# TOWARDS A MATURE MARKET FOR FUND FINANCE IN LUXEMBOURG

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## I. INTRODUCTION

The term "fund finance" refers to the various forms of recourse by investment funds to external financing, generally – but not exclusively – a bank loan[1], instead of calling capital from their investors[2]. The success of fund finance is mainly due to the operational efficiency that it allows. Be it through the monetization of the fund's assets (NAV facilities), or via the bridging of the investment period (subscription facilities), fund finance, throughout its variety of forms and structures, has become popular among lenders, borrower funds and their investors. Third-party financing avoids having to go back to investors for each investment opportunity[3]. For investors who might not be adequately staffed to deal with frequent capital calls, especially when they have investments in numerous funds, the use of a subscription facility may help in the optimization of resources. Fund finance offers a predictability for the fund which may organize the best way to take advantage of its portfolio or of the commitments of its investors in order to borrow against them at limited costs, especially given the current interest rates.

At a local level, fund finance is where two of the most successful tool boxes in Luxembourg financial law meet and combine to provide optimal flexibility for funds and robust security for lenders. Credit lines to investment funds bring together Luxembourg investment funds legislation[4] and the Luxembourg law of 5 August 2005 on financial collateral arrangements, as amended (the "Financial Collateral Act"). Undoubtedly, the main factor that allowed the significant development of fund finance in Luxembourg lies in the importance of its fund industry. In addition to the important fund incorporation, domiciliation and servicing activity with a long-standing knowledge of cross-border fund structuring, a host of economic and legal factors have contributed to the success of the Luxembourg fund finance activity. In a nutshell, these factors may be summarized as follows: (i) A flexible legal framework where the borrowing or the issuing of debt instruments by Luxembourg entities with financiers outside Luxembourg and the structuring of the underlying investments trigger minimal regulatory and tax hurdles; (ii) a variety of investment vehicles with multiple features that may suit the needs of sophisticated sponsors and the possibility, within one fund, to segregate assets and liabilities between the various compartments (or sub-funds); and, (iii) the robustness of its Financial Collateral Act which has been tested in the aftermath of the financial crisis and proved to be a formidable tool, for lenders and borrowers alike. We set out hereafter some of the main local features of lending to Luxembourg funds[5] (II), and the current and upcoming challenges due to the multi-jurisdictional nature of Luxembourg fund finance (III).

## II. LENDING TO LUXEMBOURG FUNDS

As it matures, fund finance is becoming more sophisticated and diversified[6]. There are numerous types of financing and structures, and multiple reasons for a fund to borrow from a third-party lender. Subscription facilities and NAV facilities are singled out to be the major lending structures in fund finance. In the following paragraphs, we will try to identify the salient aspects for each of the two techniques when involving a Luxembourg borrower fund.

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* The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of NautaDutilh.

1 Particularly when viewed from a Luxembourg angle, this market is mainly led by bank lenders. It is worth mentioning that an increasing number of non-bank lenders are entering the market as monopoly rules, which used to be a major hurdle, loosen up in continental European countries.

2 The definition here is only provided for clarification purposes, and this article does not purport to analyse fund finance other than under a Luxembourg practitioner's angle.

3 Credit funds are likely to be, in number, the most important chunk of the newly set up funds in Luxembourg (with the aim to service the European market). Such funds have sizeable liquidity needs and frequently encounter small-scale investment opportunities, making it very burdensome to go back and draw on investors' commitments for each investment.

4 Mainly the Luxembourg law of 12 July 2013, as amended, on alternative investment fund managers ("AIFMs"), ("AIFM Act"), implementing Directive 2011/61/EU of the European Parliament and the European Council of 8 June 2011 (the "AIFMD"), as well as the law of 15 June 2004, as amended, on risk capital investment companies (SICARs), the law of 13 February 2007, as amended, on specialized investment funds (SIFs), the law of 23 July 2016 on reserved alternative investment funds (RAIFs) and the law of 17 December 2010, as amended, on undertakings for collective investment (UCIs that are covered by the AIFM Act and UCITS).

5 There is a nascent lending activity in Luxembourg for local funds, but this is still a work in progress.

6 Various types of Luxembourg funds and fund structures can be involved in fund financing. We have seen master-feeder structures, parallel funds and standalone funds. In most cases, such funds were organized as closed-end funds.

## *1. Subscription facility agreements, an investor-based financing*

The recourse to subscription lines may be very useful for funds and their investors on the operational side. As the Institutional Limited Partners Association emphasizes in its Best Practices, "*the rationale for the use of these lines from the GP's perspective is multi-faceted*"[7]. Used as a bridge facility or as primary leverage, subscription facilities allow the fund to use the subscription line to bridge an investment until a capital call is made. This is particularly interesting for general partners when there is uncertainty about a deal's timing; in such cases, a fund might prefer not to call investors' contributions, risking that the funded contributions remain stuck in a bank account for a long period[8], until the deal finally takes place. Subscription facilities can hence prove to be useful for general partners seeking a better management of timing and amounts of capital calls, while allowing the investors more predictability on their commitments towards the fund.

