PwC Legal

MAIN BENEFITS OF THE LAW ON FINANCIAL COLLATERAL ARRANGEMENTS

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INTRODUCTION

The main features of the Luxembourg law of 5 August 2005 on financial collateral arrangements (the "**Law**"), which implemented the Financial Collateral Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the "**Collateral Directive**") are:

- liberalised rules for creating and enforcing financial collateral arrangements;
- protection of netting and financial collateral arrangements from insolvency rules;
- validity and enforceability of substitution of collateral and margin calls provisions; and
- clarification of conflict of law rules issues for financial instruments in book-entry form.

SCOPE OF THE LAW

Rationae personae

All types of parties

The Law provides that the regime is available to all types of parties, whether finance professionals or not.

Furthermore, a collateral financial arrangement may be granted in favour of a person such as a fiduciary, a security trustee or a security agent, who will act for the account of the beneficiaries of the security interest, including their successors and assigns.

The beneficiaries of the security interest may be present or future as long as they are or may be determined. The Law provides that the trustee or security agent has the same rights as those granted to the direct beneficiaries of the security interests (as defined by the Law) without prejudice to their obligations towards the beneficiaries of the considered security interest.

Exception

For fiduciary transfers of title by way of security, the fiduciary must be a finance professional.

Rationae materiae

The Law applies to assets, present or future, (hereinafter the "**Assets**"), which are defined in the Law as, on the one hand, financial instruments, defined in the broadest sense, i.e. including among others, debt and equity securities and other instruments equivalent to shares, units in companies and undertakings for collective investment and, on the other hand, claims/receivables ("*créances*").

The Law expressly recognises the validity and enforceability of contractual arrangements allowing for substitution of collateral and margin calls.

Financial collateral arrangements and netting arrangements

The Law applies to any financial collateral arrangement securing any secured liabilities, present or future, which give right to a cash settlement and/or delivery of financial instruments (or the underlying in respect of financial instruments).

A financial collateral arrangement is defined in the Law as a pledge agreement (*contrat de gage*), a transfer (including a fiduciary transfer) of title by way of security agreement (*transfert de propriété à titre de garantie*) or a repo transaction (*contrat de mise en pension*) governed by the Law.

Furthermore, the Law specifically addresses the issue of the validity of set-off mechanisms.

Pledge agreements (art.3 to 12)

Please see below.

Transfer of title by way of security (art.13 and 14)

Transfers of title by way of security are "creditor friendly" security interests because perfection is easy (mere entry into the security document), and more importantly, the parties are free to contractually provide for the enforcement procedures.

A transfer of title by way of security may be made by way of fiduciary transfer, in which case the provisions of articles 5 to 9 of the Luxembourg law of 27 July 2003 relating to trust and fiduciary contracts are applicable in close relation with articles 13 and 14 of the Law. Such fiduciary arrangements imply a transfer of title to the bank, acting as fiduciary, for which the applicable transfer of title formalities have to be complied with. In holding the fiduciary assets as security, the bank must conform to the agreed contractual enforcement provisions. These arrangements are, however, not as frequently used as pledges. It is not necessarily a security arrangement, but may be used for security purposes.

Repurchase agreements (art.15 to 17)

Repurchase agreements (or "**repo**") may be entered into in relation to all types of assets, tangible or intangible assets.

Netting arrangements

Set-off arrangements are not defined by the Law as financial collateral arrangements. Such arrangements are however protected from the Luxembourg insolvency rules.

PLEDGE AGREEMENTS

A typical distinction exists between civil law pledges, which are pledges securing civil obligations and governed by the Civil Code only, and commercial pledges, which are pledges securing commercial obligations and mainly governed by the Commercial Code. There is also another distinction between commercial pledges governed by the Law and commercial pledges outside the scope of the Law. Pledges over Assets are commercial pledges governed by the Law.

As a rule, pledge agreements are accessory to the secured obligation. As a result, if the secured obligation is terminated or invalid, the pledge is also terminated.

The Law applies to pledges over Assets and contains detailed provisions on creation, perfection and enforcement of pledges.

Creation and Perfection

The Law covers most Luxembourg pledges typically entered into in international financing transactions, such as pledges over shares, bank accounts and claims/receivables.

To create a pledge over Assets, the Law requires that the pledged Assets be transferred from the pledgor's control to the control of the pledgee or of a third party selected by the pledgor and the pledgee.

