

Restructuring and insolvency in Luxembourg

Noble & Scheidecker

PricewaterhouseCoopers Sàrl



This article first appeared in The European Restructuring and Insolvency Guide 2005/2006 published by Globe White Page.

www.europeanrestructuring.com

Luxembourg

Katia Scheidecker, Partner

Noble & Scheidecker

Jean-François Kroonen,
Corporate Finance Director

**PricewaterhouseCoopers
Sàrl**

In Luxembourg, three types of insolvency procedures are available:

- controlled management and composition proceedings, both of which facilitate corporate rescue; and
- bankruptcy/liquidation proceedings, which result in the winding-up of the company and the recovery of value from its underlying business or assets.

Most of the rules on insolvency and bankruptcy are contained in Articles 437 and following of the Commercial Code, as introduced by the Law of July 2 1870. An English translation of the legislation is not available.

Historically, the widespread use of bankruptcy/liquidation has led to a perception that Luxembourg insolvency law is particularly favourable towards debtors. However, several recent amendments and bills indicate a shift towards a more creditor-friendly approach.

Since 1870, only minor changes have been introduced:

- The Law of March 31 2000 provides for the enforceability of retention of title clauses in favour of the seller in the event of the purchaser's bankruptcy;
- The Law of August 1 2001 concerns the transfer of property intended to serve as security. It provides that bankruptcy proceedings do not preclude the security holder from enforcing such guarantees;
- The Property Transfer Bill, which was registered with the Luxembourg Parliament on November 11 2003, elaborates on the provisions set out in the Law of August 1 2001. It is envisaged that this bill will become law in the coming months; and
- A pending bill increases the minimum share capital of Luxembourg limited companies and provides for various measures to guarantee the entirety of the share capital and prevent insolvency.

The EU Insolvency Regulation, which aims to improve the effectiveness of cross-border insolvency proceedings, has had direct application in Luxembourg since it entered into force on May 31 2002.

I The legal framework and the effectiveness of court processes/ legal remedies

I.1 Describe the nature and the effectiveness of the following:

(a) Debt recovery remedies where the creditor has no security

Depending on the nature of the debt, the civil and commercial laws allow an unsecured creditor to commence different types of proceeding against the debtor. For example, Articles 2204 and following of the Civil Code allow an unsecured creditor to sue the debtor and sell the debtor's immovable property at auction once a judgment has been obtained.

It is also possible to execute a judgment against the debtor's movable property where non-compliance with the judgment might result in the sale of the property.

The timeframe for obtaining a judgment depends on the individual circumstances of the case, as well as the court before which the matter is pursued (ie, civil or commercial).

(b) The enforcement of security

Formalities relating to the enforcement of security vary according to the type of security. Articles 2095 and following of the Civil Code provide for various legal privileges applicable to creditors in specific circumstances, which may interfere with the enforcement of security.

Transfer of property as security: There are no particular formalities to be observed under the Law of August 1 2001. Where debts are not repaid in full, creditors may hold the outstanding debt against the value of the transferred assets.

Pledge: Pledged assets may be subject to different rules depending on the nature of the assets being pledged. The pledge necessarily entails a dispossession of the pledged assets.

Commercial pledge: In case of default on the maturity date, the creditor is entitled to sell the pledged assets at a public sale under the terms of either the pledge agreement or a court decision. The creditor may also request a court order so that title to the pledged assets is transferred to it.

The Property Transfer Bill provides for new enforcement procedures for pledged securities by allowing the creditor to recover its claim by selling the encumbered goods under a court order or by mutual agreement.

Pledges over goodwill: This type of pledge can be granted only to a bank or other entity certified by the Luxembourg government. To enforce the security, those assets of the business that were covered by the pledge must first be seized. The creditor must then seek authorisation from the president of the commercial court to sell these elements of the business through a public officer appointed by the president.

Mortgage: Mortgages can also be enforced through seizure of property. The property is sold at a public auction, again through a public officer. The secured creditors will receive the funds generated from the auction in order of ranking.

(c) Corporate bankruptcy/ liquidation processes

Corporate bankruptcy/liquidation proceedings may be commenced against a debtor where it has ceased to make payments and where its commercial creditworthiness has been impaired. The following actions may be taken:

- The debtor may file a bankruptcy petition with the commercial court where its registered office or principal place of management is located;
- The creditors may file a bankruptcy petition with the commercial court; or
- The court may initiate proceedings itself.

