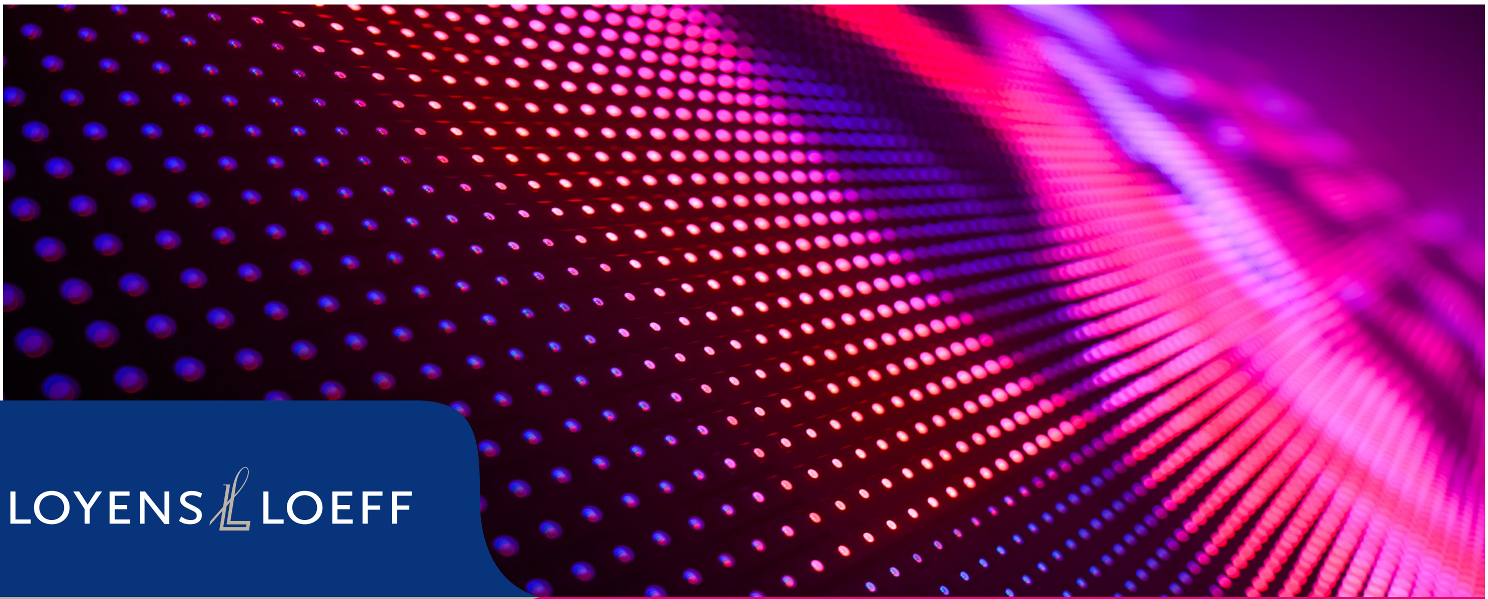

LOYENS LOEFF

FINANCE

Luxembourg Fund Finance

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Luxembourg continues to strengthen its ranking as the world's second largest fund domicile after the United States: in 2017, the assets under management of Luxembourg-domiciled funds stand at €4.5 trillion as at August 2019. This increase is not only based on the growth of traditional Luxembourg-domiciled undertakings for collective investment, but also due to the continued strong growth in respect of alternative investment funds, including private equity, real estate, infrastructure and debt.

Concurrently with the surge in the alternative investment funds market, Luxembourg has seen a significant development in fund finance activity, supported by the possibility of implementing efficient security packages in the context of credit facilities for funds. Recent years have been particularly active as regards fund finance transactions in Luxembourg, with positive growth, strong credit performance and absence of credit defaults. While capital call subscription credit facilities and bridge facilities are still used and continue their steady growth, permanent leverage facilities have become increasingly popular.

