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Kaupthing Case: Luxembourg Court of Appeal confirms the consequences of an abusive pledge enforcement

In a recent decision dated 12 July 2017 (n° 132/17 IV-COM), the Luxembourg Court of Appeal (the "Court") confirmed a decision rendered by the Luxembourg District Court dated 10 July 2013 which ruled that in the presence of a manifest abusive and fraudulent enforcement of a (share) pledge governed by the Luxembourg law of 5 August 2005 on financial collateral arrangements, as amended, (the "2005 Law"), the return of the appropriated assets to the pledgor can be ordered on the basis of the *fraus omnia corrumpit* principle.

The 2005 Law, which has implemented the European Directive n° 2002/47 EC on financial collateral arrangements (as amended by the European Directive 2009/44/EC) into Luxembourg law, provides that a pledgee may enforce the pledge upon the occurrence of an enforcement event, i.e. an event of default, or any other event agreed upon between the parties in accordance with the financial collateral arrangement (the pledge agreement) or the agreement containing the relevant financial obligation (the loan agreement) or by operation of law.

In respect of the enforcement, the ambition of the Luxembourg legislator was to shield financial collateral arrangements governed by the 2005 Law from all possible challenges and to offer the lending institutions a solid framework within which they can operate safely. In several decisions, Luxembourg courts have in the past referred to such ratio legis of the 2005 Law and ruled that the enforcement of valid financial collateral arrangements can for instance neither be interrupted nor be challenged by means of interim measures.

Whilst it was generally accepted that the remedy against an unlawful enforcement can only be an a posteriori liability claim and not an annulment of the security enforcement, the Luxembourg District Court ruled however in its decision of 10 July 2013 that a manifest abusive and fraudulent enforcement of a pledge may entail the cancellation of the pledge enforcement and the return of the appropriated assets to the pledgor.

The Court confirmed this approach. According to the Court, when entering into financial collateral arrangements, pledgors must be sufficiently confident that they will not be at the mercy of their creditors and that their legitimate rights will not be unduly sacrificed. The Court further states that the principle of good faith and the accessory nature of the pledge (i.e. the pledge being inextricably linked to the secured obligation and thus being affected by the events having an impact on it) contribute to achieving the balance between safeguarding the rights of the creditors and protecting the pledgors against any abuse.

On the basis of this, and given the Court's assessment that the secured creditor abusively accelerated the loan which was secured by the share pledge, the Court concluded that no event of default triggering the right for the secured creditor to enforce its pledge occurred and that the situation prior to the enforcement was consequently to be reinstated (thus entailing the return to the pledgor of the shares that had been appropriated by the secured creditor upon the enforcement of its pledge).

The decision of the Court may be subject to cassation before the Court of Cassation.

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