Further, the EU Insolvency Regulation provides that proceedings may be initiated in Luxembourg if a company domiciled in another EU state has an operational establishment in Luxembourg.

Evidence of the debtor's state of insolvency must be provided to the court, including the accounts (complete with a valuation of the debtor's movable and immovable assets and a list of its creditors), as well as letters from creditors refusing to deliver goods or letters from credit institutions refusing credit to the debtor.

Where a creditor is applying for the commencement of insolvency proceedings, the court will accept, among other things, evidence that the creditor has obtained a judgment against the company which it is unable to enforce.

Once the court is satisfied that the debtor is insolvent, a receiver and a judge will be appointed to supervise the proceedings.

(d) Formal corporate rescue processes

Two formal corporate rescue procedures exist in Luxembourg, both of which may be applied for by an insolvent company.

In controlled management, governed by the Grand Ducal Regulation of May 24 1935, one or more commissioners – usually an accountant and/or a lawyer – will prepare a reorganisation plan or a plan for distribution of the assets. The debtor must show that it is no longer creditworthy or is having difficulties meeting its commitments. The procedure is not available if the debtor has already been declared insolvent by the court. A formal application for controlled management must be filed, setting out justified reasons for the application and including a list of all creditors and other relevant documentation.

In composition proceedings, governed by the Law of April 14 1886, a judge is appointed to oversee negotiations between the debtor and at least half of its creditors. The debtor must file a report on the justified reasons for the application together with a detailed statement of its assets, a list of its creditors, the amount of creditors' claims and the composition proposals.

If the district court decides that the debtor has committed fraud or gross misconduct, or that irregularities in the management are apparent, the debtor will not be permitted to enter into controlled management or composition proceedings.

(e) Informal corporate rescue processes

There is no specific legal framework in Luxembourg for informal corporate rescue proceedings. However, nothing prevents a company in difficulties from entering into a contractual arrangement with its creditors.

1.2 What are the formal processes to effect a liquidation of the company's assets?

The directors of an insolvent company must file for bankruptcy within one month of the company becoming insolvent. Once the commercial court is satisfied that the company is insolvent, it will set a date for the termination of payments, after which the company is held to be unable to meet its commitments. This date may be set retrospectively to up to six months prior to the granting of the order.

Once the court has declared the company insolvent, all creditors must file and prove their claims within 20 days.

The receiver will then draw up an inventory of assets belonging to the company; these assets may then be sold, subject to court approval. The receiver will also enforce any claims the insolvent company may have against its debtors.

Next, a hearing is arranged at which the court will establish the receiver's fee and the administration costs. The company and all creditors whose claims have been accepted are summoned to attend. The receiver presents the accounts of the insolvent company and proposes a plan for the distribution of the remaining funds. If this plan is not questioned by the creditors and is approved by the receiver, the judge and the court clerk, the creditors will be paid according to its terms.

Upon payment of all funds, the receiver will file an application with the commercial court for

termination of the proceedings, providing evidence of all payments. The court will then order the winding-up of the company, bringing the receiver's duties to an end.

1.3 What is the effect on debt collection and the enforcement of security of:

(a) An adjudication of corporate bankruptcy/liquidation?

An adjudication of bankruptcy prevents unsecured or non-privileged creditors from opening proceedings against the debtor. However, it has no effect on the enforcement of some forms of security. For example, where a creditor has possession of pledged assets, it is entitled to retain them until full payment of its claim.

Similarly, where property transfers are used as security (under the Law of August 1 2001 and also under the new Property Transfer Bill, which will replace the latter), the beneficiary may cancel its obligation to surrender the assets given to it as security against the debtor if the debtor is in default.

However, in the case of pledges against goodwill, the creditor is merely entitled to priority payment from the proceeds of sale of the pledged asset. This claim may be superseded by other privileged claims.

Where the security is in the form of a mortgage and the creditor has commenced proceedings to seize the property, these proceedings may be terminated by the receiver, with the court's approval. The property can then be sold and the proceeds distributed to those creditors whose claims are secured by mortgage.

(b) The commencement of a formal corporate rescue process?

