

# Luxembourg

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## MARKET AND INCENTIVES

### 1. Please describe briefly the private equity market in your jurisdiction, in particular:

- The sources from which funds established to invest in private equity transactions (private equity funds) obtain their funding, such as institutional investors (for example, pension funds, insurance companies and banks), companies, individuals and government agencies.
- Market trends (for example, the role of hedge funds in private equity).
- Any proposed or pending regulatory changes.

### Sources of funding

Institutional investors are the most important source of funding in private equity.

However, since the introduction, in 2004 and 2007, of the *société d'investissement en capital à risque* (SICAR) (the Luxembourg-dedicated vehicle product for private equity and venture capital) and the specialised investment fund (*fonds d'investissement spécialisés*) (SIF), professional investors and high net-worth individuals now have access to private equity funds (see Questions 4 and 9).

### Market trends

Luxembourg remains the second largest global leader for domiciled funds behind the US. Successive Luxembourg governments have built efficient legislative frameworks that support the financial centre's development. Further, Luxembourg's financial authority, the Commission de Surveillance du Secteur Financier (CSSF) (see box, *Private equity/venture capital association*), supervises the fund industry pragmatically and efficiently.

The private equity industry has been significantly affected by the financial crisis. Traditional providers of debt financing to leveraged buyouts have been destabilised. Credit availability and debt service capacity for large leveraged buyouts is largely unavailable. There has been a substantial decrease in valuations in private equity. Certain private equity projects have been put on hold, or fund collection has been suspended.

However, the number of private equity vehicles has not decreased during the last year. There has been a move towards distressed assets, with some companies buying back their own debt. Many private equity players have conducted "house-cleaning" operations, resulting in reorganisations, recapitalisations and refinancings.

An analysis of investment strategies used by SICARs in 2008 shows that SICARs chose to either:

- Limit their policy to a particular strategy (for example buy, build and sell, buyouts, mezzanine financing or risk capital funds).
- Adopt a combination of strategies generally used in the field of risk capital.

The majority of SICARs have not limited their investment policy to a particular investment sector. Among those that have adopted a specialised policy, there is a particular concentration in real estate and technology. A new trend for 2008 was a focus on the renewable energy sector.

Besides the SICAR, the growing number of SIFs demonstrates that this vehicle is also designed for private equity investors. A SIF structured as an umbrella fund generally offers a compartment dedicated to private equity, as well as its sub-funds investing in real estate, hedge funds and any listed securities investment strategies.

These two lightly regulated products give private equity houses access to an onshore reputable EU centre. There were 231 SICARs registered on 9 September 2009 and 920 SIFs registered on 31 August 2009 in the official list of the CSSF (*CSSF's press release September 2009*) (see Question 4).

A recent survey conducted by the European Private Equity and Venture Capital Association (EVCA) ranks Luxembourg among the top most favourable jurisdictions in the EU for development of the private equity sector.

The majority of investors that generally use Luxembourg funds to invest in European companies are US or European investors. 50% of SICARs invest in Europe, whereas 30% of them are not limited to a specific region (*CSSF's annual activities report 2008*).

### Regulatory changes

The coming challenge in the private equity market in Luxembourg, as well as at European level, will be the approval of the proposed EU Directive on Alternative Fund Managers (AIFM) and its transposition into Luxembourg law. The proposed AIFM Directive has been disclosed on 29 April 2009 by the European Commission. The draft will be examined by the European Council after the European polls of June 2010. If political approval to the proposal is granted by the end of 2009, the Directive would come into force in 2011.

This Directive will have far reaching effects for private equity funds, establishing a regulatory and supervisory framework for

managers (encompassing management companies, investment managers and general partners) of alternative investment funds (AIFs) established in the EU, who provide management services to one or more AIF, including private equity funds. Key issues include:

- The obligations imposed on AIFMs by the draft directive may require significant changes to be made to the AIFM's current business model.
- The private equity industry has objected to being treated in the same way as hedge funds under the draft Directive since the former do not present the same systemic risk.
- An enhanced disclosure regime will apply where an AIF acquires 30% or more of the voting rights of an issuer or of a non-listed company domiciled in the EU (excluding issuers or non-listed companies being small and medium enterprises, under certain conditions).

## 2. Please summarise any changes in the level of activity in recent years in relation to:

- **Fundraising by private equity funds and hedge funds.**
- **Private equity investment in established, early stage and start-up businesses.**
- **Private equity financed transactions (for example, management buyouts (MBOs), management buy-ins (MBIs), leveraged buyouts and public to private transactions).**
- **Exits from private equity funds (that is, the realisations of the investments).**

### Fundraising

The financial crisis significantly influenced fundraising in the private equity sector. Accordingly, the growth in the volume of transactions leading up to and during the crisis has slowed dramatically.