### 1.1. Contractual considerations

The defining characteristic of subscription facilities lies in their almost exclusive reliance on the investors in the borrower fund, with specific terms dealing with the borrowing base and security interest on the investors' commitments.

**Investor-driven deals** – A lender in subscription finance generally requires a due diligence on all organizational documents of the fund as well as full information on the investors who constitute the base against which the fund is borrowing (eligible investors or included investors). Generally, subscription facilities include – among other things – a covenant prohibiting eligible investors' uncalled capital from falling below a certain level, borrower-friendly terms, limited recourse on the general partner and short standstill periods in the event of a default.

These investors are considered key for the deal, and lenders may seek to create a direct binding effect of certain transaction documents on them. The practice of investor letters aims at creating a direct relationship between the lender and the key investors in the borrower fund. There are different views on this practice, which may vary depending on the jurisdiction and the type of deal. In the early stages of fund finance this practice was uncommon. As subscription finance moved towards a form of "commoditization" it became more common for US lenders to want to create what is known in north American legal systems as the concept of "privity of contract", and, to also request investors to provide a waiver of defenses, set-off and counterclaims.

The closest equivalent to the concept of "privity of contract" in civil law systems, to which Luxembourg belongs, is the binding effect of contracts between parties[9]. Towards all third parties there is in general no binding effect under this civil law theory, hence the request from US lenders to have this practice implemented in financing transactions involving Luxembourg funds. As an alternative to investor letters, some tweaks may be included in the fund documentation if Luxembourg counsel are involved at an early stage in the negotiation of the financing and if there is still room to amend the fund organizational documents (mainly the LPA and/or the subscription agreement). In such cases, the letter or contractual arrangement may as well include a waiver of any transferability restrictions, any defenses, set-off or counterclaim the investors may have.

In recent deals, the trend is clearly towards less involvement of the investors[10]. Lenders seem to accept this paradigm and it may even sometime prove difficult – in extreme cases – to obtain acknowledgements of a pledge or waiver of certain rights[11]. However, we still regularly see requests for investor letters, mostly when dealing with US lenders. It is advisable to address this question in the early stages of the transaction. This can be done by including specific language in the fund organizational documents (in particular for investors identified as eligible or included investors) and via the acknowledgement letters from the investors where a receivables pledge is granted by the fund over its claims against the investors.

**What does the security package include for Luxembourg funds?** Given the general acceptance that subscription facilities bear a low risk, in their early days, they were mostly unsecured. As the product became more standardized, it has become very exceptional – at least on the Luxem-

7 ILPA, *Subscription Lines of Credit and Alignment of Interests - Considerations and Best Practices for Limited and General Partners*, June 2017.

8 Traditionally used as short-term bridge facilities, subscription facilities that we have seen involving Luxembourg funds generally have short maturity periods, ranging from 45 days to 36 months.

9 On this concept and the attempt to translate it into a civil code concept, see notably in a Canadian comparative approach, G. Snow, «Normalisation du vocabulaire du droit des contrats dossier de synthèse, *CTTJ* contrats 6D (2008-02-15). The author translates « privity » into « relativité contractuelle », p. 9 : « *La notion de privity est difficile à définir, mais disons qu'être privy to the contract (le mot privy est pris adjectivement dans ce tour), c'est participer au contrat d'une manière plus active que d'en être simple bénéficiaire, sans nécessairement en être partie au sens fort du terme. Force est de reconnaître cependant qu'en pratique privy in contract est souvent assimilé à party to the contract, particulièrement dans le cadre de l'analyse de la notion de privity of contract* »; Jowitt's Dictionary of English Law, 2e éd., 1977, vol. 2, p. 1432 : privity of contract.- The doctrine whereby one can enforce contractual rights against another only if one was a party to the contract.

10 The practice of investor letters is still common in funds with a high investor concentration base, i.e. where the involvement of one investor is key for the deal.

11 F. Dinh and J. Cross, "Subscription lines: opportunities multiply as they are seized", *barclayscorporate.com*, Sept. 2017, p. 3.

bourg market – not to have subscription facilities secured by capital commitments, often together with a security or control agreement on the deposit accounts where the contributions are paid[12]. Hence, the collateral package in Luxembourg subscription deals usually consists of (i) the unfunded commitments by the fund's limited partners to make capital contributions when called by the general partner and (ii) the account where the contributions are funded. The Financial Collateral Act captures these two types of assets to offer lenders a secure and bankruptcy-remote pledge while allowing the fund, as pledgor, to benefit from a continuing and flexible management of the collateral.

