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A Review of Key Legal Regulatory Issues Impacting the Global Private Equity Industry

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The Double LuxCo Structure

The Double LuxCo Structure: A Restructuring Remoteness Tool?

Under French law, a solvent French company facing material financial difficulties may unilaterally file for safeguard proceedings (*procédure de sauvegarde*) without the consent of the lenders. The opening of such proceedings immediately triggers a mandatory stay of the claims (*suspension des poursuites*), including the enforcement of security, until completion of the safeguard process (from 6 to 18 months).

Since the opening of safeguard proceeding for the benefit of Heart of La Défense SAS and Dame Luxembourg (the highly publicized *Coeur Defense* case), lenders have been wary of sponsors/borrowers in LBOs and structured finance transactions attempting to use the French safeguard proceedings regime to gain leverage over their lenders in restructuring negotiations, by neutralizing (or threatening to neutralize) the enforcement of their security package.

To protect against such "hostile" safeguard proceedings, recent French LBOs schemes have been set-up based upon a double Luxembourg holding companies structure ("Double LuxCo"): the acquisition vehicle (French NewCo) is wholly owned by a Luxembourg company (LuxCo 1) which is itself wholly owned by a second Luxembourg company (LuxCo 2). LuxCo 2 pledges its shares in LuxCo 1 and LuxCo 1 pledges its shares in French NewCo to the

SYNOPSIS

While not a fully tried and tested structure protecting the rights of creditors in the event of a safeguard proceedings and not necessarily appropriate in all French buy-out transactions, the Double LuxCo Structure already represents a substantial feature of French mid and large cap market.

Despite its complexity and costs, arrangers and debt providers have been requiring the implementation of a Double LuxCo as a condition precedent to significant syndications, especially where non-French lenders are to participate.

The highlighted "structure" is not a guaranty for preventing French targets from bankruptcy and insolvency proceedings, nor does it permit the debt financing providers to end such proceedings once started. The Double LuxCo Structure, which is in fact a whole series of varying structures, is rather aimed to redress the balance between the rights and interests of lenders and borrowers against the threat of French and EU insolvency rules in the case of restructuring of LBO transactions that involves French stakeholders and obligors.

The recent changes to the French tax laws in relation to the French thin cap rules have moreover further consequences on the deductibility of the interest on debt loans where a Double LuxCo is implemented. However, this structure is likely to provide for a concrete defense aiming to ensure the minimum insolvency remoteness lenders can reasonably rely on and also aiming to secure the enforcement of the security package all the parties have agreed upon.

lenders providing debt facilities to French NewCo and the target group in connection with the acquisition.

Luxembourg is a key jurisdiction for finance parties as it is more lender-friendly and since it offers greater flexibility regarding enforcement of securities. Moreover, reorganization and insolvency proceedings in Luxembourg are rarely applied in practice. There is no real culture of a "fresh start" in Luxembourg, which may explain why this option is often rejected to the court.

However, French courts may, based upon Article 3 of the EC regulation no. 1346/2000 of 29 May 2000 on insolvency proceedings (the "EC Regulation no. 1346/2000"), open safeguard proceedings in respect of LuxCo 1 and LuxCo 2 and therefore trigger a stay in proceedings against that company if it concludes that the COMI ("center of main interests") of such company is located in France.

In such a case and only where a Double LuxCo structure has been set-up, Article 5 of the EC Regulation no. 1346/2000 should, in theory, allows (even where LuxCo 1 is subject to a hostile safeguard) the LuxCo 1 share pledge to be spared from the effects of the French insolvency proceedings to the extent those shares are effectively located outside of France: under the above-mentioned provisions, and subject to certain exceptions, the opening of insolvency proceedings in one member state does not affect *de in rem* rights and securities (broadly, mortgages, liens and charges) of creditors or third parties over assets belonging to the debtor which are situated within the territory of another Member State at the time of the opening of the insolvency proceedings. Rights *in rem* will be governed by the applicable national legislation governing those rights. They are shielded from the application of the insolvency law of the Member State in which the proceedings are initiated. The Double LuxCo structure seeks to achieve such goal by requiring the LuxCo 1 share register be held in escrow in Luxembourg.

The Double LuxCo Structure: Additional Contractual Protection

The Double LuxCo structure relies in fact on a series of varying structures and LBO lenders are willing to secure additional protection by means of contractual agreements negotiated among the parties. Such agreements may provide, for example:

- that the enforcement of the LuxCo 1's share pledge is subject to an earlier trigger than the other security, for example, following delivery of an acceleration notice, whether or not this acceleration can be enforced in light of insolvency proceedings opened in relation to French NewCo. The aim is to facilitate enforcement of the LuxCo 1 share pledge at a time where acceleration of the debt at French NewCo level is impossible due to a stay of proceedings against French NewCo pursuant to a hostile safeguard. However, the acceleration of the LuxCo 1 share pledge by any event of default is a matter of serious concern for the sponsors and subordinated debt providers and has to be addressed by the intercreditor agreement;

