BANKING AND FINANCE

LENDING IN PORTUGAL

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OUR BANKING GROUP

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CONTENTS

1. INTRODUCTION

This paper provides an overview of the main aspects of drafting and negotiating loan agreements, taking as reference MACEDO VITORINO's standard loan agreement, the LMA standards and the documentation employed by national and international banks. This paper builds on our earlier works, "Dealing with Portuguese Borrowers" (1997) and "Lending in Portugal in the aftermath of the Banking Crisis" (2010), which examined how common law concepts from international markets gained acceptance and became standard practice in Portugal.

The object of this paper is to review some of the most important aspects of dealing with Portuguese borrowers in international loan agreements.

In addition to using their standard form agreements, most lenders will seek a legal opinion from a reputable national law firm confirming, in general terms, that the borrower has the capacity to enter into the specific agreement and that its provisions are enforceable in Portugal. This serves to provide assurance regarding the agreement's enforceability. Such an opinion is typically sufficient to address lenders' concerns related to the borrower's nationality.

However, when dealing in a different jurisdiction the lender should take the necessary time to understand the local regulations and the key concepts that could ultimately affect the loan. Some provisions may be interpreted differently by a Portuguese court and may not withstand the public order judgement if the lender attempts to seize the borrower's assets located in Portugal.

In addition, Portuguese law will apply to the enforcement of security agreements where the collateral is subject to Portuguese law, as will be the case of mortgages over real estate, pledges of securities issued by Portuguese companies or pledges of assets located in Portugal.

The recent evolution of financing contracts has led to the use of increasingly complex contracts, often unfamiliar to the Portuguese legal framework, causing significant challenges for both lenders and borrowers.

Portuguese banks are increasingly using contracts derived from common law precedents, which are more difficult to interpret under Portuguese law, rarely

addressed by legal scholars, and adopt solutions that can be questionable in certain cases.

For instance, asset protection mechanisms, such as cross-default clauses, negative pledge or no-pledge clauses, and clauses requiring that credit be maintained on a *pari passu* basis, have become commonplace.

Our experience indicates that, in many contracts, English law concepts are adopted without critical examination of their legal implications or the potential challenges they may face in court.

We have observed that internal departments of certain banks are now using drafts better adapted to the Portuguese legal framework, having removed clauses that could pose more significant issues. Generally, adaptation of precedents to Portuguese law is more frequent in corporate finance and loans for acquiring real estate or other assets, compared to leveraged buyouts (LBOs) or project finance contracts.

In some cases, this is due to the involvement of foreign banks and investors in project finance and leveraged buyouts (LBOs), who often favour the use of common law templates, making limited adjustments and only when aware of the risks associated with unsuitable standard drafts.

This paper examines the key elements of Portuguese law that influence how lenders and borrowers should approach transactions involving Portuguese borrowers, guarantors or assets located in Portugal.

2. GENERAL ASPECTS

2.1. ISSUES FOR LENDERS

When deciding to provide lending in Portugal, lenders should take into consideration some key legal issues.

In recent years, we have seen a trend toward the standardisation of legal documents. Generally, standardised documentation expedites the negotiation process, offers a common framework that facilitates the translation of agreed commercial terms into the legal documentation and minimises disputes over boilerplate provisions. However, as lenders and borrowers become more accustomed to such standardized templates, there is a risk that they may rely on documents that fail to address emerging risks or do not cover them in the most appropriate manner.

This is particularly significant for Portuguese legal documentation, which is often based on English law precedents and may not always be suited to deal with various Portuguese legal and commercial issues.

An example of a market standard that would likely fail if put to test is the call option over shares of project companies, used in many Portuguese project financing transactions. While this mechanism is widely accepted in English law transactions, it could be disputed by a defaulting borrower based on the general prohibition on lenders foreclosing (*pacto comissório*), as foreclosure of securities is only allowed under financial or commercial pledge arrangements.

We have also seen that, in several Portuguese transactions, lenders, often relying on standard legal opinions, many times do not conduct a thorough due diligence on critical Portuguese law matters that could affect their rights, such as the capacity of their counterparties to grant securities, financial assistance restrictions, the definition of default, the enforceability of certain events of default and the consequences of the insolvency of the borrower or the security provider.

Naturally, for Portuguese lawyers working on transactions with Portuguese counterparties, it may not always be possible to provide lenders with a definitive opinion on certain Portuguese law matters, particularly in the absence of legal precedents to evaluate the associated risks.

In any case, lenders should generally obtain a more in-depth advice on the Portuguese law aspects of the transaction, particularly on how these aspects may affect their position in distressed scenarios, such as the default or the insolvency of the borrower.