For convenience, the parties may want to stick to models agreed upon on previous deals or to use master documentation – often governed by a foreign law – that has been agreed upfront. This is an approach that deserves special attention given the deal (and jurisdiction) specifics[13]. To ensure their full efficiency, Luxembourg security documents need to be aligned with local practice and, at the very least, be consistent with the conditions set in the Financial Collateral Act. Comforted by a very limited number of defaults[14] and a borrower's market, and wary of the general cost sensitivity of subscription deals, lenders have increasingly been willing to accommodate funds by watering down the requirements regarding the security package and limiting the requests addressed to investors. It might be too early to draw conclusions from the Abraaj case, but it is interesting to see whether this case might be a signal that will push lenders towards more prudence. The once very successful Middle Eastern private equity group is now witnessing the dismantlement of part of the group following an application for liquidation in the Cayman Islands[15]. With lessons learned (at least partly) from the latest financial crisis, the default under the subscription facilities in Abraaj could be a call for a reinforced scrutiny in the structuring of a subscription transaction and the efficiency of the security taken. Unlike situations of technical default, which often result from cash shortages and for which the lenders would typically be willing to grant a grace period, the Abraaj default had far more complex roots. It may well be that this case is mainly an example of a fraud risk for which the response from the industry should not have a major impact on the way things are now structured. One possible impact could be to see advanced levels of scrutiny and due diligence on the fund, its general partner and its main investors, rather than a broadened security package[16].

**How does the Luxembourg security package work?** Pledges under the Financial Collateral Act can be granted over virtually all types of securities and claims (the latter include bank accounts and receivables)[17]. In addition they can be granted under private seal and, in principle, are not subject to any filing or publication requirements in Luxembourg. Contributions in the form of equity, notes or loans can be captured by the Financial Collateral Act, with a flexibility as to any contractual arrangements on their timing and mechanics. Furthermore, the Financial Collateral Act allows pledges to be granted not only over present assets, but also over future assets[18]. Consequently, counsel in Luxembourg have a large degree of flexibility in structuring the security package for subscription facilities.

In order to be fully effective, a pledge over a claim, including bank accounts, must be notified to and accepted by the debtor of the relevant claim[19]. The notification to and acceptance by the investors (debtors under the pledged claims) is thus part of the formalities that are necessary under Luxembourg law in order to perfect the pledge against the investors and ensure that they will recognize its terms and will act accordingly upon a default. Although these formalities might be unpractical in certain cases where numerous investors are in different countries, it is nevertheless a prerequisite to ensure the efficiency of the security interest. In addition, other specific requirements

12 On subscription finance deals, this is the only security that we see, the costs of running diligence on the assets of the fund and the need to involve larger risk and credit teams on the lender side make it very uncommon to include any other types of assets in the security package, unless for special lenders specializing into what is known as hybrid financing (amongst whom a lot of non-bank lenders). Very occasionally, we may see on certain deals a security package that includes assets from the general partner or cross-collateralization. This remains quite unusual especially as the latter option could trigger additional regulatory issues in Luxembourg.

13 Despite the push by multiple fund sponsors for seamless and standardized documentation across jurisdictions, each jurisdiction's specifics should be given careful consideration.

14 Until the Abraaj default (where Abraaj was a significant investor in its own funds), there were very few reported defaults, mostly relating to Chinese investors and not the funds in which they had invested (see. T. Mitchenall, "Abraaj: a test case for broken credit lines", *Private funds management*, 23 November 2018).

15 The Abraaj group has been described as having fallen "from being a respected, $14 billion powerhouse in the world of impact investing in private equity to a company offered a buyout of just $1": K. Rapoza, "Dubai Emerging Market Maverick Abraaj Gets A Lifeline", *Forbes*, 26 November 2018.

16 However, this would significantly complicate a subscription deal, the risk of fraud being one of the most difficult complications to treat from a secured lender's perspective.

17 Assets that are eligible as "collateral" under the Financial Collateral Act are financial instruments and claims (Article 1(1) of the Financial Collateral Act). Both types of assets receive a fairly broad definition under the Financial Collateral Act that can capture most of the commonly encountered financial assets.

18 Provided that such claims (the collateral) are identified or simply identifiable at the time of entry into the pledge agreement.

19 Notification and acceptance are a crucial formality under Luxembourg law. It could be debated whether the right term to use is perfection, effectiveness or enforceability, given the presence of a degree of ambiguity in the law and the fact that the French term does not necessarily translate into one of these terms. In any event the fact remains that, as long as it has not been notified of the pledge, the debtor of the pledged claim may validly be discharged from its obligations towards the creditor of the claim.

under the law of the jurisdiction of incorporation of each investor should also be looked at[20].