### Investment

The level of activity in relation to investments by regulated vehicles (see *Question 4*) is as follows:

- **SICARs.** The total subscribed capital unpaid and capital commitments of investors in SICARs was about EUR15.8 billion (about US\$23.1 billion), with capital commitments of SICARs totalling EUR10.4 billion (about US\$15.2 billion). The SICARs' balance sheets amounted to about EUR19.7 billion (about US\$28.8 billion). Investment in risk capital amounted to EUR16.9 billion (about US\$24.7 billion) (*CSSF's annual activities report 2008*).
- **Undertakings for collective investments (UCIs) (including SIFs).** Their net assets in non-listed securities and venture capital totalled EUR5.575 billion (about US\$8.2 billion) and EUR657 million (about US\$961 million) respectively as at 30 June 2009 (*CSSF website*).

There are presently no global statistics relating to the volume of activity of non-regulated funds (see *Question 4*).

The investment strategies followed by SICARs as at 31 December 2008 are as follows (*CSSF website - CSSF's annual activities report 2008*):

- Buy, build and sell investments (135 SICARs).
- Investments through buyout instruments (30 SICARs).
- Investments through mezzanine instruments (13 SICARs).
- Investments by risk capital funds in early stage investments (43 SICARs).

The types of target investments by SICARs are as follows (*CSSF's annual activities report 2008*):

- Private equity (119 SICARs).
- Venture capital (92 SICARs).
- Public-to-private (2 SICARs).
- Mezzanine (8 SICARs).

### Transactions

There are no global statistics in relation to private equity financed transactions.

### Exits

There are no global statistics on exits from private equity funds. The acquisition of the Luxembourg company Skype Technologies by eBay from Mangrove Capital Partners, the Luxembourg venture capital fund, for US\$4.1 billion (about EUR2.8 billion) (that is, US\$2.6 billion (about EUR1.8 billion) at closing, plus a bonus of US\$1.5 billion (about EUR1 billion) by 2008), remains the most significant exit for the past five years.

## 3. What tax incentive schemes exist to encourage investment in unlisted companies? At whom are the schemes directed? What conditions must be met?

In addition to the special tax regime applicable to UCIs Part II, SIFs and SICARs (see *Question 5*), Luxembourg vehicles (notably Soparfi) benefit from a number of tax incentives. These incentives are available whether the Luxembourg vehicle is a private equity fund, or only used as a holding or intermediate holding.

### Dividends and liquidation proceeds and capital gains

Dividends and liquidation proceeds received, and capital gains realised by a fully taxable Luxembourg resident company with a share capital, are exempt from income tax if all the following conditions are fulfilled:

- The distributing company is one of the following:
  - a fully taxable Luxembourg resident company with share capital;
  - a company resident in another EU member state and covered by Article 2 of Directive 90/435/EEC on the taxation of parent companies and subsidiaries (Parent-Subsidiary Directive);
  - a non-resident company with share capital that is fully liable to a foreign tax which is similar to Luxembourg corporate tax (a 11% tax rate with a similar taxable basis is usually regarded as comparable).
- At the date of realisation of the income, the Luxembourg company has been holding (or undertakes to hold) the participation for at least 12 months.

- During the 12-month period, the level of participation does not fall below 10% or the acquisition price does not fall below EUR1.2 million (about US\$1.8 million) (EUR6 million (about US\$9 million) for capital gains).

Where the above holding requirements are not met, only 50% of the dividend income is tax exempt.

Except under very limited circumstances, capital gains realised by foreign investors are not subject to withholding tax in Luxembourg.

#### Capital duty

Capital duty was abolished as from 1 January 2009. A fixed registration duty of EUR75 (about US\$110) applies to transactions involving Luxembourg entities (that is, incorporation, amendments to the articles of association and transfers of the head office to Luxembourg). In addition, proportionate registration duties may also apply in certain cases.

#### Distribution to foreign investors

Distribution by a Luxembourg vehicle to foreign investors also benefits from advantageous tax treatment in Luxembourg. There is no withholding tax on arm's-length interest paid to foreign investors (withholding tax applies to profit participating loans and similar debt instruments only) (*Directive 2003/48/EC on taxation of savings income in the form of interest payments (Savings Directive)*). Dividends are subject to 20% withholding tax (increasing to 35% from 1 July 2011), unless exemptions (such as those under the Parent-Subsidiary Directive) or reduced rates apply (arising from the investor's domestic tax law or any applicable double tax treaty).

## FUND FORMATION

### 4. What legal structure(s) (domestic or foreign) are most commonly used as a vehicle for private equity funds in your jurisdiction?

#### Non-regulated vehicles

Soparis are non-regulated vehicles that have the object of holding participations in portfolio companies. They benefit from the Parent-Subsidiary Directive and double tax treaties signed by Luxembourg. As at 12 October 2008, there were 54 double tax treaties in force and 20 in progress signature or under negotiation (*Administration des Contributions Directes website*).

The most commonly used forms of non-regulated vehicles are the:

- **Private limited company (*société à responsabilité limitée*) (SARL).** This is commonly used for investing in private equity since it offers significant flexibility. There are restrictions on the transfer of SARL shares, for example, they cannot be offered to the public.
- **Partnership limited by shares (*société en commandite par action*) (SCA).** This has two types of shareholders. Some have an unlimited liability and manage the SCA (*commandités*) and the others have limited liability (*commanditaires*). The rules applicable to a public limited company (*société anonyme*) (SA) (*see below*) are generally also applicable to the SCA.
- **Public limited company (*société anonyme*) (SA).** This is more regulated than the SARL and can be listed.

