Some aspects of Luxembourg Insolvency Law

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Statutory framework

Insolvency is regulated by Articles 437 to 614 of the Luxembourg Commercial Code.

In Luxembourg, a company is deemed to be insolvent if the two following cumulative criteria are met: the company is (i) unable to pay its creditors and (ii) unable to obtain credit.

The main options available in Luxembourg to companies in financial distress are the following:

- bankruptcy (faillite, banqueroute) (Articles 437 to 592 of the Commercial Code);
- controlled management (gestion contrôlée) (Grand Ducal Regulation of 24 May 1934);
- suspension of payments (sursis de paiement) (Articles 593 to 614 of the Commercial Code);
- scheme of arrangement (concordat) (Articles 508 to 527 of the Commercial Code)
- involuntary (court-ordered) dissolution and winding-up (dissolution et liquidation) (Articles 203 and 203-1 of the Act of 10 August 1915 on commercial companies).

A company may request controlled management if it is temporarily unable to face its obligations but there is a possibility for its business to be redressed and controlled management would heighten the possibility of realising the company's assets in the interest of its creditors.

Historically, suspension of payments have been rarely used in Luxembourg. More recently however, the three Icelandic banks which are in financial distress have been granted the benefits of this regime. Generally, this option is available only to companies that, due to the occurrence of an extraordinary and unexpected event, are temporarily unable to pay their debts.

Finally, the courts can order, at the request of the public prosecutor, the dissolution and winding-up of a company that pursues activities which constitute a criminal offence or violate the provisions of the Commercial Code or the legislation regulating commercial companies, including the laws governing authorisations to do business (for example, the requirement to file annual accounts on time).

1. Effect of insolvency on transactions

1.1 Opening of bankruptcy

The district court of the place where the company's registered office is located when it becomes insolvent has jurisdiction to declare the company insolvent (Article 440 Commercial Code).

A company can be placed in insolvency (i) further to a declaration by the company's directors; (ii) as a result of proceedings initiated by an unpaid creditor; or (iii) by the court after having received information concerning the company's financial situation (Article 442 Commercial Code).

1.2 Directors' liability

The directors of a company that fails to meet its payment obligations shall, within one month, declare the company insolvent at the clerk's office of the competent district court.

The directors may be sued, under certain circumstances, for negligent or fraudulent bankruptcy, both of which constitute criminal offences under Luxembourg law (Articles 573 to 578 Commercial Code).

In the event of the insolvency of a company, the directors may be deemed personally accountable for the bankruptcy and consequently held responsible for all debts of the company if the conditions set forth in the Article 495 of the Commercial Code are met. In particular, the directors may be declared personally liable if they: (i) under the protection of the company, acted in their own interests; (ii) disposed of the company's property as their own; or (iii) improperly pursued, for their own benefit, an operating deficit when it was clear that this would lead to a suspension of payments.

Moreover, the court may order the directors to bear all or part of the debts of the company if their gross negligence contributed to the company's insolvency (Article 495-1 Commercial Code).

1.3 Consequences

In the event of insolvency, the insolvent debtor is prevented from administering its assets as from the date on which it is declared insolvent by the competent district court (Article 444 Commercial Code). All payments, transactions and acts made by the insolvent debtor as from the date of the adjudication in bankruptcy shall be deemed null and void.

The district court, either on its own initiative or after the commencement of proceedings by an interested party, shall determine the period for which payments shall be suspended (Article 442 Commercial Code). The court shall set a date prior to the adjudication in bankruptcy, as from which time the company shall be deemed insolvent (en cessation de payments).

The hardening period (doubtful period)

The hardening period or doubtful period (période suspecte) is a key concept of Luxembourg insolvency law since transactions made during this period are particularly vulnerable to attack. In fact, Article 445 of the Commercial Code provides for the voidance of certain acts and transactions carried out prior to the adjudication in bankruptcy during the hardening period and ten days prior to the start of this period. The transactions and acts referred to in Article 445 are: (i) transactions transferring property without reasonable consideration; (ii) payments by whatsoever means of debts that are not due yet; (iii) payments

of debts by non-cash means; and (iv) the grant of security for debts incurred prior of the start of the hardening period.

