

The attractiveness of Luxembourg for international lending and collateralization operations underpinned by a recent court decision

Luxembourg courts ruled that collateral can be enforced and shares of a company appropriated by a lender even though he has not claimed repayment or if the debt guaranteed is not yet due and payable. Undoubtedly, lenders can extend the scope of contractual default under their security documentation without fear to see their enforcement rights denied. For more detailed analysis read below our legal flash news.

Summary

In a recent judgment the Luxembourg Tribunal of First Instance confirmed the validity of an enforcement of pledge over shares based on the sole notification of a breach of contractual covenants and notwithstanding that no payment default under the underlying debt obligations or their repayment had been required.

In particular, the tribunal rejected the demand of a pledgor of the shares of a Luxembourg company who sought to annul the enforcement of a pledge that he deemed abusive and fraudulent because grounded on the sole breach of a contractual financial covenant.

Facts

A group of French companies, owned (directly and indirectly) by a Luxembourg company, issued certain senior corporate bonds. The issuance of the senior bond was secured in favor of the subscribers by, amongst others, a pledge over the shares in the Luxembourg company and a security interest over subordinated bonds issued by that Luxembourg company and subscribed by its shareholders.

The terms and conditions of the senior corporate bonds contained various financial covenants and binding financial ratios to comply, including an *Actual Financial Gearing ratio (Lever Financier Reel)*. Under the pledge terms, non-compliance with the Actual Financial Gearing ratio constituted an 'Event of Realization' triggering a potential enforcement of the Luxembourg security interests.

Due to a restructuring at the level of the group companies, the *Actual Financial Gearing ratio* could no longer be respected and the group companies endeavored to obtain a general waiver from the senior bondholder. This unanimous agreement was finally not obtained and the Luxembourg security interests were finally enforced by the security agent.

Legal analysis¹

The demand to rescind the enforcement of the pledge was made on the basis of the following arguments, each of which was rebutted by the tribunal.

/ **Absence of a payment default and of breach of *Actual Financial Gearing ratio (Levier Financier Reel)***

Referring to the Luxembourg law on financial collateral arrangements of 2005, the Luxembourg judge confirmed that (i) the parties can freely agree which event may trigger the realization or appropriation of the financial collateral and (ii) Luxembourg law allows the enforcement of the security interest even though the secured debt is not due and payable nor its payment is claimed.

In particular, the non-compliance with the *Actual Financial Gearing ratio (Levier Financier Reel)*, as agreed between parties in the security agreement, constituted a valid cause for enforcement of the security interest even if the secured debt was not yet due and payable.²

/ **Abusive use of rights**

The Tribunal of First Instance rejected the argument that the enforcement of the pledge was manifestly abusive. In support of his decision, the Tribunal of First listed four situations which can be considered as constituting an abusive use of rights;

1. intention to harm,
2. an evident disproportion between the benefit obtained by the pledgee from the exercise of its enforcement rights and the damage incurred by the pledgor,
3. the diversion of the pledge objective pledge which aims at the payment of the (underlying) debt, and
4. any behavior which manifestly exceeds that of an honest, prudent and diligent creditor.

The Tribunal ruled that the enforcement of the pledge with a view to restructure and recapitalize the company and its subsidiaries, and having as goal the reimbursement of its claim, was not diverting the purpose of the pledge.

/ **Fraud**

Finally, the Tribunal confirmed that security agent, in the exercise of his realization rights, did not act fraudulently. Namely, the enforcement was made in strict accordance with the contractual clauses of the pledge (such as instructing experts and appointing lawyers to prepare the enforcement documentation) and pursuant to loyal negotiations.

¹ For the purposes of this newsflash only legal arguments deemed relevant have been raised. The judgment contains further statements on (i) legal representation and (ii) nullity of decisions of the board of managers and shareholders that we do not analyze herewith.

² The Tribunal of First Instance elaborates further on the report provided by an expert on the basis of French GAAP rather than IFRS and further states that the issuer of the bonds never contested the breach of the *Actual Financial Gearing ratio*.

VANDENBULKE's opinion on this judgement:

- / Luxembourg takes a liberal view of the contractual enforcement process of the pledge insofar as its terms conditions are implemented faithfully and with loyalty;
- / The calculation of the financial covenants must be clearly set out in the underlying debt documentation (French GAAP vs IFRS calculation);
- / The appropriation of the shares at a specific price as determined by experts, in accordance with the terms of the security agreement, does not constitute an abuse of right;
- / To challenge on grounds of fraud an enforcement of a Luxembourg pledge, the fraudulent intent must be clearly demonstrated.

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