Corporate

Structuring and financing private equity & venture capital transactions

Luxembourg

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Why Luxembourg?

Luxembourg is a jurisdiction of choice for many private equity and venture capital investors / funds due to its political and legal stability and very business friendly environment.

As one of the leading global jurisdictions for structuring foreign direct investment (**FDI**), Luxembourg has developed over the last two decades into a major hub for private equity and venture capital, both as regards to the location of their funds fundraising and the structuring and financing of their acquisitions.

The optimum balance of financing instruments in relation to any structure will vary depending on many factors, including the laws applicable to the investors, the laws of the jurisdiction of the assets into which investment is made as well as commercial decisions as to the appropriate mix of bank finance and own funds. However, one feature that all Luxembourg domiciled FDI structures have in common is the requirement for an appropriate level of equity investment.

While the level of equity investment will also vary according to the circumstances of the particular investment structure, noting in particular the requirements of applicable debt-equity ratios, the corporate structuring of that equity investment will be largely a matter of commercial choice for investors and fund managers.

This guide provides a general overview of the establishment of private equity and venture capital corporate vehicles and highlights common considerations related to equity structuring decisions. However, it does not cover investment fund structures.

One of the most flexible and attractive EU tax regimes

Luxembourg offers one of the most flexible and attractive legal framework and tax regimes in the EU with a strong and ever-expanding double-tax treaty network and attractive effective tax rates.

Tax benefits of investing through Luxembourg

- there is a wide participation exemption regime for dividends, capital gains and liquidation proceeds
- there is no withholding tax on market conform interest payments made by Luxembourg companies
- there are generally no statutory thin capitalisation rules although minimum equity may be required in some particular cases
- in most cases, there is no Luxembourg tax on any gains arising on an exit realised by a Luxembourg non-resident investor
- there is no withholding tax on liquidation proceeds
- there is no stamp duty on the sale or issuance of shares

Vehicle selection

Which type of company to use?

Luxembourg offers a wide range of structuring options with regard to non-regulated holding companies SOPARFI (société de participations financières), which are standard ordinary commercial companies governed by the Luxembourg law of 10 August 1915 relating to commercial companies as amended (the **Companies Law**). These companies are typically used for holding and financing private equity and venture capital investments and may serve as a SPV, a joint venture vehicle.

The vehicles most frequently used to structure private equity and venture capital investments are:

Société à responsabilité limitée – private limited liability company (Sàrl) - ***when control over the share capital is required (the shares are not freely transferable)***

One of the most commonly used vehicles for structuring an acquisition is the Sàrl. It is a private limited liability company, managed by a sole manager or more usually a board of managers, appointed by the shareholders. It is characterised by a very high degree of flexibility and a very limited level of statutory prescription. This makes it easy to tailor to the requirements of single investor or joint venture private investment. The Sàrl is check-the-box eligible.

Société anonyme – public limited *liability company (SA)* *- when flexibility is reqiored, in terms of the variety of instruments that can be issued is required*

The SA is a public limited liability company which is able (in contrast to a Sàrl) to make offers of shares to the public, to have a wider shareholder base and to provide a high level of confidentiality for its investors. As a public company, it does however operate in a more extensive statutory framework than a Sàrl.

Société par actions simplifiée – simplified public company (SAS) *- when flexible governance is required*

The SAS offers far more flexibility to the shareholders and managers than the SA. The SAS may be a suitable alternative to the SA or Sàrl for shareholders with special needs in respect of the balance of powers, shareholder relations and the distribution of profits (for example start-ups or joint ventures).

Société en commandite par actions – partnership limited by shares (SCA) *- when sponsors want to retain control over the management functions*

The SCA is a corporate limited partnership with a share capital. This vehicle is frequently encountered in Luxembourg structures. Although a limited partnership (with one or more general partners/unlimited partners and one or more limited partners) the SCA is also subject to the same, more extensive, statutory framework as the SA. The SCA is check-the-box eligible.

Société en commandite simple – common limited partnership (SCS) *- when tax transparency and structural flexibility are required (with legal personality) sponsors can retain control over the management functions*

The principle which underpins the SCS is one of contractual freedom and the parties are free to contract on whatever terms suit them best from a commercial perspective. The statutory provisions relating to the SCS are limited and thus allow the partnership agreement can be tailored-made to the respective needs and objectives of fund promoters and investors.

Société en commandite spéciale – special limited partnership (SCSp) *- when tax transparency and structural flexibility are required (without legal personality) - sponsors can retain control over the management functions*

The SCSp is very similar to the SCS and most of the legal regime which governs it is identical. The main difference between the two vehicles is that the SCSp does not have legal personality.

These entities benefit from flexible provisions of Luxembourg corporate law to accommodate diverse schemas in structuring debt and equity.

The SOPARFI will in principle be a fully taxable resident company subject to ordinary income tax that can take advantage of the participation exemption in Luxembourg and that is eligible to double tax treaty benefits.