All other payments made by the insolvent debtor for debts that are due, and all other transactions made in return for consideration, may be declared void by the court if the other party was aware of the suspension of payments. However, the fact the other party knew of the debtor's financial distress does not necessarily mean that it was aware of the suspension of payments (Article 446 Commercial Code).

Determination of the hardening period

The hardening period cannot be set more than six months prior to the date of the adjudication in bankruptcy. In practice, this period is usually set at six months prior to the date of the adjudication in bankruptcy.

Mortgages

Valid mortgages can be registered up to the date of the adjudication in bankruptcy. Nevertheless, mortgages registered within ten days prior to the start of or during the hardening period may be declared void by the court if more than 15 days have passed between the date on which the mortgage was created and the date on which it was registered (Article 447 Commercial Code).

Fraud

All payments intended to defraud creditors shall be deemed void, regardless of when they are made (Article 448 Commercial Code).

1.4 Exceptions to the hardening period

There are a few statutory exceptions to the rules governing the hardening period.

The Financial Collateral Act

The Act of 5 August 2005 on financial collateral (the "Financial Collateral Act") contains an important exception and increases the protection of collateral holders under Luxembourg law. Article 21 of the Financial Collateral Act states in particular that "netting agreements and financial collateral arrangements, as well as the provision of collateral in accordance with a financial collateral arrangement, entered into on the day of commencement of a reorganisation measure or winding up proceedings, but before the official judicial decision to open such proceedings or before the measure becomes effective, shall be valid and enforceable against third parties, administrators, liquidators, receivers and similar persons." This provision is of key importance as it provides exceptional protection to collateral holders in the event the provider of their collateral becomes insolvent. In fact, despite provisions of Luxembourg insolvency law to the contrary (in particular the abovementioned Article 445 of the Commercial Code), this article enables collateral holders to realise their collateral notwithstanding the insolvency of the collateral provider.

The Securitisation Act

Another important rule is set forth in the Act of 22 March 2004 on securitisation (the "Securitisation Act) which contains special provisions governing the insolvency of the assignor when future claims are assigned to a securitisation undertaking.

Article 55 of the Securitisation Act states that the assignment of a future claim is contingent on its coming into existence. However, even when the claim does not come into existence, the assignment becomes

effective between the parties and against third parties as from the time the assignment is agreed on, notwithstanding the opening of bankruptcy proceedings or any other collective proceedings against the assignor prior to the date on which the claim comes into existence. This provision provides exceptional protection to the assignee in the event of insolvency of the assignor despite the hardening period provided for by the Luxembourg Commercial Code. In fact, even if the assignment becomes effective during this doubtful period, it will still be valid and enforceable.

1.5 The effects of insolvency on employment contracts

According to Article L. 125-1 of the Labour Code, employment contracts are terminated with immediate effect when a company is declared insolvent. Each employee must be granted the wages due to him or her for the month in which the declaration of insolvency is made and for the following month. Moreover, the employees must be granted 50% of their monthly wages corresponding to the notice period to which they are entitled. However, such compensation may not exceed the total amount to which the employee would be entitled in the event of dismissal with notice.

The amounts (salary) owed to employees for the last six months of work and all compensation due as a result of termination of the employment contracts, up to an amount equal to six times the minimum reference wage, must be paid before any payments can be made to secured creditors.

1.6 Preferred claims

Under Luxembourg insolvency law, creditors must be treated equally. Consequently unsecured creditors shall not be able to enforce their rights once insolvency proceedings have started. From the date of the adjudication in bankruptcy claims may no longer be enforced. All creditors constitute the general body of creditors (masse des créanciers).

Beneficiaries of collateral arrangements, such as pledges and mortgages, are preferred creditors. Certain claims are preferred by law. Employees are ranked first; the claims of the Social Security Administration and the tax authorities also have preferred status.

Moreover, the Act of 31 March 2000 on the effects of reservation-of-title clauses provides that such a clause is, in the event of insolvency, effective against the body of creditors. Such a clause may state that the seller of an asset remains the owner of that asset until receipt of payment in full of the purchase price.

2. The EU Insolvency Regulation

The EU Insolvency Regulation (1346/2000) which aims to improve the effectiveness of cross-border insolvency proceedings, has been applicable in Luxembourg since it entered into force on 31 May 2002.