The Law provides that this requirement is met:

- in the case of financial instruments in bearer form, when the relevant instruments have effectively been transferred (*transfert par tradition du titre*) to the pledgee or the third party;
- in the case of financial instruments in registered form, when the relevant instruments have been recorded in a register for registered securities; and
- in the case of financial instruments in book-entry form:
  - if the pledgee is the depositary, when the pledge and the pledgor have entered into the pledge agreement;
  - when the pledgor, the pledgee and the depository have entered into a tripartite agreement by which the depository will act upon the instruction of the pledgee and without any further approval of the pledgor. If the depository is not a party to this agreement, the requirement is met when this agreement is notified to the depository;
  - when the relevant instruments have been recorded in an account opened in the name of the pledgee;
  - when the relevant instruments have been recorded, without any numbering, in an account held by a depository opened in the name of the pledgor or any other person as third party holder, such instruments being designated in the books of the depository, individually or collectively, by reference to the relevant account, as being pledged.

    In most cases, the pledge is notified to the account bank and must be accepted and acknowledged by the account bank in order for the pledgee to benefit from a first ranking pledge.

For financial instruments not referred to above, the dispossession is achieved vis-à-vis all third parties if the creation of the pledge has been notified to or accepted by the issuer of such financial instruments or, if the financial instruments are held by a third party holder, by the notification to or acceptance by that third party holder.

For receivables, the dispossession is achieved vis-à-vis the debtor and other third parties, by the mere conclusion of the pledge agreement.

However, the debtor, until informed of the creation of the pledge, will be validly discharged if it makes a payment to the pledgor. Pledges over receivables give the pledgee the right to exercise all rights of the pledgor attached to the pledged receivables.

If the pledged claim(s) or the debtor is subject to a law other than Luxembourg law, specific perfection requirements or formalities might have to be complied with under such other applicable law(s).

The pledgee has a retention right in connection with the pledged Assets.

Validity of second (and lower) ranking pledges

The Law expressly recognises the validity of second (or lower) ranking pledges and regulates their perfection and enforcement. With the exceptions of second (or lower) ranking pledges over financial instruments in registered form and financial instruments to order, the creation of valid second (or lower) ranking pledges always requires the prior consent of all higher ranking pledgees.

Exercise of the rights attached to financial collateral instruments

Unless there is an agreement to the contrary, the first ranking pledgee may collect interest, rights, dividends and, more generally, any income as well as, in case of reimbursement, principal on the collateral it holds and set off all such amounts against the secured liabilities.

In the absence of any agreement between the parties concerning the rights relating to the financial instruments, such rights will remain vested in the security provider, except in the case where a right of use has been granted to the secured party (in which case such rights will be vested in the secured party).

Right to use the Assets

Right of the pledgee to use the collateral

The Law provides the legal basis for the right of the pledgee, with the agreement of all higher ranking pledgees (if any) to use and dispose of the collateral, provided that:

- the parties have agreed to it; and
- at the time the secured obligations become due, the pledgee returns equivalent collateral to replace the original collateral, or, if so agreed by the parties, apply the value of the collateral to the secured obligations by way of set-off.

It should be noted that the pledgee will be deemed to remain in possession of the collateral notwithstanding the exercise of its right to use such collateral.

It should be noted also that any equivalent collateral transferred as provided above shall be subject to the same security interest as the original collateral and shall be treated as having been provided at the same time as said original collateral.

Right of the pledgor to use the Assets

The Law expressly provides that the right granted by the secured party to the pledgor to use the collateral does not affect the dispossession of the Assets.

Enforcement

The Law has simplified the enforcement of pledges in two ways.

First, unless otherwise agreed by the parties, it is no longer necessary for the secured party, before enforcing its rights on the collateral, to demand that the defaulting party pay or, if relevant, perform outstanding obligations. In other words, there is no longer a legal requirement to send a notice before the enforcement of the pledge.

