FUND FINANCE LUXEMBOURG

DEBROISELEGAL
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CLIENT BRIEFING

SECURITY OVER LP COMMIT MENTS

The purpose of this client briefing is to explain the process of establishing a security interest over LP commitments. Additionally, it covers the enforcement of such security.

TAKING SECURITY OVER INVESTOR COMMITMENTS

An investor's capital commitment is an undertaking to contribute a certain amount of capital to a fund or, where applicable, to subscribe for a certain number of shares/units in a fund.

In a recent decision, the Luxembourg Court of Appeal analysed the legal nature of an undertaking to subscribe for shares in a public limited liability company (SA):

[…] the word "subscription" refers to the act by which an investor makes a promise to acquire shares in a company, while "liberation" refers to the shareholder's obligation to make available to the company the money or goods in kind to which he or she committed at the time of subscription. The two actions do not necessarily take place at the same time. […]

The word "subscription" thus has two aspects: on the one hand, and above all, it expresses an obligation which establishes the debtor's status as a partner; but, on the other hand, this term refers to a material result: the collection, not the payment, of all the contributions that make up the company's capital; thus, for cash contributions, a distinction must be made between the promise to make the contribution (subscription) and the fulfilment of this promise, i.e. the actual payment of funds into the company's treasury (payment) (Jurisclasseur, Sociétés, Fasc. 114-10 Sociétés par actions, Constitution, Souscription des actions, no. 2). [Cour d'Appel, Luxembourg, 02/02/2021 No. CAL-2019-00190 and CAL-2019-00370]

In another decision, the Cour of Appeal further upheld that:

the commitment made by the subscriber becomes irrevocable by the transmission of the subscription agreement to the founders, or to the transfer agent, as in this case (JurisClasseur Sociétés Traité, Fasc.114-10: Sociétés par action-Constitution-Souscription des actions, no. 13). […]

The unpaid balance of the subscription constitutes a claim by the company against its partner. This claim is certain, because it arises from the subscription agreement. It is also liquid, because its amount is fixed. The only deferral is to the day on which the general partner request payment of the balance from the shareholder (Précis de droit des sociétés, no. 80). [Cour d'Appel, Luxembourg, 11/01/2024 No. CAL-2020-00758]

The obligation of the investor to pay the committed capital is resulting from the subscription agreement, which forms the basis of the claim of the fund against the investor. This claim will be crystallised by the delivery of a drawdown notice to the investor and can be pledged in accordance with the law of 5 August 2005 on financial collateral arrangements, as amended (the **2005 Law**).

Whether the fund is permitted to grant security over the uncalled capital commitments of its investors' is principally determined by the terms of the fund's constitutional documents, typically the limited partnership agreement and, where applicable, its offering memorandum.

Side letters between the fund and its investors should be carefully examined as they may contain restrictions on the ability of the fund to pledge the capital commitments of certain investors or excused investor provisions, which excuse certain investors participating in certain investments.

Tax, regulatory or ERISA reasons may also prevent a feeder fund from granting direct security to a lender if the purpose is to support the main fund’s obligations under a subscription facility.

ENFORCING SECURITY OVER INVESTOR COMMITMENTS

Enforcement may be carried out by the secured party, without requiring any court order or the involvement of any public or judicial officer.

As provided in the 2005 Law, “the pledge of a claim implies the right for the pledgee to exercise the rights of the collateral provider linked to the pledged claim”.

Upon the occurrence of an enforcement event, the secured party will be entitled to issue and deliver drawdown notices - in accordance with the provisions of the fund documents - to the investors and to receive the proceeds of the resulting capital contributions.

If the above steps fail, legal actions can be taken to compel the investors to perform their obligations.

REMEDIES AGAINST DEFAULTING INVESTORS

What if an investor doesn’t comply with a drawdown notice?

The fund's constitutional documents set out the remedies available against a defaulting investor. They include, among others, the ability to release the entire commitment and to exclude the investor from any distribution, to charge default interest or, in the worst-case scenario, to compel the investor to sell its interest.

Whilst the defaulting investor provisions contained in the fund documents are useful in terms of management of the fund prior to an enforcement event, the purpose of such provisions is ultimately to deter investors from failing to meet their funding obligations rather than to obtain payment from a defaulting investor.

In this context, the nature of the investor's contractual obligation to contribute and pay down its capital commitment could have a bearing on the types of remedies available in the event of a non-payment.

