

SCHEDULE 2

LUXEMBOURG

COUNTRY ANALYSIS

Draft - September 2000

1. General

1.1 Pledge – General Characteristics

- Articles 2071 to 2083 of the Luxembourg Civil Code provide for general rules related to pledges of moveable assets. The Articles 110 to 119 of the Luxembourg commercial code provide for specific validity and enforcement rules governing commercial pledges. The Grand-Ducal Regulation of February 17, 1971 on the circulation of securities, as amended, sets out specific rules for the pledge of fungible securities.

A pledge over securities in the widest sense of the term or over cash is deemed to be a commercial pledge according to Article 112 of the Commercial Code.

- The creation of a security interest in relation to future collateral is possible, in order to secure present and future debts of the pledgor-debtor. The constraint that such pledge may only be granted in favour of a professional of the financial sector established or operating in Luxembourg was removed by the Law of 12th March, 1998 on the financial sector and amending Article 113 of the Commercial Code.
- Regarding the creation of a pledge over a fluctuating pool of assets, Article 113 of the Commercial Code enables the pledgor, in order to secure his present and future debts, to include in the pledge agreement, securities which will belong to the pledgor-debtor in the future. The parliamentary debate records that “this provision enables to account for variations in the consistency of the pledged assets. These are often made of deposits in one or several types of currency and/or a combination of several assets. Due to currency and stock exchange fluctuations, decisions must be taken in relation to the pledged assets which may affect their consistency, whereas all such assets must remain pledged”. So Article 113 enables the creation of a pledge over a fluctuating pool of assets whereas the effectiveness of the pledge remains subject to the transfer of possession of such assets to the pledgee or a third party.
- Luxembourg law does not envisage the substitution of collateral requiring the continuous possession of collateral by the pledgee or third party in order for the pledge to be maintained. There seems to be no case law on this issue.

When determining whether substitution during the suspect period constitutes new pledge which may be voided, the Luxembourg courts would probably turn to Belgian case law as they often do in commercial matters.

- The pledgee is not allowed to dispose of the pledged assets, unless the pledgor has expressly allowed the pledgee to do so. According to Luxembourg legal writers, it should however be possible for the pledgee to pledge the collateral given that in order to create a pledge it is not a requirement that the pledgor be the owner of the collateral. However the lawful owner may claim the return of the collateral provided he proves his ownership therein and the bad faith of the pledgee.
- As a general rule, the secured party cannot use, sell or dispose of the pledged assets (as above stated), however rehypothecation or re-pledging is allowed provided the pledgor has given its prior authorisation. The secured party must

advise the second pledgee and any third party holding the assets that the secured party is not the owner of the assets. The validity of the new pledge is not affected by the absence of a right of ownership if this is not notified to the new pledgee. If the second pledge is granted without the secured party having informed the second pledgee of the existence of the original pledge, the second pledgee would be declared as acting in bona fide; so the second pledge may be enforced even if the original pledgor has not defaulted. The original pledge will not be affected by any rehypothecation, but the rights of the primary pledgor may be affected by the rights granted by the primary pledgee.

There is an argument that if the primary collateral provider gives consent to the use of the collateral for other purposes, the collateral taker should be able to use the collateral for selling or lending purposes (although there is no legal doctrine or case law expressly supporting this).

- The addition of new securities (top-up) to the pledged assets would be regarded as a new pledge, unless all future collateral of the pledgor has been included in the scope of the pledge.
- There is no compulsory stamp duty applicable to pledges of securities or cash. The pledge may be registered with the tax authorities to give it certainty as to its date. Luxembourg courts may require that it be registered before an enforcement claim, in which case a flat duty would be payable, but this is rare in practice.
- Regarding the type of investment securities which can be pledged:
 - registered shares: an inscription of transfer by way of security must be made in the company's shareholders' register.
 - bearer shares: the certificate evidencing the share must be physically delivered by way of security to the pledgee or to a specified third party holder.
 - shares in fungible form must be transferred by way of book-entry ("inscription en compte") to an account opened in the name of a person to be agreed upon with a Luxembourg depositary acting as creditor, pledgee or third party holder. The securities must be registered as pledged in the depositary's books. If the pledgor is not the legal owner of the securities to be pledged, he must inform the depositary.

1.2 Transfer of Title – General Characteristics

- There is no legal provision with regard to the establishment of the transfer of title nor is there case law of general application relating to this arrangement for collateral purposes.
- The Grand Ducal Decree of 19th July, 1963, on fiduciary agreements entered into by credit institutions provides a statutory basis for transferring title to collateral on a fiduciary basis to a credit institution on condition that the parties enter into an agreement expressly governed by the decree. The fiduciary credit institution will become the owner of the transferred collateral while being under the obligation to

exercise ownership of the collateral only in a manner consistent with the fiduciary obligations expressed in the agreement.

So transfers of collateral which are not governed by a fiduciary agreement are not protected under Luxembourg law and are subject to the same authority as existed in Belgium before the 1998 law reform.

