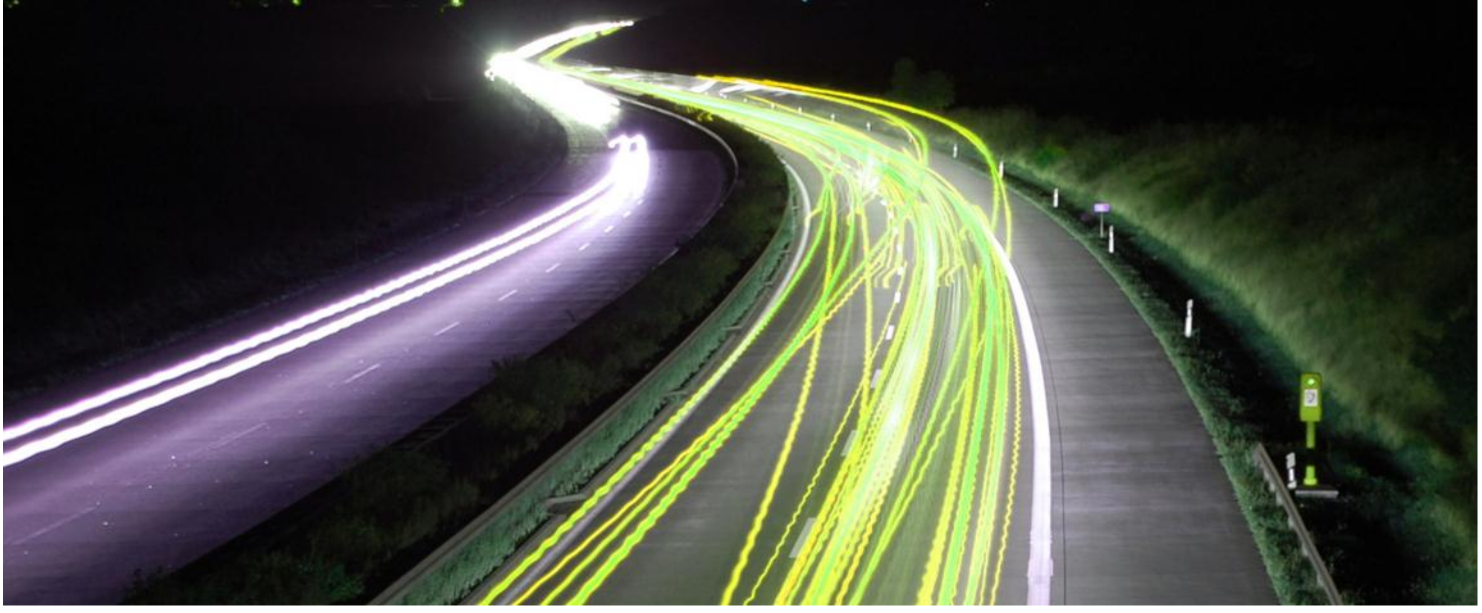
**Luxembourg**

Doing deals in the Grand Duchy, an English lawyer's perspective

*Tom Whelan (Partner, Hogan Lovells International LLP) Erin Anderson (Senior Associate, Hogan Lovells International LLP), Camille Bourke (Partner, Arendt & Medernach) and Saskia Myners (Senior Associate, Arendt & Medernach)*

December 2012/January 2013



**Further information**
If you would like further information on any aspect of this publication please contact a person mentioned below or the person with whom you usually deal.

**Contact**

Tom Whelan
T +44 (0) 20 7296 2000
tom.whelan@hoganlovells.com

Erin Anderson
T +44 (0) 20 7296 2000
erin.anderson@hoganlovells.com

# Luxembourg

## Doing deals in the Grand Duchy, an English lawyer's perspective

Luxembourg offers one of the most flexible and attractive tax regimes in the EU with a strong and ever-expanding double-tax treaty network and attractive effective tax rates. For example, in Luxembourg there is a wide participation exemption regime for dividends, capital gains and liquidation proceeds, no withholding tax on distribution of liquidation proceeds, generally no withholding tax on interest payments made by Luxembourg companies, no statutory thin capitalisation rules, and no Luxembourg capital gains or income tax on any gains arising on an exit realised by a Luxembourg non-resident investor, and no or very limited stamp duty on the sale or issuance of shares (except in limited cases) in a Luxembourg company to name just a few of the tax benefits of investing through Luxembourg. For those reasons, among other things, it is the jurisdiction of choice for many private equity investors and, as a result, many English lawyers are involved in deals structured through Luxembourg. In this article, we will look at a few of the key points to bear in mind as an English lawyer advising on such a deal.