The SCS and SCSp are fiscally transparent and are therefore not subject to tax and should not in principle be eligible to double tax treaty benefits. They can however represent an alternative when a fiscally transparent vehicle is required.

A SOPARFI may depending on the circumstances qualify as an AIF.

Setting up the vehicle

Involvement of a public notary for the SA, SAS, SCA and Sàrl

Luxembourg being a civil law jurisdiction, the SA, SAS, SCA and Sàrl must all be constituted by a formal deed, made before a Luxembourg notary. This notarial deed is the constitutional document of the vehicle, including a statement of all the characteristics of share classes. In order to carry out incorporation, the initial economic contribution of the founding investors must be unconditionally held by the vehicle at the moment of its incorporation with a value at least equal to the minimum required by Luxembourg law. Where this initial contribution/ subscription is made in cash, this cash sum, equal to at least EUR 12,000 in the case of Sàrl and EUR 30,000 in the case of SA, SAS or SCA, must be deposited with a bank account, in cleared funds, in advance of the incorporation. In practice, most of the time it is a Luxembourg bank account, although this is not an obligation.

The SCS and SCSp, as an exception to this rule may be constituted either under private seal by way of a non-notarial instrument between their members, or by notarial deed. No minimum capital requirements apply in the case of the SCS or SCSp.

Involvement of an independent auditor

For contributions other than cash in a SA, a SAS or a SCA, an independent auditor (***réviseur d'entreprises agréé***) must issue a report on the nature of the assets contributed and the valuation method used. The report must confirm that the value of the shares issued, nominal and premium, is at least equal to the value of the noncash contributions. It is important to note that the values included on the report are those which will be reflected in the notarial deed. Such a report is not required in the case of the contribution of a receivable held by the holder of a debt instrument (such as convertible bonds) against the company or for incorporation of reserves, profits or share premium to the nominal share capital.

It is worth mentioning that a similar report shall also be prepared in the case of a capital increase by way of a contribution in kind and if, in the first two years of the company's existence, the company purchases assets from a founding shareholder amounting to more than 10% of the share capital of the company. As an exception that rule, no report is required when the transaction is in the normal course of the company's business or is subject to control by a regulatory authority.

No similar requirements exist for a Sàrl, a SCS and a SCSp.

Timing / steps

It now takes around one to two months to incorporate a new company in Luxembourg. Many of the delays experienced when setting up a Luxembourg company relate to the KYC procedures that are required to be complied with by banks, domiciliation agents and notaries. The usual steps in setting-up a Luxembourg company are:

- the first step consists in identifying a bank and a domiciliation agent (required if the client does not already have a place of business in Luxembourg to provide registered office services) who can also help with setting up a bank account in Luxembourg
- the domiciliation agent, if any, and the bank will need to be supplied with AML/KYC information such a notarised copy of the passport of the beneficial owner and a utility bill of that person
- next step would be the wiring of the initial share capital amount to the bank account with the bank issuing a certificate confirming the blocking of the capital on the bank account pending the incorporation of the company to the officiating notary who will incorporate the company. Without that certificate stating that the funds are held in a blocked account in the name of the company to be incorporated, the notary cannot incorporate the company
- once the company will be incorporated, the notary will issue a certificate confirming to the bank that the capital can be released, and the blocking will be lifted
- the company will have legal personality at the incorporation meeting. The registration and filing of the incorporation deed with the Company Register (***Registre de Commerce et des Sociétés, Luxembourg***) and the publication of the incorporation deed with the RESA (***Recueil Electronique des Sociétés et Associations***) are to occur after the incorporation meeting
- For each legal entity formed, according to the requirements deriving from the fight against money laundering and terrorist financing regulations as implemented in Luxembourg, information on individuals who have effective control over Luxembourg entities are to be recorded in the register of ultimate beneficial owners (***Registre des Bénéficiaires Effectifs***). Such effective control can either derive from the direct or indirect holding of more than 25% of the shares/interest, units or voting rights or other means

Once set up, there are also ongoing practical requirements to consider. In particular, any change to the articles of association of a Sàrl, a SA, a SAS and a SCA, any capital increase or reduction (unless specific provision has been made for an authorised share capital), any merger or liquidation will require the involvement of a public notary and the passing of a notarial deed, which can take up to a couple of days to arrange.

The SCS and SCSp are generally constituted by a private instrument between their members (the limited partnership agreement) and no notary will need to be involved. Incorporation process is therefore generally relatively straightforward. It takes approximately one or two days to establish a SCS or SCSp, longer if a general partner has to be set-up first. General partners are generally incorporated under the form of a Sàrl or a SA.

Substance

One growing issue when structuring a deal through Luxembourg is the requirement by foreign tax authorities of real substance for private equity and venture capital vehicles in order to benefit from the desired tax status. The required level of substance is determined primarily by the tax rules of the country(ies) where the assets are/will be located and will have to be considered on a case by case basis.