There seems to be a consensus on the Luxembourg market that the right to make capital calls is an ancillary right to the pledge[21] and, as such, should be deemed part of it and benefit from the protection provided by the Financial Collateral Act. It is likely that a power of attorney contained in a Luxembourg pledge agreement would also receive the same treatment and be considered as a right that is attached to the pledged assets, and hence benefit, notably, from the bankruptcy remoteness offered by the Financial Collateral Act. Although the mechanics of such security interest has not been tested before the Luxembourg courts, this view, to which we totally subscribe, is generally shared among practitioners. We believe it to be in line with the provisions of the Financial Collateral Act and the parliamentary works that preceded the voting into law of the Financial Collateral Act's bill.

### 1.2. Regulatory considerations

**Fund organizational documents –** Regulatory considerations deserve close attention as part of the due diligence on a fund finance deal. Non-compliance with the regulatory requirements applicable to a fund might have an indirect impact on the financing transaction. The *Commission de surveillance du secteur financier* (Luxembourg financial supervisory authority, "CSSF") has not specifically addressed fund finance activities. Nevertheless, fund finance is considered as being covered by the general regulatory framework applicable to the fund entering into the financing and to its manager, and in particular the guidelines on portfolio management (with all the regulatory requirements they contain).

The fund's organizational documents (limited partnership agreement, subscription agreement, articles of association, AIFM and/or portfolio management agreements, depositary agreement, etc.) set the rules of commitment and the limits of involvement of each of the fund parties. It is important to make sure from the outset that there are no contradictions between the facility agreement and the organizational documents[22]. In the context of the AIFM Act for instance, the AIFM bears the regulatory responsibility as part of its portfolio management responsibilities; consequently, the financing transaction must be approved by the AIFM and, if applicable, the party to which the AIFM has delegated the portfolio management function. In the last few years, it has become increasingly accepted to have specific provisions on fund financing included in the fund's organizational documents. This is particularly helpful in the context of subscription facilities, for which – as stated earlier – provisions on capital calls, disclosures, escrows, clawbacks and certain waivers are included.

**Leverage –** Most Luxembourg alternative investment funds (within the meaning of the AIFM Act) are not subject to statutory limitations on leverage, although there may be some limitations resulting mainly from the fund's organizational documents. A Luxembourg alternative investment fund is required to conduct a self-assessment of its leverage level in order to determine whether or not it must appoint an authorized AIFM. If exceeded as a result of the bank financing, leverage level might trigger statutory obligations to appoint an AIFM and a depositary[23]. Under the AIFM Act, leverage is very broadly defined to encompass the widest possible range of debt techniques. Consequently, any method by which an AIFM increases the fund's exposure – whether through [the borrowing of cash or securities, by means of derivatives or otherwise could be deemed to constitute leverage.

In addition, for credit funds in particular, where we see a steep rise in the number of incorporations in Luxembourg, an important need for available liquidity throughout the life of the fund make it interesting to use external lending instead of drawing on the investors' commitments, especially given the relatively small amount of each individual investment. It is advisable, as part of the due diligence process, for such funds to ensure that the underlying lending activity does not cause the fund to be characterized as engaging in a regulated activity reserved for banks, entities licensed as lenders

20 Under Luxembourg private international law rules, the perfection of a pledge as against third parties is governed by the law of domicile of the debtor of the pledged claim, as further discussed below.

21 Professionals involved in fund finance in Luxembourg seem to adhere to this position: A. Fortier-Grethen, "*La mise en gage des engagements des investisseurs des fonds d'investissements à la lumière de la loi du 5 août 2005 sur les contrats de garantie financière*", JT Luxembourg, 2017, 176-179. For an early analysis on this topic also see S. Jacoby, P. Van den Abeele, "*Le financement des fonds d'investissement luxembourgeois garanti par les engagements de souscription des investisseurs* (commitment liquidity facility)", Droit bancaire et financier Luxembourg, 2014, Vol. V, p. 2547 – On the type of receivables that may qualify as eligible *financial assets* under the Financial Collateral Act, see M. Lattard, "*Typologie des créances pouvant être gagées sous un contrat de gage soumis à la loi du 5 août 2005 sur les contrats de garantie financière*", *ACE*, 4/ 2015, p. 3.

22 This is also in line with the recommendations of the ILPA in its *Considerations and Best Practices for Limited and General Partners*, June 2017.

23 The AIFM Act provides for a de minimis exemption allowing certain AIFMs to simply be registered with the CSSF without having to go through an authorization procedure. This exemption applies to (i) AIFMs whose total assets under management, including any assets acquired through the use of leverage, do not exceed a total threshold of EUR 100 million; and (ii) AIFMs whose total assets under management do not exceed a total threshold of EUR 500 million when the portfolios managed consist of AIFs which are unleveraged and have no redemption rights exercisable during five years following the date of the initial investment in each AIF. Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012 provides additional guidance on the rules to follow in the calculation of leverage, for instance addressing the question of whether revolving facilities should be included in the calculation of the leverage level.

or factoring entities[24]. Another factor to be taken into account in assessing the risk of re-characterization is the form of contributions that are made into the fund (equity or debt).