#### Regulated vehicles

The vehicles supervised and authorised by the CSSF are:

**SICARs.** The SICAR was implemented by the Law of 15 June 2004 relating to the investment company in risk capital, to offer a new regulated vehicle for investment in private equity to well-informed investors (*see Question 9, Type of investors*). It combines a flexible corporate structure for investing in risk capital with the benefits of supervision by the CSSF, and a neutral tax regime. The Law of 24 October 2008 (Sicar Amendment Law) amended this law and improved the attractiveness and flexibility of the SICAR legal regime.

SICAR is an optional regime, and must be formalised in the object clause of the company's articles of association (articles).

SICARs can be incorporated as one of the following companies:

- Limited partnership (*société en commandite simple*) (SCS).
- SCA.
- Co-operative in the form of a public limited company (*société coopérative organisée sous forme de société anonyme*).
- SARL.
- SA.

These various possibilities offer significant contractual freedom.

While general corporate law provisions apply to SICARs, they have substantial flexibility in determining their articles.

The share capital of the SICAR must be at least EUR1 million (about US\$1.5 million). This minimum must be subscribed to within one year of incorporation and paid up in principle at least up to 5% of the capital. The calculation of the minimum capitalisation can now include the share premium. It is also possible to opt for variable capital, whatever the corporate form, since the introduction of the Sicar Amendment Law. This new development should attract more foreign investors familiar with the tax incentive vehicles of common law limited partnerships.

Although SICARs are supervised by the CSSF (*see Question 7*), their monitoring obligations are lighter than those of the UCIs Part II (*see below, UCI Part II*). They must prepare and publish annual accounts, and update the prospectus on the issue of additional shares. An independent auditor (approved by the CSSF) must audit the annual accounts. However, a SICAR is not required to publish a bi-annual report. Since the Sicar Amendment Law, there is no mandatory legal requirement to calculate the net asset value on a compulsory bi-annual basis. The net asset value must be based on the principle of "fair value" (similar to the SIF regime).

SICARs must invest in risk capital and have no obligation of investment diversification for SICARs (unlike UCIs Part II or SIFs). Therefore, SICARs can invest all of their funds in a single company or project.

The creation of a SICAR as an umbrella structure is now possible. Similar to the SIF regime, a SICAR with separate compartments enabling it to run different investment policies in each compartment is authorised.

In addition, the duty of the custodian is relaxed to the same flexibility as the SIF law, (that is, its monitoring duty is restricted to the general safekeeping of the assets) (*Sicar Amendment Law*).

**SIFs.** UCIs created under the Law of 19 July 1991 concerning UCIs that did not offer their securities to the public, and invested into venture capital undertakings that were exclusively reserved to a limited number of institutional investors, have been superseded by the SIF. These UCIs automatically became SIFs as of 13 February 2007 (see *Question 1*).

SIFs are subject to lighter statutory rules than the other UCIs Part II or UCITS (see *Question 7*). The following can create and/or invest in a SIF (see *Question 9, Type of investors*):

- Institutional investors.
- Professional investors.
- Other well-informed investors (whether legal or physical persons).

The SIF aims to be an attractive vehicle through its flexible rules, and its extensive scope of eligible assets open to investment (the SIF can be used to invest in any kind of assets without limitation, to the extent it complies with the general risk spreading rules (see *Question 11*)). It is authorised and supervised by the CSSF and has a neutral tax regime.

A SIF may be created:

- In contractual form (*fonds commun de placement*) (FCP), which is a set of jointly owned assets with no legal personality and is managed by a Luxembourg management company.
- As an investment company with a variable share capital (*société d'investissement à capital variable*) (SICAV), which is incorporated as any of the following:
  - SCA;
  - co-operative in the form of a public limited company (*société coopérative organisée sous forme de société anonyme*);
  - SARL;
  - SA.
- As a company with a fixed share capital (*société d'investissement à capital fixe*) (SICAF), which is incorporated as any of the following:
  - SCS;
  - SCA;
  - co-operative in the form of a public limited company (*société coopérative organisée sous forme de société anonyme*);
  - SARL;
  - SA;
  - SNC (*société en nom collectif*) (unlimited company);
  - *Société civile* (civil company).

The legal provisions and types of companies under which a SIF can be incorporated allow investors to set up their own corporate governance rules in a flexible manner.

The subscribed share capital (and the share premium) must total EUR1.25 million (about US\$1.8 million) within 12 months from the date of CSSF approval. The shares only need to be paid up to a minimum of 5%.

SIF supervision and its monitoring obligations are the same as for a SICAR, as well as the issuing document requirements (that is, information necessary for the investors to form their view on the investments proposed and its related risks, which must be given to the investors). The SIF's issuing document must provide for the quantifiable limits to be complied with in this regard (*CSSF's circular 07/309 relating to the risk-spreading principle for the SIF*) (see *Questions 7, 8 and 11*).

A SIF may be organised with several segregated sub-funds.