Substance is therefore more a matter of creating a tangible economic reality in Luxembourg than an exhaustive list of prescribed requirements. Factors focussed on by foreign tax authorities in assessing substance generally include: (i) active, Luxembourg based employees, (ii) majority of directors being private individuals and Luxembourg tax resident, (iii) decision making process taking place in Luxembourg, (iv) specific Luxembourg office space and utilities, (v) accounting and specific company documentation being held at the company's Luxembourg office and (vi) company bank accounts being in Luxembourg with real cash movement passing through them.

Implementing the adequate level of substance comes at a cost. However, one of the more important reasons to structure private equity deals through Luxembourg in the first place is to benefit from certain tax advantages, which far exceed the costs of creating the tax substance.

Structuring the investment

Thin capitalisation

Luxembourg tax law does not provide for formal thin capitalisation rules applicable to holding activities. However, the Luxembourg direct tax authorities have developed an administrative practice whereby a debt-equity ratio of 85/15 is considered as a safe harbour for the financing of share capital participations. The latter ratio assumes a market interest rate on the debt portion whereas interest-free shareholder debt is considered as equity for the purposes of the debt-equity ratio. Borrowings for on-lending purposes are disregarded for the computation of the above debt equity ratio but may be subject to other minimum capitalization rules, such as for intra-group financing.

Contributing the equity

Equity may be contributed to a Luxembourg company in cash or, by way of assets transfer. In relation to asset transfer, almost any tangible or intangible assets may be contributed, provided that such assets are capable of credible and reliable valuation. Eligible intangible assets include securities, debt claims, goodwill in a specific business and intellectual property rights.

Where shares in an SA, SAS or SCA are issued partly paid up in consideration of an undertaking to make a contribution of assets, such assets must be fully transferred to the vehicle within five years. In relation to an SA, SAS or SCA, the valuation of an equity contribution of assets must be supported by an up-to-date valuation report from an independent auditor. This contribution-in-kind report requirement does not apply in relation to a Sàrl but the valuation of the assets must be certified by its board of managers to the notary. No report is furthermore required when the contribution in kind consist in a receivable held by the holder of a debt instrument against the company.

Equity may also be contributed in the form of share premium attaching to specific shares or in the form of capital surplus contribution (i.e. capital contribution without the issuance of shares), with a great level of flexibility. Any share premium or capital surplus contribution shall be fully subscribed for and paid up.

Sweet equity contributions (***apports en industrie***) can also be made to the extent that the shares issued in consideration are not considered as share capital from an accounting perspective and are not transferable. Such shares will benefit from governance and / or economic rights as set out in the articles of association.

Equity contribution without issuing shares

An alternative way of making or increasing equity contributions to a Luxembourg company (of any description) is by means of an a capital surplus contribution. This involves a contribution of value to the vehicle which is recorded to a special account / reserve in the company's books and records (the so called "account 115" of the Luxembourg chart of accounts) which is characterised as equity but which does not involve the issuance of shares. The absence of share issuance removes the requirement of a notarial deed that is typically required to implement such transaction. This mechanism therefore provides a highly flexible way of ensuring a company's equity that can be actively managed so as to ensure on-going compliance with required debt-equity ratios and can therefore facilitate active portfolio management.

The corporate requirements to make such contributions are: enabling provisions in the articles of association; ordinary (non-notarial) shareholders resolutions or board resolutions; and implementation by the directors. A short form contribution agreement may also be required depending on the nature of the contribution.

Financing instruments

Depending on the legal form, the proposed strategy in terms of economic and voting rights, a Luxembourg company can be financed through a variety of equity, debt and hybrid instruments. Here are the different instruments typically used by Luxembourg companies outside external financing, ordinary shares and intragroup loans:

Asset-tracking shares

Where a vehicle makes multiple investments with a commercial requirement for asset-correlated investment returns to different classes of investors then asset-tracking classes of shares and "account 115" equity contributions are entirely allowed. Tracking shares reflect the performance of underlying investments, regardless of the company's global results and allows holders of one or several classes of tracking shares to receive distributions mirroring the performance of one or several specific underlying investment(s). Such asset-tracking mechanisms are contractually binding absent insolvency. Insolvency-proof compartments have statutory recognition in the case of Luxembourg securitisation vehicles or specialised investment funds. In relation to unregulated, investment holding vehicles, insolvency-proof compartmentalisation is not statutorily recognised. If differential, asset-specific leverage is envisaged then structural asset ring-fencing may be advisable.

Alphabet shares

Also frequently encountered in the Luxembourg market is the use of alphabet shares. This technique involves the issuance of several classes of shares whose economic rights are not correlated to only certain portfolio assets, but rather apply to a pool of assets as a whole and/or to specific investment periods. The use of a number of classes of alphabet shares of this nature allows the vehicle to redeem individual classes of those shares at appropriate points in time so as to effect transfers of value, by means of redemption payments to shareholders, following the receipt of value from the underlying asset pool. Such redemption payments do not attract a withholding tax under Luxembourg law, if properly structured and under certian conditions.

