Feature

KEY POINTS

- The Grand Duchy of Luxembourg (Luxembourg) has yet to statutorily recognise the concept of contractual subordination.
- That said, contractual subordination is and remains a fairly common mechanism which is used more frequently than not even in financings originating from Luxembourg and implemented via Luxembourg law governed documentation.
- The authors submit that it is time for contractual subordination to be acknowledged by the Luxembourg legislator.

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Contractual subordination in the grand duchy of Luxembourg

In this article, Richard Ledain Santiago, Benjamin Devouassoux and Theodoros Karantanos consider the validity of contractual subordination in Luxembourg, noting its gradual acceptance by the Luxembourg courts, its empirical development and impact on third parties.

INTRODUCTION

Origins of subordination

It is no revelation that creditors have always endeavoured to engineer ways to protect themselves against the potential adverse consequences of an event, whether insolvency-related or otherwise, which might affect their debtors' creditworthiness. Alongside the traditional recourse to security interests and other available forms of guarantee, structural subordination, which effectively relies on the internal organisation of a given debtor's group, has been used as a form of simple-to-implement yet – to a certain extent – efficient protection tool by creditors. In essence, creditors of a parent company are subordinated, in terms of rank, to creditors of a subsidiary, and will only have access to whatever resources are left available after the latter see their claims satisfied. This early form of subordination relies on the assumption that any proceeds received by a group of companies would flow upstream, starting from the operating company upwards, hence allowing creditors of any entity low down in the shareholding structure to be repaid in priority to creditors of the parent company. With the increased complexity of group structures including more often than not a variety of debt and equity instruments allowing for the bypassing of certain intermediary entities, structural subordination has progressively given way to a more advanced form of subordination.

Development of contractual subordination

The first evidence of a mechanism whereby creditors could contractually agree among themselves to subordinate their claims held against a specific debtor can be traced back to the aftermath of the stock market crash of 1929. Increasingly wary about the protection of their interests, creditors in the US started to explore alternative methods; this trend spread to the UK during the 1960s. While the validity of a mechanism allowing for a contractual subordination of claims under English law was initially debated at length, it has since long been recognised and enforced by the English courts, although it is equally fair to say that the effectiveness of contractual subordination arrangements under English law is still not definitively established either in legislation or case law. In the US, the contractual tiering of creditors is expressly recognised in the Bankruptcy Code which establishes a principle of absolute priority thereby preventing a subordinated (or junior) creditor from obtaining satisfaction of its claim(s) before creditors benefiting from a higher rank.

Contractual subordination in the Grand Duchy of Luxembourg?

Today, contractual subordination is largely used throughout mainland Europe (in countries such as Belgium and Germany, where both case law and legal literature appear to accept its validity and enforceability. However, the Grand Duchy of Luxembourg (Luxembourg), which is largely seen as a pragmatic and business orientated country, considering in particular that it allows market players to benefit from a well-known creditor-friendly environment, is yet to recognise the mechanism of contractual subordination. While recourse to contractual subordination, and the use of intercreditor agreements or subordination deeds, have now become a common and long-standing feature of international finance transactions, a certain degree of uncertainty remains in Luxembourg as to whether a Luxembourg court would apply any contractual tiering between creditors in an insolvency scenario absent actual statutory recognition.

The structure of this article

Contractual subordination may be considered from a variety of perspectives (section 1). In the absence of statutory recognition in Luxembourg (section 2), both scholars and case law have attempted to bridge the gaps over the last decades (section 3 and 4, respectively) allowing an empirical development of contractual subordination in Luxembourg (section 5). In any event and in spite of the still existing uncertainty surrounding it, contractual subordination necessarily impacts Luxembourg's legal landscape (section 6).