Summing up, international and domestic lenders should review and consider:

- the legal framework governing the borrower and its business;
- the enforceability of the documentation (whether it is governed by Portuguese or English law);
- the capacity issues that may arise, in particular those that may affect the borrower's and/or guarantor's ability to give security;
- manners in which transactions can be refinanced or the borrower restructured out of court; and
- Portuguese insolvency law and its impact on a refinancing of the transaction or in the restructuring (in or out of court) of the borrower.

2.2. ISSUES FOR BORROWERS

After the financial crisis, Portuguese borrowers saw an increase in the cost of funding from banks, as banks were no longer comfortable with the levels of leverage of certain businesses which were acceptable before the financial crisis.

As a result, it became more difficult for borrowers to obtain the same level of funding without improving their capitalisation, which meant that corporations had to add more equity before they got bank funding. Although domestic banks are now in a much more comfortable position, they still require lower leverage levels.

Presently, when dealing with international and domestic lenders, Portuguese borrowers should:

- understand the cost of funding and capital requirements for the lenders involved in the transaction;
- negotiate realistic financial and information covenants as well as default clauses, as lenders may not be in a position to waive defaults if they occur;
- review any capacity issues that may arise, in particular those that may affect their and/or their guarantors' ability to give security;

- review the implications of a default; and
- prepare for distress situations where they might need to refinance the loan or even restructure their business.

2.3. CAPACITY ISSUES

When dealing with a Portuguese borrower, lenders should carefully assess the capacity of the borrower to enter into financing transactions and of guarantors to provide personal guarantees or securities. Although this is often regarded as a minor concern, since most legal entities generally possess the capacity to engage in commercial agreements, including financing and security arrangements, this matter deserves careful attention.

Certain entities, including public authorities, public undertakings, and even private companies, are subject to borrowing restrictions, particularly with regard to specific types of transactions (e.g., issuance of bonds, derivatives, etc.) that need to be assessed.

As a rule, the financing of public authorities or public undertakings is subject to budget limitations and/or special authorisation procedures. State guarantees to secure financings to both public and private undertakings are also subject to special limitations and complex authorisation formalities.

When taking guarantees or securities, special care should be taken in case such guarantees or securities are granted not by the borrower but by companies related to the borrower (*e.g.* shareholders).

Under Portuguese law, a company may only grant personal guarantees or securities whenever (i) the guarantees/securities will secure the obligations of companies under a controlling or group relationship or (ii) the company has a corporate benefit in granting the securities. Lenders should take some assurances from the borrower, as the legal concept of "controlling or group relationship" has a defined legal meaning and the corporate benefit for the guarantor is sometimes difficult to demonstrate.

In addition to the general capacity issues, when financing a direct or indirect acquisition of Portuguese companies, lenders should also consider potential financial assistance issues.

Under Portuguese law, companies may not lend or otherwise provide funds or guarantees in order to allow another person or entity to subscribe or otherwise acquire its own shares. In case of breach of this limitation, the financing, guarantee or security will be voided.

3. THE LOAN AGREEMENT

Loan agreements have developed over the years into many standardised forms, which now are currently used by most foreign lenders when dealing with a Portuguese borrower.

In the course of our practice we have found many similar provisions, in relation to:

- conditions precedent, representations and warranties;
- covenants and undertakings, including the *pari passu* and negative pledge clauses; and
- events of default.

3.1. CONDITIONS PRECEDENT

Under a conditions precedent clause most agreements require that the borrower presents evidence of its capacity to enter into a particular transaction.

If the borrower is a State-owned company (typically a limited liability company majority owned by the State or a State holding) the company's articles of association should be obtained as well as other constitutional documents, *e.g.* the decree-law determining the change in the company's legal nature. All these documents should be checked to ascertain if any specific governmental approval is required to enter into financial agreements.

If the borrower is a public undertaking the lender should obtain copies of the borrower's constitutional documents, as well as any amendments thereto, which are approved by specific decrees issued by the Government.

In these cases, the following measures should be taken:

- include a special covenant covering any changes in the borrower's legal status ensuring that all changes to the company's constitutional documents be notified to the lender and will not materially affect the company's ability to repay the loan;
- include a special representation covering those cases where the change in the legal nature may be followed by either a merger or a demerger (such events should be treated as termination events);

- include a special warranty ensuring that the new entities will be responsible for the fulfilment of the obligations assumed under the agreement; and
- if the government has provided a guarantee to secure the loan, the lender should ensure that the guarantee would not be cancelled by the changes in the borrower's legal nature (problems with anti-competition rules should also be considered).

3.2. REPRESENTATIONS AND WARRANTIES

Representations and warranties are generally statements made by a borrower for the benefit of the lender and relate to the borrower's ability to comply with its obligations under the agreement and/or the validity of those obligations. Generally a warranty is a term of the contract while a representation is made prior to execution and inducing execution. However, practice has been narrowing the differences between representations and warranties; presently both serve the purpose of ensuring the lender that no material adversity affecting the borrower will jeopardise its ability to fulfil its obligations under the agreement. Materially all representations will be considered as warranties if they are to remain true throughout the loan.

