Insolvency of a compartment of a Luxembourg umbrella investment vehicle

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Compartments of undertakings for collective investment have their assets and liabilities segregated from those of other compartments within the same umbrella structure. Since they lack legal personality, they are not eligible for bankruptcy but are subject to court-ordered dissolution and liquidation. When defining the liquidation method, the court can allow the applicability of the rules on 'liquidation of bankruptcy'. This article focuses on a recent decision handed down by the Luxembourg Court of Appeal on 14 March 2018, according to which such term excludes any other provisions governing bankruptcy (such as clawback clauses and specific sanctions against member of the management body of the investment vehicle).

Introduction

Over the last two decades, the Luxembourg fund industry has experienced a widespread use of umbrella structures used for investment purposes, that is, structures composed of multiple compartments (also named sub-funds if the compartments relate to an investment fund).

A compartment consists of a pool of assets in an umbrella structure, which is subject to a common investment policy and is only linked to the specific investors who have invested therein. This legal construction is commonly found in certain types of Luxembourg regulated investment vehicles and several unregulated entities when expressly permitted by specific laws (such as reserved alternative investment funds (RAIFs) and unregulated securitisation vehicles).

Although a compartment has no legal personality, its assets and liabilities are segregated from those of other compartments within the same investment vehicle. Therefore, the investment held by a given compartment in an investment vehicle is ring-fenced from creditors of other compartments.

In the scenario where a compartment becomes 'insolvent' so that the relevant criteria laid down under Luxembourg law to open insolvency proceedings against it would be met, the question arises as to whether those insolvency proceedings could be available to such compartment. Indeed, the relevant Luxembourg legal provisions governing insolvency proceedings refer only to the opening of insolvency proceedings against a company having legal personality and they do not contemplate the 'insolvency' of the compartment of an umbrella structure whilst the other compartments of the structure are solvent.

The following developments will describe the concept of 'compartment' and the principle of segregation. After briefly defining the insolvency proceedings and judicial liquidation procedure that may be applicable to Luxembourg investment vehicles and their compartments, this article analyses a recent decision of the Luxembourg Court of Appeal which rules out the applicability of certain fundamental rules concerning bankruptcy proceedings to the judicial liquidation of Luxembourg investment vehicles and their compartments.

Concept of 'compartment'

The existence of compartments was recognised for the first time in 1988 in respect of undertakings for collective investments in transferable securities (UCITS) and other regulated undertakings for collective investment (UCIs). The then existing legal provisions specified that provisions could be inserted in the constitutive documents of UCITS and UCIs, pursuant to which investors must treat the compartments within the

same vehicle as separate entities. No similar legal rule had been set out in relation to creditors, so that their claims against one compartment could be repaid with assets belonging to another compartment within the same entity.[1]

Twelve years later, the Luxembourg legislator decided to expressly provide for the principle of segregation of assets and liabilities between compartments of UCITS and other regulated UCIs and to give it a legal binding effect on third parties.[2]

The segregation between compartments was later replicated in specific laws concerning other types of regulated and unregulated investment vehicles.[3]

Applicable procedures in case of insolvency of a compartment

Bankruptcy and court-ordered liquidation

As a matter of principle, bankruptcy, which is in practice the most common type of insolvency proceeding in Luxembourg, can be declared against Luxembourg regulated investment vehicles as well as some unregulated entities which are subject to specific laws.

To that end, the competent district court, sitting in commercial matters, must conclude that the three cumulative conditions provided for under the Luxembourg Commercial Code are fulfilled, namely: (1) that the entity is a commercial company with legal personality; (2) that it has ceased to make payments (*cessation de paiement*); and (3) that its creditworthiness is impaired (ébranlement du *crédit*).[4]

Since the first condition requires that the entity has legal personality, investment vehicles set up in the form of mutual funds (*fonds communs de placement*),[5] which are not legal persons but merely pools of assets, are ineligible for insolvency for this reason.[6]

In the authors' view, the insolvent compartment of an umbrella structure, which also has no legal personality, cannot be subject to bankruptcy for the reason stated in the preceding paragraphs. Therefore, if the compartment of the regulated vehicles (ie, UCITS, Part II UCIs, SIFs, SICARs and regulated securitisation undertakings) is insolvent, it could not be declared bankrupt by the Luxembourg courts. The same analysis is applicable in respect of compartments of unregulated vehicles (ie, unregulated securitisation undertakings and RAIFs.

