Luxembourg pledges put to the test of insolvency proceedings: Ten years of case law

Mathilde Lattard assesses ten years of case law as Luxembourg pledges are put to the test of insolvency proceedings and provisional and protective measures

The keystone of the law of 5 August 2005 on financial collateral arrangements, as amended[1] (the "Law") is the lack of influence of any insolvency proceedings, seizures or any such measures on financial collateral arrangements (article 20(4) of the Law).

The Law covers a broad range of reorganisation measures and winding-up proceedings, which together with multiple attachment, foreclosures or other measures foreseen by the Law (article 19, point b) shall be called "insolvency proceedings" for the purpose of this article, unless the context requires otherwise.

The *ratio legis* of article 20(4) of the Law is clear: create a legal certainty for any financial collateral arrangements falling within its scope. Luxembourg's financial collateral arrangements and pledges in particular, have thus found their place in most of the international financial transactions involving Luxembourg companies.

This has not prevented the first disputes to arise in the wake of the financial crisis of 2008.

An analysis of Luxembourg case law over the past ten years confirms the primacy of pledges over insolvency proceedings (1), provided there is no fraud (2).

Primacy of pledges over insolvency proceedings

Insolvency of the pledgee

A Luxembourg bank, which was admitted to the procedure of suspension of payments, had brought its case before the Luxembourg district court (the "Court") regarding the bank's ability to enforce a pledge granted to it[2].

The Court acknowledged that the terms and conditions for the enforcement of the pledge were met. It then recalled that the provisions governing reorganisation measures (such as the suspension of payments) are not applicable to financial collateral arrangements and thus not an obstacle to their enforcement. The Court therefore concluded that the bank could enforce the pledge in accordance with the pledge agreement.

This position was confirmed when the management of another bank, also admitted to the procedure of suspension of payments, asked if they could enforce pledges governed by the Law[3]. The Court refused to confirm the possibility for the bank to enforce the said pledges as the Court considered that the provisions of article 20(4) are clear, i.e. the bank is entitled to enforce a pledge without asking if a procedure of suspension of payments may refrain it from proceeding with such an enforcement.

Insolvency of the pledgor

A company had pledged its shares held in one of its direct subsidiaries in favour of a bank[4]. When the group to which the borrowing company belonged experienced financial difficulties, the bank enforced the pledges by selling the pledged shares. Two months later, the borrowing company was declared bankrupt in Luxembourg. The bankruptcy receiver filed a claim with the

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Court to have the agreement for the sale of the pledged shares declared null and void.

The receiver's arguments were rejected by the Court which again recalled that the provisions of bankruptcy law were expressly excluded by the Law, thus preventing the receiver from relying on those provisions to challenge the agreement for the sales of the pledged shares.

The non-effect of insolvency proceedings on financial collateral arrangements shall be read in conjunction with the mechanism for the security interests (*in rem*) as provided for in the Insolvency Regulation[5]. Article 8.1 of the Insolvency Regulation[6] provides that by derogation from the universal scope of the law applicable in the place of the opening of the main insolvency proceedings, the opening of such proceedings shall not affect the rights *in rem* of creditors or third parties in respect of tangible or intangible, moveable or immoveable assets, belonging to the debtor which are situated within the territory of another Member State at the time of the opening of proceedings. Article 8.1 shall be read in conjunction with article 8.4. which provides that actions for voidness, voidability or unenforceability shall remain subject to the *lex concursus* unless the act from which arises the rights *in rem* is subject to the law of a Member State other than that of the State of the opening of proceedings and the law of that Member State does not allow any means of challenging that act in the relevant case (article 16 of the Insolvency Regulation). As recalled by the Court, the purpose of the Law is to keep the financial collateral arrangements "bankruptcy proof" in order to take advantage of the above exception.

The Court then stated that there remain two safeguards: civil liability in the case of fraudulent actions and damages if the sale did not take place under commercially reasonable measures in accordance with the Law.

Insolvency of a foreign pledgor

In 2014 the Court declared itself to be competent to rule on the conditions of enforcement of a pledge while the pledgor was subject to insolvency proceedings in Spain[7].

Pledges put to the test of seizure

In this specific case a request of return of pledged shares seized following an international action was deposited with the Court.