1. THE MULTIPLE FACETS OF CONTRACTUAL SUBORDINATION

Full versus partial or incomplete subordination

Contractual subordination is not a straightforward concept. A distinction must first be made between full, and partial or incomplete, subordination taking place within the framework of a financing transaction. Whilst the purpose of a full subordination

is to strictly prevent a debtor from validly discharging a debt owed to subordinated creditors until "senior creditors" have their respective debt(s) satisfied, generally in full, a partial or incomplete subordination will typically authorise the payment of accrued interest and/or instalments of principal to subordinated creditors throughout the duration of the designated security period, generally at the lender's election.

GENERAL VERSUS SPECIFIC SUBORDINATION

Another distinction may be drawn between general and specific subordination. On the one hand, general subordination arises where one creditor, the claim(s) of which rank(s) *pari passu* (ie ranking at the same level) with the claims of one or several other creditors, agrees with the debtor (which is common to all creditors in this scenario) to assume a lower rank in terms of repayment of its own claim(s). Consequently, a subordinated creditor will waive its right to receive repayment from the debtor before the other creditors, so that those other creditors will benefit from a priority in terms of payments and have their respective debts settled before the payment of the subordinated creditor's debt. In this instance, the subordination will be agreed between a given creditor and a debtor, but will nonetheless benefit other creditors, which will not be parties to the subordination agreement. On the other hand, specific subordination will occur when the tiering between creditors will be agreed between the debtor and all of its creditors, each of which will agree to its specific rank, as set forth in the relevant intercreditor agreement.

2. THE ABSENCE OF STATUTORY RECOGNITION IN LUXEMBOURG

Subordination in the Civil Code

To this day, Luxembourg legislative *corpus* has not expressly recognised contractual subordination. That being said, it is nonetheless interesting to note that certain statutory provisions somehow tend to indicate that contractual subordination is not entirely foreign to Luxembourg law. Indeed, Art 1252 of the Luxembourg Civil Code lays down the legal regime for partial payments with subrogation (*paiements partiels avec subrogation*) pursuant to which the subrogee (*subrogé*), having partially paid someone else's debt, will only be entitled to exercise its subrogation right against the original debtor after the principal creditor's debt has been entirely satisfied. This mechanism will result in a *de facto* statutory subordination of the subrogee.

Sector-specific examples

Another example lies in the text of Art 63(1) of the Luxembourg securitisation law of 22 March 2004, as amended (the Securitisation Act), which authorises in unambiguous terms Luxembourg securitisation vehicles to issue securities, whether equity or debt, the repayment of which will be subordinated to the repayment of certain other previously identified securities or debt receivables. On the same note, Art 64(1) of the Securitisation Act further confirms the validity of subordination clauses inserted in contracts entered into by a Luxembourg securitisation vehicle pursuant to which the investors and the creditors would agree to subordinate their claims to other creditors' claims. Other isolated examples may be found in Luxembourg sector-specific legislation, such as banking and insurance, which will not be further discussed here. Although one must admit that these isolated statutory provisions cannot constitute a general recognition of the validity of contractual subordination under Luxembourg law, they nonetheless tend to indicate that this mechanism should not be discarded as incompatible with the fundamental principles of Luxembourg law.

3. DOCTRINAL DEBATE SURROUNDING THE VALIDITY OF CONTRACTUAL SUBORDINATION IN LUXEMBOURG

Contractual freedom versus conservatism

In the absence of any express statutory recognition, the validity of contractual subordination in Luxembourg is regularly debated among academics. Those in favour of its existence argue that subordination clauses should be considered as valid based on the principle of contractual freedom (*liberté contractuelle*), which should predominantly govern the relationship between the parties to a freely negotiated – and entered into – agreement. Those against it tend to adopt a more conservative approach and consider that subordination arrangements may violate both the principle of equal treatment of creditors (*égalité de traitement des créanciers*) and the principle that no rights of preference may exist in the absence of express statutory provisions (*pas de privilège sans texte*).