Redeemable shares

Redeemable shares may be issued, subject to the following statutory requirements: redemption is authorised in the articles prior to issue of the redeemable shares; shares to be redeemed must be fully paid up; and redemption can only be funded from distributable profits and reserves or the proceeds of a new issuance of shares made for the purposes of the redemption. When funded from distributable reserves/profits, a figure equal to the redemption price must be recorded in a non-distributable reserve in the accounts of the company. Any redemption premium may only be paid where it will not cause the company's net asset value (as set out in its most recent annual accounts) to fall below its subscribed share capital plus non distributable reserves. It shall be noted that once the shares have been redeemed, the voting and financial rights attached thereto are automatically suspended as long as the shares are held by the Sàrl itself. However, it is to be further noted that in private equity and venture capital structures, the redeemed shares are usually immediately cancelled by the Sàrl. For an SA, the financial rights attached to the redeemed shares are not automatically suspended but the board of directors however has the power to resolve upon such suspension.

Non-voting shares

Non-voting shares can be issued by SA, SAS or SCA and are, as their name implies, equity that does not have a vote, even though it is entitled to a share of the profits. The economic rights of the nonvoting shares must be specifically stated in the articles of association. The most typical rights for nonvoting share are identical to those of ordinary shares apart from the lack of a vote at general meetings. Shares without voting rights shall recover their voting rights when the resolutions of the general meeting amend their rights. The purpose of non-voting shares is to allow the holders of the ordinary shares to maintain control. No-voting partnership interests can also be issued by a SCS or a SCSp.

Although non-voting shares cannot be issued in a Sàrl, we can achieved same result by issuing non-voting beneficiary shares.

Preferred shares

Preferred shares carry the preferential right to receive a fixed percentage of profits before others. In some cases, they also offer the preferential right to capital distribution before other classes. As a result they often carry no voting rights.

Share with different nominal value

All companies can issue shares with different nominal values. As regards voting rights, shares issued by SA, SAS and SCA will in principle benefit from voting rights that are proportionate to their nominal value. It is however to be noted that it is possible to have one vote for each share irrespective of the share's nominal value but with such option to be expressly set out in the articles. With respect to the Sàrl, each share entitles its owner to one vote. However, by allowing the issue of shares with different nominal value, it is possible to achieve a plural voting system as well.

Free shares

It is possible for SA, SAS and SCA to award free shares to certain employees and officers of the company and affiliated companies. An award of free shares is a right given to an individual to receive, subject to specific conditions being met, a certain number of shares. The ability to issue shares without consideration must be provided in the articles of association and the decision is to be taken by the board of directors / management board. Conditions of the issue (such as vesting period and holding period) are fixed by the general meeting of the shareholders (or by board of directors / management board duly authorised by the general meeting of the shareholders.

Beneficiary shares

In addition to shares, Luxembourg company law allows the issue of participation certificates, also called founder shares (***titres ou parts bénéficiaires***) which do not form part of the share capital. The articles of association determine the rights that are attached to such beneficiary shares. These rights could conceivably be voting rights and/or dividend rights or rights to participate in the liquidation or a combination thereof. It is possible to issue beneficiary shares with or without the right to participate in profits or with or without voting rights. These beneficiary shares can be issued for a consideration in cash or kind, but can also be issued without consideration.

Bonds and convertible bonds

The bond issuance period may be short, medium or long. Bonds can easily be transferred to a third party and generate a fixed or variable interest rate. The interest they bear is payable periodically or at maturity, depending on the coupon's terms and conditions. Bond issuance may include subordination as well as convertibility. All Luxembourg companies can publicly issue bonds.

Profit participating loan or asset linked loan

The main characteristic of profit participating loans or asset linked loans is that the lender's remuneration depends on the company's profits or the income derived from a specific asset. The profit-sharing feature may in principle not be an obstacle to qualifying the instrument as debt. Provided the instrument is properly drafted, and the return is not aligned with the profit distributions of the company, the payment of the variable interest is in principle not subject to withholding tax and is fully deductible.

Profit participating bonds and PECs having the same characteristics in terms of remuneration can also be issued.

Capital increase and preferential subscription rights

To increase the share capital of a Sàrl, an amendment of its articles of association will be required. Such amendment requires a majority of at least 75% of the share capital in issue. Any new investors (not being existing shareholders) must also be approved by existing shareholders holding at least 75% (the majority can however be lowered to 50%) of the issued share capital.

Where, in relation to an SA or an SCA, an increase of share capital, including under authorised share capital provisions, requires the articles to be amended, this requires a majority of 66.67% of shareholder votes (present or represented at the meeting) with a quorum of shareholders representing at least 50% of the issued share capital.

