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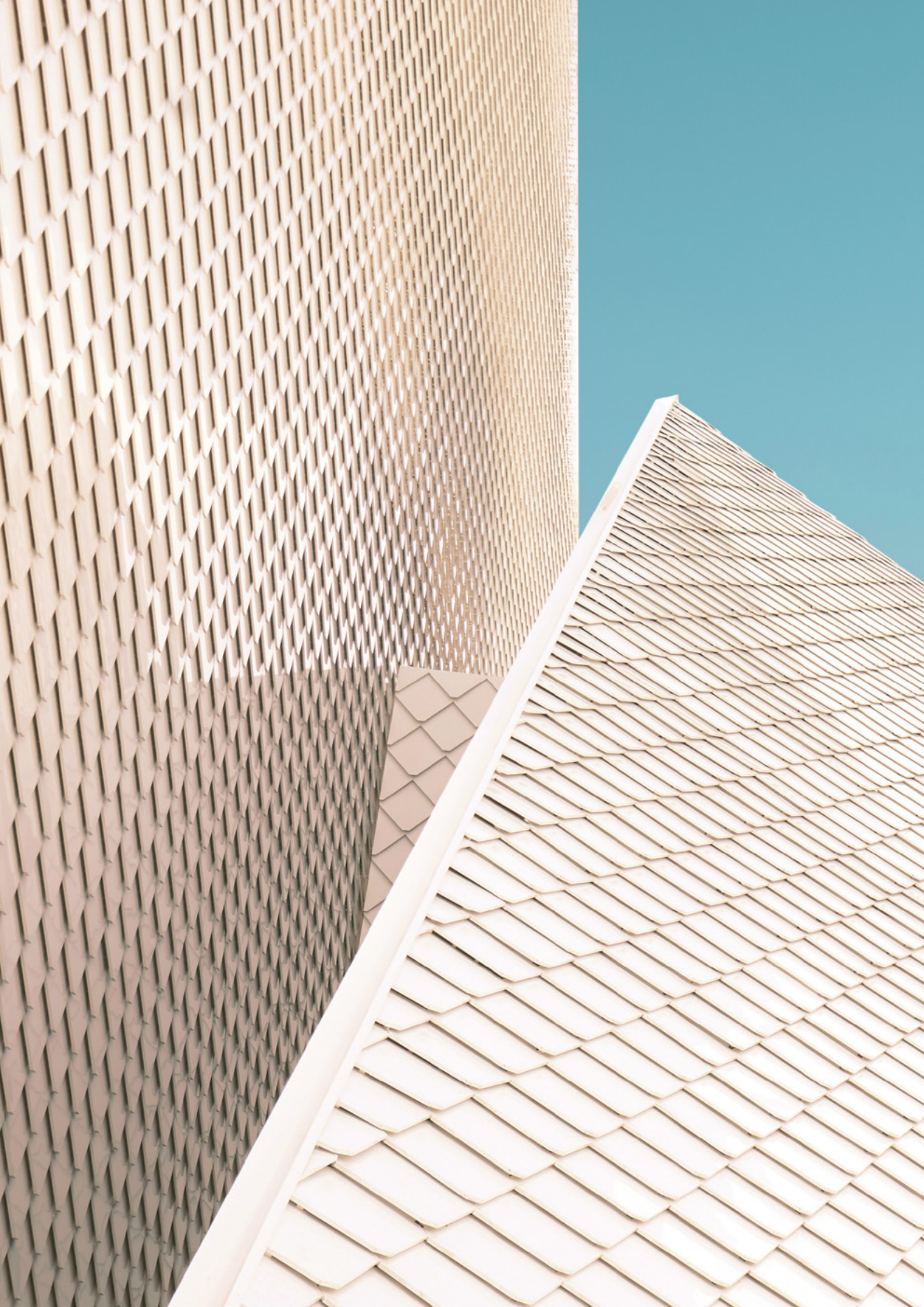
Enforcement of security under Luxembourg law

A comprehensive overview

October 2024

Outpacing change



Introduction

Luxembourg has become an extremely popular financial centre and place of incorporation for portfolio acquisition vehicles. Furthermore, as the largest fund domicile jurisdiction in Europe, Luxembourg is a key player in the fund finance space.

This development is largely due to the highly creditor-friendly Luxembourg legislation relating to security interests offering lenders a safe single point of enforcement and making Luxembourg a great jurisdiction for debt financings.