Coexistence with the principle of equal treatment

The principle according to which all creditors, in the absence of any preferential rights inuring to their benefit, must be treated equally is set forth in Art 2093 of the Luxembourg Civil Code. This principle purports to both protect creditors, hence ensuring an identical treatment to the extent they are found to be in an identical situation and prevent a non-egalitarian distribution of debtors' assets. Often deemed a point of public policy (*disposition d'ordre public*), it is generally argued that agreements violating this principle should be considered null and void. In addition, since contractual subordination introduces a priority in terms of order of payments amongst creditors which otherwise do not benefit from any statutory right of preference (*privilège*), contractual tiering would in theory result in a discrimination among those creditors, hence breaching the principle of equal treatment. Nevertheless, it should be kept in mind that the principle of equal treatment among creditors was initially aimed at prohibiting contractual clauses that would favour one creditor to the detriment of another by means of private agreements, absent any preferential right granted under statute. Against this background, we consider that contractual subordination would not breach *per se* the principle of equal treatment of creditors. That is because contractual subordination requires the prior creditor's consent, and because it does not interfere with any preference right granted to creditors under statute, as further explained below.

Coexistence with statutory rights of preference

The principle of "no privilege without text" (*pas de privilège sans texte*), which may effectively be considered as a statutory right of preference, gives a specific creditor or group of creditors the right to be paid in preference to other creditors. This preference right may be based on either or both of the type of creditors or the type of claims at stake, and is essentially, although not exclusively, set forth under Arts 2100 *et seq.* of the Luxembourg Civil Code. Following the discharge of the claims held by preferred creditors, any surplus would in theory become available to secured creditors first and eventually to unsecured creditors. Against this backdrop, the position with respect to contractual tiering would be that parties may not enter into an agreement whose purpose or effect would be to contractually vary the mandatory ranking set forth by statute. For this reason, part of the legal doctrine considers that contractual subordination arrangements would violate the principle of "no privilege without text", since by agreeing to subordinate its claim, an otherwise preferred creditor could effectively allow other creditors to acquire a higher rank and so disrupt the order imposed by statute. We consider that this position could be debated, and in any event should be nuanced. While the principle of "no privilege without text" may indeed be deemed a matter of public policy (*principe d'ordre public*), a distinction should be drawn between those mandatory provisions which aim at dictating certain statutory imposed behaviours (*ordre public de direction*) which cannot be departed from, and those others which aim at creating a protection to the benefit of a certain category of individuals (*ordre public de protection*), in respect of which those individuals have the option to waive their respective rights, without adversely affecting other protected creditors.

Therefore, contractual subordination arrangements should in our view fall within the latter category and be considered as valid to the extent they do not adversely affect the right of creditors preferred under statute, unless those creditors have expressly consented to the tiering or, in other words, have agreed to waive their right to be preferred and accepted their subordination in the first place.

4. THE PROGRESSIVE VALIDATION OF CONTRACTUAL SUBORDINATION BY LUXEMBOURG COURTS

The evolution of Luxembourg case law

In the absence of statutory provisions and considering the somehow different – and often contradictory – views taken by academics, Luxembourg courts have to some extent been reluctant to formally recognise the validity of contractual subordination in Luxembourg. Although relevant case law on this particular topic certainly remains limited, it is still possible to identify some interesting decisions which would tend to consider, if not recognise, the validity of contractual subordination under Luxembourg law. One of the first decisions touching on the validity of contractual subordination under Luxembourg law was taken on 27 October 1993, when the Luxembourg Court of Appeal ruled that the principle of equal treatment among unsecured creditors should be deemed a matter of public policy (*ordre public*), hence supposedly reinforcing the view that contractual tiering would breach this principle. That being said, it should be noted that the position taken by the Luxembourg Court of Appeal in this specific instance only applied to a particular situation where the judges effectively sanctioned a breach of the principle of equal treatment following the opening of liquidation proceedings.

A few years later, on 15 May 1998, the Luxembourg District Court (*tribunal d'arrondissement de Luxembourg*) departed from the initial position taken by the Luxembourg Court of Appeal in 1993, and ruled that general subordination was valid in the wider context of liquidation proceedings, hence paving the way for a more general recognition of contractual subordination in Luxembourg.