Increases of share capital by an SA, SAS or SCA for cash subscription (but not by way of a contribution in kind) will generally be subject to statutory, preferential subscription rights. No such statutory, preferential subscription rights exist in relation to a Sàrl although equivalent contractual rights may be included in its articles. The SA, SAS and SCA statutory, preferential subscription rights may be waived by the shareholders individually. The shareholder's meeting may also vote to reduce or cancel these preferential subscription rights, applying the same requirements as for amendment to the articles, which also requires a detailed report of the reasons for limiting the preferential subscription rights to be presented to the shareholders meeting by the board of directors.

Luxembourg companies may also provide for an authorised share capital in their articles of association authorising the board or the general partner to determine the terms of further share issuance within certain limits and to carry it out. Such authorisation may be valid for a period of a maximum of five years, and is renewable. In such case, the board or the general partner may also be authorised in the articles to remove or limit the preferential subscription rights of the shareholders.

Requirements regarding capital increase and preferential subscriptions in the case of a SCS or SCSp can be freely determined in the partnership agreement.

Redemption of shares

Share buy-back

Whilst subscription by an SA, SAS or SCA for its own shares is not permitted, it is permitted for these vehicles (and for a Sàrl) to buy back their own shares which are then either cancelled or are held in treasury (under certain conditions). For a Sàrl, the ability to buy-back the shares must be set out in its articles of association, the company must have sufficient funds to do so and requires the approval of the shareholder, whose shares are being repurchased, Such approval is generally documented in the share repurchase agreement.

In relation to an SA, SAS or SCA, an additional, generally applicable statutory framework also requires authorisation to the board (or the chairman or the general partner, as applicable), by a general shareholder(s) meeting approving the terms and conditions, the maximum number of shares, the period of validity for the authorisation of up to five years and the maximum and minimum consideration to be paid, and a summary in the annual management report.

Shares bought back must be fully paid up and the buy-back must not have the effect of reducing the vehicle's net assets below the value of its subscribed share capital plus undistributable reserves.

Buy-back of limited interests in the case of a SCS or SCSp can be freely determined in the partnership agreement.

It should be further noted that the general civil law principle of equal treatment of shareholders will require that any share buy-back needs to be proposed equally to each shareholder in the same situation.

Reductions of capital

Reductions of capital are to be carried out by way of a board resolution or a shareholders' resolution (with the same quorum and majority requirements as for the amendment of the articles). If the reduction involves repayment to shareholders or waiver of an obligation to pay up shares, creditor protection principles apply in relation to SA, SAS and SCA which allow any creditor whose claims predate the publication in the RESA (***Recueil Electronique des Sociétés et Associations***) of the shareholders' capital reduction resolution, to apply to the court for a protective order within thirty days following such publication.

That application must be for an order for the provision of security for the creditor's claim and the court may only reject such application if it considers the creditor already has adequate protection or if such security is unnecessary in view of the net asset value of the company. No payment may be made by the company to the shareholders following a capital reduction within this thirty day period, or until any objecting creditor applying to the court has had its claim settled or the court dismisses the application.

Unlike in certain other jurisdictions, creditor protection enables application by objecting creditors to the court. It does not require the positive application by the company itself for the court's approval of the proposed reduction.

No specific creditor protection provisions apply in relation to reductions of share capital of Sàrl, SCS or SCSp.

Distributions to investors

Legal reserve

After payment or provision for relevant debt obligations (including any intra-group debt financing), all Luxembourg companies (to the exception of the SCS and SCSp) are obliged to allocate to a non-distributable reserve an amount equal to 5% of the company's net profit per annum. This obligation continues until the reserve has accrued to a figure equal to 10% of the company's share capital (share premium and capital surplus shall not be taken into account for the purpose of this threshold).

Dividend distribution

After payment or provision for debt liabilities and allocation to this non-distributable reserve, the company may then declare and pay annual and interim dividends.

In relation to standard, unregulated companies (not constituting an investment fund) annual dividends are declared by the shareholders at their annual general meeting approving the company's annual accounts, provided that those accounts demonstrate that the proposed final, annual dividend would not cause the company's net asset value to fall below the level its subscribed share capital plus distributable reserves. The amount of the final, annual dividend may not exceed distributable profits, reserves (and carried forward profits) net of any current or carried-forward losses and allocations required to the non-distributable reserve(s).

Interim dividends may also be declared by the board of directors/ managers (or the general partner, as applicable), provided it has been duly authorised to do so is set out in the articles and that the proposed distribution does not exceed the profits of the company in the current year (plus net profits carried-forward) net of any current or carried-forward losses and any sums required to be allocated to non-distributable reserve(s). In declaring any interim dividend, the directors/managers must prepare a balance sheet showing the net funds available for distribution and the decision to distribute must be taken within two months of that balance sheet. At the time the annual accounts are to be approved, the statutory auditor (if any) must confirm to the board or the general partner, as applicable, whether or not these conditions are met.

Dividend payments attract Luxembourg withholding tax but it may be reduced or exempt in certain circumstances.

