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Luxembourg

PRIVATE EQUITY

Contributing firm

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This country-specific Q&A provides an overview of private equity laws and regulations applicable in Luxembourg.

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LUXEMBOURG
PRIVATE EQUITY

1. What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?

Transactions involving financial sponsors as a buyer or seller in 2021 represented a large proportion of the total transactions reflecting a continuing positive trend of the relative number of deals involving private equity, primarily driven by the strong presence of private equity firms active in the jurisdiction.

2. What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?

The differences in approach between a trade seller and financial sponsor backed entity are not specific to the Luxembourg market. In general, financial sponsor backed sellers are reluctant to grant anything other than the basic warranties (i.e. warranties as to their own ability to enter into the transaction documents and perform thereunder and title to shares). It is also less common to have delayed escrow payments, group or parent guarantees or earn out mechanisms in such transactions as, typically, such sellers wish to have a clean exit, complete the sale as promptly as possible and distribute the consideration to ultimate holders.

3. On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?

The process for effecting the transfer of shares depends on the type of corporate entity involved and the form of shares. In Luxembourg public limited liability companies (*sociétés anonymes*), partnerships limited by shares (*sociétés en commandite par actions*) and private limited liability companies (*sociétés à responsabilité limitée*), shares are typically in registered form with ownership being recorded in a share register maintained at the registered office of the company. For private limited liability companies (*sociétés à responsabilité limitée*), the shareholders are also registered with the Luxembourg Trade and Companies Register (*Registre de Commerce et des Sociétés*) and any change in ownership must be notified to and published with such register. Bearer shares are limited in application due to the requirements to deposit same with a recognised depositary. Transfers of registered shares are recorded by way of private share transfer agreements and there is no requirement for such share transfers to be notarised. In private limited liability companies (*sociétés à responsabilité limitée*), share transfers to non-shareholders must first be approved by shareholders holding at least 75% of the shares of the company (which threshold can be lowered to 50% in the articles of association of the company). There is no such mandatory prior shareholder approval required by law for share transfers in other corporate entities. There are no transfer taxes (stamp duty or otherwise) payable on the sale of shares in a Luxembourg company.

4. How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?

Where the purchasing entity is a special purpose vehicle, financial sponsors can provide comfort to sellers by: providing an equity commitment letter or parent guarantee from the ultimate fund; providing debt commitment letters from the relevant banks, where a deal is financed by external bank debt. Debt commitment letters are less commonly seen in practice – if seller requires specific comfort as to the buyer's ability to finance an acquisition, it is more typical to have buyers provide an equity commitment letter / undertaking or parent guarantee.

5. How prevalent is the use of locked box

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pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?

Locked box is commonly used as a pricing mechanism and is more typically seen when parties (in particular selling financial sponsors) are looking to minimise post transaction adjustments to consideration as would occur with closing accounts pricing mechanism.

6. What are the typical methods and constructs of how risk is allocated between a buyer and seller?

Common to other jurisdictions, the standard way of allocating risk between a buyer and seller in Luxembourg is through use of warranties and indemnities in the acquisition agreement. Financial sponsors are reluctant to give anything other than the basic warranties upon sale (i.e. as noted in the response to question 2 above, it is sought to limit warranties to warranties as to title, capacity and authority). The ultimate approach agreed to the level of warranty and indemnity protection is very much dependent on the relative bargaining power of the parties involved. As noted below, W&I insurance has become increasingly popular where anything other than fundamental warranties are given.

7. How prevalent is the use of W&I insurance in your transactions?

W&I insurance has become very popular in recent years and is commonly seen. When used, it can simplify the negotiation of the warranties between seller and buyer but, equally, putting such insurance in place can lengthen and complicate the due diligence process as the insurers also require access to the due diligence documentation and legal opinions. The COVID-19 context does not seem to have impacted the willingness of insurers to cover M&A transactions, although, unsurprisingly, there is a reluctance to cover express COVID-19 warranties.