Under a controlled management procedure, neither secured nor unsecured creditors may enforce their claims. They may only appeal against the court decision to place the debtor under controlled management.

Under composition proceedings, no further actions may be brought against the debtor once a judge has been appointed. However, ratification of the composition will have no effect on secured creditors that did not participate in the proceedings, as they are deemed not to have waived their rights. Secured creditors may thus continue to act against the debtor to obtain payment once ratification has occurred.

(c) The initiation of an informal corporate rescue process?

An informal corporate rescue process has no effect on debt collection and the enforcement of security under an informal corporate rescue process, unless the creditor has entered into an informal arrangement with the debtor.

1.4 Are insolvency procedures started in another jurisdiction in respect of a corporation incorporated in your jurisdiction recognised?

Luxembourg law does not apply the theory of incorporation. Article 440 of the Commercial Code gives exclusive jurisdiction to the commercial court where the insolvent company's principal place of business – most commonly, its registered office – is located.

As a consequence, the Luxembourg courts will not recognise foreign insolvency proceedings aimed at foreign branches of Luxembourg companies.

However, pursuant to the EU Insolvency Regulation, the Luxembourg courts are obliged, under certain circumstances, to recognise insolvency proceedings conducted in another EU member state and aimed at branches of a Luxembourg company located in that member state.

1.5 In what circumstances would the directors or officers of a company in financial difficulties face potential personal liability for continuing to trade?

Under Luxembourg commercial law, the managers of a company are liable for:

- non-execution of their mandate;
- any misconduct in the management of the company's affairs; and
- any damage caused by their fault or negligence.

Article 495 of the Commercial Code further provides that a manager may be personally declared bankrupt where he has used the company to engage in fraudulent activities or commercial dealings for his own benefit.

Further, at the receiver's request, the court can decide that the managers are liable for the company's debts where it is established that their fault contributed to the company's insolvency. In such case the proceedings are brought jointly against the company and the managers concerned.

2 What are the advantages and disadvantages of triggering a formal procedure?

The advantages of triggering the formal procedure are as follows:

- A declaration of bankruptcy prevents any rights to movable goods and real estate vesting in favour of any unsecured creditor. Additionally, employment contracts automatically cease and interest automatically ceases to accrue on unsecured claims.
- Under a controlled management procedure, no further enforcement proceedings can be brought against the debtor for the duration of the procedure.
- Under composition proceedings, the appointment of a judge provisionally prevents any further enforcement proceedings against the debtor.

The disadvantages are as follows:

- Certain contracts (eg, agency or leasing contracts) include clauses for automatic termination in case of bankruptcy, and can therefore cease immediately upon the commencement of bankruptcy proceedings.
- Under a controlled management procedure, the debtor's management cannot sell, buy, sign a contract or grant a pledge/mortgage without the prior written consent of the judge.
- Composition proceedings are not binding on secured creditors (unless they vote in favour of the composition proceedings). Secured creditors are thus free to enforce their security once the composition has been approved.

3 What are the practical options for out-of-court restructuring?

There is no specified legal framework in Luxembourg for informal corporate rescue proceedings. However, nothing prevents a company in financial difficulties from entering into a contractual arrangement with its creditors.

4 What is the effect on the management of a company of:

(a) An adjudication of corporate bankruptcy/liquidation?

Further to an adjudication of bankruptcy, the receiver will represent the company in any proceedings or third-party dealings, and the managers will be deprived of any right to run the company or dispose of its assets.

(b) The commencement of a formal corporate rescue process?

During the first stage of the controlled management procedure, the debtor cannot act without the authorisation of the designated judge. From the moment the debtor is placed under controlled

management, it is supervised by the appointed commissioners.

As with the controlled management procedure, during composition proceedings the debtor must not perform any act without the authorisation of the appointed judge. If a composition is reached, the debtor will regain its full powers, although its activities will be supervised by the appointed judge, who will examine these activities every three months.

(c) The initiation of an informal corporate rescue process?

The terms of any informal agreement reached with the creditors will determine its eventual effect on management. In practice, the debtor's management will most likely retain its powers.

5 Parties in interest/key players

5.1 Who is responsible for the 'case management' control and administration of:

(a) A corporate bankruptcy/ liquidation?

The court-appointed receiver is responsible for the control and administration of a court-ordered liquidation. The receiver is supervised by a court-appointed judge.