Fund formation

When selecting Luxembourg as their hub for setting up their investment fund, initiators generally opt for either a non-regulated ordinary commercial company (**SOPARFI**) or one of the following (regulated and non-regulated) alternative investment fund (**AIF**) regimes:

- an investment company in risk capital (**SICAR**), based on the law of 15 June 2004, as amended, on the risk capital investment company (**SICAR Law**);

- a specialised investment fund (**SIF**), based on the law of 13 February 2007, as amended, on specialised investment funds (**SIF Law**);

- a reserved alternative investment fund (**RAIF**), based on the law of 23 July 2016, as amended, on reserved alternative investment funds (**RAIF Law**); or

- an undertaking for collective investment (**UCI**), based on Part II of the law of 17 December 2010, as amended, on undertakings for collective investment (**Part II UCI**) – given the declining popularity of Part II UCIs with fund initiators (in light of the flexibility of the other available alternative investment fund regimes), this memorandum will not cover any particular aspects related to funds formed as Part II UCIs.

On the basis of Directive 2011/61/EU of the European Parliament and the European Council of 8 June 2011 on alternative investment fund managers (**AIFMD**), implemented in Luxembourg by the law of 12 July 2013 on alternative investment fund managers (**AIFM Law**), an AIF is defined as a collective investment undertaking, or the compartments of which, (i) raise(s) capital from a number of investors; (ii) with a view to investing such capital in accordance with a defined investment policy for the benefit of those investors; and (iii) which is not covered by EU Directive 2009/65/EC on UCITS. While the RAIF is an AIF within the meaning of the AIFM Law by virtue of the RAIF Law (and must accordingly appoint an authorised alternative investment fund manager (**AIFM**), as well as a depositary), the SICAR and the SIF are deemed to be AIFs (and required to appoint an AIFM), unless they qualify for one of the exemptions under the AIFM Law. Any unregulated

SOPARFI will be considered as an AIF if it fulfils all the above criteria, thereby triggering the application of the AIFM Law, including the obligation to appoint an AIFM and a depository in respect of the assets held by the SOPARFI (except if such SOPARFI is managed by an exempted AIFM).

Structuring the security package

Credit facilities relating to funds are typically secured by the unfunded capital commitments of the funds' investors. The security package may comprise: (i) a pledge over the claims and rights against the investors in relation to their unfunded capital commitments; and (ii) a pledge over the bank account into which investors are required to pay their contributions. However, other forms of security interests may be envisaged (notably pledges over shares in intermediary vehicles).

Luxembourg law typically governs the security interests granted by the borrowing fund over the rights in and to the investors' unfunded capital commitments and any claims against the investors in relation to such commitments. The relevant security interest is in the form of a financial collateral arrangement governed by the Luxembourg law of 5 August 2005 on financial collateral arrangements, as amended (the **Collateral Law**).

According to the Collateral Law, security over present and future claims against the investors may be created by way of a pledge or an assignment for security purposes. Pledges are the most common security interests over investors' commitments in relation to Luxembourg funds. The pledge/assignment agreement must be evidenced in writing, and the relevant security interest agreement must be executed by the fund (as pledgor or assignor), the fund's general partner and the security taker. If the AIFM is empowered to make capital calls or enter into borrowing arrangements on behalf of the fund, it must be added as party to the security interest agreement.

Conflict-of-laws rules

According to Luxembourg conflict-of-laws rules, the courts in Luxembourg will generally apply the *lex loci rei sitae* or *lex situs* (the law of the place where the asset subject to the security interest is situated) in the case of creation, perfection and enforcement of security interest over the asset. Thus, Luxembourg law will apply in relation to the creation, perfection and enforcement of security interests over assets which are located or deemed to be located in Luxembourg or governed by Luxembourg law. Claims (*créances*) governed by Luxembourg law or owed by a debtor located in Luxembourg, or accounts opened with banks located in Luxembourg, will be considered as located in Luxembourg and fall within the scope of the Collateral Law. In addition, the provisions of the Regulation (EU) of the European Parliament and the Council No. 2015/848 of 20 May 2015 on insolvency proceedings (recast), as amended, have to be considered. According to that regulation, claims against a third party (other than claims in relation to cash held in bank accounts) will be considered as situated in the EU Member State within the territory of which the third party required to meet the claims (i.e. the debtor) has its center of main interests (COMI).