**Which company to use?**

Although the question over which form of company to use for any transaction will most often be determined by the tax advisers, it is helpful to understand the different type of companies commonly used in private equity deals and a few of the basic differences between them. Luxembourg topcos or acquisitioncos will typically be created under the Soparfi or holding company regime in Luxembourg, which comprises several different types of companies, the most common of which are the private limited company, called a *société à responsibilité limitée* (S.à.r.l.), the public limited company, called a *société anonyme* (S.A.), or a partnership limited by shares, called the *société en commandite par actions* (S.C.A.).

A S.à.r.l. may have between one and 40 members whereas there are no limits on the number of members in an S.A. or an S.C.A (although an S.C.A, like an English limited partnership, must have at least three members comprising two limited partners and one general partner). In terms of transparency, the members of a S.à.r.l. are a matter of public record whereas there are no requirements to disclose the members of an S.A.. Absent any service agreements with a manager or director which would apply in the event of a proposed termination, it is possible in an S.A. to remove a director with or without cause without any liability, whereas in a S.à.r.l. a manager can only be removed with cause without any liability in respect of the removal, unless otherwise provided. Generally though, but by no means exclusively, the most common form of Luxembourg newco that we have seen used to make a new investment by private equity investors tends to be a S.à.r.l..

**Practical issues to consider**

In terms of the practicalities involved in structuring a deal through Luxembourg, it is worth bearing in mind from the start of the transaction that there will be a lead time in setting up a Luxembourg company. It takes around three days to incorporate a new company in Luxembourg but many of the delays experienced when setting up such a company surround the "know your client" ("**KYC**") procedures that are required to be complied with by Luxembourg lawyers, domiciliation agents (required if the client does not already have a place of business in Luxembourg to provide registered office services), banks and notaries. Each entity may have different requirements although we have found that private equity investors themselves are increasingly familiar with the KYC involved. In addition a new bank account needs to be set up prior to incorporation which must be funded with the company's share capital in order for the notary to approve the incorporation. The share capital (a minimum of €12,500) of a S.à.r.l. must be fully paid up whereas the share capital of an S.A. or an S.C.A. (a minimum of €31,000) may be partially paid provided that at least one quarter of the share capital is fully paid up.

Once set up, there are also ongoing practical requirements to consider. In particular, any change to the articles of association of a Luxembourg company, any capital increase or reduction (unless specific provision has been made for an authorised share capital in the case of an S.A. or an S.C.A.), any merger or liquidation will need to be sanctioned in front of a notary, which can take up to a couple of days to arrange.

**PECs, CPECs and Alphabet Shares**

PECs (preferred equity certificates) and CPECs (convertible preferred equity certificates) are commonly used in private equity transactions as part of the investment for the proposed acquisition. PECs are broadly comparable to the loan notes used in UK private equity deals and CPECs are broadly comparable to convertible loan notes in the UK and both play a key role in the tax planning on a Luxembourg deal, particularly so for US investors as they are hybrid instruments capable of being treated as equity for US tax purposes and debt for Luxembourg tax purposes if drafted properly. They have wider benefits than just for US investors as it is tax efficient to have highly leveraged Luxembourg companies and this can be achieved through issuing PECs and CPECs.

Whether PECs or CPECs are used often depends upon the nature of the income that will be derived from the target. For example, for investments in targets that are expected to be declaring dividends on a regular basis, the investors may find it best to use fixed-interest bearing PECs to fund topco as those PECs will in general remain in place for the life of the investment and interest payments on the PECs can be used to repatriate funds to the investors, whereas CPECs are, for example, often used to finance qualifying shareholdings where there are more likely to be partial exits or capital gains transactions. The optional redemption of CPECs before maturity can be carried out at fair market value instead of converting such certificates into shares, and such redemption is generally not subject to withholding tax in Luxembourg.

It is also possible to structure the shares in the Luxembourg topco as "alphabet shares" which are multiple classes of shares with different economic rights, for the purpose of repatriating profits to the shareholders in a tax efficient manner. This is achieved through the buy-back and immediate cancellation of a whole class of shares by the Luxembourg topco. Under certain conditions, such redemption is treated as a partial liquidation from a Luxembourg tax perspective resulting in no withholding tax on the payments of the redemption proceeds.

The combination of two or more of these instruments can give added flexibility for private equity sponsors when implementing an acquisition and exiting an investment.

**Key issues for the key investment documents**

In negotiating the key terms of the key investment documentation, particularly the articles of association and investment agreement, it is important to bear in mind the following quirks of Luxembourg law:

**Transfer of shares**

1. Shares can only be transferred to non-shareholders of a S.à.r.l. if the current shareholders representing 75% of the capital of the S.à.r.l. consent to the transfer in a general meeting. This legal requirement still applies, even if it is agreed between the parties in an investment agreement that the transfer of shares should be an investor consent issue. This requirement therefore applies to and impacts on any proposed exit including in relation to the operation of drag and tag mechanisms.