In practice, acquisition finance facilities are usually secured against the assets and cash flows of the target company as well as of the buyout vehicle. Since a Luxembourg holding company generally does not have any operational activities, securities, receivables and cash in bank accounts are the most common assets to be covered by security arrangements.

As regards fund financings, the security package will comprises of a pledge agreement over the uncalled capital commitments of the fund investors and the right of the general partner to call said commitments and a pledge over the bank account into which the capital contributions are paid.

Similarly, in margin financings or NAV facilities, it is important to have easily enforceable and solid security interests over the pledged assets, often securities accounts and other financial instruments.

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

In July 2022, the Luxembourg Financial Collateral Law was reformed. The reform reinforces the legal certainty of Luxembourg financial collateral arrangements by introducing a number of welcome clarifications to several frequently-discussed notions and enforcement mechanisms in the law.

Considerable creditor-friendly advantages under the Luxembourg Financial Collateral Law

Easy perfection steps for pledge agreements

Perfection of pledge agreements subject to the Luxembourg Financial Collateral Law is easy, fast and cheap.

Where they relate to receivables such as uncalled capital commitments or intragroup loans, pledges are validly perfected by the mere conclusion of the pledge agreement between the parties. However, payment obligations incumbent upon third parties which have been pledged under the relevant agreement can be validly discharged when payment is made by the debtor/investor to the security grantor as long as it has not received notice of the security interest. Notification of the pledge to the relevant debtor is therefore highly recommended, and market standard, even if not strictly required for security perfection purposes from a Luxembourg law perspective.

As regards the pledging of assets deposited on a bank account the relevant account bank must be notified of the pledge and asked to relinquish any rights of set off, combination of accounts or first ranking pledge or general lien in respect of the account arising from its general terms and conditions.

For registered securities such as shares in commercial companies, the pledge will need to be recorded by the relevant company in its shareholder register.

Great flexibility in case of restructurings and amendments

Market standard Luxembourg pledge agreements generally include savings or interpretation provisions whereby the security created thereunder shall automatically extend to any amendments of the underlying secured finance documents.

This means that in case of amendment or restatements or similar transactions, the security interest created under the pledge agreement can remain in place without the need for amending it or even creating supplemental or lower ranking security.

Prevailing market practice simply requires a security confirmation statement to be provided by the security grantor.

No requirement for any court order of involvement of public authority

An enforcement under the Luxembourg Financial Collateral Law can be carried out by the secured party by way of private action, without requiring any court order or the involvement of any public or judicial officer or notary.

Great flexibility with respect to the notion of enforcement event

The Luxembourg Financial Collateral Law further provides that any event can serve as an enforcement event: an enforcement event is a default or any other event 'whatsoever' agreed upon between the parties.

The agreed enforcement events entitling the secured party to enforce a pledge can be events other than payment defaults, such as breaches of financial covenants or other events or circumstances which relate to either the general framework or to certain specific aspects of a transaction and this irrespective of whether or not any payment obligations have become due and payable.

This recent change to the Luxembourg Financial Collateral Law has codified existing Luxembourg case law and legal doctrine thereby cementing the creditor friendly solutions previously adopted.

Application of enforcement proceeds

The amendment of the definition of enforcement event, raised the question whether enforcement proceeds should be applied immediately against the relevant secured obligations or whether the pledgee should be required to hold these proceeds as continuing security until the secured obligations become due and payable.

The Luxembourg Financial Collateral Law now clarifies this point by providing that, unless otherwise agreed by the parties, enforcement proceeds shallbe immediately applied towards repayment of the secured obligations.

No requirement for a formal default notice

Another important feature is the disapplication by the Luxembourg Financial Collateral Law of the civil law requirement for the service of a formal default notice (mise en demeure) prior to enforcement, unless otherwise provided for in the transaction documents.

Enforcement in insolvency situations

Certainly one of the main benefits of the Luxembourg Financial Collateral Law: pledges governed by this law are bankruptcy remote. They are valid and can be enforced notwithstanding the opening of a reorganisation, bankruptcy or winding-up proceedings or similar national or foreign proceedings against the security provider. The assets subject to the pledge also do not form part of the estate of the insolvent company. Further, no claw-back rules will apply to pledge agreements subject to the Luxembourg Financial Collateral Law. This means in practice that the secured party will be able to enforce a pledge granted after the opening of insolvency proceedings against the security provider in Luxembourg or abroad.

Furthermore, the Luxembourg Financial Collateral Law gives an extraterritorial effect to the above principle by extending the insolvency remoteness to any financial collateral arrangement, or any similar guarantee, granted by a Luxembourg-incorporated entity even if such financial collateral arrangement is governed by a law other than Luxembourg law.