**GDPR –** Personal data relating to individual investors may be transferred to the lenders as part of the due diligence on the fund and as a first step towards evaluating the fund's borrowing base. The provisions of the General Data Protection Regulation[25] should be taken into account for as long as the transfer and processing of personal data, within the meaning of the Regulation, is involved. GDPR-specific clauses should be included in the fund documentation in order to provide the necessary consent for any data transfers to non-EU/EEA lenders.

## 2. *NAV facility agreements for Luxembourg funds*

In essence, NAV facilities follow an asset-backed approach. They are credit lines extended against a fund's underlying portfolio of assets, mainly to mature funds with sizable existing investments. Fund structures can be diverse, which requires a bespoke approach for the security package on the Luxembourg side.

### 2.1. Structuring considerations

**Unlocking the value of the underlying investments –** For borrower funds wishing to monetize their investments and unlock the value of the underlying portfolio of investments, borrowing against the underlying portfolio of assets (which can consist of real estate, private equity participations, debt, infrastructure or hedge fund portfolios) offers important advantages in terms of access to liquidity and enhancement of returns. Some funds, such as mature private funds that have already called an important portion of the committed capital and have undertaken several investments, may have sizable asset portfolios against which to borrow.

**Absence of standardization –** There are various types of NAV facilities. When NAV facilities relate to a master-feeder fund structure, the borrowing base may be at the level of the feeder funds' assets or that of the master fund[26]. Hybrid financing, in which subscription lines and portfolio-based lines are combined within the same facility and which therefore takes characteristics from both types of facilities, has also been seen in Luxembourg deals. These types of facilities have been traditionally viewed with reluctance by lenders. They involve a bespoke drafting and structuring effort, and require a due diligence on the underlying portfolio, thus might prove to be more expensive than a standard subscription facility. For Luxembourg funds, particularly more mature credit funds or funds engaged in private equity or hedge fund activities, borrowing against the underlying assets over a slightly longer period is becoming increasingly common. For NAV facilities, lending is against the aggregate amount of eligible investment portfolios.

### 2.2. A bespoke Luxembourg security package

**Security over the portfolio of assets –** The Financial Collateral Act provides a high level of security for lenders and, for the fund, an important flexibility in the granting of the security and the management of the collateral. Upon a default, enforcement can be very quick, without prior notice and without the involvement of any third party, in a private process where the financial collateral is granted immunity against Luxembourg or foreign insolvency proceedings. Counsel on either side (for borrowers and lenders alike) generally seek to take advantage of the Financial Collateral Act. Lenders in particular appreciate the protection it offers in the event of a borrower fund's insolvency. Hence, when structuring a NAV facility transaction, the Luxembourg counsel to the lenders will always seek to ensure that the security package is structured under Luxembourg law to avoid discrepancies upon enforcement, and, in particular, under the Financial Collateral Act, to take full advantage of a bankruptcy-remote security package recognized across all EU/EEA jurisdictions[27].

In terms of composition of the security package, in addition or as an alternative to the deposit accounts on which the capital contributions are funded, NAV facilities are mainly granted against the fund's investment portfolio[28]. Depending on the investment policy of the fund, and the way it is structured (whether it is a fund of fund or not, and the way the holding of the underlying assets is structured) the collateral might fall in a different class of assets, and hence be subject to a different form of pledge. The most common approach in Luxembourg is to have the security package in a NAV facility include a pledge over the portfolio companies (HoldCos), a pledge over receivables (in particular for credit funds) and a pledge over bank accounts. All such pledges can be governed by the Financial Collateral Act and take advantage of its flexible and efficient regime.

24 On this question, and the possibility for alternative investment funds and ELTIFs to provide loans, see the article by M. Storck in this issue of *Revue européenne en Droit du financement de l'économie*, «Les fonds de dette», pp. 3 et s.

25 Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC, ("GDPR").

26 Secondary facilities can take a variety of forms, ranging from simple credit agreements to more complex facility structures where hedge funds are involved.

27 In accordance with the (recast) Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings.

28 Other contractual rights can also be included in the collateral package (mainly by the general partner), but this remains an exception.