A Luxembourg court might apply the 1996 Belgian case law which held that it is illegal to create a security interest by way of transfer of title (Cour de Cassation, Foyer culturel du Sart-Tilman v. C.G.E.R., 17th October, 1996).

The reasoning of the Belgian Cour de Cassation was based on the principle of equal treatment of creditors, so all the assets of an insolvent debtor must be shared pro-rata between all creditors, subject only to preferences which are recognised by law.

That principle is a rule of public policy under Luxembourg law. In the absence of Luxembourg legal provision making an exception to this principle, it is possible that a Luxembourg court would apply the above reasoning.

The risk is perhaps lower as regards repurchase or reverse repurchase agreements because such agreements are in fact not loans secured by a transfer of title to securities. Furthermore those transactions are protected from recharacterisation by the law of 21st December, 1995 relating to credit institutions "pension operations" to the extent that they effect a transfer from a transferor to a transferee against a payment of an asset which belongs to the transferee and provide for a sale back obligation or option at a price agreed upon in advance.

2. Private International Law and Domestic Law Aspects of Collateral

Validity of the Contract/Attachment

Luxembourg private international law:

- Luxembourg recognises the parties' right to choose the applicable law of any agreement creating a security interest, provided that the agreement has an international dimension and provided it is not the intention of the parties to avoid the application of mandatory provisions of Luxembourg law.

Luxembourg domestic law:

- A valid pledge requires: an agreement between the pledgor and the pledgee which must be in written form for civil pledges; commercial pledges may be entered into orally but a written agreement is preferable for reasons of evidence and a transfer of possession of the pledged assets to the pledgee or a specified third party. The manner in which this transfer is effected will depend upon the fungible or unfungible nature of the pledged assets.

Perfection:

Luxembourg private international law:

- Conflicts of law rules would apply the law of the location of the collateral for the perfection of a security interest.

Luxembourg domestic law:

- The only formality required is the transfer by book-entry of the pledged fungible securities to a separate account. It must be expressly marked in the books of the depository that the securities in that account are pledged, and the amount of securities that are pledged.

Enforcement:

Luxembourg domestic law:

- If the pledged securities are listed on the Luxembourg or a foreign Stock Exchange or traded in a public and recognised market, a formal written notice to pay must first be served on the debtor. This formal notice must be served prior to enforcement but is not subject to any other form or time requirement. The pledgee can choose to either sell the pledged securities on the Stock Exchange or the public market on which they are traded or to appropriate them.
- In all other cases the shares must be sold by a public officer in a public auction.
- Unless the parties provide to the contrary, a pledge of fungible securities granted by a credit institution, another professional of the financial sector, an undertaking for collective investment, a commercial or industrial entity having professional access to the financial market or an international public entity operating in the financial sector may be enforced without formal notice as soon as to the debtor fails to pay its debt.

Insolvency:

Luxembourg domestic law:

- Pursuant to article 119 (2) of the Luxembourg Commercial Code, a valid commercial pledge over security or cash is not impaired by bankruptcy, liquidation, respite or death of the pledgee.

3. Miscellaneous

3.1 Cross-border transactions in multi-tiered holding systems

The lex loci of fungible securities held through an account in a clearing system is the place where the account is held. If security assets are held by a third party bank or custodian the pledge must be notified or acknowledged by the third party and registered on the account.

In the area of securities settlement there is a particular interest in Cedel, which is one of the two major international securities (the other is Euroclear) settlement systems. Cedel accounts for an increasing proportion of cross-border trades of domestic as well as international securities. The potential for financial or operational problems at one of these intermediaries to cause systemic problems is evident.

Cedel maintains a network of approved depositories for custody and safekeeping of securities. Depositories may hold securities on their premises or sub-deposit these securities with sub-custodians or with local clearance systems if authorised by Cedel. Cedel enters into custody agreements with all depositories where the securities are immobilised within the depository network and the need to move physical securities is thereby minimised. Customers are given the option by Cedel of holding their securities in a fungible or non fungible form, although in practice most securities are held on a fungible basis.

Under Luxembourg law securities in Cedel would not become part of the estate of Cedel in the event of the latter's insolvency, each participant enjoying direct co-ownership rights not over specific securities, but over all securities of the same type held in Cedel on behalf of all participants (Grand Ducal Decree of February 17, 1971 as amended). So each participant is entitled to a notional portion of the pool of securities of the same type held within the depository system.

3.2. Implementation of the Settlement Finality Directive

The Central Bank of Luxembourg and the Chamber of Commerce were working together on the implementation process. A draft bill on the implementation of the Directive was not published. The government has yet to approve the draft text, which has been prepared and submitted to the government. Upon approval of the language by the government, the draft bill will be presented to Parliament.

The change of government in June 1999 was expected to delay the process. By this time the language may have been approved, although it is as yet unclear what position will be taken on the question of scope.