issuing vehicle in accordance with its articles and carry a preferred right to repayment at maturity. Mandatory redemption is often set at the expiry of a fixed term (such as 10 years). Such shares tend to have very limited voting rights and do not carry any additional profit entitlement above the preferred dividend. Whilst considered as equity from a corporate law perspective, the prevalent debt features of MRPS may lead to a debt treatment for accounting and tax purposes. MRPS are mainly used for on-lending activities and could therefore cater for a tax deduction and payment free of withholding tax.

Non-voting shares

Non-voting shares can be issued by SA, SAS or SCA and are, as their name implies, equity that does not have a vote, even though it is entitled to a share of the profits. The economic rights of the non-voting shares must be specifically stated in the articles of association. The most typical rights for non-voting share are identical to those of ordinary shares apart from the lack of a vote at general meetings. Shares without voting rights shall recover their voting rights when the resolutions of the general meeting amend their rights. The purpose of non-voting shares is to allow the holders of the ordinary shares to maintain control. No-voting partnership interests can also be issued by a SCS or a SCSp.

Preferred shares

Preferred shares carry the preferential right to receive a fixed percentage of profits before others. In some cases, they also offer the preferential right to capital distribution before other classes. As a result they often carry no voting rights.

Share with different nominal value

All companies can issue shares with different nominal values. As regards voting rights, shares issued by SA, SAS and SCA will benefit from voting rights that are proportionate to their nominal value. With respect to the Sàrl, majority requirements are determined based on the proportion held by each shareholder in the share capital of the company (irrespective to the number of shares), thus achieving the same outcome. Through the issuance of shares carrying multiple votes, it is possible to further affect the proportionality between capital investments and governance rights, and to entrust the control of a company with a minority.

Free shares

It is possible for SA, SAS and SCA to award free shares to certain employees and officers of the company and affiliated companies. An award of free shares is a right given to an individual to receive, subject to specific conditions being met, a certain number of shares. The ability to issue shares without consideration must be provided in the articles of association and the decision is to be taken by the board of directors/management. Conditions of the issue (such as vesting period and holding period) are fixed by the general meeting of the shareholders.

Beneficiary shares

In addition to shares, Luxembourg company law allows the issue of participation certificates, also-called founder shares ("**titres ou parts bénéficiaires**") which do not form part of the share capital. The articles of association determine the rights that are attached to such beneficiary shares. These rights could conceivably be voting rights and/or dividend rights or rights to participate in the liquidation or a combination thereof. It is possible to issue beneficiary shares with or without the right to participate in profits or with or without voting rights. These beneficiary shares can be issued for a consideration in cash or kind, but can also be issued without consideration.

Bonds and Convertible bonds

The bond issuance period may be short, medium or long. Bonds can easily be transferred to a third party and generate a fixed or variable interest rate. The interest they bear is payable periodically or at maturity, depending on the coupon's terms and conditions. Bond issuance may include subordination as well as convertibility. All Luxembourg companies can publicly issue bonds.

PECs and CPECs

Hybrid instruments, such as Preferred Equity Certificate (**PEC**) and Convertible Preferred Equity Certificate (**CPEC**), are often used in cross-border investment structures. They are designed to be regarded as debt at the level of a Luxembourg issuer from a Luxembourg tax perspective whilst in some cases as equity for foreign tax purposes (notably for the US). Because PECs and CPECs are treated as debt for Luxembourg tax purposes, interest expense may be imputed on PECs and CPECs resulting in Luxembourg tax deductions, subject to recapture. In addition, interest paid on PECs and

CPECs as well as the payment of a redemption premium, is generally exempt from Luxembourg withholding tax.

Typical features of PECs and CPECs include a 30-year term; a fixed annual interest rate computed based on the "arm's-length" principle, convertibility (as regards to CPECs) into shares of the issuer at a fixed ratio established upon the issuance of the CPECs, the possibility to be redeemed at fair market value under certain conditions, transferability restrictions, deep subordination to other debt and no voting rights.