The main purpose of the EU Insolvency Regulation is to codify the manner in which the Member States determine whether they have jurisdiction to open insolvency proceedings. In addition, its objective is to impose a uniform approach to the choice of governing law of insolvency proceedings.

The basic rule is that the courts of the Member State where the debtor's "centre of main interests" is located shall have jurisdiction over insolvency proceedings. The Regulation also contains a presumption: the courts of the place where the company's registered office is located are presumed to have jurisdiction.

The decision of the European Court of Justice (ECJ) in the Eurofood IFSC (case C-341/04) established a very important rule concerning the centre of main interests. According to this decision, where the debtor is a subsidiary whose registered office and that of its parent company are situated in two different Member States, the above presumption can be rebutted only if factors which are both objective and ascertainable by third parties enable it to establish that "an actual situation exists which is different from that which locating it at that registered office is deemed to reflect" (para. 34). This could in particular be the case if the company does not carry out any business on the territory of the Member State in which its registered office is situated.

The Regulation provides for separate branch proceedings or so-called territorial or secondary proceedings under certain limited circumstances in countries other than the Member State in which the debtor's centre of main interests is located. In this case, the courts of a Member State have jurisdiction to open secondary insolvency proceedings against the debtor only if the debtor has an establishment on the territory of that Member State. However, unlike main proceedings, secondary proceedings are restricted to the debtor's assets situated in that specific Member State and are limited to winding-up proceedings.

As to the law applicable to insolvency proceedings and the effects thereof, the general rule set out in the Regulation is that the applicable law shall be that of the Member State within whose territory the proceedings are opened. The law of the Member State in which the proceedings are opened shall determine the conditions for the opening of the insolvency proceedings and the conduct thereof. In particular, it shall determine inter alia against which debtors insolvency proceedings may be brought, the assets which form part of the estate, the parties' respective powers and the effects of the insolvency on contracts.

Specific rules apply to the following:

- Rights in rem

One important exception concerns third parties' rights in rem (i.e. rights that bind all parties, regardless of whether they are parties to the insolvency proceedings) including rights to security: the opening of insolvency proceedings shall not affect rights in rem of creditors in respect of the debtor's assets situated within another Member State. The law of the place where the assets are located is therefore applicable. Nevertheless, this provision shall not preclude actions for voidness, voidability or unenforceability of legal acts detrimental to all creditors.

- Set-off provisions

The opening of insolvency proceedings shall not affect the right of creditors to request the set-off of their claims against the claims of the debtor, where such set-off is permitted by the law applicable to the insolvent debtor's claim.

- Payment systems and financial markets

Moreover, another important exception applies to payment systems and financial markets. The effects of insolvency proceedings on the rights and obligations of the participants in a payment or settlement system or in a financial market shall be governed solely by the law of the Member State applicable to that system or market.

- Employment contracts

The effects of insolvency proceedings on employment contracts shall be governed solely by the law of the Member state applicable to the contract. Consequently, if insolvency proceedings are started against a company in Luxembourg, the law governing the company's employment contracts shall determine the employees' rights.

3. Reorganisation and winding-up of certain financial sector professionals in Luxembourg

The Act of 5 April 1993 on the financial sector (the "Financial Sector Act") as amended sets the statutory framework for the reorganisation and winding-up of certain financial sector professionals in financial distress in Luxembourg. In particular these provisions apply to establishments that manage funds for third parties.

3.1 Suspension of payments (sursis de paiement)

These rules bring about a temporary suspension of all payments by the distressed bank and prohibit all acts and decisions unless authorized by the administrators. The top priorities of the bank's management and its administrators include protecting the bank's assets, safeguarding client deposits and ensuring the equal treatment of creditors.

According to the Financial Sector Act, a suspension of payments may occur when (i) the establishment's creditworthiness is undermined or it has a liquidity problem, regardless of whether there is a stoppage of payments; (ii) the establishment's ability to meet its commitments in full is compromised; or (iii) the establishment's authorisation has been withdrawn and this decision has not yet become final.

