

High growth companies and how to fund them – a real driver of economic growth?

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The working session in Prague is entitled “*High-growth companies and how to fund them – a real driver of economic growth?*” In the working session we plan to address funding alternatives for high-growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high-growth companies. This questionnaire mainly concentrates on these two topics in relation to high-growth companies, but will also cover commercial and regulatory opportunities and constraints.

1. CORPORATE FINANCE – FUNDING ALTERNATIVES

1.1 Which financial instruments are typically used when investing in high growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

Luxembourg offers a large choice of vehicles and financing instruments to suit each entrepreneur and each investor's profile and their common interests.

In particular, high growth companies can be financed by means of equity, debt or hybrid instruments such as convertible preferred equity certificates (CPECs) or preferred equity certificates (PECs). Depending on the legal form of the vehicle, different classes of shares with specific rights to be defined in the articles of association of the company may be issued (*e.g.* ordinary shares, preference shares without voting rights/with a preferred dividend or beneficiary shares), to the extent that no shareholder is allotted the whole of the profit gained, or is released for the whole of the losses and no shareholder is excluded in whole from the profit or is liable for the whole of the losses.

It is also standard practice to finance investments in high growth companies through tracking instruments (shares, hybrid instruments or debt) allowing to link a category of instruments to the performance of a specific asset.

Besides these most commonly used instruments, investors may also invest through simple bonds, convertible bonds, warrants or employee share plans.

1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above) (Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

The most widely used instruments by high growth companies are shares which can be issued with or without share premium. Capital contributions without issuance of shares (*e.g.* allocation to specific account), bonds and hybrid instruments (*e.g.* CPECs and PECs) are also commonly used.

These instruments are generally issued jointly and not separately.

a. Shares

Depending on the legal form of the company, specific rights may be allocated to the issued shares. Luxembourg private limited liability companies (*sociétés à responsabilité limitée*) cannot issue preferred shares without voting rights due to the *intuitu personae* nature of this type of company, whereas public limited liability companies are entitled to do so.

The issuance of different classes of shares may allow for a differentiation in terms of economic rights (*e.g.* preferred dividend, distribution waterfalls, tracking features) or control (absence of voting rights or increased control,

right to propose managers for appointment, mandatory redemptions and implementation of exit strategies).

Luxembourg recently extended its spectrum of structuring possibilities by providing the possibility to issue shares with multiple voting rights or deprived of such right, atypical distribution rights, or a forced redemption mechanism, by creating the special limited partnership (*société en commandite spéciale*).

b. CPECs/PECs

CPECs and PECs are hybrid financial instruments which are considered as debt for the issuing company but may be considered as equity for the subscriber of such instruments. They concede no voting right to their holder who will also be subordinated to all creditors.

c. Bonds

Bonds are a standard debt instrument, offering high level of flexibility: their holder may receive a variable interest and may become shareholder upon exercise of their right to convert such bonds into shares of the issuing company.

However, compared to CPECs, bond holders have a decision-making power for some particular subjects, provided for by Luxembourg law.

Luxembourg offers flexibility to financial instruments with the possibility to issue or to convert equity and debt securities into “dematerialised” form, through the registration in an issuance account, allowing swift and cost efficient circulation of securities.

1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?

Particular attention must be paid to the issuance of instruments to the public and the listing of shares. In particular, debt instruments cannot be issued to the public.

1.4 Is crowdfunding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.

Crowd-funding in Luxembourg is still in its infancy, even if Luxembourg does not yet provide for a specific legal framework tailored to the needs of crowd-funding, several initiatives are currently in progress and the first platforms are highly expected in the course of 2014.

Depending on the crowd-funding model (*i.e.* donation, lending or securities-based investments), the existing legal framework might be applicable but is lacking the flexibility which is essential for this new type of financing, as it was designed for other kinds of financing activities.

The Supervision Commission of the Financial Sector (*Commission de Surveillance du Secteur Financier*) is highly expected to introduce a set of guidelines in this regard.

Given the fact that Luxembourg has become an important e-commerce and ICT hub over the last decade, it wouldn't come as a surprise if the country would draw-up specific legislation, in order to promote the creation of crowd-funding platforms in Luxembourg and thereby further consolidate its position as a financial center and a technology hub.

2. INVESTORS VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

2.1 Who are typical investors into a high growth company in your jurisdiction? Sources of funding (i.e founders-family-friends, angel investments, venture capital investments, private equity)

Investment in Luxembourg high growth companies depend on the stage of development of the companies. Business angels have taken an important place in the financing of research, development of concepts and ideas before the start-up phase of development.

Luxembourg fosters several initiatives, such as cross border forums which aim to help innovative entrepreneurs to find the capital needed for their companies and to offer private investors a set of promising investment opportunities by connecting entrepreneurs and business angels.

Usually entrepreneurs do not approach private equity and venture capital investors without a consistent business plan.