Profit participating loan or asset linked loan

The main characteristic of profit participating loans or asset linked loans is that the lender's remuneration depends on the company's profits or the income derived from a specific asset. The profit-sharing feature may in principle not be an obstacle to qualifying the instrument as debt. Provided the instrument is properly drafted, and the return is not aligned with the profit distributions of the company, the payment of the variable interest is in principle not subject to withholding tax and is fully deductible.

Profit participating bonds and PECs having the same characteristics in terms of remuneration can also be issued.

Capital increase and preferential subscription rights

To increase the share capital of a Sàrl, an amendment of its articles of association will be required. Such amendment requires a majority of at least 75% of the share capital in issue. Any new investors (not being existing shareholders) must also be approved by existing shareholders holding at least 75% (the majority can however be decreased to 50%)

of the issued share capital.

Where, in relation to an SA or an SCA, an increase of issued or authorised share capital requires the articles to be amended, this requires a majority of 66.67% of shareholder votes (present or represented at the meeting) with a quorum of shareholders representing at least 50% of the issued share capital. Quorum and the conditions of majority are freely determined in the articles of association of the SAS.

Increases of share capital by an SA, SAS or SCA for cash subscription (but not by way of a contribution in kind) will generally be subject to statutory, preferential subscription rights. No such statutory, preferential subscription rights exist in relation to an Sàrl although equivalent contractual rights may be included in its articles. The SA, SAS and SCA statutory, preferential subscription rights may be waived by the shareholders individually. The shareholder's meeting may also vote to reduce or cancel these preferential subscription rights, applying the same requirements as for amendment to the articles, which also requires a detailed report of the reasons for limiting the preferential subscription rights to be presented to the shareholders meeting by the Board.

Luxembourg companies may also state an authorised share capital in their articles of association authorising the board or the chairman or the general partner to determine the terms of further share issuance within certain limits and to carry it out. Such authorisation may be valid for a period of a maximum of five years, and is renewable. In such case, the board or the chairman or the general partner may also be authorised in the articles to remove or limit the preferential subscription rights of the shareholders.

Requirements regarding capital increase and preferential subscriptions in the case of a SCS or SCSp can be freely determined in the partnership agreement.

Redemption of shares

Share buy-back

Whilst subscription by an SA, SAS or SCA for its own shares is not permitted, it is permitted for these vehicles (and for a Sàrl) to buy back their own shares which are then either cancelled or are held in treasury (under certain conditions). For a Sàrl, the ability to buy-back the shares must be set out in its articles of association, the company must have sufficient funds to do so and transfers into treasury requires shareholder approval as set out above under "pre-emption rights", but is otherwise largely a matter of contract.

In relation to an SA, SAS or SCA, an additional, generally applicable statutory framework also requires authorisation to the Board (or the chairman or the general partner, as applicable), by a general shareholder(s) meeting approving the terms and conditions, the maximum number of shares, the period of validity for the authorisation of up to five years and the maximum and minimum consideration to be paid, and a summary in the annual management report.

Shares bought back must be fully paid up and the buy-back must not have the effect of reducing the vehicle's net assets below the value of its subscribed share capital plus undistributable reserves.

Buy-back of limited interests in the case of a SCS or SCSp can be freely determined in the partnership agreement.



The general civil law principle of equal treatment of shareholders will require that any share buy-back needs to be proposed equally to each shareholder in the same situation.

It should be further noted that the general civil law principle of equal treatment of shareholders will require that any share buy-back needs to be proposed equally to each shareholder in the same situation.

Reductions of capital

Reductions of capital may be carried out by way of a board resolution or a shareholders' resolution (with the same quorum and majority requirements as for the amendment of the articles). If the reduction involves repayment to shareholders or waiver of an obligation to pay up shares, creditor protection principles apply in relation to SA, SAS and SCA which allow any creditor whose claims predate the publication in the RESA (*Recueil Electronique des Sociétés et Associations*) of the shareholders' capital reduction resolution, to apply to the court for a protective order within thirty days following such publication.