Share premium or account 115 distribution Luxembourg

Companies may also distribute profits to shareholders through the share premium account or the capital surplus account, commonly referred to as "account 115." Share premium arises when shares are issued at a price higher than their nominal value, while account 115 is generated when a company's equity increases without issuing new shares. This surplus, recorded separately from the company's nominal share capital, is often governed by specific distribution rules.

A distribution from the share premium or account 115 account should not be confused with a dividend distribution but must still adhere to the requirements of Article 461-2 of the company law of 10 August 1915. As a result, such a repayment is prohibited if it would reduce the company's net assets, as shown at the end of the preceding financial year, below the amount of subscribed share capital plus any reserves that are legally or contractually non-distributable.

However, subject to these conditions, repayments from the share premium or account 115 can still be made even if the company has incurred losses, including those carried forward from previous years that remain unoffset by profits.

In practice, the board of directors (or executive board) confirms the availability of funds in the share premium account or account 115 and proposes their distribution. This decision is based on an interim balance sheet demonstrating sufficient distributable funds. The proposed repayment is then presented to the general meeting of shareholders for approval. Upon shareholder approval, the distribution may be made in cash or in kind, depending on the company's financial position and strategic goals.

Structuring the governance

The importance of shareholders agreements

Purpose

Luxembourg company law affords relatively few rights to shareholders with the result that a shareholders or joint venture agreement can be used to confer additional rights and powers on shareholders, in particular particularly regarding the transfer of shares (pre-emption rights, drag-along rights and tagalong rights), rights of veto and corporate governance matters.

Ensuring compliance

To ensure compliance with the commercially agreed position in practice, it is better to replicate certain clauses from the shareholders or joint venture agreement in the articles of association. If the clause appears solely in the shareholders or joint venture agreement, the remedy for any breach will generally be a claim for damages with the related uncertainties associated with litigation risk including any difficulties of evidential proof. The availability of a court order to compel mandatory performance (rather than a claim for damages following non-compliance) will often be uncertain.

In many circumstances, the shareholders will prefer (at least at the outset) that all parties simply comply with their agreed joint position, rather than to seek financial compensation for breach, after the event. Thus, the matters set out below will often be included in the articles of association, breach of which results in immediate invalidity. Those constitutional documents can also be relied on against third parties by reason of their public filing and consequent registration at the Luxembourg companies registry, in the case of Sàrl, SA, SAS and SCA. A shareholders or joint venture agreement, in contrast, being a private contract, cannot be relied on against third parties.

However, as the articles of association is publicly available on the Luxembourg companies' registry, a balance between the commercial confidentiality on one hand and the reliance against third parties and constitutional effect on the other hand, may need to be considered.

Duration

Shareholders or joint venture agreement are subject to a general principle of civil contract law that no contract can be made for an infinite duration. This does not necessarily require that a fixed number of years be set out in the agreement. As many shareholders or joint venture agreements are constituted for the purpose of a specific project with a required period of time or for a set investment period, reference to such a period for determining the duration of a shareholders or joint venture agreement is an appropriate approach.

Duty of good faith

In relation to any Luxembourg law governed contract, an overriding duty of good faith applies between the parties not only in their performance of the contract but also in pre-contractual matters and in any ultimate enforcement that may become necessary. This generally applicable duty has two specific, additional areas of application in the corporate context: abuse of majority; and abuse of minority.

Abuse of majority may occur both in actions taken by shareholders and in actions taken by directors if those actions are:

- taken contrary to the general best corporate interests of the company
- are taken either with the sole and exclusive intention to favor or prefer the majority shareholders to the detriment of the minority or to have, and to be intended to have, a damaging effect on the minority shareholders

Abuse of minority refers to a situation where minority shareholders refuse to take decisions which are in the best corporate interests of the company and includes both voting under the articles and taking decisions within the contractual framework of the shareholders or joint venture agreement. Such refusal must be characterised by bad faith and be taken for exclusively self-referential, non-corporate reasons, contrary to the company's best corporate interests and causing damage to the company out of proportion to positive effects sought by the minority.

Governance arrangements

Governance arrangements would typically involve voting undertakings, veto rights in favour of a class of shareholder or class of directors / managers and rights to nominate directors / managers.

Appointment of directors / managers

Private equity and venture capital investors would usually have the rights to appoint directors / managers. Provisions that reserve the right to a shareholder to appoint one or several directors / managers are in principle not effective under Luxembourg law. However, in order to remedy such ineffectiveness, different classes of shares may be created in the articles of association in order to secure that each shareholder or group of shareholders (representing each a class of shares) may appoint one or more directors/managers on the board. Each class would be entitled to propose one or more candidates for a directorship. The shareholders would elect the directors/managers among the candidates proposed by the shareholders of such class. This formal procedure is necessary in order to circumvent the rule according to which the power to appoint directors/managers is exclusively vested in the general meeting of shareholders acting as a global corporate body.