Concerning claims against investors which are subject to security interests, certain conflict-of-laws rules must be taken into consideration when structuring the security package. According to article 14 of Regulation (EC) N° 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (**Rome I Regulation**): (i) the relationship between the security provider and the security taker is governed by the law applicable to the contract between the security provider and the security taker under the Rome I Regulation; and (ii) the law governing the pledged/assigned claim will determine its assignability, the relationship between the security taker and the debtor, the conditions under which the pledge or assignment may be invoked against the debtor and whether the debtor's obligations have been discharged. Because the fund documentation and subscription agreements are typically governed by Luxembourg law, that law will apply to such matters.

Since the Rome I Regulation does not provide explicitly for any conflict-of-laws rules concerning the enforceability of and possibility to invoke a pledge/assignment over claims against third parties, some Luxembourg legal practitioners consider that a pledge over, or assignment of, claims would become invocable *vis-à-vis* third parties other than the debtor if the legal formalities applicable in the debtor's jurisdiction are duly complied with.

Given that investors in Luxembourg funds are generally located in different jurisdictions outside Luxembourg, the lenders and the security takers will need to take the above considerations into account when structuring the security package.

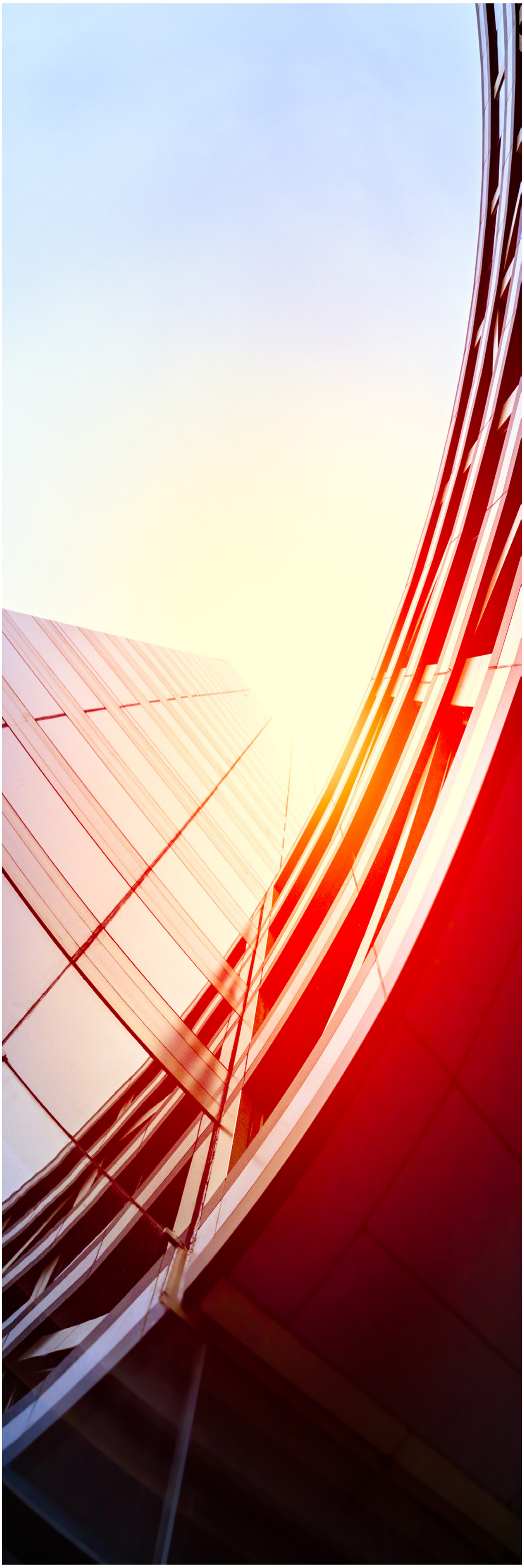
On 12 March 2018, the EU Commission published a proposal for a regulation on the law applicable to the third-party effects of assignments of claims (the **EU Commission Proposal**). This proposal will have an impact on the current conflict-of-laws rules and will reduce the uncertainties that surround the enforceability of security interests over claims against debtors (including investors) located in different jurisdictions. The new rules clarify which law applies to the third-party effects of assignments of claims in cross-border transactions. The EU Commission Proposal defines the term "*assignment*" as 'a voluntary transfer of a right to claim a debt against a debtor. The term includes outright transfers of claims, pledges, transfers by way of security or other security rights over claims. As a general rule, the law that governs the third-party effects of assignments of claims is the law of the country where the assignor has its habitual residence. If adopted, the new regulation will provide increased certainty with respect to the perfection and enforceability of security interests over claims against investors (located inside or outside of the European Union) in relation to their commitments and it will significantly reduce the discussions around the applicable creation, perfection and enforceability formalities.