With a flexible legal framework, variations are possible around these types of pledges, which can be adjusted to align to the type of transaction and the structures involved. For funds of funds, when the portfolio is composed of hedge funds, certificates are held within a bank account chosen by the lender who further benefits from a control agreement. Under Luxembourg law, the terms that are usually used in a control agreement may be incorporated in a pledge over bank account receivables so that they may take advantage of the robust protections offered by the Financial Collateral Act. In borrowing structures involving funds of private equity funds, we have seen cascading pledges being used in Luxembourg deals. However, the efficiency of a cascading collateral involving Luxembourg funds is not as obvious as it might be under common law rules[29]. Some additional structuring could be required and will have to be addressed on a case-by-case basis.

In hybrid financings (i.e. financings including an NAV and a subscription component), the security package consists of the standard security package for subscription facility agreements in addition to security over the investments portfolio. For multiple – mainly operational – reasons, hybrid financings remain quite uncommon.

**Important role for the custodian/depositary –** In NAV facilities, the security is taken over the portfolio of assets. This requires counsel to pay particular attention to the role of the Luxembourg custodian/depositary of the fund's assets. The AIFMD, adopted in the wake of the financial crisis and the Madoff scandal, has put increased liability on the depositary who holds a duty to monitor and reconcile the fund's cash flows and supervise its assets and has a prevention and detection role (the scope of obligations may vary depending on the type of fund used but, in general, the foregoing applies to all funds that are subject to the AIFMD). Any action that might affect the fund's assets would require the approval of the depositary. Hence, a smooth enforcement of the pledge requires that the depositary be informed beforehand of the existence of the pledge and acceptance by the depositary of its terms (might even be a party to the pledge agreement).

Contractual arrangements would normally be included to ensure a periodic valuation of and reporting on the pledged portfolio with the consent and contribution of the depositary. Moreover, the depositary arrangements commonly provide for a pledge over all or part of the fund's assets in favor of the depositary. Any security to be granted over such assets will need to take into account the existing pledge in favor of the depositary, either by releasing such pledge or by creating a higher-ranking pledge in favor of the lenders.

## III. THE MULTI-JURISDICTIONAL NATURE OF LUXEMBOURG FUND FINANCE

As Luxembourg continues to attract global fund managers to set up funds in the country, the number of fund finance deals is constantly growing. This multi-jurisdictional nature of Luxembourg fund finance makes it important for local counsel and international counsel alike to be wary of the multiple impacts of such feature.

**Local due diligence and the costs/timing quagmire –** The use of finance documentation drawn up under foreign law may certainly help save time and unnecessary negotiations at the local level. However, the local regulatory considerations, and the robustness of the security created under Luxembourg law are of primary importance in a secured lending context. Pressure on fees – and, in the case of subscription facilities, the general perception that such facilities bear a low risk – may drive advisors and sponsors to push for limited involvement of Luxembourg counsel, often requesting the simple replication of the standard documentation they usually use on domestic deals. While Luxembourg counsel should be aware of this and do their best to accommodate these concerns, looking to optimize expenses associated with a Luxembourg fund acting as guarantor or as borrower under a facility agreement governed by English or New York law should not be at the expense of a properly enforceable documentation in Luxembourg (the fund's jurisdiction of incorporation) or in the respective jurisdictions in which the secured assets and/or investors are located. It is strongly advisable that all local law concerns be diligently and comprehensively addressed at an early stage of the transaction, taking into account Luxembourg legal concepts and local market practice. This is notably the case for all regulatory/AIFM-related matters, but also holds true for requirements relating to the perfection and effectiveness of the security package.

Meanwhile, professionals in Luxembourg advising on a cross-border financing need to bear in mind the general context of a fund finance deal. The benefits from the use of third-party financing may largely outweigh the costs (for both the investors and the fund), and should remain an opportunity for the fund[30]. This should result in Luxembourg professionals understanding the deal dynamic and adopting a pragmatic and flexible stance to accommodate what has been negotiated and agreed upon

29 Difficulties might mainly arise from the ancillary nature of the Luxembourg pledge (*caractère accessoire du gage*). On this concept, see P. Geortay, "*Le caractère accessoire du gage et la loi sur les garanties financières*", Droit bancaire et financier Luxembourg, Vol. III, p. 1271.

30 Subscription finance deals are particularly time sensitive and may need to be closed within very short timeframes.

between the sponsors and the bank while continuing to apply a high diligence on the local legal requirements[31].

The fact that a variety of legal systems may come into play when investors in a Luxembourg borrower fund are located in multiple jurisdictions should be viewed as an additional incentive to diligently address private international law considerations and local perfection requirements.

**Private international law considerations –** Due to the multi-jurisdictional nature of finance transactions involving Luxembourg funds, it is essential to properly consider questions of private international law. This is the case for the choice of law and choice of jurisdiction in the finance documentation, but more specifically, as it relates to the recognition of the right *in rem* over the collateral and its enforceability against the pledgor, the investor and any other third party (competing creditors) in a context where all such parties are located in different jurisdictions. Moreover, the impact of an insolvency of the fund or of any other guarantor or security provider should be considered in an international context.