Either the Luxembourg Financial Supervisory Authority (Commission de Surveillance du Secteur Financier) or the establishment itself may apply to the competent district court for a suspension of payments. The judgment ordering the suspension of payments shall lay down, for a period not to exceed six months, the conditions and procedures applicable to the suspension of payments.

The competent district court shall have exclusive jurisdiction to declare a suspension of payments with respect to a Luxembourg establishment. The suspension of payments shall have universal effect and shall apply to branches and assets of the establishment located outside Luxembourg.

3.2 Winding-up proceedings

The Financial Sector Act provides that an establishment may be dissolved and wound up if (i) it has become apparent that the previously ordered suspension of payments has not been able to rectify the situation; (ii) the establishment's financial position has been undermined to such an extent that it can no longer meet its commitments to creditors and stakeholders; or (iii) the establishment's authorisation has been withdrawn and this decision has become final.

Only the Luxembourg Financial Supervisory Authority or the public prosecutor may apply to the competent district court for an order to dissolve and wind up an establishment. When ordering the winding-up, the district court shall appoint an official receiver and one or more liquidators. It shall also determine the manner in which the winding-up is to be carried out.

Unless provided otherwise by law, payments, transactions and other acts, including acts in connection with the provision of collateral by an establishment and the realisation of such collateral, shall be valid and enforceable against third parties and the liquidators, provided the payments, transactions and acts were carried out before the judgment ordering the winding-up was pronounced or were carried out without knowledge of the winding-up. The competent district court shall have exclusive jurisdiction to order the dissolution and winding-up of an establishment governed by Luxembourg law.

Where an establishment is wound up, its authorisation shall be withdrawn.

3.3 Provisions common to suspension-of-payments and winding-up proceedings

The effects of a suspension-of-payments order or of winding-up proceedings on employment contracts and relationships shall be governed exclusively by the law applicable to the employment contract.

The opening of proceedings for suspension of payments or winding-up shall not affect the rights in rem of creditors or third parties in respect of tangible or intangible property, whether movable or immovable, belonging to the establishment and which are situated outside Luxembourg at the time the proceedings are opened.

The opening of proceedings for suspension of payments or winding-up shall not affect the right of creditors to set off their claims against the claims of the establishment managing funds for third parties, where such set-off is permitted by the law applicable to that establishment's claim.

3.4 Special provisions applicable to payment and securities settlement systems

In the event of insolvency proceedings against a participant in a payment or securities settlement system, transfer orders and netting within systems authorised in Luxembourg shall be legally enforceable between the parties and binding on third parties, provided the transfer orders were entered into the system before the opening of insolvency proceedings.

Transfer orders entered into a system after the opening of insolvency proceedings and executed on the day on which the proceedings are opened shall be enforceable between the parties and binding on third parties only if, after settlement, the system operator, the settlement agent, the central counterparty or the clearing house can prove that it was not aware and should not have been aware of the opening of the insolvency proceedings. The zero-hour rule does not apply.

The opening of insolvency proceedings against a participant shall not prevent funds or securities available on that participant's own settlement account from being used to fulfil that participant's obligations in the system on the day of the opening of insolvency proceedings. Any credit facility of the participant connected to the system may be used against available, existing collateral to fulfil that participant's obligations in the system.

3.5 Deposit guarantee and investor compensation

The purpose of the deposit guarantee is to ensure that, in the event deposits become unavailable, compensation is provided to natural and legal persons that have deposited funds with credit institutions subject to Luxembourg law.

In the event a Luxembourg bank or investment firm that is a member of the Association pour la Garantie des Dépôts Luxembourg (the "AGDL") becomes insolvent, the AGDL will protect all cash depositors by guaranteeing reimbursement of their deposits up to the amount of 20,000 euros.
Likewise, the AGDL protects investors by guaranteeing the reimbursement of their claims arising out of investment transactions up to the amount of 20,000 euros. All deposits in cash, including funds associated with investment transactions, are eligible for the deposit guarantee while all claims resulting from investment operations qualify for investor compensation.

It is important to note that no claim can be covered by both guarantees simultaneously. The total claimed amount can therefore never exceed 20,000 euros (for the deposit guarantee) plus 20,000 euros (for investor compensation). Consequently the two guarantees may not exceed a total of 40,000 euros per customer.