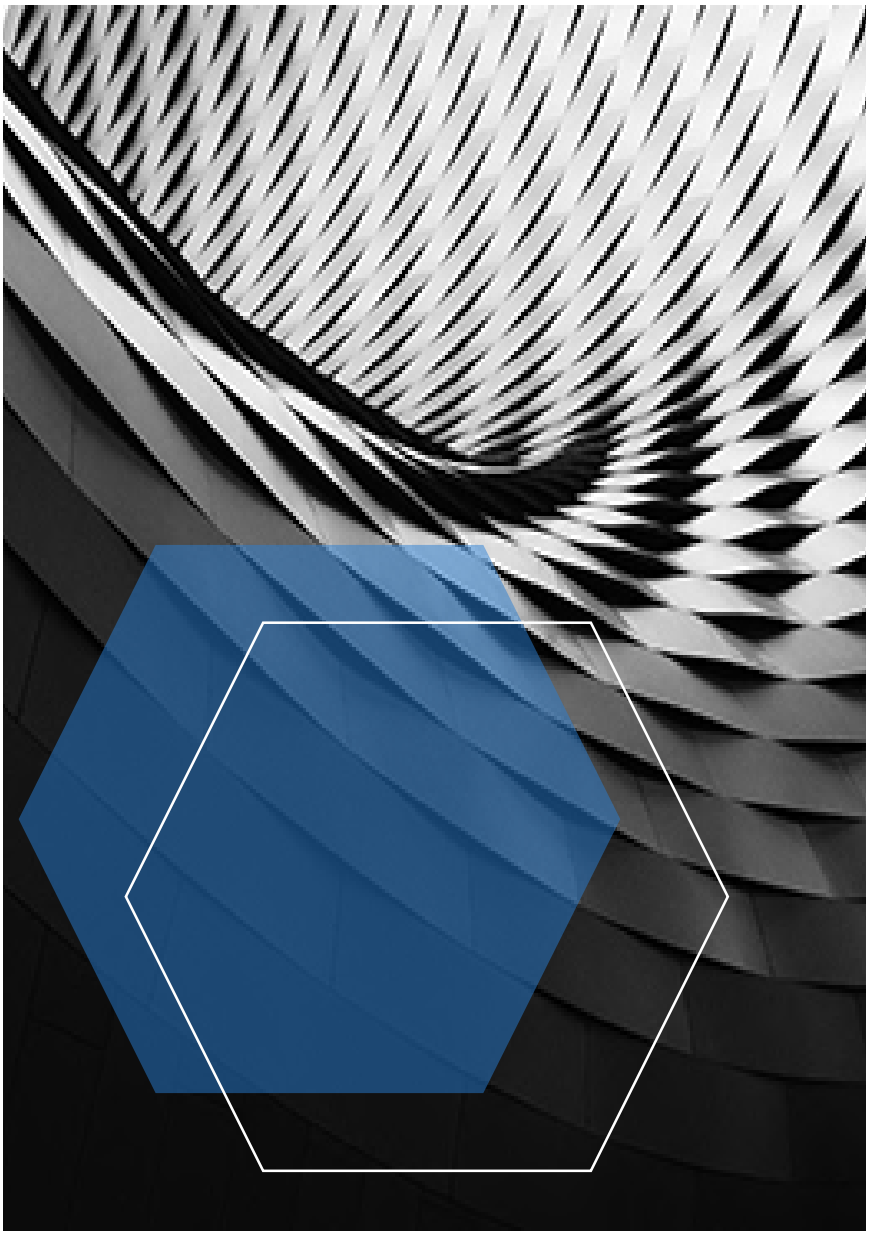
If capital commitments usually take the form of an obligation to pay, they could also be construed as an obligation to do or perform when drafted in the form of an undertaking to subscribe for new shares/units in the fund.

While the natural remedy for an obligation to pay is specific performance (i.e. the right to force the debtor to comply with its obligations), in the case of an obligation to perform, article 1142 of the Luxembourg civil code provides that a breach will generally result in the payment of compensatory damages.

Another potential pitfall is when the obligation to fund takes the form of an undertaking to subscribe with a corresponding obligation for the fund to issue new shares or units. This is generally the case when the fund borrower is established as a limited liability company. A capital commitment structured in this way may prove to be harder to enforce, as the secured party will need to be able to issue the corresponding shares or units to the investors. Luxembourg case law recognises the exception of non-performance (*exception d’inexécution*); allowing a party to suspend the performance of its own obligations if it is clear that the other party will not perform

its obligations and that the consequences of such non-performance are sufficiently serious. If no shares or units can be issued in consideration for its investment (for instance because of the opening of an insolvency proceedings against the fund), an investor could argue that its payment obligation has no cause and is thus not enforceable. One way of reducing such a risk would be to use a capital call structure involving the issue of partly paid-up shares. A waiver of defence will also be required.

If so provided in the fund documents, another option to bypass the lengthy process of enforcing the defaulting investor's payment obligation, is for the lender to rely on the overcall provision and call capital from the other fund's investors to cover the shortfall created by the defaulting one.



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