

**International Swaps and Derivatives Association, Inc.**  
COLLATERAL LAW REFORM GROUP

# **LUXEMBOURG**

## **COUNTRY REPORT**

Supplement to  
*Collateral Arrangements in the European Financial Markets:  
The Need for National Law Reform*

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*European Office:*  
International Swaps and Derivatives Association, Inc.  
One New Change  
London EC4M 9QQ  
Telephone: +44 171 330 3550  
Fax: +44 171 330 3555  
**International Swaps and Derivatives Association, Inc.**

**COLLATERAL LAW REFORM GROUP*****LUXEMBOURG****Summary report on the legal framework for collateral arrangements for financial activity*

Summary of the legal analysis under the laws of Luxembourg applicable to collateral arrangements intended to secure financial trading activity in relation to privately negotiated derivative transactions, securities trading, securities repurchase transactions, stock lending and similar financial transactions in the wholesale financial markets. It is assumed that at least one of the parties involved is a financial institution (credit institution or investment firm) and that the collateral involved is cash, in euros or some other freely available currency, and/or fungible securities listed on a stock exchange or recognised market and held in immobilised or dematerialised form in a clearing system (“Fungible Securities”). References to “collateral” below indicate cash and Fungible Securities, unless otherwise specified.

*This summary was prepared for the purpose of identifying possible areas of uncertainty or commercial impracticality arising under the laws of Luxembourg in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in Luxembourg and should not be relied on as such.*

*The position is stated as of December 1999.*

***This summary, prepared by the Collateral Law Reform Group, does not necessarily represent the views of ISDA or any of its members. It is a subjective assessment of the position in Luxembourg and is simply intended to encourage debate and discussion of the relevant issues.***

**KEY POINTS FOR CONSIDERATION FOR LUXEMBOURG**

- (1) The owner of a share in a pool of Fungible Securities would have absolute title to the assets.
- (2) The *lex loci* of Fungible Securities held through an account in a clearing system is the place where the account is held.
- (3) Conflicts of law rules would apply the *lex loci* to a holding or the transfer of Fungible Securities and the perfection of a security interest in Fungible Securities and the governing law of any agreement to the creation of a security interest.
- (4) If security assets are held by a third party bank or custodian the security interest must be notified to or acknowledged by the third party and (in relation to Fungible Securities) registered on the account.
- (5) No official registration of a security interest with any state agency is necessary.
- (6) A pledgee may not use pledged assets as its own property.
- (7) No formal procedures apply to enforcement of a security interest where the pledgor is a wholesale market participant.

- (8) Enforcement of a security interest may not be delayed and is not stayed on insolvency.
- (9) Whether title transfer arrangements will be recharacterised is uncertain.
- (10) Close-out netting under an ISDA Master Agreement is enforceable.
- (11) Contractual set-off is only enforceable on insolvency for connected obligations.
- (12) Third party claims will not disrupt set-off and netting between solvent counterparties.
- (13) Top-up collateral will not be avoided as a preference.

**1. Do the laws of Luxembourg deal clearly with the nature of a participant's interest in a holding of Fungible Securities?**

Yes. See *Règlement Grand-ducal* of February 17, 1971 regarding the circulation of securities.

**2. How would such an interest be characterised under this law?**

The interest of a participant as the client of a Luxembourg incorporated depository with whom the participant has deposited the securities on a fungible basis, can be considered to be a co-property right to the Fungible Securities.

**3. How would the location of Fungible Securities be determined under the laws of Luxembourg?**

Fungible Securities, will be deemed located in the place where the accounts evidencing the co-property rights in the pool of Fungible Securities are located (at least with regard to Fungible Securities held through a Luxembourg depository). The position is unclear if Fungible Securities are held through foreign intermediaries. European Directive 98/26/EC of May 19, 1998 (the "Settlement Finality Directive") had not been implemented in Luxembourg as of 30th July, 1999.

**4. Under Luxembourg's conflict of laws rules, what law would govern:**

**(a) the characterisation of a person's holding of Fungible Securities?**

The law of the jurisdiction of the intermediary through which the participant holds any Fungible Securities.

**(b) the creation of a security interest in cash or Fungible Securities?**

Luxembourg law recognises the parties' right to choose the applicable law of any agreement creating a security interest, provided that the agreement has an international dimension (for example, the parties are of different nationalities or the collateral is located outside of Luxembourg) and provided it is not the intention of the parties to avoid the application of mandatory provisions of Luxembourg law.

**(c) the formal validity or perfection of a security interest in cash or Fungible Securities?**

The law of the location of the collateral.

**(d) the effectiveness and formal validity of a transfer of title to Fungible Securities?**

The law of the location of the collateral.

