FUND FINANCE
LUXEMBOURG

DEBROISELEGAL
Luxembourg Law Firm

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CLIENT BRIEFING

DEFAULTING INVESTOR REMEDIES

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A LUXEMBOURG PERSPECTIVE

In contrast with other corporate forms, Luxembourg limited partnerships have significant contractual freedom to establish effective remedies against defaulting investors.

INTRODUCTION

This briefing outlines the typical remedies available against defaulting investors in Luxembourg investment funds and their enforceability under Luxembourg law.

It differentiates between vehicles formed as commercial companies (SA – *société anonyme*, SARL – *société à responsabilité limitée* and SCA – *société en commandite par actions*) and limited partnerships (SCSp – *société en commandite spéciale* and SCS – *société en commandite simple*), with references to the law of 10 August 1915 on commercial companies, as amended (the **1915 Law**).

STANDARD REMEDIES IN FUND DOCUMENTATION

In Luxembourg investment funds, investors usually commit capital to the fund, which is drawn down over time.

Failure by an investor to fund a capital call when due may result in the investor being deemed a "defaulting investor."

To protect the interests of the fund and its non-defaulting investors and to deter any payment default, fund documents typically include a range of remedies that may be exercised against defaulting investors.

The following remedies are commonly included in fund documentation (e.g., limited partnership agreements (LPA), shareholders' agreements, or prospectuses) against defaulting investors:

Remedy	Description
Suspension of Rights	Defaulting investors may lose: • voting rights • the right to participate in future investments • entitlement to distributions
Default Interest	A defaulting investor may be required to pay: • interests on unpaid capital contribution, typically at a contractual default rate • late fees or administrative charges
Clawback of distributions	A defaulting investor may be required to repay distributions received
Forfeiture	In certain cases, the fund may: • forfeit all or part of the defaulting investor's interest in the fund; and • apply a haircut on redemption proceeds or profit distributions
Forced Sale	The fund or the general partner (GP) may force the transfer of the defaulting investor's interest to the fund, other investors, or third parties at a discounted price (often based on its net asset value (NAV) or a formulaic discount)
Dilution	Dilution of the defaulting investor's interest by way of issuing new interests to other investors without pre-emption right
Set-Off	The fund may set off any amounts owed to the investor (e.g., distributions) against the defaulted amounts
Legal Action	The GP or the fund may initiate legal action to recover the unpaid commitment and related costs

ENFORCEABILITY UNDER LUXEMBOURG LAW

UNDERSTANDING ARTICLE 1142 OF THE LUXEMBOURG CIVIL CODE

Article 1142 of the Luxembourg civil code provides that: "any obligation to do or not to do resolves into damages in case of non-performance."

This means that, as a general principle, under Luxembourg law, if a party fails to fulfil an obligation to act as stipulated in a contract, the primary legal remedy available to the aggrieved party is monetary compensation, rather than compelling the defaulting party to perform the obligation.

In the context of shareholders' agreements or LPAs, this provision implies that if a shareholder breaches an obligation - such as failing to vote in a certain way or not adhering to non-compete clauses - the non-breaching parties may not be able to enforce the specific performance of these obligations through the courts. Instead, they would typically be limited to seeking damages for any losses incurred due to the breach. For example, if a shareholders' agreement includes a clause requiring a shareholder to sell their shares under certain conditions, and the shareholder refuses, Article 1142 may prevent the enforcement of the sale through specific performance. The aggrieved parties would then need to pursue damages for any harm suffered due to the refusal.

However, while Article 1142 sets a general rule, Luxembourg courts have, in certain instances, recognised exceptions where specific performance may be granted. For instance, if the obligation is clear, precise, and its enforcement is feasible, courts may order the defaulting party to perform the obligation. Article 1142 is not of public order (*ordre public*). Parties could also waive its application by contract.

SUSPENSION OF VOTING RIGHTS

The 1915 Law provides that the management of a SA or SARL may suspend the voting rights of a shareholder who breaches its obligations under the articles of association or its subscription agreement, including failure to pay capital commitments.

Luxembourg case law has upheld such clauses when they are clearly defined in the company's constitutional documents, and the remedy is proportionate to the breach.

For limited partnership structures, the voting rights of partners can be freely organised under the LPA. It is common practice to include clauses that suspend a limited partner's voting rights upon default of capital contributions.