Towards a general recognition of contractual subordination by Luxembourg courts?

More recently, on 9 January 2013, the Luxembourg Court of Appeal ruled that subordination clauses could not possibly violate the principle of equal treatment among shareholders given the absence of violation of any statutory prohibition. This decision came after an appeal against the decision of the Luxembourg District Court which did not take into consideration the existence of subordination provisions included in certain loan agreements entered into between a Luxembourg company acting as lender, and a Belgian company acting as borrower. The court held that, among other factors, subordination arrangements should meet the usual conditions for the validity of contracts under Art 1108 of the Luxembourg Civil Code (ie consent and legal capacity of the parties, determined object and lawful cause), and that subject to the foregoing, a breach of such tiering arrangements could cause an acceleration of the relevant loan. This last decision seems to expressly recognise the validity of contractual subordination in Luxembourg as a valid legal concept despite the lack of express statutory authority for it.

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5. THE EMPIRICAL DEVELOPMENT OF CONTRACTUAL SUBORDINATION IN LUXEMBOURG

The central role of contractual subordination in syndicated and structured finance

Despite the relative uncertainty in the absence of legislative approval, contractual subordination has been widely used and

developed by practitioners over the last decades. In the framework of international financings, contractual subordination is generally implemented through foreign law governed finance documents in the form of loan agreements, intercreditor agreements or other subordination deeds entered into by Luxembourg entities in various capacities. Subordination provisions included in these documents aim at setting out the relative position of different creditors in terms of rank with respect to a debtor or a group of debtors.

Content of subordination agreements

Subordination arrangements may be pretty specific and detailed, and include, among others, provisions as to:

- the order for the repayment of creditors according to their rank;
- the relationship between senior and junior debts;
- the prohibition for a debtor to discharge a junior debt before senior debts have been discharged;
- the description of the assets of the debtor and other guarantors that may be used to repay the subordinated debt and to which creditors may have recourse in accordance with certain agreed security principles;
- the right of subordinated creditors to be informed of an event of default affecting the service of the senior debt(s) and in respect to the remedy applied;
- the period during which, except in the occurrence of an event of default or acceleration event (absent any cure period), junior creditors may not exercise their rights;
- the commitment of the junior creditors not to challenge the rank and validity of senior creditor's claims;
- the possibility for senior creditors to renegotiate their debt without consent from junior creditors; or
- the prohibition against junior creditors modifying the terms of the subordinated debt or to be granted new securities that would adversely affect the rights of senior creditors.

Subordination in an enforcement scenario

On a default of the debtor, junior creditors will generally have to wait until senior debts have been satisfied in full. If the debtor does not have enough assets to discharge all the various claims, creditors coming lower in terms of rank will potentially have to write off all or part of their claim, based on the subordination arrangement. It goes without saying that this type of contractual tiering generally comes alongside the implementation of a wider security package, where certain assets of the debtor or other obligors such as shares, receivables or accounts, will be subject to security interests created to the benefit of a security agent. In the case of an enforcement of those security interests, a representative of the secured parties (including senior and junior creditors), acting as security agent, will carry out the enforcement actions and pay out to the various creditors, according to the subordination arrangement in place, the enforcement proceeds.

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6. SUBORDINATION ARRANGEMENTS AND THIRD PARTIES

Creditors of subordinated creditors

While in accordance with the principle of privity of contract (*effet relatif des contrats*), subordination arrangements should in theory only affect, and be binding upon, the parties to the relevant agreement (*acte juridique*), their existence will nonetheless produce certain effects (*effets juridiques*) which will somehow affect third parties. For instance, in the case of a solvent debtor, subordination arrangements will affect creditors of subordinated creditors, such that their right of recourse over the assets of their own debtor (ie the subordinated creditor(s)) will be limited by the effects of the contractual subordination hence affecting, at least in terms of timing, the assets against which they might potentially exercise their rights until those are effectively received by the subordinated creditor in accordance with the tiering arrangement.