Secondly, the enforcement methods of the pledge may be tailored to the type of collateral which is the subject of the pledge. The realisation of collateral on enforcement of security could therefore be quicker and more efficient. The methods of enforcement available include:

- appropriation of the collateral either by the pledgee or by a third party appointed by the pledgee at a price determined, before or after the appropriation, in accordance with a valuation process agreed upon by the parties;
- sale of the collateral:
  - in a private transaction at arm's length conditions (including by way of a redemption order given to the issuer of such collateral);
  - by public auction;
  - on a stock exchange, or
  - by way of set-off mechanisms;
- appropriation of the collateral at a price to be determined by experts following a court order;
- where the collateral consists of financial instruments admitted to trading on the Luxembourg Stock Exchange or a foreign stock exchange or traded in a regulated market operating regularly, recognised and open to the public, appropriation of such financial instruments at their market value;
- where the collateral consists of units or shares in a Luxembourg or foreign undertaking for collective investment calculating and regularly publishing a net asset value, appropriation of such collateral at a price corresponding to the last published net asset value; and
- where the collateral consists of claims for sums of money due by a third party, the secured party may require the third party to make payment of the amount due by the third party directly to the secured party, upon maturity of such third party's debt and unless set-off has occurred.

Pledge of shares in a S.à r.l.

Notwithstanding the provisions of Article 189 of the Luxembourg law of 10 August 1915 on commercial companies, as amended pursuant to which shares in a S.à r.l. may not be transferred to non-shareholders unless shareholders representing at least three-quarters of the corporate

capital shall have agreed thereto in a general meeting, such general meeting of the shareholders is not required in case of enforcement of a pledge over all issued shares of a S.à r.l. and granted, at the time of its creation, to one or several persons in the framework of a single transaction.

In all other cases, the consent of the general meeting of the shareholders may be given in accordance with the above provisions at any time before enforcement of the pledge to one or several identified or non-identified persons and such consent is irrevocable.

NETTING AND FINANCIAL COLLATERAL ARRANGEMENTS IN INSOLVENCY SITUATIONS

Enforceability of financial collateral arrangements in insolvency situations

The Law expressly provides that all financial collateral arrangements (including pledges) as well as the enforcement events are valid and enforceable, even if entered into during the pre-bankruptcy period, against all third parties, including supervisors, receivers, liquidators and any other similar persons or bodies irrespective of any bankruptcy, liquidation or other situation, national or foreign, of composition with creditors or reorganisation affecting any one of the parties.

Enforceability of netting arrangements in insolvency situations

The Law provides that contractual set-off arrangements are valid and enforceable in the event of insolvency proceedings or any other similar situation of conflicting claims of creditors, even if the relevant debts are not connected, provided that the set-off arrangement is embedded in a valid agreement or clause and relates to Assets and the set-off operates on the basis of bilateral or multilateral set-off clauses or agreements.

Contractual arrangements allowing for substitution of collateral and margin calls are also protected from insolvency provisions.

PRIVATE INTERNATIONAL LAW ISSUES

Conflict of laws rules for book-entry financial instruments

According to the principle of lex situs, the law governing collateral security is the law of the country where the financial collateral is located.

The Law clearly specifies that, in the case of Assets consisting of book-entry securities, the law of the place where the account is held governs:

- the perfection requirements;
- the steps required for the realisation of book entry securities collateral following the occurrence of an enforcement event; or

- the scope of the financial collateral arrangement (identification of pledged Assets and related rights, such as dividends, income and other proceeds).

Foreign law financial collateral instruments

The Law clearly states that foreign law financial collateral arrangements or foreign law security interests similar to financial collateral arrangements granted by a pledgor established or residing in Luxembourg benefit from the same protection against insolvency, bankruptcy, composition with creditors or similar proceedings as Luxembourg law financial collateral arrangements.

MISCELLANEOUS

Waivers

In a pledge over receivables, debtor(s) may validly waive its/their right of set-off vis-à-vis their creditors or any other objection (exception) it/they may have vis-à-vis its/their creditor(s) and vis-à-vis the pledgee.

In addition, the parties to a financial collateral arrangement may provide that the pledgor may waive, in case of enforcement, any recourse (personal or by way of subrogation) it may have against the debtor of the secured obligations.

The above waivers are valid between the parties and opposable to third parties. They are also bankruptcy remote.

Registration

No registration, filing or similar formalities are required to ensure the validity, binding effect and enforceability of financial collateral arrangements.

As a rule, financial collateral arrangements do not need to be registered with the tax authorities. If the parties wish to register the above arrangements, they may do so against the payment of a fixed registration duty of EUR 12.

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