(b) A formal rescue?

Under the controlled management procedure, the appointed commissioners (normally an accountant and/or a lawyer) supervise the activities of the debtor and its management. In composition proceedings, the management retains control of the business and the appointed judge supervises the debtor's activities.

(c) An informal rescue?

In an informal rescue, the management retains control of the debtor and its negotiations with creditors.

5.2 Who is responsible for preparing the restructuring plan in a formal or informal rescue?

In the controlled management procedure, the appointed commissioners will prepare the restructuring plan. In composition proceedings, the management, under the supervision of the judge, will prepare the composition proposal.

In an informal rescue, the management prepares the restructuring plan, often with assistance from accountants and/or lawyers.

5.2 Who are the key players? What are their roles and responsibilities?

Secured creditors: In principle, unless a secured creditor votes on a composition proceeding and by so doing waives its right of priority, it will not be bound by the composition once the proposal has been ratified by the court. Accordingly, a secured creditor will remain free to enforce its security.

Credit institutions: Credit institutions, as creditors of the debtor, can play a key role in voting on proposals put forward by the debtor.

Insolvency practitioners: There is no separate profession of insolvency practitioner in Luxembourg. Instead, lawyers and accountants are usually appointed in insolvency proceedings.

Accountants: Accountants are normally retained to assist the appointed judge in controlled management proceedings, and to review the debtor's financial situation and affairs. Following the approval of a petition for controlled management, an accountant will normally be appointed as one of the commissioners in the proceeding that will supervise the debtor's management and prepare a rescue plan for presentation to the creditors. Accountants are also frequently retained in composition proceedings to assist the appointed judge in his review of the debtor's affairs and in negotiations between the debtor and its creditors.

Lawyers: When appointed in liquidation proceedings, the receiver (usually a lawyer) becomes the sole legal representative of the company. His key roles and responsibilities are to:

- advertise the declaration of bankruptcy;
- request, record and admit creditor claims;
- prepare an inventory of assets;
- collect and realise the assets;
- settle creditors' claims; and
- distribute assets in favour of the creditors.

In carrying out these duties, the receiver is guided and supervised by the court-appointed judge.

In the controlled management procedure, a lawyer will often be appointed as one of the commissioners responsible for supervising the debtor's management and preparing a rescue plan for presentation to the creditors.

Other advisers: Other advisers may be called on as and when necessary.

6 What financial information is available to creditors?

All private limited and public limited companies must prepare annual accounts in a format that complies with the Company Act 1915. In principle, these accounts must be deposited with the Companies Registry at the district court in the month following their approval by the shareholders. The accounts must be approved by the shareholders within six months of the company's financial year-end.

In practice, there is a significant level of delay in the registration of annual accounts.

The annual accounts are subject to an external audit if the company meets two or more of the following criteria:

- turnover above €6.25 million;
- total balance sheet above €3.125 million; and
- more than 50 staff members.

Where these criteria are met, the external auditor must be a qualified Luxembourg *réviseur d'entreprises*. Where the external auditor is not a qualified *réviseur d'entreprises*, the reliability of audit reports – and hence the reliability of the annual accounts – cannot be guaranteed.

In principle, companies prepare their accounts in accordance with Luxembourg Generally Accepted Accounting Principles.

7 Common questions

7.1 Funding and the priority given to new money

(a) If an insolvent corporation requires urgent working capital funding, what difficulties are likely to be encountered in the provision of such funding?

In addition to the financial risk, a credit institution may incur liability for supporting a company in the knowledge that it is insolvent should this result in increased damage to other creditors.

(b) Are lenders providing new money, or debtor-in-possession financing, given any statutory priority?

Luxembourg law contains no provisions on new money or debtor-in-possession financing.

The receiver may be authorised to borrow new money where this would be in the best interests of the liquidation process – for instance, in case of post-bankruptcy business continuity. In such case the new funding will have priority as an expense of the liquidation.

7.2 Ranking of creditors

In what order are creditors paid in a corporate bankruptcy/liquidation?

Apart from certain exceptions concerning secured

and privileged creditors, all creditors must be treated equally.

The claims given first priority of payment from the assets available for distribution to the pool of creditors are the receiver's fee and the liquidation expenses. Once these have been paid in full, other privileged claims – such as money owed to employees, certain social security contributions and outstanding taxes – are then repaid.