2.2 Is there a typical size of the investment into a high growth company in your jurisdiction?

The size of investments in Luxembourg high growth companies depends on the investors' profile and on the stage of business development of the company.

Recently established companies often have difficulties to borrow from traditional banks and seek for financial support from investors, which at this early stage can take a substantial stake in the company for a limited investment, whereas investors who come later to complete a process of investment ought to invest more.

2.3 Describe the process of documenting the investment (Which documents are typical? Which terms need to be included in the articles to be enforceable? etc.)

The investment process comprises several steps from initial enquiry to completion which are all subject to legal documents required to protect both the investors and the entrepreneurs.

Before investing in high growth companies, investors often need time to proceed to the due diligence of the company. In order to reduce competition from other investors during this period, it is common that investors and entrepreneurs enter into exclusivity agreements in order to prohibit the entrepreneurs from entering into parallel negotiations with other potential investors. Such agreements are always limited to a fixed time period.

In the meantime entrepreneurs generally want to ensure that all the information disclosed to the investors in course of the negotiation process will remain confidential and therefore require the investors to enter in non-disclosure agreements for such purpose.

Once the terms of the investment have been defined and determined by the parties, the typical legal documents are the articles of association (they are commonly amended at the investment time), the shareholders agreement, and the subscription agreements (regarding equity, bonds etc.).

Investors typically require maximum control over the company and restrictions on the transfer of shares (such as lock-up periods, pre-emption rights, drag-along or tag-along rights). The choice to include certain clauses into the shareholders agreements and/or the articles of association is always made in consideration of criteria such as confidentiality and enforceability toward third parties. Statutory clauses offer the advantage to be enforceable towards third parties including future shareholders.

2.4 Are there incentive schemes for investing into high growth companies (governmental grants (including co-investment funds, state as a guarantor of loans, etc.)?)

Luxembourg offers various financial aids for investments in high growth companies, such as the co-financing from the National Credit and Investment Corporation (*Société nationale de crédit et d'investissement*), in order to complement equity and bank financing and offer an appropriate balance between the various available sources of finance.

The Luxembourg government also supports investments in high growth companies through the granting of insurances and guarantees covering certain risks.

In addition, Investors also benefit from a favourable tax regime for investments in small and medium sized enterprises.

2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?

Investments in high growth companies are usually made by a combination of equity, debt and hybrid instruments. Despite the considerable number of instruments, shares often remain the most preferred instrument for investors

allowing them (i) to have rights to attend and vote at shareholders meetings, (ii) to receive information regarding the company's situation and (iii) to participate in the company's profits.

Luxembourg does not impose any restrictions on foreign investments and it is worth mentioning that hybrid instruments which combine the elements of debt and equity may be of particular interest for foreign investors.

3. ENTREPRENEUR'S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

3.1 Which company form is most popular? (Special company forms for high growth companies? Tiers of management typical for a high growth company? Liability point of view?)

Luxembourg offers the combination of an interesting tax environment and a flexible legal framework offering a broad choice of vehicles in order to suit each type of investor. The choice between the different Luxembourg vehicles allows each investor to find an efficient structure for managing its investments.

Private limited liability companies (*sociétés à responsabilité limitée*), public limited liability companies (*sociétés anonymes*), and partnerships limited by shares (*sociétés en commandite par actions*) are the most commonly used forms of vehicles.

Public limited liability companies may be managed by a two tier system consisting of a supervisory board that is elected by the shareholders, which appoints the members of the management board. One tier system public limited liability companies are managed by a board of directors that is appointed by the general meeting of shareholders. The board of directors or the management board are empowered to undertake any action in the name of the company but the day to day management may be delegated to directors, officers, managers or other agents.

Luxembourg law allows for the creation of different categories of directors/managers with specific rights, and allows the granting of a casting vote to the chairman of the board.

By introducing the law of 12 July 2013, Luxembourg has created a new special partnership form in Luxembourg: the special limited partnership (*société en commandite speciale*) which offers a lot of structuring flexibility, as the parties are free to organise their political and economic rights in the partnership agreement.

3.2 What sectors are most preferred by high growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?

Apart from the traditional financial services sector, Luxembourg has diversified its activities in recent years and welcomed many actors in new technologies, e-commerce and communications sectors.

Government investments in quality infrastructure such as high-speed Internet broadband lines have positioned Luxembourg as a leading data center marketplace in Europe for many high growth companies.

Its high-quality infrastructure and a qualified workforce contribute to Luxembourg's solid reputation as a dynamic country for R&D and innovation activities, attracting high growth companies and creating new players in the health tech, clean tech, eco tech and bio tech sectors.

Aware of the fact that intangible assets such as intellectual property account for an ever growing portion of the balance sheets, Luxembourg further consolidated its efforts to position itself as a hub for research, development and innovation activities by creating a favourable intellectual property tax regime that has become applicable on 1st January 2008.

