MACEDO VITORINO

BANKING AND FINANCE

PARALLEL DEBT IN FINANCING TRANSACTIONS

INTRODUCTION

Syndicated financings are, by design, transferable. Lenders may sell their participations after closing, new lenders may join through incremental facilities, and the lending group at maturity may look different from the one that signed the facility agreement. The security package, on the other hand, is usually intended to remain in place for the life of the loan. Where that package includes Portuguese assets, reconciling these two features is not entirely straightforward.

In common law jurisdictions, the traditional answer has been the security trustee, who holds the security on behalf of the lenders from time to time. Portuguese law does not generally recognise the trust (however, the Madeira Free Trade Zone allows trusts under Decree-Law No. 352-A/88 of 3 October, but the scope of that regime is limited, and it does not offer a general solution for security arrangements in financing transactions). Portuguese security interests are also accessory to the claim they secure, which means that the person in whose favour the security is granted must, in principle, hold that claim. A security agent acting only as representative of the lenders does not hold a claim of its own, and parallel debt is one of the contractual mechanisms that the market has developed to deal with this difficulty.

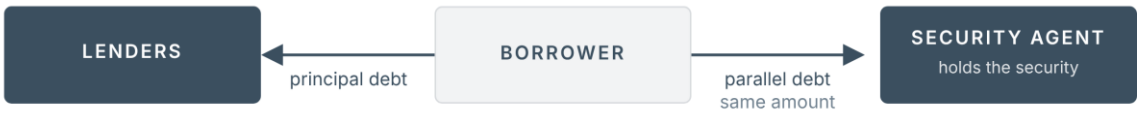


Figure 1 – The borrower owes the principal debt to the lenders and a parallel debt of the same amount to the security agent, in whose favour the security is granted. A payment on either debt reduces the other.

In Portuguese financing transactions, two main security structures may be considered. Under the first, security is granted in favour of the security agent, either to secure a parallel debt governed by foreign law or under arrangements whereby the agent acts for the benefit of the lenders. Although this

structure may facilitate changes in the lending syndicate, its effectiveness depends on the legal position of the security agent and the enforceability of the corresponding security interests.

Alternatively, security may be granted directly in favour of the lenders, with the security agent acting on their behalf under a mandate, including for enforcement purposes. In cross-border financings, the parallel debt may remain relevant under the finance documents without necessarily being secured by the Portuguese security package. This approach avoids relying on the recognition of the parallel debt for the purposes of Portuguese security.

This note describes how the mechanism works, why it is used in transactions involving Portuguese assets and some of the questions it leaves open under Portuguese law.

THE MECHANISM

Under Portuguese law, the granting of security interests generally requires the existence of an identifiable or determinable secured claim, as well as a corresponding creditor position held by the beneficiary of the security. Parallel debt arrangements do not depart from these requirements but rather seek to satisfy them through the establishment of a separate and independent claim in favour of the security agent.

In a parallel debt arrangement, each obligor may assume in the finance documents two payment obligations for the same money. The first is the ordinary debt owed to the lenders under the loan, commonly referred to as the corresponding debt. The second is the parallel debt, owed to the security agent in its own name, and not as representative of the lenders, for an amount equal at all times to the corresponding debt. Since each obligor owes the parallel debt to the security agent, each obligor must execute the finance document containing the parallel debt provision. As the agent is then a creditor in its own right, the security over Portuguese assets can be granted and registered in its favour to secure the parallel debt, with the security agent designated as the sole registered beneficiary of the security interests.

To prevent the obligors from owing the same amount twice, the two obligations are linked by a reciprocal discharge mechanism.

The benefit of the structure becomes visible when the lending group changes. If one of the lenders sells its participation to a fund, the creditor of part of the corresponding debt changes, but the parallel debt continues to be owed to the same agent and for the same total amount. Because the security secures the parallel debt, and that debt has not changed, no new deed or registration should be needed, and the risk of the security being affected by the transfer is, in principle, avoided. This

assumes, however, that the security agent's position as secured creditor is recognised under Portuguese law.