For security interests, being part of the family of rights *in rem*, Luxembourg private international law rules refer to the *lex situs* of the assets for all non-contractual aspects (mainly the creation and perfection of the security right). As a result, for security granted over an investor's commitment in the framework of a fund finance transaction, enforceability against third parties (other than the debtor) is governed by the law of residence of the debtor (the investor)[32]. It is important to note that this is a position that is not harmonized across the EU countries which might leave room for certain discrepancies at the moment of enforcement. Due to the absence of consensus on this matter among Member States, the amendment of article 14 of the Rome I Regulation[33] has not addressed this matter[34]. A draft EU Commission proposal for a regulation on the law applicable to the third-party effects of assignments of claims, published on 12 March 2018, is set to deal with this question. The draft proposal aims to reduce the uncertainty as to the law applicable to perfection requirements and the enforceability of security interests over claims against third parties. The proposal provides that, as a rule, the law of the country where the assignor has its habitual residence will govern the third party effects of the assignment of claims. As a result – should the current draft be adopted – across EU/EEA countries, Luxembourg law, as the law of the pledgor of the claim (the Luxembourg fund) will be recognized as the governing law of the third-party effects of a Luxembourg pledge over receivables (i.e. claims that the fund has against its investors, which are pledged in favor of the lenders) allowing for more certainty and a better harmonization, at least across the EU/EEA.

In certain deals, the lenders seek to have a dual layer of security interests granted: one layer under the Financial Collateral Act (as the law of the fund and its organizational documents) and, another under foreign law, for example by means of, an "all assets" security interest under New York law. This may be a way to minimize the risk resulting from non-recognition of the choice of law in a complex multi-jurisdictional context.

**Future prospects –** As the volume of fund finance is constantly growing[35], the fund finance market is attracting new entrants at a global level. On the lender side, more banks and non-bank lenders are entering the market, resulting in more competition and more pressure on pricing of the facility. Players are seeking standardization to reduce expenses. The increased knowledge of the product on the Luxembourg market and an established practice amongst professionals should help the constant growth of cross-border lending into Luxembourg funds and the creation of a domestic lending market.

Luxembourg bank lending to local funds is starting to develop in Luxembourg. With smaller amounts and simplified conditions, domestic lending transactions could be a major development to be followed in the coming months.

**Brexit –** With all the uncertainty surrounding Brexit, it has become increasingly common to see contingency plans and specific legislations adopted across Europe. The multiple delays in Brexit effective date negotiated between the United Kingdom and the European Union have given more time to the industry to organize the transition. On the contractual aspects, while the impact of Brexit is likely to be limited on the choice of English law to govern certain facility agreements given the universal remit of the Rome I Regulation, it is unclear at this stage

31 One of the clauses that is often used in facility agreements with Luxembourg guarantors is the guarantee limitation, a standard market clause that has been used by professionals in the last two decades. Using the standard clause might prove difficult in certain cases, particularly in the case of unregulated funds that have no legal personality (*Sociétés en commandites speciales*, or SCSp (Luxembourg special limited partnerships)) or are not under an obligation to publish annual accounts. Such matters require a tailored approach in the context of fund finance.