Under Portuguese law there is no distinction between representations and warranties but very broadly it may be considered that while a representation, by virtue of inducing execution, would be taken as a "condition" upon which the lender based its decision to enter into the loan, a warranty, being a term of the contract itself, would be considered as an "obligation" of the borrower.

Therefore, some warranties such as those concerning the validity of the agreement or changes in the law, and in general all terms that are not within the borrower's control, would not be enforceable in Portugal as warranties but as representations.

The practical impact of this distinction would be that no breach of representation would be considered a breach of contract unless proven that the borrower had willingly misrepresented certain events.

We recommend that loan agreements have different representations and warranties sections and that warranties be restricted to information within the borrower's control prior and throughout the loan.

Even considering that the main function of these clauses is informative, a Portuguese borrower should not accept to warrant any information that it is not capable of

maintaining after the execution of the loan. A way to avoid this problem is to establish that only the breach of any warranty with a material consequence may be considered a breach of contract. Except for 100% owned subsidiaries warranties related to the borrower's affiliates should be avoided since they most probably would not be enforceable in Portugal.

From the lender's standpoint it would be better to ensure that the borrower makes warranties that will remain accurate during the loan than to face a situation where the warranties may be declared null and void or unenforceable in Portugal on the grounds that they were not within its control.

In general, the warranties concerning (i) litigation, (ii) insurance, (iii) stamp duty and other taxes, as they exist upon the closing, (iv) subsidiaries as they exist upon the closing and (v) default would stand as such in a Portuguese court of law.

As to warranties regarding the borrower's identity, it must be noted that in case of public undertakings the Government may decide to change the company's structure and legal status and that the company would not control events such as the merger or demerger of the company. In those cases the lender should ask either to have the right to renegotiate and/or withdraw from the agreement or to have specific provisions ensuring that the new entities succeeding in the borrower's obligations shall remain responsible for the loan.

Also in relation to State-owned companies with their liability limited by shares, the lender should obtain information as to the Government's management power over the company. In certain cases the State may have retained a golden share in the company or the company may be going through a restructuring or privatisation process. To avoid the existence of a potential future breach of contract, the lender should ask for concrete financial information to the extent this may be either represented or warranted by the borrower.

If the borrower is a private company it may warrant that the list of its subsidiaries attached will not suffer any change that will materially affect its ability to fulfil its obligations.

3.3. CONVENANTS

The most important covenants in international lending to Portuguese borrowers have been:

- **The restrictions on mergers and disposal of assets**. Both these clauses are standard in foreign and national loans, but care should be taken when dealing with public undertakings because decisions concerning mergers and demergers are taken by the government by way of special decree-law. When the future of the borrower is uncertain the lender should procure to secure the loan by way of collateral instead of trying to have some degree of influence with regard to the management and operation of the borrower's businesses. In relation to private companies standard restrictions on mergers and demergers or the disposal of assets as well as the monitoring of the borrower's business usually prove to be sufficient;
- **The «pari passu» and negative pledge covenants**. Both these clauses are now standard in foreign loans and no major legal concerns would affect both their validity and enforceability in Portugal; the information provided by the borrower concerning its assets by way of representation and the «pari passu» covenant should be sufficient to reassure the lender that it will rank in effect equally with all present and future unsecured indebtedness. On the other hand, the negative pledge covenant will reassure the lender against the allotment of assets to a secured creditor and establish equality with other creditors of the same class;
- **The restrictions on borrowings**. This covenant may be used when a major loan is being made available. Sometimes the restrictions on borrowings will not prohibit borrowing altogether but trigger off an obligation to partially repay the loan in advance; and
- **The information covenant**. The information covenant completes the warranties concerning the company's management and allows the lender to monitor the borrower's capability to fulfil its obligations under the agreement.

Certain events such as mergers and spin-offs are within the borrower's control, and it may undertake not to change the corporate structure and grant the lender the right to terminate the agreement upon the verification of any such event.

However, it must be noted that no covenant can be given that would bind a subsidiary of the borrower except for 100% owned subsidiaries or companies that have entered into a management and control agreement. Consolidation may have an impact on taxable profits, but it will not affect the company's capacity to enter into agreements, and the parent company shall not be allowed to take decisions on behalf of its subsidiaries nor shall it be responsible for the agreements entered upon by its subsidiaries unless it is 100% owned.

3.4. TERMINATION EVENTS

Under standard loan agreements used by foreign lenders certain events are considered as events of default triggering the default provisions. Under Portuguese law an event may only be categorised as an event of default if it constitutes a breach of the loan agreement itself, such as inaccuracy of a warranty or failure to comply with a covenant. Other events, such as insolvency, which would be treated as anticipatory breaches under certain foreign jurisdictions because they might lead to the borrower being unable to comply with its payment obligations, would not be considered a breach under Portuguese law.