Notifications, acceptances and investors' waivers

Under Luxembourg law, pledges/assignments for security purposes which are not notified to or accepted by the investors are fully recognised and enforceable. However, the debtor of a pledged/assigned claim may be validly discharged from its obligation *vis-à-vis* the security provider if it had no knowledge of the pledge/assignment in favour of the security taker. It is therefore usual for lenders to require security interests granted by the fund to be notified to and accepted by the investors, in order to ensure that the investors act in accordance with the security taker's instructions and pay the unfunded commitments to the pledged accounts if the security interest is enforced.

Notices may be served to the investors by different means (registered letters, emails, electronic communications, etc.). Alternatively, notices may be included in the financial reports (distributed to the investors) or published on an investor portal.

It is usually required by the lenders that the investors waive any defences, right of retention or set-off and counterclaim the investors may have with regard to the pledged/assigned claims and any transferability



restrictions which may be applicable. According to the Collateral Law: (i) a debtor of a claim provided as financial collateral may waive his rights of set-off in writing or a legally equivalent manner, as well as any other exceptions *vis-à-vis* the creditor of the claim provided as collateral and *vis-à-vis* persons to whom the creditor assigned or pledged such claim as collateral; and (ii) the waiver is valid between the parties and enforceable against third parties. A proper waiver will give comfort to the lenders that the investors will pay their capital commitments upon the enforcement of the security interest without challenging their obligations.

Given the above and to pre-empt any difficulties with the investors, it becomes usual to include "bankable" financing provisions in advance in the fund documentation (notably the partnership agreements and the subscription arrangements), such as investors' acceptance of the possibility for the fund and its general partner to borrow and pledge the unfunded capital commitments, the security taker's right to initiate and enforce capital calls, waivers of defences to funding, provisions allowing the security taker to give instructions to the investors upon the occurrence of an event of default, subordination of the investors' claims, etc.

Right to make capital calls

Concerning the right of the fund to make capital calls and enforce the obligations of the investors to contribute capital, it should be considered that such right is an ancillary right to the pledged/assigned claim (*droit lié à la créance gagée/transférée*), and as a result the security taker may be entitled to exercise that right in accordance with the provisions of the security interest agreement. This view is supported by the Collateral Law, which provides that the pledge/assignment of a claim implies the right for the security taker to exercise the rights of the security provider linked to the pledged/assigned claim.