**UCI Part II.** Some specific UCIs can invest in venture capital undertakings (investment in non-listed securities of companies, which have been newly created or are in the development process). This includes a UCI of risk capital, which have investment policies for the placement of 20% or more of their net assets into high risk capital and are regulated by Part II of the law of 20 December 2002 relating to UCIs (Capital Risk UCIs Part II).

Capital Risk UCIs Part II can be incorporated either:

- By contract (FCP).
- As a company, which can only be incorporated under the form of an SA, SICAV or SICAF. Shares issued by a UCI Part II in this form must have a minimum value of EUR12,395 (US\$18,230).

This vehicle is subject to investment diversification rules (see *Question 11*).

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**5. For each structure identified in *Question 4*, identify whether it is taxed, tax exempt or fiscally transparent (that is, tax is levied on the individual investors rather than the fund itself):**

- So far as domestic investors are concerned.
  - So far as foreign investors are concerned.
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## SICAR

The tax status of SICARs depends on the legal form chosen:

- **SCS.** SCSs are tax transparent and tax is levied on the investor. Double tax treaties apply in the country of the investor and the country of the portfolio company.
- **Other SICARs.** All other SICARs are fully taxable in Luxembourg (at 28.59% (as from 1 January 2009), which is expected to be gradually decreased in the coming years to reach 25.5%) and should, in principle, benefit from double tax treaties and the Parent-Subsidiary Directive. The following are generally tax exempt at SICAR level:
  - capital gains from transferable securities;
  - income from transferable securities;
  - income from cash funds held pending their investment in risk capital, subject to certain conditions.

For all types of SICAR vehicle:

- There is a fixed annual fee of EUR1,500 (about US\$2,200) and a registration fee of EUR1,500 (EUR2,650 (about US\$3,900) for umbrella SICARs) payable to the CSSF.
- There is no liability for wealth tax.
- An application cannot be made for tax consolidation with other European subsidiaries.
- Withholding tax on distributions does not apply. There is generally no taxation in Luxembourg on the disposal of an interest in a SICAR by non-resident investors.

Since its introduction, there has been some debate about whether this tax system qualifies as state aid within the meaning of EU law. However, the Luxembourg Government has firmly ruled against this.

### Capital Risk UCIs Part II/SIF

SIFs and Capital Risk UCIs Part II are generally subject to the same tax regime as follows:

- Income and capital gains are exempt from tax (that is, corporate income tax, municipal business tax and net wealth tax). Both are subject to a subscription tax on the net asset value (0.01% for the SIF and 0.05% (which can be reduced to 0.01% in certain cases, particularly for institutional investors) for Capital Risk UCIs Part II), which is calculated quarterly. The law allows some specific exemptions.
- For a UCI Part II, either:
  - an annual CSSF fee of between EUR2,650 and EUR5,000;
  - a registration fee of EUR2,650 (EUR5,000 for umbrella structures).
- For a SIF, either:
  - an annual fee of EUR1,500 (EUR2,650 for umbrella structures);
  - a registration fee of EUR1,500 (EUR2,650 for umbrella structures).
- Withholding tax is levied at source on income received by a Capital Risk UCI Part II or SIF, and is technically non-refundable. However, UCIs formed as investment companies (SICAVs) can benefit from double tax treaties. UCIs formed as investment partnerships (FCPs) generally do not benefit from double tax treaties, unless the unit-holders themselves are able to claim the reduced rate under the applicable treaty.

The following tax treatments apply for:

- **Domestic investors.** Income received by both individuals and corporate domestic investors from Capital Risk UCIs Part II or SIFs are taxable under Luxembourg regular tax rules (and exempt from withholding tax). Capital gains realised by individual investors are taxable if the sale occurs less than six months following the purchase of the units and the seller holds more than 10% of the UCI.

- **Foreign investors.** Foreign investors investing in Luxembourg Capital Risk UCIs Part II or SIFs benefit from favourable tax treatment in Luxembourg. Dividends distributed by Capital Risk UCI Part IIs and SIFs are not subject to withholding tax in Luxembourg (except when they are paid to a permanent establishment in Luxembourg). This also applies to interest paid by the Capital Risk UCIs Part II or SIFs (subject to the Savings Directive in relation to physical investors). Except for certain limited cases, capital gains on the sale of units of Capital Risk UCIs Part II or SIFs are also exempt from tax (subject to the Savings Directive in relation to physical investors).

For non-regulated vehicles (Soparfis), see *Question 3*.

Services rendered directly to UCIs Part II, SIFs and SICARs are exempt from VAT if they qualify as management services. Services covered by this definition are broad (including, accounting services, calculating the net asset value and investment advice services). EU case law excludes custody services from being classed as management services.

### 6. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as not being tax transparent (in so far as they invest in companies in your jurisdiction)? What parallel domestic structures are typically used in these circumstances?

There is no particular foreign investment vehicle commonly used for private equity funds in other jurisdictions that are not available for investment in Luxembourg. The structure to be used is determined on a case-by-case basis.

### 7. Are a private equity fund's promoter, principals and manager required to be licensed?

Whether the management organs require CSSF approval depends on the type of investment vehicle used.

#### Soparfi

Soparfis do not require CSSF approval (*see Question 4*).