In general, we recommend foreign lenders to include provisions covering all "termination events" or "acceleration events", including events of default and all other situations that would justify termination of the loan. However, a clear line should be drawn between the events that lead to the triggering of the default provisions and those leading to the termination or acceleration of the loan. The latter should never be subject to penalties since it would hardly stand the judgement of the Portuguese courts.

Typically, the following situations would be considered a breach of contract:

- failure to pay;
- breach of other obligations, other than payment obligations;
- repudiation;
- breach of covenants and undertakings; and
- misrepresentation.

These defaults give the lender the right both to terminate or accelerate the loan and to demand the repayment of all sums due under the contract, as well as to be indemnified for the damages the default might have caused.

If the loan agreement especially provides default interests, they would be due from the moment a default exists. In addition, if the borrower has given collateral to secure the loan, *e.g.* shares, these assets may be seized by the court to ensure repayment of the loan. Other security provided by the borrower, such as letters of credit issued on its behalf or bank guarantees provided to the lender, will also be triggered by the default.

However, other so-called events of default, which are meant to give the lender additional protection by triggering the same mechanisms as those put in place for default

situations would not be considered as such by Portuguese courts and might be voided. Given the accessory nature of the security, such events of default would not be considered to trigger the enforcement of the security.

In order to ensure the same kind of protection, we would recommend foreign lenders to avoid categorising the following events as default:

- cross-default;
- bankruptcy, insolvency, creditors processes and liquidation;
- material adverse changes; and
- change in ownership.

These events should be construed as conditions to the survival of the loan upon their verification, *e.g.* the lender would have the right to terminate the agreement or accelerate the loan and be repaid of all sums due at that time, but would not seek to use the same remedies the law provides for default situations, such as the penalty interests or other damages for breach of contract.

In fact, the lender would obtain almost the same degree of protection as is provided by the standard form loan agreements, since upon the verification of the termination event it would be allowed to accelerate the debt. The borrower would then have to repay the loan and the interests due at that time. If it failed to do so, it would be in breach and the default provisions would apply as in ordinary default situations, triggering the enforcement of the security.

4. THE SECURITY AGREEMENT

4.1. FORMS OF SECURITY

As in most other jurisdictions, there are several forms of securities that a lender may resort under Portuguese law, *e.g.*:

- the mortgage (*hipoteca*);
- the pledge (*penhor*); or
- the assignment of proceeds (*consignação de rendimentos*).

The choice of the most suitable security in respect of the loan obligations must take into account the existing default risk, the nature and value of the borrower's assets and its business activity as well as the purpose of the financing. In project financing, it is common practice to require securities over the whole project. They may be constituted through a pledge over the shares of the project company, a mortgage over the project facilities or a pledge over the business establishment. In standard corporate financing, it is more common to find pledges of securities and assets or mortgages over factories.

The nature of the security must also take into account the type of asset or right that is given to secure the borrower's liabilities: security over real estate (so-called immoveable property) or moveable assets subject to registration may only be created by way of a mortgage, whereas security over other moveable assets must take the form of a pledge.

Portuguese law also allows the borrower to assign by way of "consignação de rendimentos" the proceeds of immoveable or moveable property subject to registration, as well as of the proceeds derived from registered debt instruments, but not other types of receivables.

4.2. THE MORTGAGE

The mortgage enables the lender to be paid with respect to the secured liabilities by the value of certain immoveable assets, or other assets treated as such, with preference in relation to the remaining common creditors.

Under Portuguese law, only the following assets and rights can be mortgaged:

- real estate;
- concessions over state property;
- right of usufruct over the assets and rights mentioned above (*usufruto*); and
- moveable assets subject to registration (ships, aircrafts and vehicles).

Mortgages must be created by way of public deed and registered before the relevant land or property registry office.

The main features of the mortgage's legal framework are as follows:

- the mortgage is a charge over the mortgaged property as a whole, including any fixed parts thereof, but not over the proceeds generated by the mortgaged property;
- the mortgage secures both the payment of the borrower's liabilities as well as other accessory obligations provided that the mortgage deed so specifies. The mortgage shall only secure the interests accrued during the three years prior to the enforcement of the mortgage;
- the mortgage shall continue to encumber the mortgaged property until the secured liabilities have been fully discharged. In the event the mortgagor sells the mortgaged property to a third party, the purchaser of the mortgaged property, who is not personally liable for the secured liabilities, has the right to redeem the mortgage provided that it either discharges the secured liabilities directly or undertakes to deliver to the creditors the proceeds of the sale up to the amount of the secured obligations;
- the borrower is not allowed to give non-disposal covenants. Any provision restricting the borrower's ability to sell or further encumber the mortgaged property will be voided;

- the lender may demand the replacement or the reinforcement of the mortgage if the mortgaged property is destroyed or its value is no longer sufficient to cover the secured liabilities;
- the mortgage's rank may be assigned accordingly with the rules of the assignment of credits provided that the mortgaged property might be separated from the borrower and the mortgaged property is not owned by third party; and
- the lender cannot foreclose the mortgaged property.