Without prejudice to and independently of the above, Luxembourg security interest agreements provide for a power of attorney granted by the borrowing fund and its general partner in favour of the security taker to make the capital calls, send funding notices and require the investors to make payments into the pledged accounts, it being understood that this power of attorney may be subject to certain limitations arising under Luxembourg law.

Enforcement of the security interests

The Collateral Law allows the enforcement of a security interest over claims upon the occurrence of an event of default (freely determined by the parties), without prior notice (*mise en demeure*). Subject to the terms of the fund documents and certain Luxembourg regulatory requirements, in respect of pledges, the security taker (as pledgee) may, *inter alia*, (i) serve a funding notice on the investors, requesting payment into the pledged accounts; (ii) request direct payment from the investors; (iii) appropriate the pledged claims (at a value determined using the valuation method agreed upon by the parties); (iv) sell the pledged claims by way of a private sale (at arm's length conditions) or a public sale; or (v) request a court to attribute the pledged claims. Concerning assignments for security purposes, in the event of the security provider's failure to perform the relevant financial obligations, the security taker (as assignee) is discharged from its obligations to re-transfer the assigned claims up to the amount of the secured obligations.

Pledges over bank accounts

The security interest over bank accounts (held in Luxembourg) into which investors are required to fund their contributions may be created by way of a pledge in accordance with the Collateral Law. The pledge agreement must be evidenced in writing and perfected in accordance with Luxembourg law. In practice, as a result of their general terms and conditions, Luxembourg account banks have a first ranking pledge over such accounts. Provided the terms and conditions do not prohibit pledges, the pledge will become valid and enforceable against the account bank and third parties once the existence of the pledge has been notified to and accepted by that bank.

Insolvency protection

The Collateral Law provides that the provisions of Book III, Title XVII of the Luxembourg Civil Code, of Book 1, Title VIII and of Book III of the Luxembourg Commercial Code and national or foreign provisions governing reorganization measures, winding-up proceedings or other similar proceedings and attachments or other measures referred to in article 19(b) of the Collateral Law are not applicable to financial collateral arrangements (such as Luxembourg pledges over claims or accounts) and shall not constitute an obstacle to the enforcement and to the performance by the parties of their obligations.

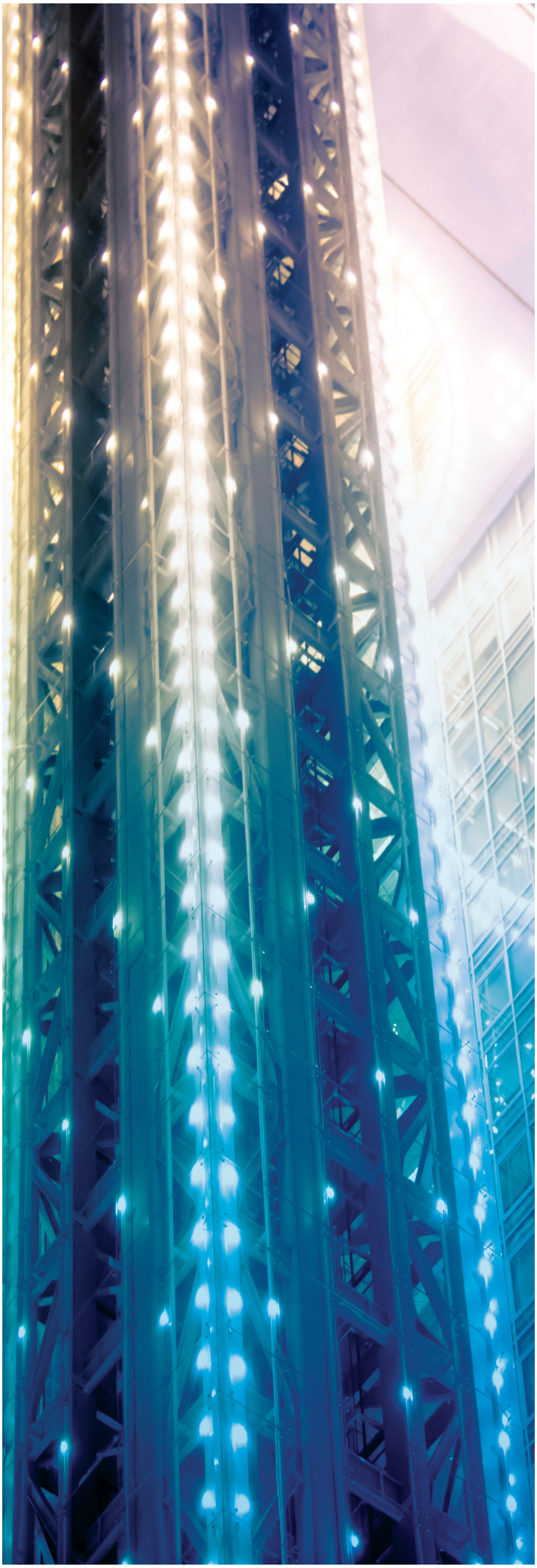
Luxembourg law pledges/assignments over claims or bank accounts falling within the scope of the Collateral Law, as well as all enforcement measures and valuation and enforcement measures agreed upon by the parties in accordance with this law, are valid and enforceable even if entered into during the hardening period against third parties, commissioners, receivers, liquidators and other similar persons notwithstanding the insolvency proceedings (save in the case of fraud).