That application must be for an order for the provision of security for the creditor's claim and the court may only reject such application if it considers the creditor already has adequate protection or if such security is unnecessary in view of the net asset value of the company. No payment may be made by the company to the shareholders following a capital reduction within this thirty day period, or until any objecting creditor applying to the court has had its claim settled or the court dismisses the application.

Unlike in certain other jurisdictions, creditor protection enables application by objecting creditors to the court. It does not require the positive application by the company itself for the court's approval of the proposed reduction.

No specific creditor protection provisions apply in relation to reductions of share capital of Sàrl, SCS or SCSp.

Distributions to investors

Legal reserve

After payment or provision for relevant debt obligations (including any intra-group debt financing), all Luxembourg companies (to the exception of the SCS and SCSp) are obliged to allocate to a non-distributable reserve an amount equal to 5% of the company's net profit per annum. This obligation continues until the reserve has accrued to a figure equal to 10% of the company's share capital (share premium and capital surplus shall not be taken into account for the purpose of this threshold).

Dividend distribution

After payment or provision for debt liabilities and allocation to this non-distributable reserve, the company may then declare and pay annual and interim dividends.

In relation to standard, unregulated companies (not constituting an investment fund) annual dividends are declared by the shareholders at their annual general meeting approving the company's annual accounts, provided that those accounts demonstrate that the proposed final, annual dividend would not cause the company's net asset value to fall below the level its subscribed share capital plus distributable reserves. The amount of the final, annual dividend may not exceed distributable profits, reserves (and carried forward profits) net of any current or carried-forward losses and allocations required to the non-distributable reserve(s).

Interim dividends may also be declared by the board of directors/managers (or the chairman or the general partner, as applicable), provided that the proposed distribution does not exceed the profits of the company in the current year (plus net profits carried-forward) net of any current or carried-forward losses and any sums required to be allocated to non-distributable reserve(s). In declaring any interim dividend, the directors/managers must prepare a balance sheet showing the net funds available for distribution and the decision to distribute must be taken within two months of that balance sheet. At the time the annual accounts are to be approved, the statutory auditor (if any) must confirm to the board or the chairman or the general partner, as applicable, whether or not these conditions were met.

Dividend payments attract Luxembourg withholding tax but it may be reduced or exempt in certain circumstances.

Structuring the governance

The importance of shareholders agreements

Purpose

Luxembourg company law affords relatively few rights to shareholders with the result that a shareholders or joint venture agreement can be used to confer additional rights and powers on shareholders, in particular particularly regarding the transfer of shares (pre-emption rights, drag-along rights and tag-along rights, ...), rights of veto and corporate governance matters.

Ensuring compliance

To ensure compliance with the commercially agreed position in practice, it is better to replicate certain clauses from the shareholders or joint venture agreement in the articles of association. If the clause appears solely in the shareholders or joint venture agreement, the remedy for any breach will generally be a claim for damages with the related uncertainties associated with litigation risk including any difficulties of evidential proof. The availability of a court order to compel mandatory performance (rather than a claim for damages following non-compliance) will often be uncertain.

In many circumstances, the shareholders will prefer (at least at the outset) that all parties simply comply with their agreed joint position, rather than to seek financial compensation for breach, after the event. Thus, the matters set out below will often be included in the articles of association, breach of which results in immediate invalidity. Those constitutional documents can also be relied on against third parties by reason of their public filing and consequent registration at the Luxembourg companies registry, in the case of Sàrl, SA, SAS and SCA. A shareholders or joint venture agreement, in contrast, being a private contract, cannot be relied on against third parties.

However, as the articles of association are publically available on the Luxembourg companies' registry, a balance between the commercial confidentiality on one hand and the reliance against third parties and constitutional effect on the other hand, may need to be considered.