4.3. THE PLEDGE

The pledge enables the lender to be paid with respect to the secured liabilities by the value of certain assets or rights with preference before common creditors.

The pledge can be created over assets or rights that cannot be mortgaged, *e.g.*:

- moveable assets not subject to registration;
- shares in limited and unlimited liability companies; and
- debt receivables and other rights.

The main features of the pledge are the following:

- the pledge is a charge over the pledged asset as a whole including its proceeds and shall continue to encumber the pledged assets until the secured liability has been fully discharged; and
- the lender is not allowed to foreclose on the pledge. However the parties may agree that the lender may acquire the pledged assets in case of commercial and financial pledges and provided that the parties so agree in advance.

4.3.1. PLEDGE OF MOVEABLE ASSETS

The pledge of moveable assets requires:

- the delivery to the lender or an agent of the pledged asset or of a document that would entitle such lender or agent to exclusively dispose of the asset; or
- the joint possession of the pledged asset, provided that it prevents the borrower from disposing thereof.

In respect of commercial pledges, the law allows a symbolic delivery of the pledge through (i) registration in the books of a public agency where the assets are deposited, (ii) delivery of the title of transport in respect of the assets or (iii) endorsement of the title of deposit of the asset in a public warehouse. If the pledge is securing a liability towards a bank, the borrower does not need to transfer the possession of the pledged asset provided that the pledge deed is executed before a public notary.

While in control of the pledged asset, the lender is required to act as a *bonus pater familia* and may not dispose of the pledged asset without the borrower's prior consent, except to the extent necessary to maintain the marketability and suitability of the asset or to enforce the pledge if allowed by the security agreement. The lender is also obligated to return the pledged asset upon the discharge of the secured liabilities.

4.3.2. PLEDGE OF CREDITS

When a credit is pledged, the relationship that is established between the pledgee and the obligor shall be subject to the same rules that apply to the assignment of credits. The creation of pledges over credit rights must comply with the formalities required for the assignment of the pledged rights.

As a rule, the enforceability of the pledge will depend on the notice of the debtor.

Unless otherwise provided in the security agreement, the debtor may only discharge the pledged credit to both the pledgor and the pledgee.

4.3.3. PLEDGE OF SHARES

The most effective type of security in Portugal, particularly in project and acquisition finance, is the pledge of shares, as it allows the lenders to effectively sell the entire business of the borrower, together with its authorisations, licenses and contracts.

Unlike other forms of security, such as the pledge of business establishments and assets or the assignment of credits, pledges of shares give pledgees direct access to the borrower's entire business. If the lenders need to realise the pledge and sell the shares, the purchaser will be able to continue operating the company with minimum disruption of the business activity, whereas a sale of the borrower's assets and assignment of its key contracts would present several difficulties.

However, if the parent company secures the obligations of its Portuguese subsidiary by way of a pledge of shares in the Portuguese company, the parent company will be subrogated in the lenders' position against the company in the event the pledge is enforced. Consequently, the company, whose shares have been given as collateral, would not be sold debt free, thus reducing its value for a potential buyer. One way of solving this problem is limiting the parent company's subrogation rights, but this solution may be challenged under the voidable preferences of the jurisdiction of the parent company or of the end borrower.

The creation of pledges over shares in private limited companies (*sociedades por quotas*) requires the registration of the pledge with the Commercial Registry Office.

The pledge of paperless shares in public limited liability companies (*sociedades anónimas*) must be registered in the account of the owner of the shares. When physical shares are being pledged, the pledge must be recorded in the share certificates and registered in the issuer's share lodger or before the financial intermediary where the shares are deposited.

As a rule, the pledgor may continue to exercise the rights attached to the shares, unless otherwise agreed in the security agreement. It is implied by law as well as current market practice to accept that, for so long as no event of default has occurred, the pledgor may receive and retain all dividends, interest and other income deriving from and received by it in respect of the pledged shares as well as exercise the voting and other rights or powers attached to the shares.

However, a provision should be included in the security agreement allowing the pledgee, following the occurrence of an event of default, to receive all dividends, interest and other income forming part of the pledged shares to be paid to an interest bearing suspense account in the name of the pledgee, to be applied either to the fulfilment of the secured liabilities or to the creation of new securities. The pledgor should also have the right to exercise the voting rights of the shares in the event of default.

4.3.4. PLEDGE OF BUSINESS ESTABLISHMENTS

The pledge over the borrower's business establishment (*penhor de estabelecimento comercial*) purports to create a charge over its entire business assets and contracts combining a pledge of rights (*penhor de direitos*) with a pledge of assets (*penhor de coisas*). The purpose of this type of pledge is to ensure that, upon the occurrence of an event

of default, the lenders would be able to sell the whole business assets and assign the remaining contracts of the borrower to a third party.