Courts would support the enforceability of such clauses, provided they are not contrary to the corporate interest of the fund and do not permanently eliminate the shareholder's rights.

FORFEITURE AND FORCED TRANSFER

With respect to limited partnership companies, the 1915 Law offers significant contractual flexibility. The LPA may authorise the reduction or the redemption of all or part of the partnership interests of one or more of the partners and determine the terms of such reduction or redemption. A clause allowing for the compulsory sale or forfeiture of a limited partner's interest in the event of default on capital commitments would be enforceable, provided it is clearly stipulated in the LPA and does not contravene mandatory legal provisions or public policy.

The conditions for the redemption must be stated in the LPA, in particular regarding the determination of the price, which cannot be symbolic.

While the 1915 Law does not explicitly provide for the forfeiture of shares in a SA or a SARL or forced transfer due to non-payment, it does not as such prohibit contractual arrangements that compel the sale of a defaulting shareholder's shares, provided such provisions are included in the company's constitutional documents.

In a judgment by the Luxembourg District Court (No. 162980 dated April 28, 2016), the court examined the validity of a mandatory share transfer clause triggered by the termination of the employment contract of a shareholder. The court emphasized that, in the absence of a clear and precise clause in the shareholders' agreement providing for such an automatic transfer, the company could not enforce a share transfer without the consent of the concerned shareholder or a judicial order mandating it. As such, the mechanism was not deemed prohibited.

Luxembourg courts handle a limited number of disputes between funds and investors. Published case law indicating that such remedy is likely to receive a sympathetic hearing in Luxembourg is therefore rare. In particular, Luxembourg courts are cautious about forfeiture clauses or forced transfers and may review their enforceability based on principles of good faith, proportionality, and fairness. Article 1855 of the Civil Code which permits the exclusion of a partner in certain circumstances, could support compulsory transfer or redemption clauses.

The situation would be slightly different if redeemable shares are at stake.

Unless the forfeited interest is reallocated to other investors or sold to third parties (non-defaulting or secondary investors), forfeiture has the direct consequence of reducing the total committed capital of the fund.

CLAWBACK OF DISTRIBUTIONS

Articles 310-4 (SCS) and 320-5 (SCSp) of the 1915 Law recognise the right of the GP to recall distributions and withdrawals paid out to partners (clawbacks), subject to the terms of the LPA.

There is no equivalent provision in the 1915 Law for SA or SARL. In case of dispute, legal action is generally required to enforce clawback.

CHARGING MAXIMUM INTEREST ALLOWABLE BY LAW FOR LATE PAYMENTS

Where the remedy does not constitute a genuine pre-estimate of the loss likely to be suffered by the fund in consequence of the default and is rather a device to deter a party from breaching an agreement, it may be regarded as a penalty.

Luxembourg courts have a discretionary power to reduce the agreed remedy where they could justify that the clause is « manifestly excessive ».

WITHHOLDING OF FUTURE DISTRIBUTIONS TO COVER UNPAID COMMITMENTS.

To the extent, limited partners or shareholders were entitled to receive distributions before the occurrence of the relevant trigger event, the prohibition of leonine clauses sets forth in article 1855 of the Luxembourg civil code should not affect the possibility to exclude a limited partner or shareholder, as appropriate, from future distributions to cover unpaid commitments.

PRACTICAL CONSIDERATIONS AND DRAFTING TIPS

Luxembourg courts would be supportive of well-structured remedies, particularly in professional investor contexts, but care must be taken to follow due process and proportionality.

To ensure the enforceability of remedies against a defaulting partner under Luxembourg law, it is advisable to:

- define what constitutes a “default”
- ensure that all remedies are clearly defined and consistent across the constitutional documents, PPM, and side letters
- for commercial companies, incorporate the remedies in the articles of association, as they may override shareholder agreements
- include a grace period and cure mechanism to avoid arguments of bad faith
- specify who decides (GP, investor committee, majority LPs)
- include NAV mechanism or independent expert for pricing forfeited/transferred interests
- insert a waiver to the application of Article 1142 of the Luxembourg Civil Code
- maintain transparency and documentation when triggering default remedies to ensure defensibility.

ABOUT US

Debroise Legal is a Luxembourg-based boutique law firm dedicated to providing expert legal services in the realm of corporate, financing and restructuring transactions.

Founded by a seasoned lawyer with over 20 years of experience in the Luxembourg legal market, our firm is committed to delivering tailored solutions that meet the specific needs of our clients.

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