#### SICAR/SIF

The CSSF is the competent authority for approving SICARs and SIFs, and specifically require the following:

- SICAR or SIF directors and managers must prove their ability to perform their duties.
- Constituent documents (prospectus, issuing documentation, management regulations or articles of incorporation) ensuring they comply with the applicable laws.
- The appointment of a custodian with whom the SICAR's or SIF's assets are deposited.
- The appointment of an independent auditor (for monitoring obligations, *see Question 4*).

There is no requirement for a promoter.

### Capital Risk UCIs Part II

In addition to the management organs for the SICAR (*see above, SICAR/SIF*), the promoter and the management company or the UCI Part II's management body require CSSF's approval. The people who effectively conduct the business must demonstrate their good reputation and that they are sufficiently experienced to perform their duties (notably in high-risk capital areas).

In addition, because of the specificity of their investments, additional rules apply to Capital Risk UCIs Part II, including:

- Managers and investments counsel working for Capital Risk UCIs Part II must comply with some professional improvement requirements (in high risk capital areas).
- The prospectus and the bi-annual and annual reports must contain specific information related to specific investments.

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### 8. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

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SIFs, SICARs and UCIs Part II are regulated entities, and therefore subject to the prior approval of the CSSF before their launch, within the month of the offer of securities for a SIF. These vehicles must issue a prospectus or issuing document examined and/or approved by the CSSF. The central administration of the fund (book keeping, share registrar and transfer agent services) must be located in Luxembourg.

Soparfis are non-regulated vehicles and therefore do not require regulatory approval. However, if Soparfi shares are offered to the public (that is, marketed in any manner) then a prospectus complying with the rules of the Law dated 10 July 2005 implementing Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading (Prospectus Directive) must be approved by the CSSF. Soparfis can be exempt from publishing a prospectus (for example, if the shares are offered to fewer than 100 persons).

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### 9. Are there any restrictions (for example, nationality, age and number) on investors in private equity funds?

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#### Number of investors

A SARL must have a minimum of one shareholder and a maximum of 40. An SCA must have a minimum of two shareholders with no maximum limit. The minimum required for an SA is one shareholder. The shareholding of an SCA must comprise at least one general partner and two limited partners.

#### Nationality of investors

There are no nationality restrictions.

#### Age

There are no age restrictions.

#### Type of investors

Capital Risk UCIs Part II can be used for any type of investors.

The investors of SICARs and SIFs must be "well-informed investors", which are any of the following:

- An institutional investor.
- A professional investor.
- Any other investor which:
  - confirms in writing that it adheres to the status of a well-informed investor; and
  - invests a minimum of EUR125,000 (about US\$183,000); or
  - is certified by another professional of the financial sector as having experience and knowledge in risk investment or area of investment made by the SIF.

Since the Sicar Amendment Law, managers and "other persons who are involved in the management of the SICAR" are no longer required to certify their status of "well-informed investor" to be an eligible investor. This clarification has been welcomed by all SICAR fund promoters acting as founding partners or shareholders at the launch of the SICAR.

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### 10. How is the relationship between the investor and the fund governed? What protections do investors typically seek?

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The prospectus or issuing document and the articles or management regulations regulate the relationship between the investors and the fund.

The main aim of the prospectus or issuing document is to protect the investors by giving them information on the nature of the investments to be made. Among other provisions, the prospectus states the rules relating to:

- Dividends.
- Commitments required from investors.
- The investment's policy.
- Draw-downs.
- Subscription or redemption rights.

Examples of protection sought by investors are:

- Establishing an investors' committee within the fund with the right of information and consultation.
- Veto rights for certain matters or actions.
- Conflict of interests and corporate governance rules.
- Information rights (a minimum reporting obligation is required for regulated vehicles).
- Where co-investment agreements are entered into with the managers or with some investors, an obligation to disclose the agreements to the other investors.
- Exit clauses.

### 11. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

#### SICAR

There are no specific limits on maximum or minimum investment periods, amounts or transfers of investments in the SICAR. Any limits are subject to the contractual terms agreed by the parties themselves. The investment(s) in a SICAR must be made for a certain period of time with the intention of selling it at a profit at a later date.

#### Capital Risk UCI PART II

In a Capital Risk UCI Part II, no more than 20% of its net assets can be invested in the same venture securities.

#### SIF

The risk-spreading principle applies for a SIF fund. A SIF cannot invest more than 30% of its net assets in the same investment, subject to certain exceptions (*CSSF circular 07/309*). In practice, on CSSF approval, this spreading rule could be reached within 12 months following the SIF's launch. The CSSF can also give some additional requirements for a specific investment policy.

## INVESTMENTS

### 12. What are the most common investment objectives of private equity funds?

The main objective of private equity funds is to have the highest return on capital possible at the time of the exit (capital gain). The average rates of return range between 20% and 25%.

For mezzanine funds, the main objective is to distribute a regular return to their investors. The average rates of return range between 12% and 16%.

The average duration of private equity funds are between seven and ten years.

### 13. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? What are the relative advantages and disadvantages of each? Are there any restrictions on the issue or transfer of shares by law?