Due to its central location in Europe, Luxembourg has also become a key location for logistic services and suppliers to the automotive industry.

3.3 Are there incentive schemes for entrepreneurs incentivising high growth companies (e.g accelerators/incubators? Other?)

The law of 5 June 2009 relating to the promotion of research, development and innovation offers financial support to innovative companies, such as aid for research and development projects or programmes, aid for technical feasibility studies, aid for protection of technical and industrial property, aid for young innovative enterprises, innovation advisory services and innovation support services, temporary secondment of highly qualified personnel, process and organisational innovation in services.

Several initiatives support collaborations between the private and the public sectors in order to facilitate the identification of potential partners among Luxembourg actors involved in R&D and innovation activities.

Luxembourg innovative enterprises active in technological development also benefit from incubators programs supporting them by providing access to networks of partners, individualised coaching and a work infrastructure and an environment that correspond to their needs.

Different incubators offer a support programme for foreign companies that wish to establish themselves in Luxembourg.

3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?

From the entrepreneur's perspective the key element is to maintain control over the company, thus shares with voting rights remain the most preferred instruments. Founders are also incentivised by subscription to convertible bonds and warrants.

4. CORPORATE GOVERNANCE – CONTROL ISSUES

4.1 In a typical investment into a high growth company, whether a loan related investment or equity investment, how much control would a typical investor take? and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:

- a. Anti-dilution measures
- b. Rights of first refusal, pre-emption rights, drag and tag along
- c. Protective provisions
- d. Information rights
- e. Dead-lock resolution
- f. Board seats / observer rights
- g. Any other terms specific/important in your jurisdiction?

In view of their investment into a Luxembourg based company, investors are generally looking for maximum level of control. The articles of association and shareholders' agreement finalise the negotiation of the parties in respect to their respective rights and obligations and governance of the company.

- a. Anti-dilution measures

Investors are always very concerned about potential dilution in the course future steps of financing, to which they do not want to participate, in case additional contributions to the capital are made at a lower price than the price paid for initial investment. Depending on the level of protection, investors may either want to protect themselves with full ratchet mechanisms or weighted ratchet mechanisms.

- b. Rights of first refusal, pre-emption rights, drag and tag along

Such clauses are part of every package for investors in high growth companies, but are also of interest for the entrepreneurs themselves, since they ensure continuity of the investors' commitments. Exit clauses may also serve different objectives, such as the opening of the share capital at one hand or closing the share capital to new investors on the other hand.

- c. Dead-lock resolution

It is common practice to ensure that once best efforts have been made to resolve a deadlock situation, specific provision of the shareholders' agreement permit to resolve irreconcilable conflict between shareholders.

To this purpose Put and Call options are often used to offer to the holder of the option the right to require the other party to sell or buy its stake in the company, but other mechanisms such as the Russian Roulette clause or Texas Shout Out clause are also frequently used to permit deadlock resolution.

d. Information rights -board seats / observer rights

Investors usually require specific rights to propose candidates for the appointment of directors/managers in order to ensure themselves full access to information. In addition, it is common that investors require veto rights on specific matters such as major investments, changes in strategic direction, business acquisitions and/or disposals.

5. EXIT STRATEGIES AND TIME HORIZON

5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?

Exit strategies may vary depending on factors such as the company's line of business, development stage, financial situation, etc.

The most frequent exit route remains the sale of the company's shares to new investors which can be realised on very short notice, once the negotiation process has come to an end.

Merger may also be an option but remain cumbersome since it requires additional formalities and specific notice periods.

IPO's are less common, as they entail heavy administrative procedures, high floatation costs and must be planned well in advance. They cannot be undertaken by Luxembourg private limited companies.

5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 5 above be dealt with? Are initial investment and shareholders' agreements/shareholders' agreements upheld in the next round, or new agreement is entered into?

New investors have to comply with Luxembourg's stringent anti-money laundering regulations.

Luxembourg applies the principle of privity of contract, that means that shareholder agreements produce effect only between the contracting parties, they cannot create any rights or obligations towards third parties. In many shareholders agreements, share transfers are only possible once that the transferee has acceded

to the shareholders agreement and taken over the rights and obligations of the transferor.

6. REGULATORY ISSUES

6.1 Any tax implications (positive or negative) that a high growth company encounters in your jurisdiction?

Luxembourg offers an overall favourable and stable tax regime (including, the lowest VAT rate in Europe and an important double tax treaty network) and a high-level access to government officials and a pro-business environment, enabling quick decision-making.

In addition, Luxembourg has a favorable intellectual property tax regime offering an 80 % tax exemption on income generated by the IP rights (including damages and interests) and the gain on their disposal.

6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high growth companies? Any constraints deriving from obligation for local participation in a high growth company? Co-investment obligation? etc.

There are no other constraints than those listed above in the relevant section-.

7. OTHER

7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high-growth companies which have not been discussed in responses to earlier questions (if any).

Nil.