The main risk of creating a pledge over the borrower's business establishments is that this type of pledge may be deemed to create a floating charge, which is not recognised in Portugal, as pledge agreements must specify the assets that are charged. In addition, consent from key suppliers and clients to assign such contracts should be procured prior to taking the security. In other words, it is possible that a court would consider that only the assets and contracts that were expressly specified in the security agreement were actually charged.

In our view, it is possible to create a charge over the business establishment, but in order for such charge to become effective, care should be taken in ensuring that the security agreement includes a detailed and accurate list of the assets that are pledged to the lenders and of all contracts, licenses and authorisations that would be assigned in the event of a enforcement of the pledge.

Additionally, it is advisable that the lender perfects the pledge by requesting the obligor to specify the assets pertaining to the business establishment periodically.

The lender should also request the court to seize the business establishment upon the occurrence of an event of default and before insolvency proceedings are initiated to ensure its priority and avoid being treated as a common creditor with respect to the assets that are not mentioned in the pledge agreement, as under the new insolvency code, which is expected to be published soon, any securities given in the six months prior to the initiation of the insolvency proceedings shall be voided.

4.3.5. FINANCIAL PLEDGE OF SECURITIES

The financial pledge of securities is governed by Decree-Law 105/2004, dated 8 May 2004, which established the legal framework for financial collateral arrangements in Portugal (Financial Pledge Law), implementing Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002.

The Financial Pledge Law allows lenders, including banks and financial institutions, to enforce security interests over securities (such as shares, bonds, or cash) without court intervention, subject to specific conditions.

Financial collateral arrangements must comply with the following requirements:

- at least one of the parties must be a bank or a financial institution;
- the collateral must consist of cash or a financial instrument (such as shares or bonds);
- the secured obligations relate to payment duties or the obligation to deliver a financial instrument; and
- the collateral must actually be delivered to the collateral taker or be under its possession, and the arrangement should be recorded in a contract or deed.

The enforcement out of court may be used if the agreement clearly outlines both the process and the method for valuing the collateral.

The main advantage of the financial collateral is the protection upon insolvency of the collateral provider. In case of insolvency, financial pledges remain effective despite the opening of insolvency proceedings, and pledges perfected before insolvency are generally immune from clawback actions, save in case of fraud, while general pledges may be vulnerable to clawback.

4.4. ASSIGNMENT OF PROCEEDS

The assignment of proceeds (*consignação de rendimentos*) is a form of security over the proceeds of the following assets:

- real estate;
- moveable assets subject to registration (ships, aircrafts, vehicles and shares in a private limited company).

A public or private deed is required if the proceeds derive from immoveable or moveable property respectively. The charge must be registered with the competent property registry office.

The security agreement should detail if the assigned proceeds shall be used to pay the principal, the interest or both principal and interest, as well as who will hold the assets from which the proceeds originate.

The assets may be held by the borrower, by the lender or by a security agent. In case the assets are held by the borrower, the proceeds must be delivered to the lender or to a security agent.

The assignment of proceeds will be enforceable in accordance with the security agreement; no default or court order is required for the assignee to have title over the proceeds. Therefore, the security agreement should also detail whether the proceeds are to be immediately used for discharging the secured liabilities or be kept in a suspense account pledged to the lenders until the loan is fully discharged.

4.5. ENFORCEMENT OF THE SECURITY

There are two methods of enforcement of securities under Portuguese law: court sale (*venda judicial*) or private sale (*venda extrajudicial*).

In principle, securities shall be enforced by way of a court sale, which is the default enforcement procedure, if the security agreement does not expressly provide for a private sale. The resort to a private sale is only permitted for pledges. Mortgages must always be enforced by a court.

This represents an important disadvantage of mortgages in relation to pledges, as the court proceedings typically last over one year and may entail a significant devaluation of the mortgaged asset.

4.5.1. COURT SALE

The enforcement procedure in relation to mortgaged property and pledged assets is described in detail in the Portuguese Code of Civil Procedure.

Once a request to start enforcement is filed, the chargor will be requested to pay within ten days or to oppose to the enforcement, which it may only do if the charge is invalid or the chargee was not entitled to enforce the security. If it fails to do so, the court will issue a distraint order and seize the security. The chargor will also have the right or the obligation to offer other assets in lieu of the security to discharge the secured obligations.

There are three forms of court led sale procedures:

- sale by a court bailiff, which can be made by way of an open auction or by way of sealed bids;
- sale by private negotiation, which shall be applicable following a proposal by the charger or the debtor or in the event the sale by way of sealed bids fails; and

- sale of the pledged asset in an exchange where such assets are or may be traded.