In transactions documented on the basis of Loan Market Association (LMA) standards, the parallel debt provision usually appears in the intercreditor agreement or the facility agreement. In multi-jurisdictional financings, its inclusion is often driven by the requirements of civil law jurisdictions. Portuguese security documents may, in turn, define the secured obligations by reference to the parallel debt established under the relevant finance documents. Conversely, a separate parallel debt undertaking may be unnecessary if the facility agreement already establishes an independent claim in favour of the security agent, capable of being directly secured by the relevant security interests.

THE PARALLEL DEBT AND ITS USE IN FINANCE

From a transactional perspective, one of the potential advantages of parallel debt arrangements is the possibility of maintaining the existing security structure notwithstanding changes in the composition of the lending syndicate. Following an assignment or transfer of a lender's participation, the security agent remains the creditor under the parallel debt and the beneficiary of the relevant security interests. However, the validity and enforceability of security granted solely in favour of the security agent on this basis remain subject to debate under Portuguese law. Where effective, this structure may reduce the need to amend the Portuguese security documents or update the corresponding registrations following loan transfers. Similar advantages may arise in refinancings and incremental facilities, provided that the existing security arrangements are sufficiently broad to cover the additional financing. By contrast, where security is granted directly in favour of the lenders, changes in the lending syndicate may require additional documentation and formalities to reflect the incoming lenders as beneficiaries of the security.

The security agent may coordinate the enforcement of security on the instructions of the majority lenders or the relevant instructing group under the intercreditor agreement, regardless of whether the security is granted in favour of the agent or directly to the lenders, provided that the agent has the necessary authority.

THE PARALLEL DEBT STRUCTURE

Portuguese law does not expressly regulate parallel debt arrangements, and their validity and enforceability under Portuguese law remain subject to debate. This does not make parallel debt irrelevant in Portuguese transactions, but it helps to explain why such arrangements may be governed

by foreign law and combined with other contractual mechanisms. In this context, particular consideration must be given to the legal position of the security agent and the extent to which its claim may be secured by security interests governed by Portuguese law.

The accessory nature of security interests under Portuguese law raises particular questions regarding the position of the security agent. Under articles 666 and 686 of the Civil Code, pledges and mortgages secure claims held by the secured creditor. Although the Civil Code allows security to be granted for future or conditional obligations, the granting of security in favour of a security agent to whom no payment obligation is owed may raise questions as to the validity of such security under Portuguese law.

A separate issue concerns the validity of the parallel debt obligation under Portuguese law. Although Portuguese law recognises a broad principle of freedom of contract under article 405 of the Civil Code, it does not generally recognise obligations that are entirely independent of an underlying legal relationship (under article 458 of the Civil Code, an acknowledgment of debt gives rise to a rebuttable presumption of an underlying legal basis, without creating an independent obligation). Accordingly, the validity of a parallel debt arrangement may be questioned on the grounds that the obligation lacks an autonomous legal justification.

However, its purpose within the financing structure, together with the reciprocal discharge mechanisms linking the parallel debt to the underlying financing obligations, may be relevant when assessing its validity under Portuguese law. Even so, the absence of express statutory recognition and settled case law from the Portuguese higher courts remains a source of legal uncertainty, which explains why parallel debt arrangements in transactions involving Portuguese security are commonly governed by foreign law.

A further issue arises from the distinction between the law governing the parallel debt and the law applicable to the corresponding security interests. In cross-border financing transactions, the parallel debt may be governed by English law, in accordance with the law governing the finance documents. However, the creation, perfection and enforcement of security interests over assets located in Portugal remain subject to the applicable requirements of Portuguese law. In this context, even if a parallel debt might not be valid as an obligation governed by Portuguese law, Portuguese-law security may secure a parallel debt that is valid under the foreign law governing it, provided that the security documents identify that debt with sufficient precision and that the registered maximum amounts are sufficient to cover it. Accordingly, the Portuguese security documents may expressly include the parallel debt within the definition of secured obligations and, where applicable, specify the corresponding maximum secured amounts.