In such an instance, the only procedure available for an orderly liquidation of the compartment would be judicial liquidation, which shall be ordered by the Luxembourg courts.

Judicial liquidation (dissolution and liquidation) is decided by the district court, sitting in commercial matters and can affect certain regulated entities (UCITS, Part II UCIs, SIFs, SICARs and regulated securitisation undertakings) whose regulatory authorisation has definitively been withdrawn or refused, and RAIFs which have pursued activities contrary to Luxembourg criminal law or seriously breach the law of 23 July 2016 on RAIFs, as amended, or the law of 12 July 2013 on alternative investment fund managers, as amended, or the laws governing commercial companies.

Such liquidation proceedings can be requested by the State Prosecutor, acting on its own initiative, or the Luxembourg financial supervisor (the Commission de Surveillance du Secteur Financier (CSSF)) in respect of regulated vehicles.[7]

Some legal provisions also expressly allow Luxembourg district courts, sitting in commercial matters, to order the dissolution and liquidation of any compartment of UCITS, Part II UCIs and SIFs, whose regulatory authorisation has finally been refused or withdrawn by the CSSF, such proceedings being initiated by the State Prosecutor or the CSSF.[8] In this respect, it is worth noting that the laws governing SICARs, RAIFs and securitisation vehicles do not contain any similar provisions allowing liquidation of a compartment by a court.

Therefore, should any of the aforementioned vehicles and compartments eligible for court-ordered liquidation face insolvency, the CSSF could decide to withdraw the regulatory authorisation and motivate such decision by the fact that these entities or compartments are no longer able to comply with the legal and regulatory requirements applicable to them and that the interests of the investors require such administrative sanction.[9]

Differences between the bankruptcy and court-ordered liquidation regimes

The legal rules applicable to court-ordered liquidation of regulated investment vehicles and RAIFs provide that the competent court must determine the method of liquidation and when doing so, can decide to apply the rules governing 'liquidation in bankruptcy'. The choice of such words by the legislator has led to uncertainties as to their exact meaning and the parliamentary documents concerning them do not provide for any satisfactory explanation in that respect.[10]

Some authors have noted that the legal rules governing the court-ordered winding-up of credit institutions and professionals of the financial sector allow the competent court to apply any or all of the 'rules governing bankruptcy'[11] and were inclined to think that the court-ordered liquidation regime for regulated investment vehicles should be construed as allowing the judge to allow the application of all

the rules governing bankruptcy, since any other interpretation could lead to inconsistencies between liquidation/winding-up regimes.[12]

In a recent court decision concerning a high-profile court-ordered liquidation of a Luxembourg UCITS in the wake of the Madoff fraud,[13] the Luxembourg Court of Appeal on 14 March 2018 rejected an appeal made by the liquidators against a decision of the Luxembourg District Court of 16 June 2016.[14] In that decision, the lower court rejected the request of the liquidator to fix the date on which the UCITS was deemed to have ceased to make payments in accordance with article 442 of the Luxembourg Commercial Code, since that legal provision concerns bankruptcy but falls outside of the scope of the rules governing the 'liquidation in bankruptcy'. The request of the liquidator was made with a view to subsequently request that the redemption of units made by the UCITS, as from the date of cessation of payments, be declared null and void, pursuant to the relevant clawback provisions set out in the Luxembourg Commercial Code.[15]

The Court of Appeal refused to rule in favour of the request made by the liquidators. It held that the intent of the legislator was to insert flexible provisions regarding liquidation of UCITS in order to define a liquidation method which would be the most suitable to the specificities of the entity to be liquidated. However, the court concluded that the term 'liquidation in bankruptcy' should be interpreted strictly (ie, literally), so that only the rules governing the liquidation aspects of bankruptcy[16] should be applied by the court-appointed liquidator(s). By doing so, it rejected the argument of the liquidators whereby they attempted to draw a parallel between the legal rules governing the liquidation of a UCITS and the liquidation of a credit institution (the latter expressly allowing the inclusion of 'rules governing bankruptcy' in the definition of the liquidation method).[17]

Since the wording used in the provisions concerning the liquidation of UCITS and of their compartments are identical in the 2010 Law, the dicta contained in the decision of the Luxembourg Court of Appeal of 14 March 2018 should apply *mutatis mutandis* and the rules governing bankruptcy other than those concerning the liquidation in bankruptcy should be excluded from the liquidation regime to be defined by the competent court.