Duration

Shareholders or joint venture agreement are subject to a general principle of civil contract law that no contract can be made for an infinite duration. This does not necessarily require that a fixed number of years be set out in the agreement. As many shareholders or joint venture agreements are constituted for the purpose of a specific project with a required period of time or for a set investment period, reference to such a period for determining the duration of a shareholders or joint venture agreement is an appropriate approach.

Duty of good faith

In relation to any Luxembourg law governed contract, an overriding duty of good faith applies between the parties not only in their performance of the contract but also in pre-contractual matters and in any ultimate enforcement that may become necessary. This generally applicable duty has two specific, additional areas of application in the corporate context: abuse of majority and abuse of minority.

Abuse of majority may occur both in actions taken by shareholders and in actions taken by directors if those actions are:

- taken contrary to the general best corporate interests of the company;
- are taken either with the sole and exclusive intention to favor or prefer the majority shareholders to the detriment of the minority or to have, and to be intended to have, a damaging effect on the minority shareholders.

Abuse of minority refers to a situation where minority shareholders refuse to take decisions which are in the best corporate interests of the company and includes both voting under the articles and taking decisions within the contractual framework of the shareholders or joint venture agreement. Such refusal must be characterized by bad faith and be taken for exclusively self-referential, non-corporate reasons, contrary to the company's best corporate interests and causing damage to the company out of proportion to positive effects sought by the minority.

Governance arrangements

Governance arrangements would typically involve voting undertakings, veto rights in favour of a class of shareholder or class of directors/managers and rights to nominate directors/managers.

Appointment of directors / managers

Private equity and venture capital investors would usually have the rights to appoint directors/managers. Provisions that reserve the right to a shareholder to appoint one or several directors/managers are in principle not effective under Luxembourg law. However, in order to remedy such ineffectiveness, different classes of shares may be created in the articles of association in order to secure that each shareholder or group of shareholders (representing each a class of shares) may appoint one or more directors/managers on the board. Each class would be entitled to propose one or more candidates for a directorship. The shareholders would elect the directors/managers among the candidates proposed by the shareholders of such class. This formal procedure is necessary in order to circumvent the rule according to which the power to

appoint directors/managers is exclusively vested in the general meeting of shareholders acting as a global corporate body.

Voting undertakings (which are recognised by law) whereby all shareholders undertake to vote in favour of directors/managers nominated by a specific shareholder can also be implemented.

Management clauses

The board/general partner is in charge of determining the guidelines for the company's management and business development. Contractual provisions in a shareholders or joint venture agreement aiming at delegating the decision taking to a CEO or an executive committee would in principle be valid. Other down-stream delegations would only be acceptable provided that the management may not be deprived of any power to interfere in the management and to act in the interest of the company.

Veto rights – reserved matters

- Board level

Different classes of directors/managers may be created, each or some of them benefiting from certain veto rights on matters falling within the competence of the board and that are of particular interests for the shareholder(s) that "appointed" them.

Thresholds and majority requirements applicable to resolutions to be taken by the board can also be structured in order to ensure that no decision could be taken without the attendance or the approval of the relevant class of directors/managers.

- Shareholders level

Different classes of shares may also be created. Each shareholder or category of shareholders (e.g. majority shareholder, sponsor, minority shareholder, management, ...) will hold a class of shares entitling it/them to specific voting or economic rights.

In relation to general meeting of shareholders, the statutory quorums and majority requirements may be increased so as to ensure that no key decisions can be taken without the affirmative vote of the relevant category(ies) of shareholder(s). Each class of shares may also have veto rights over certain matters. They arrangements are generally quite effective provided they are included in the articles of association of the company.