Usually, securities or financial instruments which may carry specific financial or voting rights (such as preferred dividend rights) are commonly taken. More complex and hybrid instruments may be used depending on the ultimate tax planning (tracking stocks, preferred equity certificates (PECs), convertible preferred equity certificates (CPECs), profit participating loans and credit linked notes, and so on) enabling profit repatriation, capital gains or dividend flows in an efficient tax incentive manner (for information on debt interests, see *Question 21*).

The Luxembourg tax administration considers that for a pure Soparfi, provided shareholder funds represent at least 15% of the total of the financing of the company, participations can be financed up to 85% by debt. However, for mixed Soparfis (companies conducting certain other activities in addition to holding participations) the 85:15 ratio generally only applies to their holding company vehicles.

The issue or transfer of shares is subject to statutory legal requirements and bye-laws. Generally, transfers or issues require approval by an extraordinary general meeting of shareholders (general meeting) or by the board for authorised capital. The issue of shares in exchange for contributions in kind in an SA and an SCA requires the issue of a special report by an independent auditor. These rules are much more flexible for a SICAR or a SIF.

The legal restrictions on the transfer of shares depend on the type of company:

- **SARL.** A SARL's shares can be transferred to non-shareholders if the current shareholder(s), representing at least three-quarters of the corporate capital, agree in a general meeting. In addition, specific clauses can be included in the articles relating to pre-emption and rights of first refusal for the benefit of the remaining shareholders.
- **SCA and SA.** With an SCA, a general partner's shares are non-transferable. However, the limited partner(s)' shares are freely transferable. An SA's shares are also freely transferable. Other clauses relating to restrictions on transfers, pre-emption and first-refusal rights are generally allowed, but are subject to certain restrictions given that a shareholder of an SA or SCA cannot be fully restricted from selling its shares.

## BUYOUTS

### 14. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

Although auctions of private companies exist, they are not common in Luxembourg.

### 15. Are buyouts of listed companies common (public to private transactions)? If so, which legislation and rules apply?

Buyouts of listed companies in Luxembourg are not common, since the number of companies listed at the Luxembourg stock exchange is not significant.

Until recently, Luxembourg did not have specific legislation regulating takeover bids. The hostile takeover bid by Rotterdam-based Mittal Steel for steel producer Arcelor prompted the Luxembourg government to implement Directive 2004/25/EC on takeover bids. As a result, security holders are now protected and have enough time and information to allow them to reach a properly informed decision on the bid. In addition, new principles of mandatory offer, squeeze-out, sell out and right of withdrawal regulate the takeover bids and better secure this kind of transaction.

## 16. What are the principal documents produced in a buyout?

### Due diligence phase

The documents usually provided in relation to the target include:

- Documents containing financial information.
- Corporate documentation authorisation(s) relating to the company's activity.
- Employment or insurance contracts.
- Documents relating to the guarantees granted by the company (pledge and mortgages).
- The IT contract.
- Other material contracts.

### Implementing the buyout

The documents usually produced relating to the implementation of the buyout include the:

- Placement memorandum.
- Term sheet.
- Letter of intent.
- Confidentiality agreement.
- Exclusivity agreement.
- Share purchase agreement.
- Shareholder agreement.
- Amended and restated employment and service contracts.
- Documents relating to the guarantees concerning the purchase price payment and the satisfaction of potential liabilities (for example, in case of breach of a representation and warranty).
- Debt financing documents.

Certain documents are often produced to meet the conditions precedent to the closing, for example, documents providing information on:

- Executed guarantees.
- Board of directors.
- Updated shares register.

## 17. What forms of contractual buyer protection are commonly requested by private equity funds from sellers and/or management?

### Representations and warranties

The buyer typically requires the seller (and sometimes the managers) to give representations and warranties in the share purchase agreement in relation to various matters relating to the seller's business, for example:

- The seller's capacity to enter into the share purchase agreement.

- The target's shares.
- Compliance with corporate and tax law.
- The target's financial position (particularly the accuracy of the accounts on which the purchase price is based).

The seller provides the buyer with indemnification guarantees for breach of the representations and warranties. In addition, guarantees are often provided to secure the payment of the indemnity.

### Purchase price adjustment

The transaction documents typically provide for an adjustment of the purchase price on the target's post-closing financial results.

### Conditions precedent

The transaction documents may also provide for conditions to be fulfilled for the acquisition to take effect, for example:

- Evidence of the seller granting the guarantees.
- Managers' letters of resignation.

### Covenants

The share purchase agreement usually provides:

- A non-compete clause.
- An obligation to properly manage the company before closing.

### Management continuity

The fund may also require, from the target's management, an undertaking to remain in office for a minimum duration. Some services contracts (such as, IT and accounting) may be extended for an agreed duration.

## 18. What non-contractual duties (for example, of confidentiality and employment) do the portfolio company managers owe and to whom (for example, when approaching possible investors in relation to an MBO)?

Non-contractual duties, such as duties of confidentiality and loyalty to the portfolio company, derive from general civil law obligations to act in good faith in the execution of any contract. These obligations are also usually set out contractually (common for employment contracts, less common in the corporate mandate between the company's management body (managers or directors) and the company).

In addition to these duties, managers with a corporate mandate must exercise their mandate in line with the principles of good management, and act in the company's interest. If not, the managers are liable to third parties and the company under the corporate law and common law (*Articles 1382 and 1383, Civil Code*).