8. How active have financial sponsors been in acquiring publicly listed companies and/or buying infrastructure assets?

The acquisition of public listed entities in Luxembourg is rare, though we do see increasing activity in the formation of Luxembourg-based consortiums comprising financial sponsors who team up for the purposes of driving takeover offers in other European jurisdictions.

Infrastructure assets in other European countries such as France, Spain, Portugal, Greece are commonly acquired by Luxembourg SPVs due to large investors not wishing to invest funds directly in those jurisdictions and Luxembourg's collateral law being very creditor friendly. Infrastructure projects in Luxembourg itself are less common.

9. Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?

Luxembourg has an open economy and offers a business climate favourable to foreign investment, without any general system of foreign investment control or governmental consent requirements for foreign investors. Non-Luxembourg residents are free to incorporate new Luxembourg companies or acquire existing Luxembourg companies without restriction.

A bill of law was submitted to the Luxembourg Parliament in September 2021 in application of Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union. The bill is aimed at introducing a national mechanism for the screening of foreign investments from outside the European Economic Area made through Luxembourg entities conducting activities in sectors regarded as critical (e.g. energy, transport, water, health, communications, media, etc.) on the Luxembourg territory. The bill includes provisions on the applicable notification and screening procedure applicable to relevant investments, as well as enforcement measures (e.g. withdrawal of licenses, fines, reparatory measures etc.)

10. How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?

Luxembourg has chosen not to put in place any merger control on a national level. The Luxembourg competition authority does however retain the power to intervene after completion of a transaction should it consider there to be anti-competitive practices or an abuse of a dominant position as a result of the relevant acquisition. Transactions may also of course require merger clearance from competition authorities in other jurisdictions. Typically merger clearance is a condition precedent to completion with transactions in which merger clearance is required being structured with a

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split signing / completion. As is the case with all aspects of a transaction, the ultimate allocation of risk between the parties is made on a case-by-case basis depending on the relative bargaining power of the parties involved.

11. Have you seen an increase in the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside?

We have not observed a particular increase in minority investments by financial sponsors in the last year. Most minority investments by financial sponsors are structured as a mix between subordinated debt instruments and equity investments with negotiated minority protections, the most common being: Information rights; Board representation rights; and Veto rights with respect to certain key decisions. It is common for such minority investors to also negotiate certain exit rights such as tag along rights, rights of first refusal and to a lesser extent, put options. Typically such rights are set out in the relevant shareholder or investor agreement which may be subject to Luxembourg law, or to the laws of another jurisdiction, with key provisions frequently being replicated in the articles of association of the Company. While shareholder / investor agreements relating to Luxembourg companies were historically commonly put under the laws of England and Wales or the laws of New York, there has been a noticeable shift in approach in this respect in the last year with parties showing a much greater willingness to use Luxembourg law as the governing law of their agreements. In recent years, the *sociétés en commandite spéciale* (being without legal personality) and the *sociétés en commandite* simple have become more popular vehicles allowing parties significant flexibility and also benefitting from the fact that, unlike the more traditional corporate vehicles (SARL, SA and SCA), the relevant partnership agreement is not required to be published in full. It is also possible for such minority investments to be for pure debt instruments or convertible instruments such as convertible bonds or warrants that can be converted into equity.

12. How are management incentive schemes typically structured?

Management incentive schemes can be implemented in various ways, depending on a number of different factors including the type of corporate entity involved and the residence of the management who are to participate. Most commonly they take the form of the issuance of a separate class of shares with specific economic rights attached. These can be held directly or through a pooling vehicle depending on the desired control structure and the number of participants. It is worth noting in the context of management incentive schemes and, more generally, management participation in Luxembourg entities, that Luxembourg public limited liability companies (SAs) have the ability to issue free shares to employees and management, both of the SA itself and certain group companies. This offers significant flexibility in the implementation of management incentive schemes in such entities – before the free shares concept was introduced in 2016, the Luxembourg legal requirement to pay up a minimum of one-fourth of the nominal value of a share in an SA prior to issuance had complicated the process. It is also possible to issue to management share like securities known as parts *bénéficiaires* whose features are as set out in the articles. Such flexibility with respect to voting rights, economic entitlement, make them an attractive option for use in certain situations. The *sociétés en commandite spéciale* (without legal personality) and the *sociétés en commandite* simple are however the most popular Luxembourg vehicles for structuring management incentive schemes, due to their flexibility and partnership governance features (allowing full control by the general partner and limited to no voting rights for limited partners).

13. Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?

(i) Carried interest tax regime

The Luxembourg income tax law distinguishes between two categories of carried interest income earned by the employees of alternative investment fund managers (AIFMs) or management companies of alternative investment funds (AIFs): (i) carried interest not structured under units, shares or representation issued by an AIF; and (ii) carried interest structured under units, shares or securities issued by an AIF. The return on the first type of carried interest arrangement is taxed at the progressive income tax rate up to 45.78%. Capital gains on the second type of carried interest realised are subject to the same progressive income tax rate. However, if the gain is realised after a period of six months it is not subject to taxation, unless the carried interest represents a substantial stake in a tax-opaque AIF. Such a substantial stake is generally present if the carried interest directly or indirectly represents more

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than 10% of the AIF's capital. In this case, gains are taxed at half the progressive income tax rate (maximum tax rate of 22.89%). To ensure that the income paid under the second type of carried interest arrangement benefits from this exemption, the carried interest-holder should dispose of its carried interest, which would generally entail a buy-back of carried units by the AIF.

(ii) Abolition of the circular letter on stock-options and new tax regime on bonuses

The Luxembourg tax circular on stock options has been removed on 1st January 2021, and a new tax regime for bonuses granted to employees on the basis of employer's annual results has been introduced with the Luxembourg 2020 Budget Law so called "*primes participatives*". These bonuses would be exempt up to 50 per cent for the employee for Luxembourg personal income tax purposes while being tax-deductible at the level of the employer as operational expenses. This regime will only be available for employees that are (1) Luxembourg taxpayers with income derived from an employment activity and (2) affiliated to the Luxembourg social security regime or any social security regime covered by a bilateral or multilateral social security convention that applies to Luxembourg. The bonus is capped at 5 per cent of the employer's annual result for the year immediately preceding the year for which the bonus is granted and 25 per cent of the annual gross remuneration of the employee.

14. Are senior managers subject to non-competes and if so what is the general duration?

Within the context of an employment contract, a non-compete clause cannot be for a period exceeding 12 months after termination of the contract. However, a manager's contract which is not subject to the provisions of the Luxembourg Labour Law Code (*Code du Travail*) is subject to the ordinary provisions of the Luxembourg Civil Code, which provides that the parties are subject to the principle of contractual freedom. The company is therefore free to decide whether or not it wants to impose a non- competition obligation on the manager for a certain period of time after termination of his/her contract. There is no standard duration or limitation with regard to the duration of a non-compete clause provided in a manager's contract. However, in order for a company to restrict a manager's freedom of commerce and industry and free competition, there must be a legitimate interest at stake. The legitimate interest must therefore justify the period of time during which the manager is subject to a non-compete clause. If a non-compete clause is disputed before a Luxembourg court, the courts will (i) require the clause to be limited in time in order to avoid a perpetual prohibition on the manager but will also (ii) analyse the company's legitimate interest in the non-compete obligation imposed on the manager and will consequently compare and aim to balance out the interests of both contracting parties.