   One of the ways around this restriction is for the private equity investors to include undertakings on management in the investment agreement to approve such resolutions in the event that, for example, the drag rights are exercised. Powers of attorney can also be used to achieve the same outcome although these should always be subject to English law as all powers of attorney are revocable under Luxembourg law and to include such powers of attorney in the articles of association would be ineffective.

   This restriction on the transfer of shares does not apply to S.A. or S.C.A. vehicles where the shares are freely transferable. Conversely, the statutory free transferability of shares in the S.A. and S.C.A. will impact on any lock-up provisions contained in any shareholders agreement as shareholders in those companies may not be locked up indefinitely. Commonly, lock-ups are limited to 7 years in an S.A. or S.C.A., which is considered to be acceptable under Luxembourg law.

**Same currency, same nominal value**

2. It is not possible to have shares with different nominal values or denominated in different currencies from each other. A Luxembourg company can have its capital denominated in any tradeable currency but all of the shares in the company must be denominated in the same currency. The shares though can have very low nominal value and it is possible for shares in Luxembourg companies (although of the same nominal value) to be issued with differing share premiums.

**One share, one vote**

3. In a similar vein, each share in a Luxembourg company carries one vote and it is not possible to have shares with enhanced voting rights. In order to allow members of management teams who hold less than 5% of the equity in economic terms to qualify for UK entrepreneurs' relief (which currently requires them to hold at least 5% of the voting ordinary share capital of the relevant company), it is possible to create classes of shares which, although they carry voting rights, do not carry any meaningful economic rights and which can be used by certain members of management teams to reach the 5% voting threshold required to qualify for entrepreneurs' relief. Non voting shares

may be issued in an S.A. or S.C.A. (not in a S.à.r.l.), provided that (i) they do not represent more than 50% of the share capital; and (ii) they entitle their holders to (x) a preferential cumulative dividend; and (y) a preferential return on liquidation proceeds.

It is not possible to strip shares of their voting rights in a S.à.r.l. This rule impacts on any proposed default mechanism where, for example, the voting rights on the shares of a defaulting shareholder are proposed to be suspended or removed. The most common ways of effectively removing the votes of defaulting shareholders are either to provide for the mandatory redemption or sale of their shares at a discount or for powers of attorney (governed by English law) to be granted to a non-defaulting shareholder which gives the non-defaulting shareholder the right to vote the shares of a defaulting shareholder. With an S.A. or S.C.A., it is also possible to issue partially paid up shares, for which, by statute, the voting right may be suspended where there has been default by their holder on a capital call, until such default is remedied.

**Double majority**

4. Where a S.à.r.l. is used, a majority of shareholders in both number and representing at least 75% of the share capital is required to pass any resolution for any change to the articles of association, any capital increase or reduction, and any merger or liquidation. This is often an issue for private equity investors where management teams hold shares directly in such a Luxembourg company, as the investor is usually a minority in number, so it may be necessary for the private equity investor to hold shares through multiple nominees to ensure that they are able to pass resolutions by both measures of majority. Voting undertakings given by members of management in favour of the investor can also cut across the entrepreneurs' relief provisions, so a balancing act needs to be achieved between the parties to achieve, for example, entrepreneur's relief for some of the key managers on the one hand and effective control over the S.à.r.l. for the investors on the other hand.

**Conclusion**

Although the use of Luxembourg topco vehicles in private equity transactions is becoming a well-trodden path, it is important to ensure both the private equity investor and management team receive proper advice to ensure that the deal is structured in the most tax efficient manner possible and that the commercial deal works for both parties and is structured in a manner which is effective under Luxembourg law and which works for both tax and legal purposes. Otherwise, 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.

# www.hoganlovells.com

Hogan Lovells has offices in:

| | | | | |
|---|---|---|---|---|
| Alicante | Denver | Jakarta* | New York | Silicon Valley |
| Amsterdam | Dubai | Jeddah* | Northern Virginia | Singapore |
| Baltimore | Dusseldorf | London | Paris | Tokyo |
| Beijing | Frankfurt | Los Angeles | Philadelphia | Ulaanbaatar |
| Berlin | Hamburg | Madrid | Prague | Warsaw |
| Brussels | Hanoi | Miami | Riyadh* | Washington DC |
| Budapest* | Ho Chi Minh City | Milan | Rome | Zagreb* |
| Caracas | Hong Kong | Moscow | San Francisco | |
| Colorado Springs | Houston | Munich | Shanghai | |