## 19. What terms of employment are typically imposed on management by the private equity investor in an MBO?

A private equity investor typically imposes the following terms on management in an MBO:

- **Exclusivity.** This restricts the manager from carrying out other professional activity (such as, other employment, self-employed activity or corporate mandate) during the course of employment.
- **Non-solicitation.** This prevents the manager, during or after termination of the employment contract, from:
  - contacting the company's clients for his own interest or the interest of another company;
  - poaching the company's employees.
- **Confidentiality.** The employee undertakes, both during the performance of his contract and at any time after its termination, to keep confidential and not disclose confidential information or data collected during the employment relationship to third parties, unless specifically authorised.
- **Ownership.** This gives the exclusive ownership to the company of all documents and equipment, which are used by the manager or put at his disposal during employment.
- **Copyright.** The literary and artistic works a manager creates in the course of his employment belong to him. The employer may, therefore, require an assignment of the patrimonial rights on any works created during his employment.
- **Non-competition clause.** This prevents the employee from competing with his employer after termination of the employment contract.
- **Communication.** This prevents the management from speaking in public on behalf of the company, unless expressly authorised to do so.

**20. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company (for example, representation at board level)? Are such protections more likely to be given in the shareholders' agreement or company bye-laws?**

This depends on the outcome of negotiations between the funds and its management, and the legal rules regulating the target.

However, a fund typically requires from its portfolio company:

- Shareholder approval of some major decisions, stricter rules of quorum, majority voting for some decisions and rights of veto.
- The right to submit a list of candidates from which the shareholder meeting must choose a manager.
- Stricter rules of quorum and majority requirements for board resolutions.
- The right to receive certain relevant information.
- The creation of internal committees in the portfolio company (right of information and consultation).

Whether these protections should be inserted in the bye-laws or into a shareholder agreement is considered on a case-by-case basis.

**21. What percentage of finance is typically provided by debt and what form does that debt financing usually take (for example, term loans, working capital facilities, convertible loans and bonds)?**

Financing by debt may come either from the investors (to benefit from the deduction of interest) or from third parties.

Investors' debt financing may take several forms ranging from straightforward shareholder loans to hybrid, convertible or subordinated instruments. Interest paid to investors must be at arm's length. In addition, an 85:15 debt-to-equity ratio is generally regarded in practice as acceptable (other ratios are acceptable provided the overall interest is not excessive). Excessive interest is regarded as deemed dividends (subject to withholding tax, if applicable) and as such, may not be tax deductible.

Third-party financings usually take the form of senior or mezzanine loans (syndicated or otherwise). Bond issues are also an option (parties enjoy a large degree of freedom in their terms and conditions).

**22. What forms of protection do debt providers typically use to protect their investments, in particular through what types of:**

- **Security?**
- **Contractual and structural mechanisms (for example, covenants or subordination)?**

Protection for debt providers is generally regulated by the Law of 5 August 2005 on collateral arrangements implementing Directive 2002/47/EC on financial collateral arrangements.

**Security**

- **Pledge of assets (*contrat de gage*).** This is the most common way of taking security over Luxembourg assets. The pledge is usually granted over (present and/or future) bank accounts, financial instruments (which include all type of securities) and/or receivables of the pledgor.

Luxembourg law provides for efficient and effective methods of enforcing a pledge. On default, the pledgee can:

- take ownership of the pledged assets at the price determined in accordance with the rules of valuation agreed between the parties;
- sell the pledged assets through legally permitted means (for example, through an arm's-length sale);
- obtain a court decision stating that the pledged assets will be transferred to the pledgee as payment up to the amount of the debt owed, as estimated by an expert.
- **Transfer of ownership by way of security interest (*transfert de propriété à titre de garantie*).** This transfer can apply to the same assets as for a pledge of assets (*see above, Pledge of assets*). On default, the transferor does not need to transfer ownership back in accordance with the terms and conditions agreed in advance by the parties.

**Contractual and structural mechanisms**

Contractual subordination, acceleration and netting mechanisms are frequently used to secure investments.

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**23. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?**

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In principle, an SA or SCA cannot advance funds, make loans or provide security with a view to the acquisition of its shares by a third party. However, this rule does not apply to transactions effected with a view to the acquisition of shares by, or for, the company's employees. The Law of 10 June 2009 (which incorporated into Luxembourg law Directives 2005/56/EC on cross-border mergers of limited liability companies, 2006/68/EC on the formation of public limited companies and the maintenance and the alteration of their capital and 2007/63/EC requiring an independent expert report for a merger or division and amending the commercial law of 10 August 1915) has however set out exemptions to this rule.

Since the enactment of this law, financial assistance for the purpose of assisting a purchase of shares in an SA or SCA is now allowed under the conditions detailed in the law. For example:

- Transactions must take place under the responsibility of the board of directors or the management board, and gain prior approval at a general meeting of shareholders.
- The transaction must be at fair market value, particularly in relation to interest received by the company and in relation to security provided to the company for the loans and advances.
- The credit standing of the third party must be duly investigated.
- The aggregate financial assistance granted must at no point result in the reduction of the net assets below the amount specified in the law.
- The company must include in the liabilities in the balance sheet, a reserve, unavailable for distribution, of the amount of the aggregate financial assistance.