- for a new type of mandatory prepayment event: any decision or proposal to change the corporate governance rules ("adverse corporate decision") of both LuxCo 1 and LuxCo 2 or French NewCo (e.g. the corporate decision to file for safeguard proceedings) automatically results in an immediate obligation to repay all the debt in full so as to ensure the lenders that, if they ever were to enforce their pledge and take control of LuxCo 1, they would be able to control key corporate decisions relating to French NewCo. In some transactions, an adverse corporate decision may also occur if attempts are made to circumvent the Double LuxCo structure, for example by moving the COMI of the Luxembourg companies to France;

- that the security agent can exercise voting rights attached to the shares, including prior enforcement of the pledge. The purpose here is to allow the replacement of the existing management of the French NewCo so to control or cease a hostile safeguard, though, the French NewCo's new management will have to satisfy the Court that the difficulties justifying the commencement of such proceedings are no longer applicable or propose an acceptable safeguard plan.

Tax Concerns: the Impact of the Tightening of French Thin Cap Rules

The Double LuxCo structure may be adversely impacted by the amendments to the French thin capitalization rules introduced by the Finance Law for 2011 (the "New Rules"). As a reminder, French thin capitalization rules provide for various limitations in respect of the deductibility for French tax purposes of interest expenses incurred by French borrowing companies on loan facilities made available by entities related to the borrower. In particular, where the amount of interest expenses simultaneously exceed (i) the relevant interest rate assessed on 1.5 times the net equity of the borrower and (ii) 25% of the borrower's profits before taxes (increased by the relevant interest expenses), the portion of the interest expenses exceeding the higher of these two limits would not be deductible for French tax purposes in the fiscal year during which the interest expenses are incurred, unless such portion is less than €150,000. The non-deductible portion may be deducted under the same conditions in the subsequent fiscal years, but a 5% discount would be applied on the carried-over interest expenses in each fiscal year following the second fiscal year.

Pursuant to the New Rules, the scope of thin capitalization limitations is extended to loan facilities made available by third-parties (including third-party banks) guaranteed either by (i) an entity that is related to the borrower, or by (ii) a non-related third-party if that third-party is itself guaranteed by an entity that is related to the borrower.

The New Rules generally apply to interest expenses incurred during fiscal years closed on or after December 31, 2010 in respect of loan facilities granted as of, or prior to, such date. By exception, they do not apply to:

- bonds issued as part of a public offering;
- third-party loan facilities made available pursuant to loan agreements entered into prior to January 1, 2011 whose purpose is to finance or refinance the acquisition of shares;
- third-party loan facilities whose purpose is to refinance a pre-existing debt, the repayment of which became mandatory due to the change of control of the borrower (up to an amount equal to the outstanding debt plus accrued interest);
- such portion of third-party loan facilities whose repayment is exclusively secured (otherwise than with pledges on the borrower's assets) with (i) a pledge on the borrower's shares or receivables, or (ii) a pledge on the shares issued by a company controlling (directly or indirectly) the borrower, provided however that the pledgor and the borrower are included in the same French tax consolidated group.

Pursuant to the Double LuxCo structure, LuxCo 2 would pledge its shares in LuxCo 1 so as to secure the loan facility made available by third-party banks to the French borrower. To the extent that Luxco 2 does not establish a branch in

France, it would not be able to become a member of a French tax consolidated group and the above mentioned fourth exception would therefore not be applicable.

As a result of the New Rules, as regards Double LuxCo structures set up as of January 1, 2011:

- where the purpose of the new loan facility is to refinance a pre-existing debt, the repayment of which became mandatory due to the change of control of the borrower, only such portion of the new loan facility that exceeds the amount of the outstanding debt plus accrued interest should be subject to thin capitalization limitations;

- where the purpose of the new loan facility is not to refinance a pre-existing debt, the repayment of which became mandatory due to the change of control of the borrower, the full amount of the new loan facility should be subject to thin capitalization limitations, in which case the new loan facility would need to be structured so as to mitigate the adverse impact of those thin capitalization limitations.

Conclusion

Because of the extra complexity and costs that it could entail, the Double LuxCo structure has mainly established itself as a feature of the French mid and large cap transactions. For small cap transactions, other legal vehicle and structure might be set-up by investments through a French venture capital mutual fund ("FCPR", F*onds commun de placement à risques*). Such vehicle cannot be subject to safeguard proceedings. In such case, in order to give the lenders a protection similar to the one they would have in a Double LuxCo structure, pledges on the shares of both the acquisition vehicle (i.e. the shares it holds in the target company) and the FCPR must be granted.

That being said, such alternative structure, if less costly, seems inadequate for foreign investment funds that don't invest through French "FCPRs" in France. Moreover, it doesn't offer the flexibility of Luxembourg legislation regarding the enforcement of security.

Finally, the actual exercise of *de in rem* securities in the context of the EC Regulation no. 1346/2000 has not yet been tested before the courts and one may consider that courts will carefully review the conditions of exercise of *de in rem* securities before adversely altering the outcome of bankruptcy and restructuring proceedings initiated in another jurisdiction.

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