**5. What types of security interests may be created under the laws of Luxembourg in:**

**(a) cash?**

**(b) Fungible Securities?**

**Where more than one type of security interest is possible, please indicate which type(s) would typically be used for collateral arrangements involving cash and/or Fungible Securities, and why.**

(a) Pledge of cash (effective as a pledge over a current account);

(b) Pledge (see Art. 8 of *Règlement Grand-ducal*).

**6. In relation to each of these types of security interest, describe briefly any filing, registration, notification, notarisation or other formal requirements necessary to ensure validity of (or “perfect”) the security interest? In relation to each type of security interest, please indicate the consequence of failing to comply with the relevant requirement.**

**(a) Pledge of cash or current account**

A pledge over cash (or over the claim represented by a current account) is created either (i) by notifying the relevant bank (as debtor, and depository of the cash) or any third party holding of the cash or (ii) if the pledge is acknowledged by the bank or that third party. The notifications can be a private notice (by way of registered letter), or by bailiff, or alternatively can be acknowledged by a private deed or a notarised deed.

**(b) Pledge of Fungible Securities**

The only formality required is the transfer by book-entry of the pledged Fungible Securities to a separate account. It must be expressly marked in the books of the depository that the securities in that account are pledged, and the amount of securities that are pledged.

- 7. In relation to each type of security interest, indicate whether the collateral receiver is entitled to use the collateral as though it were the absolute owner of the collateral, including the right to sell, lend or re-pledge (rehypothecate) the collateral to a third party.**

**(a) Pledge**

The pledged assets will remain the property of the pledgor. Thus, as a general rule, the secured party cannot use, sell or otherwise dispose of the pledged assets. However, rehypothecation (in the narrow sense of the word: that is, re-pledging) is allowed provided the pledgor has given its prior authorisation. The secured party must advise the second pledgee and any third party holding the assets that the secured party is not the owner of the assets. However the validity of the new pledge is not affected by the absence of a right of ownership if this is not notified to the new pledgee. If a second pledge is granted without the secured party having informed the second pledgee of the existence of the original pledge, the second pledgee would normally be considered as acting *bona fide*. Therefore the second pledge may be enforced even if the original pledgor has not defaulted. The original pledge itself will not be affected by any rehypothecation (so long as the formalities for a valid pledge continue to be fulfilled), but the rights of the primary pledgor (to return of the assets) may be affected by the rights granted by the primary pledgee.

There is an argument that if the primary collateral provider gives its consent to use the collateral for other purposes, the collateral taker should also be able to use the collateral for selling or lending purposes (although no legal doctrine or case law expressly supports this).

- 8. Briefly describe the enforcement procedures for each type of security interest commonly used for collateral in relation to financial activity. For example, is court approval required before the security interest may be enforced and/or is some form of auction procedure required. Indicate any practical difficulties typically encountered and also the relative efficiency and speed (or lack of same) of such procedures. Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

The secured party is not required to obtain judicial authorisation, commence any court proceedings, or take any other action before any official authority or otherwise (except as required under the security agreement and as described below) to enforce its security interest in the collateral.

**(a) Pledge of Fungible Securities**

A pledge of collateral consisting of Fungible Securities can be enforced forthwith, without any obligation to serve prior written notice on the pledgor provided the pledgor is an entity operating in the financial sector (that is, a credit institution; other financial sector professional; broker; custodian; money dealer; investment advisor; undertaking for collective investments (“ucit”); or a commercial or industrial institution having professional access to the financial markets; or an international public institution operating in the financial sector). If the pledgor is not such an entity, a prior written summons to pay must be served on the pledgor and any relevant third party (in the case of a pledge of receivables). If the pledged securities are admitted to the official listing of the Luxembourg Stock Exchange or another recognised market they may be sold on that market or appropriated by the pledgee at the market price. In all other cases, the pledged securities must be sold by way of public auction by a public officer of the stock exchange.

**(b) Pledge of Cash**

A pledge of cash collateral can be enforced by requesting any third party with whom the cash is held to make payment to the secured party of the amount due or if the cash is held by the secured party. Enforcement is by setting-off the claim against the secured exposure, following a written summons to pay having been served by registered letter on the pledgor and the third party at least 8 days before enforcement takes place (or as otherwise provided in the security agreement).

With regard to (a) and (b) above, it should be noted that Luxembourg insolvency laws do not contain any provisions which might prevent the secured party from promptly liquidating securities collateral.