15. How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?

There are a number of common approaches to ensuring that a financial sponsor has control over material business decisions. Typically, even with a minority shareholding, financial investors will seek to have a board nomination right (at a minimum they are granted information rights and observer status). As a matter of Luxembourg law, it is not possible to have a shareholder appoint a board member unilaterally; however, the common approach is to be granted a nomination right with parties giving a voting undertaking to vote in favour of the appointment of a person so nominated. In addition and depending on the financial sponsor's negotiation power in the particular transaction, they may provide in the relevant documentation that certain key business decisions can not be taken without either (i) the vote of the financial sponsor's nominated board member or (ii) the consent of the financial sponsor shareholder. It is worth noting that if an element of control is vested in the financial sponsor only through a nominated board member, this may not offer adequate comfort as such board member is required as a matter of Luxembourg law to act in the company's interest and would not therefore be free to take into account its nominating shareholder's interest in a specific matter. Board composition and alignment of voting rights must also be considered. When it is agreed that certain matters may only be carried out by the board and/or the shareholders having obtained the consent of the financial sponsor shareholder, it is common to have such recorded in the Articles as reserved matters. Although not a right which vests any control in a shareholder, it is also standard practice to have all shareholders in a company vested with standard information rights. Typically a shareholders agreement, together with the articles of association of the portfolio company, are used to regulate its governance. As Luxembourg law requires that the articles of the traditional corporate vehicles (SARL, SA and SCA) be published, parties may choose to include certain confidential information in the shareholders agreement only. As mentioned in the

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response to question 11 above, the *sociétés en commandite spéciale* (being without legal personality) and the *sociétés en commandite* simple have become more popular in recent years, one advantage of them being that the relevant partnership agreement is not required to be published in full and there is therefore no issue regarding potential misalignment of certain provisions as there can be when governance is included in both a shareholders agreement and the articles of association but without being replicated in full in the articles of association to avoid public disclosure of confidential information.

16. Is it common to use management pooling vehicles where there are a large number of employee shareholders?

It is relatively common to have a separate vehicle through which management holds shares (typically the pooling vehicle takes the form of a *société en commandite spéciale* or a *sociétés en commandite simple*) – the drivers for putting in place such a vehicle are usually practical considerations to avoid complicating governance at the level of the main company and potentially exit planning by benefitting from the withholding tax exemption where management are not EU resident or have special tax regimes.

17. What are the most commonly used debt finance capital structures across small, medium and large financings?

In Luxembourg, traditional loans granted by banks or other financial institutions are still commonly seen across all types of financing. High yield bonds (sometimes with a conversion feature) and PIK Notes are also frequently seen in the financing of transactions in the Luxembourg legal market.

18. Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?

Financial assistance rules are applicable to public limited liability companies and provide that a company may not advance funds, make loans or provide security whether directly or indirectly, with a view to the acquisition of its shares by a third party. The financial assistance rules do not apply to Luxembourg private limited liability companies. However, a transaction which raises financial assistance concerns may also be difficult for a company to approve from a corporate interest perspective – therefore for private limited liability companies, even if not subject to financial assistance rules, this must be considered carefully. If a company which is subject to financial assistance rules directly (SA, SCA) takes an action in breach of the financial assistance rules, such action will be null and void. Breach of the financial assistance rules also triggers potential criminal and civil liability of the directors of the company. There is a 'whitewash' procedure available under Luxembourg law which can be followed if parties wish to proceed with a transaction notwithstanding that it constitutes financial assistance; however, such procedure is not commonly applied in practice.

19. For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?

The vast majority of the credit agreements are governed by foreign law, and based on the Loan Market Association standard. Discussions on the Luxembourg elements of the credit agreement are often limited. The main concerns remain any corporate interests issue relating to the granting of cross stream and upstream guarantees or any potential financial assistance (in particular in acquisition finance). (See the response to question 18 above.)

20. What have been the key areas of negotiation between borrowers and lenders in the last two years?

The scope of representations and covenants remain a hot topic in many finance deals. In that respect, the number of covenant-lite credit agreements seen on the market is significantly increasing.

21. Have you seen an increase or use of private equity credit funds as sources of debt capital?

It is relatively common to see private equity funds provide debt capital – typically as the mezzanine lender in a larger financing. The presence of private equity firms in Luxembourg is increasing consistently each year and is fuelled by the legal stability of the country, the presence of private equity firms, banks, insurance houses in Luxembourg and the creditor friendly collateral law. Luxembourg is also a large investment fund business centre and increasingly private equity firms are using Luxembourg as their European house (whether US or other funds) or raising the capital directly in a Luxembourg fund.

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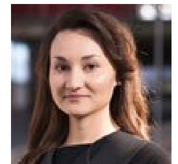

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