The law remains silent on the rules applicable to SARLs. Although there are arguments to conclude there is no prohibition applicable to SARLs, it is open to interpretation.

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**24. What is the order of priority on insolvent liquidation? Are certain debt providers given priority over other debt providers? Are debt providers given priority over other stakeholders by law or is priority purely a matter of contract and company constitution?**

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The rules regulating the insolvency procedure are a matter of law (notably Commercial and Civil Codes, the Law dated 24 May 1989 relating to the employment contract, the law of 5

**PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATION**

*Commission de Surveillance du Secteur Financier (CSSF)*

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**Status.** The CSSF is a governmental organisation.

**Membership.** Not applicable.

**Principal activities.** The CSSF is responsible for supervising:

- Credit institutions and other professionals of the financial sector.
- Undertakings for collective investment (including SIFs).
- Pension funds.
- SICARs.
- Securitisation vehicles issuing securities to the public on a continuous basis.
- Stock exchanges.
- Payment and securities settlement systems.
- Operators of payment or securities settlement systems.
- The securities markets.

**Published guidelines.** The CSSF ensures that the laws and regulations governing the various areas of the financial sector are enforced and observed. The circulars issued by the CSSF complement the regulatory framework. Through these circulars, the CSSF clarifies the implementation of different legal provisions regulating the supervised entities, publishes prudential rules relating to specific activities and gives recommendations concerning financial activities.

**Information sources.** See website above.

August 2005 on collateral arrangements and Regulation (EC) No. 1346/2000 on insolvency proceedings).

All creditors, other than secured and privileged creditors, must be treated equally. Payments to secured and privileged creditors are made in the following order:

- The receiver's fees and the liquidation expenses.
- Privileged claims such as money owed to employees, certain social security contributions and outstanding taxes.
- Payment of the lower ranking privileges and secured creditors.

However, the following remain valid and fully enforceable despite the commencement of insolvency proceedings against the grantor of the following security interests:

- Pledges.
- Transfers of ownership by way of security interest (to the extent these pledges or transfers apply to financial instruments (including all types of securities) and/or receivables (including those resulting from bank accounts), as well as netting arrangements).

Secured assets covered by the security interests listed above are, therefore, not included in the assets available for distribution to the general pool of creditors.

Shareholders' capital contributions are only repaid if and when all other creditors have been fully satisfied.

#### 25. Is it possible for a debt holder to achieve equity appreciation through conversion features such as rights, warrants or options?

It is possible, and common in some circumstances, for debt holders to achieve equity appreciation through the use of conversion features such as convertibles, debt instruments, warrants and options.

### PORTFOLIO COMPANY MANAGEMENT

#### 26. What management incentives are most commonly used (for example, shares, options and ratchets) to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

There is no specific legislation regulating management incentives, and therefore the standard labour, corporate and financial law provisions apply.

Share options are most commonly granted to encourage management to become involved in the company's development (since they are subject to a favourable tax treatment under certain circumstances) (see *Question 27*).

Share purchase plans, phantom share plans or other types of bonus schemes linked to the company's results are also used.

In addition, ratchets are used in practice and their mechanism is defined contractually, since they are not regulated and may take different forms.

#### 27. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

A special tax regime deriving from a circular from the Director of the Direct Tax Authorities (LIR no. 104/2, 11 January 2002 relating to share option plans) applies to share options granted to employees.

If the share options can be traded freely (a pre-emption right may, however, be provided in favour of the company), tax is levied at the time of grant. The tax base is equal to the market value of the option on the grant date, less the price paid by the employee

to acquire the options, if any, and is subject to the progressive income tax rate (from 0% to 38.95%). The gain earned when the option is exercised is not taxed as salary.

If the options are subject to trading restrictions, taxation is levied when the options are exercised and the benefits are taxable at the progressive income tax rate (from 0% to 38.95%). The tax base is equal to the stock market value on exercise of the option less the strike price.

If the shares obtained further to the exercise of the option are subject to trading restrictions (lock-up period), the taxable gain is calculated by applying a discount to the stock market value of 5% per year of lock-up (maximum 20%).

Capital gains are tax free if the options or shares are sold at least six months after their purchase, and the transferor does not own a major shareholding interest in the company (10%).

If the employee is subject to Luxembourg social security, social contributions are due under the same conditions and on the same base as income taxes. Capital gains are subject to a 1% dependence contribution.

### EXIT

#### 28. What forms of exit are typically used to realise a private equity fund's investment in a successful company (for example, trade sale, initial public offering (IPO) and secondary buy-out)? What are the relative advantages and disadvantages of each?

Trade sales and secondary buyouts are the most common form of exit. The form of exit used depends mainly on which country the portfolio company is located.

#### 29. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

In most cases, the form of exit from an unsuccessful portfolio company depends of the foreign law applicable to such a company.

Unsuccessful companies are often written off in the balance sheet of the private equity funds. A voluntary winding-up may also be undertaken. In some cases, the bankruptcy rules may also apply.

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