Veto rights held by private equity or venture capital investors usually cover the following matters (either at the level of the investment vehicle or of the subsidiaries):

Veto rights

Corporate affairs

amendment to the constitutional documents
alteration of the financial year end or of the accounting policies
variation in the authorised or issued share capital
declaration or distribution of dividends
approval right of any transfer of shares, pre-emptive right, exercise of drag along and tag along rights
listing on an international stock exchange
appointment and change of the auditors
appointment or removal from office of any director
liquidation, winding-up or dissolution

Material changes

sale, transfer, leasing, licensing or disposal of all or a substantial part of the company/subsidiary's business, undertaking or assets whether by a single transaction or series of transactions, related or not
transfer of any shares in the capital of subsidiaries
entry into a partnership or joint venture arrangement or merger or similar mechanism
demerger, division or split of the company or subsidiary

Commitments

adoption of or any amendment to the operating budget
entry into any contract or arrangement (including mortgages or charges) which is unusual, onerous or otherwise outside the normal course of trading
making of any payment otherwise than on an arm's length basis
entry into by any (new) borrowings facility, the variation of the terms of any borrowing facilities or the issue or redemption of any loan capital prior to its due date
entry into any commitment or arrangement which is material to the business of the company or subsidiary
granting of any guarantee (other than in relation to the supply of goods or services in the normal course of trading) or the creation or issue of any debenture, mortgage, charge, pledge or other security (other than liens arising in the course of trading)
entry into any lease, contract, memorandum or other agreement for the licence, lease, sale or purchase of land or real property
establishment of any pension, profit sharing, bonus or incentive scheme
initiation and the subsequent conduct of any litigation, arbitration or mediation proceedings

Voting rights

General principle

As a general rule, one share gives right to one vote. It is however possible to issue shares with different nominal values with related pro rata voting rights (please see above under the financing instruments section (preferred shares)).

Voting arrangements

Voting arrangements among shareholders are valid and can be enforced to the extent that (i) they do not infringe the law or the corporate interest of the company and (ii) shall not be construed as granting the management of the company or of a subsidiary the right to give instructions to the shareholders.

Suspension of voting rights

If provided by the articles of association, the management can be authorized to suspend the voting rights of a “defaulting” shareholder under the conditions and formalities specified in the articles of association. Suspending the voting rights of defaulting shareholders may impact quorum requirements for holding a general meeting and approval requirements for ballot issues. Shareholders whose voting rights have been suspended still have the right to attend meetings.

Waiver of voting rights

A shareholder may agree to waive in full or in part its voting rights on a permanent or temporary basis. This option may use to accommodate certain regulatory obligations that a shareholder may be subject to.

Minority shareholders rights

Majority shareholder(s) / private

equity or venture capital investor(s) do not owe a fiduciary duty to the minority shareholders. Luxembourg law however provides for certain limitations such as the abuse of majority and the general principle of good faith.

Minority action

Shareholders of an SA or an SCA representing at least ten percent of the share capital and/or of the voting rights entitled to be exercised, have the rights to initiate an individual *actio mandati* (on behalf of the company) against members of the board of directors having defaulted in their duties.

Independent investigation

Minority shareholders of all types of companies representing at least ten percent of the share capital and/or of the voting rights entitled to be exercised, have the rights to address questions on the company and affiliated entities' affairs. In the absence of a response by the management, an independent expert may be appointed by a Luxembourg court to establish a report on the matters that were the object of the questions.

Convening of general meetings

Shareholders of an SA or an SCA holding ten per cent of the registered share capital may request a shareholders' meeting in writing, indicating the purpose of the meeting. Shareholders representing ten per cent of the registered share capital may also request that a certain matter be put on the agenda of a shareholders' meeting.

With respect to the S.à r.l., the threshold to convene a shareholders' meeting is set at fifty per cent of the registered share capital. Threshold for an SAS can be freely fixed in the articles of association.

Adjournment of a general meeting of the shareholders

Shareholders of SA, SAS and SCA representing ten percent of the share capital may request the adjournment a general meeting of the shareholders. The request should be addressed in session to the board of director / general partner and for a maximum period of four weeks.

Enhancing minority shareholder protection

Improving the protection of minority shareholders can be achieved by stipulating certain provisions in a shareholders' agreement or in the company's articles of association (e.g., information rights, right to have a representative appointed to the management board, provisions for a more stringent majority for certain decisions, veto rights on certain matters, approval clauses or share transfer restrictions).