Voting undertakings whereby all shareholders undertake to vote in favour of directors / managers nominated by a specific shareholder can also be implemented.

Management clauses

The board / general partner is in charge of determining the guidelines for the company's management and business development. Contractual provisions in a shareholders or joint venture agreement aiming at delegating the decision taking to a CEO or an executive committee would in principle be valid. Other downstream delegations would only be acceptable provided that the management may not be deprived of any power to interfere in the management and to act in the interest of the company.

Veto rights – reserved matters

Board level

Different classes of directors / managers may be created, each or some of them benefiting from certain veto rights on matters falling within the competence of the board and that are of particular interests for the shareholder(s) that "appointed" them.

Thresholds and majority requirements applicable to resolutions to be taken by the board can also be structured in order to ensure that no decision could be taken without the attendance or the approval of the relevant class of directors/managers.

Shareholders level

Different classes of shares may also be created. Each shareholder or category of shareholders (for example, majority shareholder, sponsor, minority shareholder, management) will hold a class of shares entitling it/them to specific voting or economic rights.

In relation to general meeting of shareholders, the statutory quorums and majority requirements may be increased so as to ensure that no key decisions can be taken without the affirmative vote of the relevant category(ies) of shareholder(s). Each class of shares may also have veto rights over certain matters. They arrangements are generally quite effective provided they are included in the articles of association of the company.

Veto rights held by private equity or venture capital investors usually cover the following matters (either at the level of the investment vehicle or of the subsidiaries):

Veto rights

Corporate affairs
amendment to the constitutional documents
alteration of the financial year end and/or of the accounting policies
variation in the authorised or issued share capital
declaration or distribution of dividends
approval right of any transfer of shares, pre-emptive right, exercise of drag along and tag along rights
listing on an international stock exchange
appointment and change of the auditors
liquidation, winding-up or dissolution

Material changes
sale, transfer, leasing, licensing or disposal of all or a substantial part of the company/subsidiary's business, undertaking or assets whether by a single transaction or series of transactions, related or not
transfer of any shares in the capital of subsidiaries
entry into a partnership or joint venture arrangement or merger or similar mechanism
demerger, division or split of the company or subsidiary

Commitments
adoption of or any amendment to the operating budget
entry into any contract or arrangement (including mortgages or charges) which is unusual, onerous or otherwise outside the normal course of trading
making of any payment otherwise than on an arm's length basis
entry into by any (new) borrowings facility, the variation of the terms of any borrowing facilities or the issue or redemption of any loan capital prior to its due date
entry into any commitment or arrangement which is material to the business of the company or subsidiary
granting of any guarantee (other than in relation to the supply of goods or services in the normal course of trading) or the creation or issue of any debenture, mortgage, charge, pledge or other security (other than liens arising in the course of trading)
entry into any lease, contract, memorandum or other agreement for the licence, lease, sale or purchase of land or real property
establishment of any pension, profit sharing, bonus or incentive scheme
initiation and the subsequent conduct of any litigation, arbitration or mediation proceedings

Voting rights

General principle

As a general rule, one share gives right to one vote. It is however possible to issue shares with different nominal values with related pro rata voting rights.

Voting arrangements

Voting commitments clauses are clauses by which a shareholder of a company undertakes to vote in a specific manner or to abstain from voting. Voting arrangements among shareholders are valid and can be enforced to the extent that (i) they do not infringe the law or the corporate interest of the company and (ii) shall not be construed as granting the management of the company or of a subsidiary the right to give instructions to the shareholders.

Suspension of voting rights

If provided by the articles of association, the management can be authorised to suspend the voting rights of a "defaulting" shareholder under the conditions and formalities specified in the articles of association. Suspending the voting rights of defaulting shareholders may impact quorum requirements for holding a general meeting and approval requirements for ballot issues. Shareholders whose voting rights have been suspended still have the right to attend meetings.

Waiver of voting rights

A shareholder may agree to waive in full or in part its voting rights on a permanent or temporary basis. This option may use to accommodate certain regulatory obligations that a shareholder may be subject to.

Minority shareholders rights

Majority shareholder(s) / private equity or venture capital investor(s) do not owe a fiduciary duty to the minority shareholders. Luxembourg law however provides for certain limitations such as the abuse of majority and the general principle of good faith.

Minority action

Shareholders representing at least 10% of the share capital and/or of the voting rights entitled to be exercised, have the rights to initiate an individual actio mandati (on behalf of the company) against members of the board of directors having defaulted in their duties.

Independent investigation

Minority shareholders representing at least 10% of the share capital and/or of the voting rights entitled to be exercised, have the rights to address questions on the company and affiliated entities' affairs. In the absence of a response by the management, an independent expert may be appointed by a Luxembourg court to establish a report on the matters that were the object of the questions.

