Modernization of the law 5 August 2005 on financial collateral arrangements

The amended law of 5 August 2005 on financial collateral arrangements has long been recognized in Europe as offering strong legal certainty and protection to creditors (the **Financial Collateral Law**).

While the Financial Collateral Law has been tested on many occasions in courts and has proven to be very effective in enforcement scenarios, some Luxembourg practitioners thought that the law could be further improved in order to facilitate the enforcement. The Luxembourg Parliament heard the market and took up the issue by passing a law on 15 July 2022, which came into force on 24 July 2022 (the **Amending Law**)[1].

Against this background, the Amending Law aims to modernize the provisions relating to the enforcement of financial collateral, notably by reforming the regime for the public sale of financial instruments following the enforcement of pledges. Prior to the adoption of the Amending Law, the Financial Collateral Law provided that public sales of financial instruments were only carried out through a public sale organized at the Luxembourg Stock Exchange. This provision dated back to the time when the Luxembourg Stock Exchange operated on the basis of a state concession and was no longer relevant, necessitating the provision of a new regime for the public sale of financial instruments inspired by the classic auction procedure. In addition, the Amending Law also modernizes the other methods of enforcement of collateral, and introduces provisions to clarify the enforcement measures for assets of a special nature, such as units or shares in collective investment undertakings or insurance policies.

The key takeaways of the Amending Law are as follows:

1. The Amending Law makes it clear that an “enforcement event” in a financial collateral agreement can cover any event as freely agreed between the parties. This means that the parties are entirely able to determine, by agreement, the occurrence of facts that may lead to the enforcement of a financial guarantee. In practical terms, events not related solely to the “financing” aspect of the transaction may, therefore, be defined as enforcement events, such as, for example, failure to meet certain financial ratios, or other elements that relate to the general economics or specific aspects of a transaction. Practically, this means that the pledgee is entitled to enforce its pledge even though the secured obligations are not yet due.

2. The Amending Law further amends the Financial Collateral Law in order to specify that the pledged assets may be sold over the counter or publicly, or that they may be sold on a trading platform on which they are admitted to trading. This includes regulated markets, MTFs and OTFs in Luxembourg, Europe or third countries.

   On this specific item, the Amending Law brings useful clarifications. If admission to trading on this platform allows the pledged instruments to be sold, it should also be possible to appropriate them at the current price on these markets. However, the “current price” is only a default price and is, therefore, not binding on the parties that may, in the financial collateral arrangement or a separate instrument, agree on another value. Where the shares or units of undertakings for collective investment are admitted to trading on a trading platform, the Amending Law clarifies that the pledgee will have the choice to proceed to an appropriation either at the latest published net asset value or at the current price on this platform (unless otherwise agreed).

3. Another notable feature is that the Amending Law explicitly confirms enforcement methods which were conceived by Luxembourg practitioners to deal with specific situations. In particular, the Amending Law clarifies enforcement rules to be applied with respect to pledges over shares of a collective investment undertaking (**UCI**) and pledges of insurance policies. No doubt that these clarifications are welcome, as the solutions devised by Luxembourg practitioners, until now, had never been tested in courts and were subject to some form of legal uncertainty.

From a practical perspective, with respect to pledges over shares or units of UCI, the Amending Law provides that the pledgee will be allowed to enforce its pledge over such instruments on the basis of the redemption value determined in accordance with the constitutive documents of the UCI. It also makes it clear that redemptions by the UCI can be staggered over several days. These clarifications will not upset the market practice as the Amending Law only ratifies a well-established practice.

As regards pledges over an insurance policy, the Amending Law confirms that the pledgee may exercise the rights under insurance contracts (life or non-life) in the context of an enforcement of the pledge. In practice, this means that the pledgee can exercise all the rights arising from the pledged insurance contract, including, in the case of a life insurance contract or capitalization transaction, the right of redemption or the pledgee can demand payment of any sums due under the insurance contract from the insurance company. Here again, this amendment is consistent with the practice which prevailed until now.

4. One of the major innovations introduced by the Amending Law is the modernization of the public sale regime provided for in the Financial Collateral Law. In this context, the Amending Law removes the role of the Luxembourg Stock Exchange in the enforcement of pledges by public auction and provides for new procedures for such enforcement. In that respect, it is worth noting that those new rules are to be applied in an implied manner, i.e., even if a pledge agreement has not provided for specific provisions to deal with this issue.

5. Therefore, moving forward, the public sale will be carried out by a bailiff or a public notary (unless agreed otherwise). The initiative for the sale will lie with the pledgee, who can be a security agent, a security trustee or the secured creditor. For that purpose, the pledgee may, *inter alia*, appoint the auctioneer, set the particular terms and conditions applicable to the sale, and, where appropriate, the currency in which the auction will take place. This may include the currency of the financial instruments offered for sale, or the currency provided for, or permitted by, the parties' agreement. Although the publications announcing the public auction are, under the new regime, to be made by the auctioneer, the pledgee may request the auctioneer to make additional insertions containing only certain information, or a full publication of the notice in foreign newspapers. The pledgee will also have the right to cancel the auction until the beginning of the sales transaction.

6. The Amending Law also contemplates scenarios where the sale must be explicitly or implicitly approved by a Luxembourg or foreign public authority competent in the matter – in particular, if the sale involves a major shareholding of a company active in a regulated sector such as the financial sector, or for reasons of competition or national security. In this case, the notice of auction will have to make clear that the effectiveness of the sale of the pledged assets is subject to the satisfaction of the condition precedent of the relevant authority providing its explicit or implied consent with respect to the sale.

   While all the above changes introduced by the Amending Law add some clarity, which Luxembourg practitioners will undoubtedly appreciate, the Luxembourg members of Parliament have decided to go even further to ensure that no legal challenge would be possible in order to prevent a pledgee from enforcing its pledge. To that effect, the Amending Law includes a statutory provision, which precludes the president of the district court, seized by unilateral application or in summary proceedings, from ordering that pledged assets be put into escrow to preserve the rights of the pledgor. This solution is not brand new. It was already set by Luxembourg appeal court in a matter referred to as Galapagos. However, this decision had not relied on a specific statutory provision of the Financial Collateral Law. Hence, there was a hypothetical risk that a Luxembourg court in a future litigation could take a different approach and decide otherwise.

   With the introduction of this new provision in the Financial Collateral Law, this risk becomes very remote, if not nil. This means, for instance, as stressed in the preparatory works of the Amending Law, that the new rule introduced by the Amending Law implies that a pledgor who might claim to be the

victim of fraud or abuse of rights will no longer be able to stop the enforcement of the pledge in summary proceedings, but will only be able to seek compensation for any damage it may have suffered in proceedings on the merits.

In conclusion, it is clear that Luxembourg intends to remain a pledgee friendly jurisdiction where pledges governed by the Financial Collateral Law must be enforceable quickly and without legal obstacles. In that respect, the Amending Law is fully consistent with the approach taken by the legislature in 2005.

[1] Published in the Memorial N° 371 of 20 July 2022.

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