**9.a. In relation to collateral arrangements based on transfer of title, please indicate whether there is a risk that the courts of Luxembourg would recharacterise the transfer of title as the creation of a form of security interest? If so, please give some indication of the degree of that risk (for example, very low, low, medium, high, very high). Please indicate the consequences of such a recharacterisation.**

Luxembourg law recognises title transfer collateral arrangements both with respect to repos (see Law of December 21, 1994 on *opérations de mise en pension*); and as fiduciary transfers of title (Grand Ducal Decree of July 19, 1983). At least one of the parties to a repo, and the transferee under a fiduciary transfer must be a Luxembourg bank.

Under a repo, the collateral receiver is considered to be the absolute owner of the collateral, as a result of which he has the right to sell, lend or use the collateral in any other manner. The only formality with which the parties need to comply is the transfer from the account of the collateral provider to the account of the collateral taker. Since the collateral receiver becomes the absolute owner of the collateral, no enforcement procedures apply.

Grand Ducal Decree of July 19, 1983 on fiduciary agreements entered into by credit institutions (the “Grand Ducal Decree”) provides an express statutory basis for transferring title to collateral to a Luxembourg fiduciary bank (*fiduciaire*), on condition that the transfer takes place under a fiduciary agreement. Although the fiduciary bank will become the owner of the transferred collateral, the fiduciary bank will be constrained to use its ownership of the collateral only as consistent with the fiduciary obligations expressed in the agreement. In addition, the Grand Ducal Decree makes it clear that notwithstanding the transfer of title to the collateral to the fiduciary, third parties (for example, creditors of the fiduciary bank) cannot assert any claims to the fiduciary assets in the absence of a direct fiduciary obligation in their favour. A fiduciary transfer can also be used in order to collateralise an outstanding obligation of the transferor owed to the fiduciary bank.

The following uncertainties and limitations, however, continue to exist:

First, it remains unclear under Luxembourg law, whether an asset can be validly transferred under a fiduciary agreement to a fiduciary bank in order to guarantee an obligation owed to a third party. In those circumstances, the fiduciary transfer could be interpreted as an attempt to circumvent the prohibition against the *pacte commissoire* (a Luxembourg statutory rule which prohibits a pledgor and a pledgee from agreeing that the pledgee has the right to appropriate pledged collateral and dispose of it without court approval) resulting in the collateral transfer being void.

Second, transfers of collateral which are not fiduciary transfers (that is, not governed by a fiduciary agreement) are not protected under Luxembourg law and are therefore subject to the risk of recharacterisation. This could raise questions as to whether the formalities for the valid creation of a pledge have been met and whether parties have complied with the prohibition against the *pacte commissoire*. The degree of risk can be described as medium.

**9.b. If the agreement is governed by a foreign system of law that does not recharacterise, would the risk of recharacterisation under domestic law still be present?**

See above.

**10. Is close-out netting, for example under a 1992 ISDA Master Agreement, enforceable under the laws of Luxembourg? If so, but subject to certain limitations (for example, as to the nature of the counterparty or types of transaction included within the netting), please indicate briefly what those limitations are.**

Yes. Luxembourg law will only interfere if chosen as the law applicable to the agreement or if insolvency proceedings have been commenced in Luxembourg against a company that is incorporated under Luxembourg law or an individual engaged in business with the principal establishment in Luxembourg. Close-out netting is enforceable under Luxembourg law.

Regardless of the type of insolvency proceeding, under the 1996 Netting Act, bilateral or multilateral close-out netting agreements or clauses entered into between certain entities described in the Netting Act are protected from cherry-picking. Bilateral and multilateral netting provisions and close-out provisions stipulated in an agreement or a clause between two (or more) parties are given effect in Luxembourg insolvency proceedings.

In particular, the Netting Act declares “clauses establishing connexity, indivisibility clauses, acceleration clauses, termination clauses, close-out clauses and other clauses stipulated in order to allow netting” (the “Termination and Close-out Netting Provisions”) to be valid and binding against any third party, including the receiver or liquidator, in Luxembourg insolvency proceedings, if two conditions are met:

- (a) the Termination and Close-out Netting Provisions must clearly cover all transactions in respect of which the parties want to terminate and net their outstanding positions; and
- (b) the transaction must be entered into between parties that are of a type listed under the Netting Act as eligible for special treatment (“Netting Act Entities”).

The Netting Act contains no limitation as to the type of transaction to which Termination and Close-out Netting Provisions may apply, except that the relevant transactions must be financial transactions. Also, there are no limitations in the Netting Act as to what constitutes a master netting agreement, a netting agreement or a netting clause. Netting Act Entities include banks, broker-dealers, insurance companies, ucit’s, commercial or industrial institutions benefiting from professional access to the financial markets and international public institutions active in the financial sector.

It should be noted that the Netting Act applies only if at least one of the parties is a Netting Act Entity that is established or operates in Luxembourg. Moreover, netting agreements or clauses that are entered into after the date of cessation of payments set by the Luxembourg courts are null and void and are not binding on the general body of creditors, even if they concern claims not due but which arose prior to the date of the netting agreement.