Duties of the depositary

The duties of a depositary of a Luxembourg fund may generally be described as covering: (i) safekeeping and supervision of the assets; (ii) day-to-day administration of the assets; and (iii) control over the transactions of the fund (including compliance with investment policies and monitoring of the cash flows). With the ultimate goal being increased investor protection, the exact scope of a depositary's duties depends on whether the AIF concerned is subject to the SICAR Law, the SIF Law, the RAIF Law and/or the AIFM Law.

The depositary of a fund organised as a SICAR or a SIF is entrusted with the supervision of the fund's assets. This implies that the depositary must always know how the fund's assets of the fund have been invested and where and how they are available.

With the implementation of AIFMD, the initial role of depositaries was supplemented by additional overview obligations relating to: (i) the valuation of assets; (ii) the subscription and redemption of shares or units; (iii) the execution of the AIFM's instructions; (iv) the timely settlement of transactions; and (v) distribution of the AIF's income. Depositaries are now also required, in addition to the custody/safekeeping of assets of the relevant AIF, to monitor and reconcile the AIF's cash flows by obtaining a full overview of its cash positions and cash movements. These duties apply to any depositary appointed in respect of an AIF, whether it is organised as a SICAR, a SIF, a RAIF or any non-regulated SOPARFI qualifying as an AIF (except for a SOPARFI managed by an exempted AIFM).



The depositary must in general ensure that the AIF's cash flows are properly monitored, and ensure in particular that all payments made by or on behalf of investors upon the subscription of units or shares in the AIF have been received, and that all the AIF's cash has been booked in cash accounts opened in its name, the name of the AIFM acting on behalf of the AIF, or the name of the depositary acting on behalf of the AIF.

Special attention must be paid to situations where lenders and/or security takers require the investors' contributions to be paid into an account, which is not opened in the name of the AIF, the AIFM acting on behalf of the AIF or the depositary acting on behalf of the AIF.

Interactions between the duties of the depositary and the rights of the lenders and the security takers

It is important for the borrowing fund, the lenders and the security takers to verify whether the provisions of the depositary agreements and the duties of the depositary might have an impact on the financing transaction and the effectiveness of the security package.

In practice, the depositary agreements usually provide for: (i) a right of information and/or (ii) a right of prior consent. Both these rights aim to ensure that the depositary obtains sufficient information on transactions affecting the fund's assets which it has to monitor and supervise, and is able to block transactions which may violate the fund documentation or the applicable laws and regulations. It is therefore usual for lenders to require an acceptance letter from the depositary in relation to the financing transaction and the security package.