Payment of lower-ranking privileges and secured creditors then follows. Under the Law of August 1 2001, and as proposed in the new Property Transfer Bill, where the security is a pledge or a transfer of property, the secured assets are not included in the assets available for distribution to the general pool of creditors.

However, where the pledge is one of goodwill, or in case of claims secured by a mortgage on property, the creditor has no right of retention and is thus entitled only to priority of payment from the proceeds of sale of the particular asset. Where the proceeds of sale are insufficient to cover the claim in full, the secured creditor will be treated as an unsecured creditor for the balance of its claim.

Unsecured creditors are paid only once the claims of the more senior creditors have been satisfied in full.

If there are insufficient assets to pay all creditors in full, the remaining assets will be used to pay creditors of the same ranking *pari passu*.

7.3 Avoidance of antecedent transactions

Are there any legal provisions that might operate to invalidate the creation of security, the disposal of an asset or the payment of a creditor by a company in financial difficulties?

Three main provisions are of significance in this respect:

- Certain types of transactions carried out between the date of termination of payments, as established by the court, and the opening of insolvency proceedings by court order – or in the

10 days prior to the termination date – are void. These include the creation of security for pre-existing debts.

- Transactions carried out between the date of termination of payments, as established by the court, and the opening of insolvency proceedings by court order will be void if the counterparty was aware of the court order terminating payments and/or the debtor's insolvency.
- Securities created under the Law of August 1 2001 and the new Property Transfer Bill may not be annulled as described above. However, they remain voidable in general if they were created at the expense of the other creditors.

7.4 'Cram-downs'

What is the position of both unsecured and secured creditors that vote against, do not agree with or do not consent to either a formal or informal rescue plan?

In composition proceedings, a majority of creditors representing three-quarters of outstanding unchallenged claims must support the composition proposal. If the requisite support is given, all unsecured creditors will be bound by the composition once it has been ratified by the court. Those secured creditors that did not participate in the composition proceedings will be unaffected by the composition proposal.

Under the controlled management procedure, a rescue plan is binding once it has been approved by the court. The court will approve the plan only if it has been accepted by a majority of the creditors representing over 50 per cent in value of the unchallenged claims. If the debtor defaults on this plan, any creditor may sue it.

7.5 Creditor protection

What actions can creditors take if they are not satisfied with the conduct of either a formal rescue procedure or a corporate bankruptcy/liquidation?

In composition proceedings, creditors may enforce their rights only within the terms of the

composition proposal. A judgment approving the composition proposal; may be opposed by any creditor within the framework of a controlled management situation.

All judgments in a bankruptcy/liquidation proceeding may be appealed, usually within 15 days. Action may also be taken against the receiver; this must usually be commenced within five years of the closing of the insolvency proceedings.

Noble & Scheidecker

398, route d'Esch, L – 1471 Luxembourg

Tel +352 26 48 421 Fax +352 26 48 42 35 00

Web www.mnks.com

Firm profile

Noble & Scheidecker is a full-service Luxembourg law firm dedicated to business law and characterised by a dynamic team of multinational lawyers. The 35-member firm is one of the top 10 in the jurisdiction.

Throughout the years, Noble & Scheidecker has established strong relationships with other foreign law firms, consultants and service providers which enable it to provide global coordination and integrated advice to clients whose business activities reach beyond Luxembourg.

Noble & Scheidecker is best known for its corporate practice, with significant expertise in mergers and acquisitions, employment law,

intellectual property, communications, technology, banking and finance, and dispute resolution.

Its client base is multinational, especially in the private equity, technology and banking sectors.

Katia Scheidecker

Partner

Email Scheidecker@mnks.com

Katia Scheidecker is a founding partner of Noble & Scheidecker and is leader of the IP/Information and Communications Technology team. She often advises national and international clients in the field of corporate and financial law, and has notably assisted numerous large European and US groups to establish structures in Luxembourg. With regards to debt and insolvency issues, Ms Scheidecker has acted as receiver and assisted clients within the framework of insolvency procedures.

Noble & Scheidecker

www.mnks.com

398, route d'Esch, L – 1471 Luxembourg

Tel +352 26 48 421 Fax +352 26 48 42 35 00