Profit allocation

In principle, the shareholders are free to determine profit allocation as they consider commercially appropriate, subject only to a generally applicable, longstop prohibition on clauses which purport to totally exclude certain shareholders from participation in profits or exposure to risk of loss (*clauses léonines*).

Transfer of shares

Introduction

Shares in a SA, SAS or SCA are in principle freely transferable. However any transfer of shares performed in violation of the transfer restrictions included in the articles of association of a SA, SAS or SCA shall be null and void.

Shares in a Sàrl are not freely transferable to non-shareholders.

The prior approval of at least seventy-five percent of the share capital (this can be reduced to fifty percent) is required. Stricter consent thresholds may also be contractually agreed in the articles of association. In the case of a transfer to a fellow shareholder, no such consent is required.

Transfer of shares in a SCS or SCSp can be freely organized in the partnership agreement.

Approval and pre-emption clauses

In the Sàrl, the approval clause is automatically provided for by law and the shares in a Sàrl are no freely transferable to non-shareholders.

Approval clauses and pre-emption clauses in a SA, SAS or SCA are valid provided that the non-transferability period (which starts from the date of the transfer of approval request or the invitation to exercise pre-emptive rights) does not exceed twelve months. After such period, the parties will have to find an arrangement to allow the departing party to leave the company.

Lock-up

Lock-up clauses in a SA, SAS or SCA should be reasonably limited in time and in the corporate interests of the company. No such requirements exist for Sàrl.

Drag-along and tag-along clauses

Drag-along and tag-along clauses are in principle valid under Luxembourg law (article 1855 of the Luxembourg civil code formally recognized the validity of arrangements organizing the transfer of shares that do not have as sole purpose the control of participation in profits and losses).

The statutory framework regarding the transfer of shares applicable to Sàrl (i.e. the prior approval of new shareholders by at least seventy-five (or fifty) percent of the share capital) however results in an area of sensitivity in relation to drag-along and tag-along provisions. It is not possible to pre-approve a possible transfer blind as to the identity of proposed future transferees. Unless supported by a proprietary security interest, the most that can be done is to include a contractual provision in the shareholders' agreement / voting agreement where all parties agree to vote in favor of such transfer.

Good-leaver and bad-leaver provisions

One of the most important elements of a management incentive program is the leaver scheme, which makes provisions concerning the compulsory transfer of the manager's shares if the manager ceases to be active for the company. Technically, this is structured by call and/or put options. The validity of such clauses is expressly recognized by article 1855 of the Luxembourg civil code.

Efficiency

If a share transfer restriction clause is valid, it is however not necessarily effective in practice. Indeed, future shareholders are not automatically bound by an existing shareholders or joint venture agreement and shareholders or joint venture agreements are not enforceable against third parties (except in case of fraud of the latter).

Therefore, when a party transfers its shares in breach of the transfer restrictions, the transferee (who was not aware of the transfer restrictions) becomes the legal owner of such shares, though the transferor may be sued for damages for breach of contract or, as the case may be, be required to pay a contractual penalty.

Inserting the transfer restrictions into the articles of association would improve their enforceability against third parties - transferees will not be able to claim that they were unaware of the transfer restrictions as the articles of association are public. Another advantage of entering the transfer restriction in the articles of association is that the restrictions will apply to all future shareholders, whether parties to the agreement or not to the shareholders or joint venture agreement.

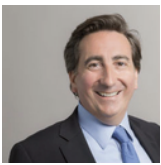
Conclusion

It is important to ensure both the private equity or venture capital investors and, as the case may be, management teams receive proper advice to ensure that:

- the deal is structured in the most tax efficient manner possible and that the commercial deal works for all parties; and
- the deal is structured in a manner which is effective under Luxembourg law and which works for both tax and legal purposes.

If not, either party could end up making an expensive mistake, particularly if a falling out were to occur between the management team and the sponsor at a later point when, for example, the investors could (if not properly advised at the outset) find themselves trapped, should they not have taken into account the restrictions for the transfer of shares to non-shareholders.

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