The Court recalled that Article 20(4) of the Law clearly confers to the Law the feature of a public policy rule and that the seizure shall not prevent the enforcement of the pledge.

Pledges put to the test of receivership

The pledgee of a share pledge had enforced the pledge in accordance with the pledge agreement by selling the disputed shares by mutual agreement in the first case[8], and by acquiring the pledged shares in the second case[9].

In both cases the pledgor tried to avoid the enforcement by requesting for the disputed shares to be put in escrow. In the first case the first judges granted the application, whereas the Court of Appeal repealed the decision on the grounds that the pledged shares having been taken over by the creditor in accordance with the pledge agreement, there was no dispute regarding their ownership and the first judges were not entitled to allow an escrow on them. This position was confirmed by the Court in the second case.

Pledges put to the test of summary proceedings

In the first instance the Court ordered the suspension of the effects of an enforcement

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following a two-step reasoning. Firstly, the Court stated that if pursuant to Article 20(4) of the Law a certain number of provisions, notably insolvency proceedings, are not applicable to financial collateral arrangements, this Article does not provide that the rules derived from common contract law and the consumer protection rules are not applicable to financial collateral arrangements. Secondly, the Court ruled that the conditions of emergency were met: the enforcement of the pledge and the appropriation by the bank of the pledged assets could have cause damage to the pledgor. The Court then ordered the suspension of the enforcement.

The Court of Appeal[10] overruled this decision: a bank may put its liability at risk if it commits errors in the enforcement of the pledge, but the enforcement of the pledge itself cannot be suspended in emergency proceedings[11].

Fraud

By a judgment of 10 July 2013[12] the Court ordered a restitution of the pledged shares appropriated by a bank on the sole ground that a fraud had been committed by the bank[13]. In this specific case, a bank enforced a pledge less than one hour after the signature of a pledge agreement. The Court ordered the restitution of the pledged shares considering the enforcement of the pledge to be fraudulent.

Fraud would therefore be the sole limit when a court would accept to cancel the effects of enforcement of a pledge. Absent any fraud, the only remedy would be damages for non-compliance with the contractual terms and conditions of enforcement of a pledge.

Ten years of case law clearly show the primacy of Luxembourg pledges whose sole limit would only be the fraud of the pledgee. ■

Footnotes:

1 The Law implemented the Financial Collateral Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements. Since 2005 the Law has been amended once by the law of 20 May 2011
2 Luxembourg District Court, 29 October 2008, n°1314/08
3 Luxembourg District Court, 31 October 2008, n°1349/08
4 Luxembourg District Court, 16 November 2012,n°1802/2012
5 Regulation (EC) n°2015/848 of 25 May 2015 on insolvency proceedings (recast) reforming the former European Regulation on insolvency proceedings (EC) 1346/2000 of 29 May 2000. Regulation (EC) 1346/2000 will continue to apply to insolvency proceedings that are within its scope and that have been opened prior to 26 June 2017. The provisions of Regulation (EC) n° 2015/848 are applicable to insolvency proceedings opened after 26 June 2017.
6 At the time of the aforementioned Court decision of 16 November 2012 it was article 5.1 of the Insolvency Regulation in its version of 29 May 2000. Article 5.1 of the new regulation was not amended.
7 Luxembourg District Court,29 January 2014
8 Luxembourg District Court, 23 December 2009
9 Luxembourg Court of appeal, 3 June 2009, Kaupthing Bank Luxembourg S.A.
10 Luxembourg Court of appeal, 3 November 2010
11 Position confirmed in Luxembourg District court, 8 December 2010 and Luxembourg District court (summary proceedings) on 15 July 2015.
12 Luxembourg District court, 10 July 2013, n°1089/13
13 Decision of the Luxembourg District court of 10 July 2013 was heavily commented. See ALJB, Bulletin droit et banque n°54, décembre 2014 et Suretés & Garanties Financières. Le droit et la morale, Daniel Boone, Jurisnews droit des sociétés vol. 6 n°9-10/2013.

FRAUD WOULD BE THE SOLE LIMIT WHEN A COURT WOULD ACCEPT TO CANCEL THE EFFECTS OF ENFORCEMENT OF A PLEDGE