To enforce the pledge in court the lenders must possess an enforceable title (*título executivo*), which may consist of a public deed, authenticated document or ruling that creates or acknowledges the debt.

4.5.2. PRIVATE SALE

In general, the pledge of shares and the pledge of assets may be realised by way of private sale.

It is advisable that the sale procedure be detailed in the security agreement so as to ensure that the sale is made at arm's length from the lender and reduce the chances of such private sale being deemed a sale at an undervalue (*negócio usurário*) or a foreclosure of the security (*pacto comissório*).

Even if the security agreement does not detail the steps required to realise the pledge through private sale, such procedure may still take place provided that the agreement so allows and the sale is made for the fair market value or a fair consideration.

To determine the fair market value, it is advisable to appoint an appraiser to assess the value of the pledged shares. In our view, the security agreement should also specify the evaluation criteria to be used in determining the fair market value, which may take into account, among other things, the trading conditions of the pledged assets or securities then current and the availability of potential buyers to purchase the shares within a short timeframe from the date of the determination of the fair market value and the willingness to pay immediately and in cash, as this may be essential to complete the sale in a timely fashion.

In order to realise the pledge it is also customary to grant a power of attorney to the chargees, although it may be preferable that the power be given to a security agent independent from the lenders to ensure that the sale is made at arm's length from the lenders.

5. INSOLVENCY OF THE BORROWER

5.1. VOIDABILITY OF SECURITY INTERESTS

The first concern for lenders when they have to consider a possible insolvency of the borrower or the security provider are the conditions under which transactions can be voided under Portuguese insolvency law, codified by Decree-Law 53/2004, of 18 March 2004, as amended (Insolvency Code).

Under Insolvency Code, the following transactions, among others, may be cancelled by the insolvency administrator:

- personal guarantees granted by the insolvent in the six months prior to the initiation of the insolvency proceedings which are related with transactions which are not in the best interest of the insolvent;
- security interests given in respect of existing obligations or new obligations replacing such existing obligations in the six months prior to the initiation of the insolvency proceedings; or
- security interests granted simultaneously with the creation of the secured obligations in case they are undertaken in the sixty days prior to the initiation of the insolvency proceedings.

In addition, the insolvency administrator may void any transactions deemed prejudicial to the insolvency estate performed in the two years prior to the initiation of the insolvency proceedings, which include any transactions that are considered prejudice the rights of the creditors of the insolvency estate or to have been entered into with a counterparty acting in bad faith.

5.2. RANKING OF CLAIMS

A key issue to consider in the event of insolvency of the borrower or a guarantor is the ranking of the lenders' claim.

The Insolvency Code distinguishes four types of claims:

- preferred claims (*créditos privilegiados*), which entail preference on the company's assets;
- secured claims (*créditos garantidos*), which entail a security on any of the company's assets;
- common claims (*créditos comuns*), which do not entail any security or preference but are not deemed as subordinated debts; and
- subordinated claims (*créditos subordinados*).

The Portuguese Civil Code establishes specific preferred claims in respect both of movable assets and immoveable assets. Preferred credits include:

- the State and local authority's credits for indirect taxes, direct taxes, as well as for property tax registered for collection in the current year on the date of the attachment, or equivalent act, and in the two preceding years;
- employees' credits arising from employment contracts, or from the breach or termination of employment contracts, arising in the six months prior to the insolvency declaration;
- credits for court expenses incurred directly in the common interest of the creditors, for the preservation, enforcement, or liquidation of movable and immovable assets;
- credits for debts related to ground rents for the current year on the date of the attachment, or equivalent, and for the previous year, enjoy a privilege over the rents of the respective urban properties.

Therefore, special care should be taken in ensuring that there are no preferred claims or, if there are, that the lender will be entitled to declare the default.

Lenders should also be aware that under the Insolvency Code certain claims will be deemed legally subordinated, including among others:

- shareholder loans (*suprimentos*);
- claims subordinated by agreement between the parties;
- claims arising from gratuitous acts of the insolvent;
- interest of non-subordinated claims accrued after the insolvency ruling up to the value of the respective assets (save those benefiting of a security interest);

- interest of subordinated claims accrued after the insolvency ruling; and
- claims of persons especially related with the insolvent, provided that the special relationship already existed before the insolvent incurred in such debt and of any third parties that acquired such credits in the two years prior to the initiation of the insolvency proceedings.

5.3. IMPLICATIONS FOR SECURITY INTERESTS

The declaration of insolvency leads to the suspension of all enforcement proceedings or measures initiated by creditors that affect the insolvent estate's assets, and prohibits the commencement or continuation of any enforcement actions pursued by creditors.

Therefore, following the declaration of insolvency, creditors shall no longer be entitled to enforce security interests outside court proceedings, and collateral may only be sold within the insolvency process. This means that all enforcement actions shall be suspended or limited and secured creditors will not be permitted to freely exercise their security rights.