See also the netting opinion provided to ISDA by Zeyen Beghin Feider Loeff Claeys Verbeke of December 1997.

- 11. Is contractual set-off and/or insolvency set-off enforceable in the event of formal insolvency proceeding in the courts of Luxembourg in relation to a counterparty organised in Luxembourg? Please indicate the answer in relation to each type of formal insolvency proceedings (including rehabilitation or reorganisation proceedings such as administration or *redressement judiciaire*) possible in Luxembourg in relation to a corporate entity (including a financial institution). Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

If the 1996 Netting Act does not apply, the general principles of law governing set-off will be applicable. Contractual set-off provisions will be held valid by a Luxembourg court in the event of bankruptcy of a Luxembourg company which is party to an agreement containing such rights only to the extent that the claims to be set off against one another derive from the same transaction (*dettes connexes*). Claims under an ISDA Master Agreement are part of a single agreement and so may be sufficiently connected in this way (even if the Netting Act does not apply). However in the absence of any decided case-law on this point it is impossible to give a definite answer.

- 12. Would the exercise of netting or set off rights under a title transfer collateral arrangement be vulnerable to the rights of third parties in the event of the insolvency of the collateral giver? For example, would it be possible for the collateral giver to disrupt (deliberately or inadvertently) the netting or set-off by assigning to a third party creditor its right to redelivery of equivalent collateral under the collateral arrangement? Could that right to redelivery be attached by a third party creditor of the collateral giver free of the collateral taker's netting or set off rights under the collateral arrangement?**

Under Luxembourg law claims may be assigned by a creditor to a third party without the consent of the debtor. In order for the assignment to be binding on the debtor (*opposable*) and on third parties other than the assignee, the debtor must be notified of the assignment (by registered letter or by service by a bailiff) or must assent to the assignment (by private deed or by a notarised deed). Contractual claims may be assigned in this way without the contract as a whole being transferred. A party may not transfer obligations under a contract (the burden rather than the benefit of the contract) without the consent of the other party. Hence, *a priori*, it would be possible to assign to a third party creditor the right to delivery of equivalent collateral under a collateral arrangement without the collateral arrangement being assigned as a whole (unless both parties to the collateral arrangement agree thereto). The right to delivery may also be attached by a third party creditor of the collateral giver. The attachment of rights or claims is known under Luxembourg law as *saisie-arrêt*.

However it is unlikely that any assignee or attaching creditor will take such rights free of any rights of netting or set-off under the collateral arrangement. He who transfers an asset (such as a claim) cannot transfer more than he owns. It is therefore important to determine (under the law applicable to the collateral arrangement) what rights relate to the assigned or attached claim. For example whether the claim can be considered as conditional upon the performance of other obligations. The collateral arrangement may also contain specific provisions which may affect the assignment.

- 13. In relation to mark-to market collateral arrangements, is there any risk under the preference (or similar) rules of Luxembourg that “top-up” deliveries of collateral would be vulnerable to avoidance if made during a relevant period prior to the insolvency of the collateral giver?**

Under article 445 of the Commercial Code any delivery of collateral for a pre-existing debt during the so-called suspect period will be null and void. The suspect period is normally a period of six months and ten days preceding the date on which the courts make any declaration of bankruptcy. This is a result of the presumption that a company will have become insolvent six months prior to such bankruptcy order. The period prior to the presumed insolvency (as opposed to the bankruptcy proceedings themselves) is ten days. Article 61-1 paragraph 3 of the law 5th April, 1993 on the financial sector (as amended in particular by the 1996 Netting Act) also states that netting agreements, and any related agreements regarding termination or the indivisibility of claims are null and void if agreed during the suspect period (to the extent such agreements relate to obligations which are not yet due and which were agreed prior to the date of the netting agreement). Therefore, deliveries of top-up collateral pursuant to a netting agreement or collateral arrangements which were agreed prior to the suspect period should be enforceable.

- 14. Please add any additional comments on the general legal framework for collateral arrangements under the laws of Luxembourg, whether based on creation of a security interest or on title transfer, highlighting any difficulties that should be addressed in any project for collateral law reform in Luxembourg.**

Luxembourg law is still uncertain regarding whether and to what extent a transfer of title is a possible form of collateral. It is generally considered under Grand-Ducal decree of 19th July, 1983 on fiduciary agreements, that a fiduciary agreement may be used for the purposes of creating a transfer of title to collateral in favour of a fiduciary bank although there is no express confirmation of this in the decree. It is doubtful whether the 1983 decree can be used where the beneficiary of the transfer is not identical to the fiduciary.

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