CPEC: debt or equity

A financial instrument considered in Luxembourg's courts

Fabio Trevisan and **Valérie Kopéra** of **Bonn Steichen & Partners** in Luxembourg discuss a highly publicised case in that jurisdiction, which finally gives clarity on the meaning of a commonly used cross-border financial instrument

Much has been written regarding one of Luxembourg's most high-profile trials of the last few months, as much for its international dimension, with several countries being involved in the case – namely Luxembourg, the United-Kingdom, Greece and the United-States – and the huge amount at stake in the litigation (liability under the claim is sought for up to EUR 975 million, plus interest), as for its impact on the Luxembourg financial market.

Indeed, the case gave the Luxembourg courts the opportunity for the first time to deal with a question of particular interest, in determining the nature of a commonly used hybrid financial instrument, the 'CPEC' (Convertible Preferred Equity Certificate), which could be regarded either as debt or as equity for tax purposes, depending on the jurisdiction.

The question under consideration was the following: should a CPEC be treated as debt or equity? It had previously avoided serious consideration; for years, it had been taken for granted by practitioners dealing with these types of instruments that they have to be treated as a debt instrument.

Such a position had not, until recently, had any firmly established legal basis. The judgment rendered in the present case filled ▸

this gap and confirmed the opinion held in common practice, giving it a solid reliable foundation.

Clarity at last

On 23 December, 2015, the District Court of Luxembourg gave judgment in a case between the liquidators of the Luxembourg company Hellas Telecommunications II SCA (a company belonging to a large Greek telecommunications group) and two investment funds, namely **TPG Capital** and **Apax Limited** (the ultimate beneficiaries of the structure), ruling that:

> "CPECs subject to Luxembourg law are debt securities... of a purely contractual nature, which are out of any statutory provisions, which do not grant their holders either voting rights in the general meetings of shareholders, nor the right to a share of the profits distributed by the company to its shareholders, but given that they might be converted into equity shares under certain circumstances, they are often referred to as "hybrid securities". From an accounting and Luxembourg tax perspective, they are also considered as debt and booked as such on the liabilities side of the balance sheet."

The Luxembourg judge deduced from rules prohibiting the distribution of fictitious dividends, under articles 72-1 and 167 of the Luxembourg Company Law, "is clearly linked to the distributions made to the shareholders in their capacity as subscribers to equity shares that represent the company's share capital. Therefore, it does not apply to the CPECs, which are mere debt securities".

The decision gives clear guidance to Luxembourg's financial industry that CPECs are debt instruments subject only to the contractual terms and conditions agreed between the parties, namely the issuer and the subscribers, and all legal provisions relating to shares, equity capital or the distribution of dividends are not applicable to CPECs.

Additionally, its ruling may actually reassure Luxembourg financial players by confirming a position which is well-established in practice in both Luxembourg and other countries familiar with this type of financial instrument; finally giving some comfort to an industry which is all too often unfairly condemned these days.

Clarity on legal position

The judgment also addresses many other procedural and legal issues. It is a sort of catalogue of legal principles and rules which deal with, among others, the effects of registrations with the commercial register, the criteria of a new application during the investigation phase of the case (*demande nouvelle*), limitations applicable to the discharge given to managers, the distinction between relative and absolute nullity, and that of public policy provisions and simple mandatory provisions.

It also considered the consequences of the failure to appoint a permanent representative under article 51bis of the Luxembourg Company Law, the concept of corporate interest, the distinction between subjective and objective due cause and the notion of fraud.

It not only contains a reminder of the general principles applicable to the various legal issues raised by the case, but also provides innovative solutions to some issues faced by practitioners that had never been brought before the Luxembourg judge until this case.

The corporate position

Concerning the rules in terms of discharge [from liability] given to managers, the judgment specified that "regardless of the severity or nature of the fault committed by the

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manager (whether a mismanagement or a violation of law) and even, in case of a violation of a public interest rule that is subject to criminal sanction, the general meeting of shareholders, provided that it is acting in full knowledge of the circumstances, can validly waive its right to invoke the liability of its corporate body by discharging it of liability".

Another interesting and often debated notion tackled is the concept of 'corporate interest'. Here, the court adopted a specific approach to the notion by extending to and confusing the corporate interest *stricto sensus*, meaning the interest of the company as a legal autonomous entity, with the interest of the shareholders of the company, while taking into account the peculiar activities of that company in question, namely that the company at stake was a holding company (activity limited to the holding of participations in Luxembourg and foreign entities).

Further, the court explained that the definition of 'corporate' has not been specifically defined by the legislator. It noted the flexibility of that notion that can be identified either with the interest of the shareholders, according to ▶

the narrow approach, or on a broader scale, the interest of the enterprise as a legal person as a whole, which includes the interests of the shareholders but also those of the employees and creditors.

Either approach can appear to be the most appropriate one, the court said, depending on the nature of a company involved and its work. .In the case of a purely financial company, such as a holding company, the narrow approach appears to be the only one worthy of consideration as the entire activity of the company was focused on maximising the profitability of its investments. On top of that, the court noted that they could only give judgment on matters before it.

Noting that the shareholders, as the ultimate arbiters of the corporate interest, had ratified the transaction by granting a discharge of liability to the general partner who was in charge of ensuring compliance within the interest of the company, the court held that "the claim for annulment based on a purported violation of the interest of the company must be declared unfounded".

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On these questions the court ruled that "the failure for a company to appoint a permanent representative does not invalidate the decisions that are validly taken by its corporate bodies", such as the managers who have been regularly appointed in accordance with Luxembourg corporate law.

Further, it noted, "Article 5bis should not be treated as part of the general public order law of Luxembourg governing corporate management (*ordre public de direction*) as there was no legal sanction justifying such a qualification.

Conclusion

The richness and completeness of the topics concerned have made this a major piece of jurisprudence for 2015. Indeed, an appeal has just been lodged against this judgment which will in turn allow the appeal court to rule on this interesting case. ■

About the authors

Fabio Trevisan is a partner in charge of the litigation, arbitration and general commercial department in Bonn Steichen & Partners Luxembourg. He is regularly involved in high-stakes cross-border arbitration proceedings and represents high-profile international clients in Court. Real estate is also one of his specialist areas. Thanks to his native origins and having an extensive experience in representing Italian clients, Fabio is also the head of BSP's Italian desk.

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