Financial pledges are excepted from this rule; the commencement of the insolvency proceedings will not preclude the financial pledgee's right to set-off its claims.

6. GOVERNING LAW

One of the issues that may now arise more often is that of the choice of the governing law.

Like in most continental countries, during the eighties and, in the case of Portugal, well into the last decade of the century, most international financing transactions were governed by English law.

The adoption of English law like documents, in the last decade, as standards for local law documentation, Portuguese law became the preferred solution for most transactions, as international banks became more comfortable with Portuguese law documentation.

There are advantages and disadvantages to any of these options.

In favour of choosing English law as the governing law for financing documentation are:

- English law documentation is well known in the international markets;
- Portuguese law aspects can be managed in an efficient manner in line with international practice by local lawyers;
- English courts have issued precedents on many controversial legal issues;
- procedures in English courts are more efficient and expedite; and
- as a rule, judgments of English courts will be enforceable in Portugal, unless they contradict Portuguese "public policy".

On the other hand, the choice of Portuguese law is also not without many merits on its own, as there will always be matters which are subject to Portuguese law, such as the capacity of the borrower and or guarantors and the security documentation must, as a rule, be governed by Portuguese law. As a result, choosing Portuguese law as the law governing all aspects of the transaction will facilitate the negotiation.

In addition to these arguments, we may add that:

- local borrowers prefer using Portuguese law;

- the judgements of English courts will ultimately have to be enforced and pass the "public policy" test; and
- in event the borrower becomes insolvent, Portuguese courts will take over the matter, where English law documentation will be more open to challenges than Portuguese law contracts.

The arguments for and against the choice of one or the other show that this choice must made on the basis of the real interest of the parties involved.

In our view, English law should be used when the borrower needs to access a wider pool of investors around the world, many of whom would be more comfortable in using English law (provided they deal adequately with Portuguese law issues), as the English legal and court system has unrivalled experience in handling and preparing for disputes on financial transactions.

On the other hand, Portuguese law should be used in transactions where the international investors are better versed in the concepts of Portuguese law and can make an informed assessment of the risks involved, as having to deal with Portuguese law only will avoid the disruptions in the overall deal structure that will naturally arise when there are multiple laws applicable in case of dispute.

7. FINAL REMARKS

The main lesson that should be learned from the crisis is that lenders and borrowers alike must be more careful in negotiating transactions. Using standardised documents is useful and improves the overall quality of the final documentation, but it does avoid making a careful assessment of the legal risks.

This means that lenders should be more careful in their legal due diligence on the local borrowers and have a more in-depth knowledge of local law.

For borrowers, this means that they should be prepared to answer questions from lenders and anticipate issues that, in general, borrowers try to avoid, such as potential defaults and the risk of insolvency.

These lessons apply to any jurisdiction and Portugal is no exception. The recent pressures on Portuguese sovereign debt may lead potential lenders to have to consider more carefully any risks associated with their Portuguese clients, including the legal risks.

Portuguese law documentation, though broadly in line with international standards, can and should be improved to offer real answers and solutions to the issues raised by international and local lenders. This will mean that lenders and borrowers should consider carefully the legal implications of the existing market standards and question how they will apply if the transaction is put at risk by a default or the insolvency of the borrower.

ABOUT US

MACEDO VITORINO IS A LEADING PORTUGUESE LAW FIRM. WE ADVISE DOMESTIC AND FOREIGN CLIENTS IN A WIDE RANGE OF BUSINESS SECTORS, INCLUDING BANKING, DISTRIBUTION, INDUSTRY AND PROJECTS. WE ARE KNOWN FOR OUR PROFESSIONAL AND CLIENT-ORIENTED APPROACH TO COMPLEX AND DIFFICULT MATTERS.

Since the incorporation of the firm, we have been involved in several high-profile transactions in all of the firm's fields of practice, including banking and finance, capital markets, real estate, M&A, complex disputes and corporate restructurings.

We have strong relationships with many of the leading international firms in Europe, the United States and Asia, which enable us to handle effectively any cross-border legal matters.

We are mentioned by The European Legal 500 in several practice areas, including Banking and Finance, Capital Markets, Corporate and M&A and Litigation. Our firm is also recommended by IFLR 1000 and Chambers and Partners.

The multidisciplinary and integrated character of our firm allows us to efficiently solve the legal issues of our clients, in particular:

- COMMERCIAL CONTRACTS, DISTRIBUTION AGREEMENTS AND FRANCHISING
- COMPETITION AND EUROPEAN LAW
- COPYRIGHT, INTELLECTUAL PROPERTY, IT, PATENTS AND TRADEMARKS
- CORPORATE AND ACQUISITION FINANCE
- DISPUTE RESOLUTION, LITIGATION, MEDIATION AND ARBITRATION
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