Impact of the strict interpretation of the term 'liquidation in bankruptcy'

The literal interpretation taken by the Court of Appeal restricts the powers that a court-appointed liquidator of a compartment would have otherwise had when it acts as a trustee in bankruptcy during bankruptcy proceedings. This section aims at briefly describing the main actions that are not available to a court-appointed liquidator.

Clawback actions and actions for avoidance

According to article 442 of the Luxembourg Commercial Code, the court which declares a commercial company bankrupt must fix the date on which such company is deemed to have ceased to make payments (such date being not earlier than six months before the date of the bankruptcy judgment).

The lapse of time between these two dates is defined as the hardening period (*période suspecte*) and certain acts performed by the bankrupt company within this timeframe must – in respect of payments or other actions deemed suspicious by law such as a payment for a debt which not yet payable – or can – in respect of other payments or acts made to the benefit of a person with the knowledge by such person of the cessation of payment of the bankrupt company – be declared null and void.

Actions against the management of the bankrupt company

If a Luxembourg commercial company is declared bankrupt and upon request of the trustee in bankruptcy, the directors could be subject to, among others: (1) sanctions for having committed negligent bankruptcy and fraudulent bankruptcy, which are criminal offences; (2) the obligation to pay all or part of the company's debts if they have committed serious and characterised faults having contributed to bankruptcy; and (3) personal bankruptcy, in each case if the applicable conditions are met.

Conclusion

Turning to the scenario of an insolvent compartment, which cannot be declared bankrupt, its investors and creditors can be faced with two different situations:

- in respect of the compartment of SICARs, RAIFs and securitisation vehicles, the judicial liquidation regime is not available, and hence, the insolvency of a compartment should be merely governed by the general principles of civil law, which cannot be viewed as a satisfactory procedure to deal with insolvency, as opposed to an orderly liquidation procedure;[18] and
- in respect of the compartment of UCITS, Part II UCIs and SIFs, the judicial liquidation regime is available, although the opening of such proceedings is not based on a insolvency test but rather on the existence of certain breaches of law by the compartment, which could triggers the withdrawal of its authorisation by the CSSF, even if insolvency can in itself give rise to legal breaches justifying the withdrawal.

Finally, based on the aforementioned decision of the Luxembourg Court of Appeal, certain fundamental rules governing bankruptcy proceedings, such as the clawback regime, are not applicable to the judicial liquidation of: (1) UCITS, Part II UCIs, SIFs, SICARs, regulated securitisation vehicles and RAIFs; and (2) compartments of UCITS, Part II UCIs and SIFs.

In the authors' view, this situation is unsatisfactory as it reflects inconsistent responses that were given over the years and taken by the legislator to address issues presenting similar features. The authors would welcome legislative changes to create a more uniform set of rules. Such new laws would give the opportunity to hold debates on insolvency-related topics such as, the best way to address the insolvency of an investment vehicle or any of its compartments (bankruptcy versus judicial liquidation) or whether certain rules applicable to a bankruptcy, such as the clawback provisions, should be included, even to a certain limited extent, in the regime of judicial liquidation of investment vehicles.