Transfer of subordinated claims

On a different note, the transferee of a subordinated claim would, in theory, also be bound by the pre-existing subordination mechanism affecting the modalities of settlement of the relevant claim. While the nature of the subordination itself has been debated by scholars to determine whether it should be deemed a personal obligation (*obligation personnelle*) of the subordinated creditor or, conversely, an accessory (*accessoire*) to the relevant claim, in practice, the transfer of the subordinated claim would generally require the prior consent of the senior creditors (or of the security agent acting on their behalf) and the simultaneous compliance by the transferee with the subordination mechanisms.

Set-off and contractual subordination

More interestingly, in the case of an insolvency event affecting a (Luxembourg) debtor, the majority of academics' opinion seems to suggest that a liquidator should be bound by the terms of a pre-existing subordination arrangement. This means that such pre-agreed tiering among creditors should interfere with, and prevail over, the statutory rules governing the liquidation of an insolvent entity and ultimately the distribution of any liquidation proceeds to its creditors. That being said, certain mechanisms such as set-off or netting, whether legal or contractual, might themselves also impact a pre-agreed subordination arrangement.

Protection of senior creditors against set-off mechanisms

The potential occurrence of a legal or

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contractual set-off or netting (*compensation*) between existing (*certaines*), liquid (*liquides*) and payable (*exigibles*) reciprocal claims held respectively by the debtor and a junior creditor might represent a significant risk for senior creditors, in particular in the case of a legal netting (*compensation légale*) which may take place *de jure* each time the above referenced conditions of existence, liquidity and payability of reciprocal claims are characterised, without any requirement for the parties to agree to such netting. That being said, different mechanisms are traditionally used in order to circumvent potential adverse consequences to creditors. On the one hand, legal set-off or netting, which would automatically occur by effect of law, as outlined above, may be frustrated by having both the debtor and the junior creditors covenanting to suspend their respective right of repayment under any reciprocal claims that these parties may have against each other until the repayment in full of the senior claims, hence preventing one of the essential conditions of the legal set-off (ie payability) from being satisfied. On the other hand, contractual set-off or netting might be expressly excluded by the parties in the contractual documentation, either expressly or by a sweeping prohibition against debtors and junior creditors taking any measures that may adversely affect senior creditors' rights under the finance documents.

CONCLUSION

An existing mechanism without formal recognition (yet)

In spite of the still existing lack of legislative recognition in Luxembourg, contractual subordination is and remains a fairly common mechanism which is used more frequently than not in international financings, and more interestingly, also for financings originating from Luxembourg and implemented via Luxembourg law governed documentation. In this respect, even if the use of, for example, a Luxembourg law governed intercreditor agreement remains extremely rare, contractual subordination mechanisms would nonetheless be directly embedded into the loan documentation in order to set forth the respective rights of senior and junior lenders vis-à-vis one or several obligors. Based on the above, and in particular in the light of the latest developments of Luxembourg case law, we would submit that the concept of contractual subordination in Luxembourg should not be seen as fundamentally disruptive. On the contrary, we consider that this popular mechanism should be acknowledged by the Luxembourg legislator and recognised as another tool in the yet extremely efficient Luxembourg security package tool box. Consistent with its long-standing endeavour to position itself as a creditor friendly jurisdiction, a formal recognition confirming the position taken by Luxembourg courts would reinforce the legal certainty surrounding contractual tiering among creditors and contribute to maintaining an edge in order to attract international finance players. ■

Further Reading:

- Can set-off prejudice a debt subordination agreement? (2009) 2 JIBFL 64.
- The principle against divestiture and the *pari passu* fallacy (2010) 1 JIBFL 3.
- LexisNexis Banking and Finance blog: The LMA REF intercreditor agreement for contractual subordination.