The depositary arrangements often provide for a pledge over all or part of the fund's assets of the fund in favour of the depositary. As long as that pledge remains in place, the fund will not be able to grant a first ranking pledge over the same assets for the purpose of a financing transaction. A waiver of the pledge granted in favour of the depositary will be required in order to conclude the new security interest agreement validly and perfect the pledge it creates. Without such a waiver, the pledge granted by the fund in favour of the lenders may either rank as junior to the pledge granted in favour of the depositary, or even be considered as not validly created.

GDPR

The EU Regulation No. 2016/679 on the protection of natural persons with regard to the processing of personal data (the **GDPR**) regulates how personal data (relating to natural persons) is processed and transferred. In the context of fund finance transactions, a point of attention is how personal information regarding investors and their commitments may be transferred to the lenders in order to determine the borrowing basis and take the security interests over the unfunded capital commitments. As a result, GDPR provisions and consents are included in the fund documentation in order to authorise the fund and its general partner to share such information with the lenders and transfer such information outside of Europe.

Securitisation Regulation

The Regulation (EU) 2017/2042 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation (the **EU Securitisation Regulation**) came in force on 1 January 2019.

Certain fund finance transactions (notably leveraged transactions) and borrowing entities may potentially fall within the scope of the EU Securitisation Regulation, which would trigger a broad array of obligations for the borrowing entity, but also for originators, sponsors and certain investors (among others, requirements with regard to risk retention, due diligence, transparency and disclosure, restrictions on sale to retail investors, etc). In order to determine whether such obligations would be applicable, one needs to assess whether the transaction meets the definition of "*securitisation*" as set out in the EU Securitisation Regulation and whether any of the involved entities may be considered as a securitisation special purpose entity (**SSPE**) for the purpose of the EU Securitisation Regulation.

Article 2(1) of the EU Securitisation Regulation defines "*securitisation*" as a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having all of the following characteristics:

- payments in the transaction or scheme are dependent upon the performance of the exposure or the pool of exposures; and
- the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

It follows from the above definition that a transaction would only fall within the scope of the EU Securitisation Regulation if the securitised credit risk is tranched. The EU Securitisation Regulation defines "*tranche*" as:

- a contractually established segment of the credit risk associated with an exposure or a pool of exposures;
- where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment; and
- without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments.

Furthermore, the transactions falling within the "*specialised lending*" exception (as described in article 147(8) of the Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms) are not subject to the EU Securitisation Regulation, even if the above conditions are satisfied.

In addition, it has to be assessed whether any of the involved entities may be considered as an SSPE for the purpose of the EU Securitisation Regulation. According to article 2 of the EU Securitisation Regulation, an SSPE is defined as "*a corporation, trust or other entity, other than an originator or sponsor, established for the purpose of carrying out one or more securitisations, the activities of which are limited to those appropriate to accomplish that objective, the structure of which is intended to isolated the obligations of the SSPE from those of the originator*".

The definition of securitisation under the EU Securitisation Regulation is thus quite large and it is therefore advisable to assess each transaction (notably any transaction involving entities investing in credit assets and receiving financing with different payment priorities and seniorities) and the involved entities on a case by case basis to determine whether the above conditions are met.

Conclusion

Significant drivers for the success of Luxembourg as a European hub for the structuring of AIFs, in particular over the past few years, have been:

- the success of the modernisation of the Luxembourg partnership regime, which has led to offering fund initiators accustomed to Anglo-Saxon partnerships a new onshore alternative for fund structuring, as well as

- the addition of the RAIF to the Luxembourg fund structuring toolbox, replicating, without any regulatory supervision at product level, the flexibility of regulated AIF regimes.

There is no reason to doubt that this trend will continue and sustain a growing demand from fund managers for financing solutions.

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