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Insolvency & Restructuring - Luxembourg

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Introduction

In Luxembourg, company insolvency is regulated by Articles 437 to 614 of the Commercial Code. Specific provisions apply to professionals in the financial sector and insurance companies. These are set out in the law of April 5 1993 on the financial sector, as amended, and the law of December 6 1991 on the insurance sector, as amended.

This Overview sets out the insolvency principles which apply for commercial companies. This includes the *société de participations financières* - better known by the acronym SOPARFI - which is a form of investment vehicle.

Definition

In Luxembourg, a commercial company is deemed to be insolvent if it is unable to pay its creditors and unable to obtain credit.

The main options available to companies in financial distress are:

- bankruptcy under Articles 437 to 592 of the code;
- controlled management under the Regulation of May 24 1934;
- a suspension of payments under Articles 593 to 614 of the code;
- a scheme of arrangement under Articles 508 to 527 of the code; and
- involuntary (ie, court-ordered) dissolution and winding-up under Articles 203 and 203 (1) of the Act of August 10 1915.

A company may request controlled management if: (i) despite being temporarily unable to meet its obligations, it still has a chance of resolving its financial problems; and (ii) controlled management would improve the likelihood of the company's assets being realized in the interests of its creditors.

Historically, suspensions of payments have rarely been used in Luxembourg. Generally, this option is available only to companies that are temporarily unable to pay their debts because of an extraordinary and unexpected event.

At the request of the public prosecutor, the courts can order the dissolution and winding-up of a company if it pursues activities that constitute a criminal offence or violate the provisions of the code or other company legislation, including the laws governing authorisations to do business (eg, the requirement to file annual accounts on time).

Initiating bankruptcy

Article 440 of the code provides that 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. A company can be declared insolvent:

- further to a declaration by its directors;

- as a result of proceedings initiated by an unpaid creditor; or
- by the court on the basis of information concerning the company's financial situation. (1)

Directors' liability

The directors of a company that fails to meet its payment obligations have one month in which to declare the company insolvent at the clerk's office of the competent district court. In certain circumstances the directors may be sued for negligent or fraudulent bankruptcy, both of which constitute criminal offences under Luxembourg law.(2) When a company becomes insolvent, the directors may be deemed personally accountable and may consequently be held liable for the company's debts if the conditions set forth in Article 495 of the code are met. Directors may be declared personally liable if they:

- acted in their own interests under the company's protection;
- used company property as their own; or
- improperly pursued an operating deficit for their own benefit 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 company's debts if their gross negligence contributed to its insolvency.(3)

Consequences

An insolvent debtor is prevented from administering its assets from the date on which it is declared insolvent by the competent district court.(4) All payments, transactions and acts by the insolvent debtor as of the date of the court's bankruptcy adjudication are deemed null and void.

The district court determines the period for which payments are suspended, either on its own initiative or following the commencement of proceedings by an interested party. (5) The court must set a date before the adjudication (from which time the company is deemed insolvent).

Hardening period

The so-called 'hardening period' (or 'doubtful period') is a key concept in Luxembourg's insolvency law, since transactions during this period are particularly susceptible to re-examination. The suspect period cannot be set more than six months before the adjudication date, although in practice it is usually set at six months before that date.

Article 445 of the code provides that certain acts and transactions carried out during and up to 10 days before the suspect period may be declared void. Article 445 covers:

- transactions that transfer property without reasonable consideration;
- the payment (by any means) of debts that are not yet due;
- the payment of debts other than in cash; and
- arrangements granting security for a debt incurred before the start of the suspect period (except for financial collateral guarantees granted under the Luxembourg Financial Collateral Act of August 5 2005).

All other payments by an insolvent debtor for due debts and all other transactions for a consideration may be declared void by the court if the other party was aware of the suspension of payments. However, the other party's knowledge of the debtor's financial distress does not necessarily equate to knowledge of the suspension of payments.(6)

Mortgages
Valid mortgages can be registered up to the date of the adjudication. Nevertheless, mortgages registered within 10 days of the start of the suspect period - or at any time during it - may be declared void by the court if more than 15 days elapsed between the creation and registration of the mortgage.(7)

Fraud
All payments intended to defraud creditors are deemed void, regardless of timing.(8)

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

The Financial Collateral Act contains a significant exception and increases the protection of collateral holders under Luxembourg law. Article 21 of the act states 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 protects collateral holders if the collateral provider becomes insolvent.

Despite provisions to the contrary (particularly Article 445 of the code), Article 21 of the act enables collateral holders to realise their collateral notwithstanding the provider's insolvency.

Article 55 of the Securitisation Act contains special provisions governing the insolvency of an assignor when future claims are assigned to a securitisation undertaking. It 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 from the date on which agreement is reached on the assignment, notwithstanding the opening of bankruptcy proceedings or other collective proceedings against the assignor before the date on which the claim comes into existence. This provision provides exceptional protection to the assignee in the event of the assignor's insolvency, despite the provisions of the code on the suspect period. Even if the assignment becomes effective during the suspect period, it remains valid and enforceable.

Effects on employment contracts

According to Article L125(1) of the Labour Code, employment contracts are terminated with immediate effect when a company is declared insolvent. Each employee must be paid the wages due to him or her for the month in which the declaration is made and for the following month. Moreover, employees must be granted 50% of their monthly wage for the notice period to which they are entitled. However, such compensation may not exceed the total amount to which the employee would have been entitled in the event of dismissal with notice.

The sums owed to employees for the preceding six months' work and all compensation due as a result of the termination of the employment contract, up to an amount equal to six times the minimum wage, must be paid before payments are made to secured creditors.

Preferred claims

Luxembourg insolvency law requires that creditors be treated equally. Unsecured creditors cannot enforce their rights once insolvency proceedings have started. As from the adjudication, claims may not be enforced.

All creditors belong to the general body of creditors. 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 and the tax authorities also have preferred status. Moreover, the Act of March 31 2000, which deals with the effects of reservation-of-title clauses, provides that such a clause is effective against the body of creditors in the event of insolvency. Such a clause may state that the vendor of an asset retains ownership until full payment of the purchase price is received.

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Endnotes

(1) Article 442 of the code.

(2) *Id*, Articles 573 to 578.

(3) *Id*, Article 495(1).

(4) *Id*, Article 444.

(5) *Id*, Article 442.

(6) *Id*, Article 446.

(7) *Id*, Article 447.

(8) *Id*, Article 448.

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