Adjournment of a general meeting of the shareholders

Shareholders of SA, SAS and SCA representing 10% of the share capital may request the adjournment a general meeting of the shareholders. The request should be addressed in session to the board of director / general partner and for a maximum period of four weeks.

Enhancing minority shareholder protection

Improving the protection of minority shareholders can be achieved by stipulating certain provisions in a shareholders' agreement or in the company's articles of association (for example, information rights, right to have a representative appointed to the management board, provisions for a more stringent majority for certain decisions, veto rights on certain matters, approval clauses or share transfer restrictions).

Profit allocation

In principle, the shareholders are free to determine profit allocation as they consider commercially appropriate, subject only to a generally applicable, longstop prohibition on clauses which purport to totally exclude certain shareholders from participation in profits or exposure to risk of loss (***clauses léonines***).

Transfer of shares

Shares in an SA, SAS or SCA are in principle freely transferable. However any transfer of shares performed in violation of the transfer restrictions included in the articles of association of a SA, SAS or SCA shall be null and void.

Shares in a Sàrl are not freely transferable to non-shareholders. The prior approval of at least 75% (an be reduced to 50%) is required. In the case of a transfer to another shareholder, no such consent is required.

Transfer of shares in a SCS or SCSp can be freely organized in the partnership agreement.

Approval and pre-emption clauses

In the Sàrl, the approval clause is automatically provided for by law. Shares in a Sàrl may indeed only be transferred to non-shareholder subject to the prior consent of shareholders representing at least 75% of the share capital (such majority can be reduced to 50%). Stricter consent thresholds may also be contractually agreed. However prior approval is not require in case of a sole shareholder company.

Approval clauses and pre-emption clauses in a SA, SAS or SCA are valid provided that the nontransferability period (which starts from the date of the transfer of approval request or the invitation to exercise pre-emptive rights) does not exceed twelve months. After such period, the parties will have to find an arrangement to allow the departing party to leave the company.

Lock-up

Lock-up clauses in a SA, SAS or SCA should be reasonably limited in time and in the corporate interests of the company. No such requirements exist for Sàrl but also advisable in such case.

Drag-along and tag-along clauses

Drag-along and tag-along clauses are in principle valid under Luxembourg law (article 1855 of the Luxembourg civil code formally recognized the validity of arrangements organizing the transfer of shares that do not have as sole purpose the control of participation in profits and losses).

The statutory framework regarding the transfer of shares applicable to Sàrl (that is, the prior approval of new shareholders by 75% (or 50%) of the existing shareholders except in case there is a sole shareholder), however, results in an area of sensitivity in relation to drag-along and tag-along provisions. It is not possible to pre-approve a possible transfer blind as to the identity of proposed future transferees. Unless supported by a proprietary security interest, the most that can be done is to include a contractual provision in the shareholders' agreement/ voting agreement where all parties agree to vote in favor of such transfer.

Good-leaver and bad-leaver provisions

One of the most important elements of a management incentive program is the leaver scheme, which makes provisions concerning the compulsory transfer of the manager's shares if the manager ceases to be active for the company. Technically, this is structured by call and/or put options. The validity of such clauses is expressly recognized by article 1855 of the Luxembourg civil code.

Efficiency

If a share transfer restriction clause is valid, it is however not necessarily effective in practice. Indeed, future shareholders are not automatically bound by an existing shareholders or joint venture agreement and shareholders or joint venture agreements are not enforceable against third parties (except in case of fraud of the latter).

Therefore, when a party transfers its shares in breach of the transfer restrictions, the transferee (who was not aware of the transfer restrictions) becomes the legal owner of such shares, though the transferor may be sued for damages for breach of contract or, as the case may be, be required to pay a contractual penalty.

Inserting the transfer restrictions into the articles of association would improve their enforceability against third parties - transferees will not be able to claim that they were unaware of the transfer restrictions as the articles of association are public. Another advantage of entering the transfer restriction in the articles of association is that the restrictions will apply to all future shareholders, whether parties to the agreement or not to the shareholders or joint venture agreement.

Conclusion

It is important to ensure both the private equity or venture capital investors and, as the case may be, management teams receive proper advice to ensure that:

- the deal is structured in the most tax efficient manner possible and that the commercial deal works for all parties
- is structured in a manner which is effective under Luxembourg law and which works for both tax and legal purposes

If not, either party could end up making an expensive mistake, particularly if a falling out were to occur between the management team and the sponsor at a later point when, for example, the investors could (if not properly advised at the outset) find themselves trapped, should they not have taken into account the restrictions for the transfer of shares to non-shareholders.

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Bertrand specialises in corporate law, advising hedge funds, private equity and real estate clients as well as multinational companies in connection with mergers and acquisitions, joint ventures, structuring of international transactions, reorganisations, refinancing and corporate finance. He has working experience in Belgium, England and the United States.

Bertrand is also a lecturer on civil law and corporate governance at the University of Luxembourg and regularly speaks at seminars in Luxembourg on a broad range of topics, including recently on directors' duties.

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