Notes

1 Law of 30 March 1988 relating to undertakings for collective investment, art 111; parliamentary document No 3172/00, p 56.
2 Law of 17 July 2000 amending certain provisions of the law of 30 March 1988 relating to collective investment undertakings (the 'Law of 1988"'), art V). According to the parliamentary documents concerning this law, the segregation between compartments was already existing de facto at that time, since UCIs were often entering into individual agreements with the creditors to ensure that the assets of a given compartment could only meet debts relating to that specific compartment (parliamentary document No 4612/00, p 6).
3 For example, art 71(5) of the law of 13 February 2007 relating to specialised investment funds, as amended (the 'SIF Law'); art 3(5) of the law of 15 June 2004 on investment companies in risk capital, as amended.
4 Article 437 of the Luxembourg Commercial Code.
5 This legal form is available to UCITS, UCIs governed by part II of the law of 17 December 2010 relating to undertakings for collective investment, as amended ('Part II UCIs'), specialised investment funds ('SIFs'), investment companies in risk capital ('SICARs') and RAIFs.
6 As a matter of principle, the same comment could be made in respect of special limited partnerships (*sociétés en commandite spéciale*) which is a type of commercial company with no legal personality. However, some authors have questioned this traditional analysis and believe that bankruptcy should not necessarily be ruled out for this type of company, since it has assets and liabilities which are separated from those of its partners and are available to its creditors (see Katia Panichi, Laurent Schummer and Olivier-Gaston Braud, '*Les sociétés en commandite luxembourgeoises : des véhicules d'investissement adaptés aux besoins des investisseurs*', in *Droit bancaire et financier au Luxembourg*, Larcier, Brussels, 2014, vol 3, Nos 74, 75, pp 1599 to 1600).
7 In practice, the CSSF will decide to withdraw the authorisation of the regulated vehicle and will inform the State Prosecutor accordingly. The State Prosecutor will then request the court to declare the judicial liquidation of the investment vehicle.
8 2010 Law, art 143(1), para 2; SIF Law, art 47(1), para 1. It is worth noting that the laws governing SICARs, RAIFs and regulated securitisation vehicles do not contain any similar provisions allowing liquidation of a compartment by a court.
9 For example, breaches of the statutory principles whereby units of UCITS can be issued at any time or redeemed at the request of a unit holder could be relevant to justify the withdrawal of the authorisation. The CSSF relied on those principles to withdraw the authorisation of the UCITS involved in the court case in the section below.
10 However, the legal provisions on court-ordered liquidation of regulated investment vehicles and RAIF derive from art 203 (currently renumbers as art 1200-1) of the law of 10 August 1915 on commercial companies, as amended (the '1915 Law') which apply to all commercial companies falling within the ambit of that law. The latter provision allows courts, acting at the request of the State Prosecutor, to open judicial liquidation proceedings against companies which were pursuing activities contrary to criminal law or were committing serious breaches to commercial law rules or rules governing commercial companies. Judicial liquidation is of a punitive and deterrent nature and is independent from insolvency proceedings which apply to entities facing financial difficulties (parliamentary document No 2366/00, pp 61 and 102, which relates to the law of 1988).
11 The corresponding provision, which is currently in force is art 129(7) of the law of 18 December 2015 on the failure of credit institutions and certain investment firms, as amended.
12 Laurent Fisch, Franz Fayot and M Esteves, '*La législation sur les insolvabilités dans le secteur financier à l'épreuve des crises*', in *Droit bancaire et financier au Luxembourg* (see n 6 above), vol 1, pp 659 to 660.
13 Luxembourg Court of Appeal, 14 March 2018, roll Nos 44556 and 44493.
14 Luxembourg District Court (6th Chamber), 6 June 2016, No 602/2016.
15 The liquidators requested that the date of cessation of payments be fixed at 3 August 2008, or in the alternative, 2 October 2008 or 12 December 2008, the net asset value (NAV) of the UCITS, and hence the redemptions of units, having been suspended on 15 December 2008.
16 Namely arts 455 to 495-1 of the Luxembourg Commercial Code.
17 The Luxembourg Court of Appeal referred to the parliamentary history of the legal provisions on liquidation of credit institutions. According to parliamentary document No 2548, pp 21, 41, although the wording of the applicable provisions is partly inspired by art 203 of the 1915 Law, the rationale between these rules is different, since the liquidation of credit institution purports to prevent bankruptcy, while judicial liquidation sanctions certain irregularities committed by the entity to be liquidated.
18 The risk of insolvency of the compartment of a securisation vehicle should be viewed as theoretical as it is generally structured as bankruptcy remote pursuant to limited recourse, non-seizure of assets and non-petition for bankruptcy contractual arrangements, which are expressly recognised by law.

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