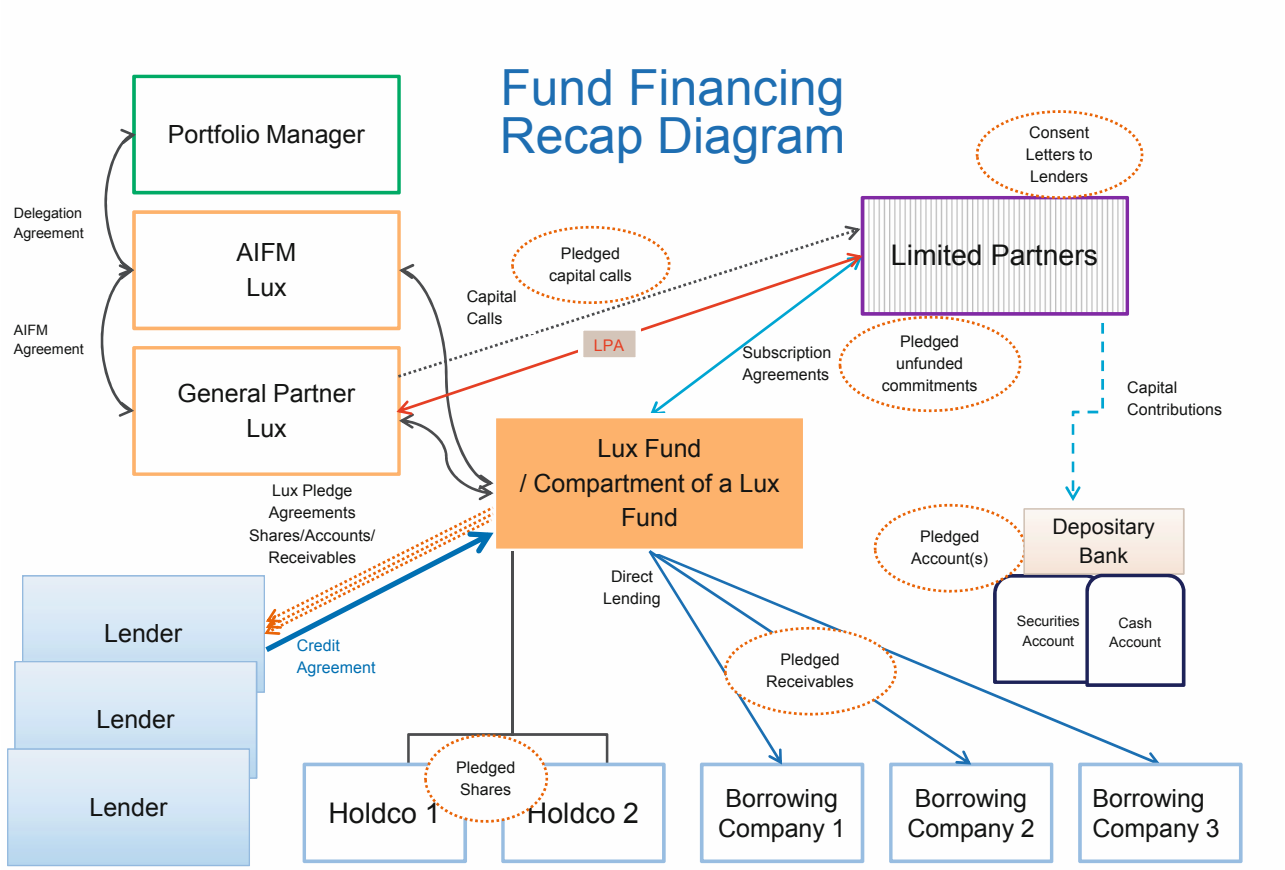
32 This position has historically been advocated by Luxembourg scholars and is consistent with Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast).

33 Regulation (EC) N° 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations.

34 T. Hartley, "Choice of law regarding the voluntary assignment of contractual obligations under the Rome I Regulation", The International and Comparative Law Quarterly, Vol. 60, No. 1 (2011), pp. 29-56.

35 This is believed to be the case, while the number of fund raisings is believed to have decreased over the last year.

– and given the persisting uncertainty on the timing, terms and even the fate of Brexit as we write this article – what would be the impact of Brexit on the choice of English courts in fund finance as well as throughout the general spectrum of lending activity[36]. In addition to the choice of law and jurisdiction, certain other contractual aspects may also be affected[37]. The disruption resulting from Brexit is likely to be more important on the structuring of the fund and its management company, in particular for alternative investment fund managers (AIFMs) established in the UK, which may lose the benefit of managing alternative investment funds in the EU after Brexit, and, given the absence, at least for now, of a passporting regime for non-EU AIFMs. Luxembourg was nimble in addressing this uncertainty on a unilateral basis and providing for a legal framework that ensures continuity in a no-deal scenario[38]. Something to follow closely as well.




36 For one of the most comprehensive articles on this topic, see A. Dickinson, "Back to the future: the UK's EU exit and the conflict of laws", Journal of Private International Law, 2016, 12:2, 195-210.

37 Material adverse change clauses are yet another type of clause that might give rise to questions in connection with Brexit. Counsel will have to provide answers as to whether Brexit is a MAC event, and to identify and manage a potential Brexit impact on all contractual references to EU directives and regulations, checking them one by one to assess the impact and check whether there has been a negotiated alternative (e.g. if a withdrawal agreement is reached and it contains answers) or a national alternative has been adopted.

38 A Luxembourg fund with a UK-based AIFM is far from being an unusual structure. Some players have already started setting up Luxembourg AIFMs with the aim of minimizing any disruption that may result from a loss of passport rights due to Brexit. In this context, it is interesting to note that Luxembourg has voted two draft laws aiming to limit the negative impact of a no-deal scenario on certain UK-based financial institutions. The draft law provides for a grandfathering period that, subject to certain conditions, would enable UK UCITS management companies and AIFMs managing Luxembourg funds (among others) to continue operating under the current EU rules (in particular the UCITS and AIFMD frameworks) for a limited period following the Brexit effective date (as of this date, these draft laws, after a first unanimous vote at the Luxembourg parliament have been granted exemption from a second vote, but would still need to be published – Draft law no. 7401 voted on 26 March 2019, and Draft law no. 7426 voted on March 2019).