The enforcement of Portuguese security interests also requires consideration of the security agent's powers. Where the security is granted directly in favour of the lenders, the agent's authority to enforce it must be established under the relevant mandate. Where the security secures a parallel debt, the agent's enforcement rights also depend on the validity of that obligation and the corresponding security interests.

RISKS ASSOCIATED WITH PARALLEL DEBT

Although parallel debt arrangements may simplify the holding and enforcement of security in syndicated financings, the granting of Portuguese security exclusively in favour of the security agent raises additional questions regarding the agent's position and the enforceability of the security interests.

The insolvency of the security agent is particularly relevant, as parallel debt arrangements do not, in themselves, provide the asset segregation associated with a common law trust. Questions may therefore arise concerning the treatment of the parallel debt and any enforcement proceeds held by the agent.

The replacement of the security agent may also require the transfer of its rights under the parallel debt and the corresponding Portuguese security interests, together with any applicable registration formalities, where the agent is the beneficiary of those security interests.

Mortgages in Portugal are registered for a maximum amount and do not cover interest for more than three years (article 693 of the Civil Code). Where the security covers a parallel debt, the maximum secured amount should reflect the obligations intended to be secured, including any relevant hedging liabilities.

A comparable concern applies to the limitations on upstream and cross-stream guarantees resulting from the corporate interest requirement (article 6 of the Companies Code) and from the prohibition on financial assistance (article 322 of the Companies Code). Since these limitations apply to the parallel debt as much as to the security itself, a parallel debt that does not reflect them could, in theory, exceed what the obligor can validly owe.

A further risk concerns the enforcement of Portuguese security granted exclusively in favour of the security agent to secure a parallel debt. In such circumstances, the agent's entitlement to enforce the security may be challenged on the grounds that the parallel debt does not constitute a valid secured claim under Portuguese law. This may create additional uncertainty for the lenders, particularly where they are not themselves beneficiaries of the security. By contrast, where security is granted directly

in favour of the lenders, enforcement does not depend on the recognition of the parallel debt, although the agent must have the necessary authority to act on their behalf.

FINAL REMARKS

Parallel debt may offer greater flexibility in cross-border syndicated financings involving Portuguese security. Nevertheless, its use does not eliminate legal uncertainties, particularly where security is granted exclusively in favour of the security agent.

An issue that deserves further attention is the insolvency of the borrower, where both the lenders and the security agent may seek recognition of claims arising from the same financing. The interaction between those claims and the corresponding security interests should be carefully considered to prevent double recovery. Similarly, the insolvency of the security agent raises questions concerning the treatment of the parallel debt and enforcement proceeds, particularly where the agent holds the security in its own name and no separate arrangement exists to protect the lenders' interests.

Another relevant consideration is the consistency of the financing documentation. In cross-border financings, parallel debt provisions originally drafted to address the requirements of other jurisdictions may not necessarily align with the Portuguese security package. Particular attention should therefore be given to ensuring consistency between the finance documents and the Portuguese security documents, especially regarding the identification of the beneficiaries of the security, the definition of secured obligations and, where applicable, the maximum secured amounts registered in Portugal.

The inclusion of a parallel debt provision should not, in itself, determine how Portuguese security is structured. Whether security is granted in favour of the security agent or directly to the lenders, the arrangements should allow enforcement to be coordinated in accordance with the agreed intercreditor arrangements and enforcement proceeds to be applied towards the secured obligations. Both structures raise different considerations regarding the position of the security agent, changes in the lending syndicate and the enforceability of the security interests.

Ultimately, granting security directly in favour of the lenders may offer greater legal certainty by avoiding reliance on the recognition and enforceability of the parallel debt under Portuguese law. The appropriate structure should therefore reflect the specific requirements of the financing, with particular attention to its effectiveness throughout the life of the transaction.

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ABOUT THE AUTHOR

Filipe Henriques Rocha is a Senior Associate in the Banking and Capital Markets group at MACEDO VITORINO.

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