Explicit enforcement provisions over claims arising under insurance contracts

The Luxembourg Financial Collateral Law explicitly allows for insurance contracts to constitute financial collateral within its scope (some legal scholars had in fact debated this previously). A pledge over such insurance contracts can be enforced by requesting the repurchase of the contract or the payment of all sums due under the insurance contract in satisfaction of the secured obligations.

It is, however, important to note that a pledge over a Luxembourg life insurance contract still needs to comply with articles 116 and 117 of the Luxembourg law of 27 July 1997 on the insurance contract. This law has not been amended by the reform to the Luxembourg Financial Collateral Law. Specific rules in this respect provide that amongst other things, a life insurance contract may only be pledged by an endorsement signed by the policyholder, the collateral taker and the insurer and, where the benefit of a life insurance contract has already been accepted, with the consent of the beneficiary.

Main methods of enforcement of a pledge under the Luxembourg Financial Collateral Law

The main enforcement procedures are:

- appropriation at a price determined pursuant to a pre-agreed valuation method;
- sale of the pledge assets (by private sale, sale on a trading venue or by public auction);
- attribution in court; and
- set-off/netting.

The two most commonly-used are undoubtedly the procedures of appropriation and sale of the pledged assets.

A Appropriation

The appropriation of the pledged assets at a pre-agreed price or a price determined pursuant to a pre-agreed valuation method is an out-of-court enforcement procedure that does not require the intervention of a public authority; making an appropriation a very cost-efficient method depending on the relevant valuation method.

Another advantage is the fact that the valuation can be performed after the appropriation has occurred. This is useful for example where the secured creditor is missing financial or other information on a pledged company that it would be able to obtain only on enforcement.

Furthermore, the pledged assets can be appropriated by the pledgee himself or by any third party designated by it (e.g. a special purpose vehicle wholly owned by the secured creditor or set up as an orphan structure).

In order to reduce the risk of challenge, in most instances, the parties to the pledge agreement decide that the valuation is to be carried out by an independent external auditor (for instance, a réviseur d'entreprises agréé).

Appropriation of financial instruments and of units or shares in a collective investment undertaking

A recent feature in the Luxembourg Financial Collateral Law is the introduction of provisions regarding the value at which financial instruments admitted to trading on a trading venue and units or shares in collective investment undertakings can be appropriated.

The Luxembourg Financial Collateral Law now clearly distinguishes between (i) an appropriation of financial instruments admitted to trading on a trading venue (which appropriation can be made at the market price of such financial instruments), and (ii) an appropriation of units or shares in a collective investment undertaking, which can either be made at their market price, provided that such units or shares are admitted to trading on a trading venue, or at the price of the last published net asset value by, or for that, collective investment undertaking, provided that the latest publication of the net asset value is not older than one year.

B Sale

Private sale in a commercially reasonable manner

Unlike appropriation, a valuation of the assets is not required in the event of the enforcement of a pledge by way of a private sale of the pledged assets. However, such sale must then always be done in a commercially reasonable manner.

In order to effect the sale under arm's length conditions the secured creditor would usually have to contact several potential buyers and sell the pledged assets to the highest bidder. Many market participants, in this respect and for reasons of certainty and prudence prefer that an independent valuation be obtained to reduce the risk of challenge.

In the absence of legal definition, as a guidance, a private sale would meet the "normal commercial test" if it has been 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.

The Luxembourg Financial Collateral Law also clarifies that, with respect to units or shares in a collective investment undertaking, the secured creditor can enforce the pledge by requesting the redemption of the pledged units or shares at their redemption price in accordance with the constitutional documents of the relevant collective investment undertaking.

Sale of pledged assets on trading venues

In respect of the private sale of financial instruments admitted to trading on a trading venue, the sale of such pledged assets can generally happen on the platform on which the pledged assets have been admitted to trading, which does not necessarily need to be a regulated market only. Assets which have been admitted to trading on any unregulated market can also be directly disposed of on the same market. Such markets include any Luxembourgish, European or third country regulated markets, multilateral trading facilities (MTF) or organised trading facilities (OTF).

Public auction enforcement regime

Finally pledged assets can be sold by public auction.

The Luxembourg Financial Collateral Law now provides that assets can be acquired during such a public auction through any payment method, including set-off against the obligations secured under the relevant security arrangement. However, it ought to be noted that the public auction procedure is not used very frequently as pledgees tend to prefer the shorter and less expensive appropriation or assignation mechanisms as described above.

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