The guarantees are intended to cover both natural persons and legal entities; however, only "small" European corporate entities are covered. A corporate entity shall no longer be regarded as small when two of the following three criteria are met: (i) balance sheet total in excess of 3.125 million euros; (ii) turnover in excess of 6.25 million euros; and (iii) more than 50 employees.

The Luxembourg government intends to increase these guarantees to 100,000 euros. If more than one person holds a single account, the portion accruing to each account holder shall be taken into account in determining the amount due under the guarantee.

4. The rights of bondholders in the event of the issuer's insolvency under Luxembourg law

Bondholders are creditors of the issuing company whose rights are represented by securities. The rights of bondholders are incorporated into negotiable securities issued in return for advance payment. These securities must guarantee the same rights to all bondholders.

The Act of 10 August 1915 on commercial companies (the "Companies Act") contains some very important provisions on the rights of bondholders under Luxembourg law.

4.1 Bondholders' representative

Article 86 of the Companies Act states that all bondholders holding bonds from the same issue shall form a body ("masse des obligataires"). It is possible to have different groups of bondholders within the same company (if there are several bond issues). The Companies Act states also that the body of bondholders does not have legal personality.

The bondholders' representative represents the bondholders in any bankruptcy proceedings, suspension of payments, composition with creditors or controlled management. The bondholders' representative in particular asserts in any such proceedings all claims in the name and in the interest of the bondholders: the bondholders are no longer permitted to take any action on an individual basis in order to enforce their rights.

The bondholders' representative may be appointed: (i) at the time of the issuance by the issuer itself; (ii) during the term of the bond issue by the general meeting of bondholders; or (iii) by the competent district

court in urgent cases, further to an application by the company, any bondholder or an interested third party.

However, the general meeting of bondholders may dismiss the representative appointed by the issuer. The bondholders' representative may also be removed for legitimate (just) cause by the competent district court further to an application by the company or any bondholder.

4.2 Insolvency of the issuer

If the issuer becomes insolvent, the bondholders are entitled to take several actions in order to recover their investment. First, it should be noted that bondholders are part of a group and, consequently, the power to take decisions concerning the bonds is transferred to a bondholders' representative. However, bondholders have the right to take individual action if the issuer fails to satisfy its payment obligations. Article 98 of the Companies Act indeed states that a termination right is implicitly included in every bond issuance in the event either party fails to satisfy its obligations. Nevertheless, in this case, the contract shall not be terminated by operation of law: the non-breaching party shall have the option either to enforce the agreement or request the termination thereof with damages. Consequently, the bondholders may, in the event the issuer defaults, enforce the agreement before the courts unless there is a bondholders' representative, in which case the latter shall exercise this right. This right is in personam and every bondholder can exercise it in its own interest.

The bondholders have a claim against the issuer. Like any other creditor, bondholders have a right to repayment upon the maturity date of the bond, this right not being subject to the existence of distributable funds on the debtor's balance sheet. However, in the event of the debtor's insolvency, debts which are not yet due shall become due in full. The bonds will thus become due in full should the issuer become insolvent. Notwithstanding the foregoing, non-interest-bearing debts which are not yet due and whose expiration date is more than one year after the debtor's insolvency shall be entitled to repayment only after the statutory interest will be deducted starting from the insolvency date.

4.3 Insolvency of a depository of securities and other financial instruments

The rights of the depositors of securities and other financial instruments which are deposited or held in an account with a depository are governed by the Act of 1 August 2001 on the circulation of securities and other financial instruments.

The key rule is that the depositor has the same rights as if the securities and other financial instruments had remained in its possession.

The depositor has an intangible right in rem, up to the number of securities and other financial instruments booked in its account, over all securities and other financial instruments of the same kind deposited with or held in an account by the depository.

In the event of the depository's insolvency, the right in rem to the number of securities or other financial instruments due to the depositor shall be exercised against the entirety of securities or other financial instruments of the same kind deposited with the depository or deposited by the latter, either by book entry or otherwise in its name, with other depositories in Luxembourg or abroad.

If the total number of securities is not sufficient to fully refund all depositors, they will be divided equally amongst them in proportion to their rights.

Contact

We hope you found this publication useful and welcome the opportunity to answer any questions you may have with respect to its contents.

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