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**EFFECTS AND RECOVERY
FROM THE FINANCIAL CRISIS**

Diogo Tavares de Carvalho
dte@tc-advogados.pt

João Guilherme Duarte Gil Figueira
jgf@cameiralaw.com

Maria Antónia Cameira
mac@cameiralaw.com

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Section I. “Chapter 11” type process

Brief introduction to the Portuguese Insolvency Regime

In Portugal, the legal provisions dealing with insolvency and the restructuring of a business are the Insolvency and Corporate Recovery Code (CIRE - “*Código da Insolvência e Recuperação de Empresas*”). While there may be certain broad similarities between the two systems, the protection from creditors provided to distressed businesses under the applicable provisions of this code differs substantially from Chapter 11 of the United States Bankruptcy Code.

When a business operating in the US finds that it is in trouble and no longer able to pay its creditors or maintain its debts, it can file with a bankruptcy court for protection under Chapter 11. A Chapter 11 filing means that the business intends to continue trading while the bankruptcy court supervises the company's debt and contractual obligations. The court has the power to cancel all or some of the company's debts. Critics of Chapter 11 have claimed that it is too lenient, allowing incompetent managers to continue managing. It is seen as a convenient escape route if things go wrong for a company.

Bankruptcy proceedings under the Portuguese legal framework are guided by a rather different set of principles, with the main focus being the satisfaction of creditors where the latter have much greater powers to decide the insolvent entity's ultimate fate.

The paradigm shift towards a creditors-biased regime

This state of affairs is best understood within a historical context. The Portuguese insolvency regime preceding CIRE enshrined a set of principles which might even be defined as a form of Chapter 11 “*avant la lettre*”. It safeguarded the interests of debtors through proceedings predominantly in favour of recovery of businesses and therefore afforded much greater protection from creditors for businesses in financial distress (in contrast to protection for creditors *stricto sensu*).

The previous focus was on corporate recovery at all costs, while working in favour of businesses' shareholders and general stakeholders. Nevertheless practical experience indicated otherwise, giving rise to several pitfalls.

In effect the enforcement of the predominantly Court-led system not only demonstrated abundant leniencies to insolvent companies but proved also to be unwieldy and lengthy in its ability to recover debts and protect creditors' guarantees. It was felt that without reform the old regime would cause serious harm to the economy and workers in general.

With the enactment of the new legal framework the priority changed, setting its tone on the satisfaction of creditors and no longer prioritising the recovery of financially distressed businesses.

For this reason creditors have become the leading figure in the Portuguese Insolvency and Corporate Recovery regime and are required, under the supervision of the Courts, to assess the distressed company's financial viability and decide jointly whether recovery or liquidation is appropriate, and in what terms. In practice, this allows total flexibility for creditors while on the other hand vastly restricting the options available to the debtor company and/or its management when attempting to come to some sort of agreement with overzealous creditors.

Does the law in your jurisdiction provide protection from creditors for businesses in financial distress?

Contrary to most other EU member states, which have restructuring procedures for companies in financial distress as well as liquidation regimes, the Portuguese CIRE provides for just a single insolvency procedure, in which the creditor has all the main decision-making powers and the debtor cannot of its own accord file for a restructuring or recovery process.

The only true alternative to bankruptcy lies with the shareholders' and directors' capacity to prove that the Company is not insolvent, and is recoverable from its current financial distress. However such process can only take place after insolvency proceedings have been filed, whether to wind up or restructure the Company and this may be decided by the creditors alone while debtors cannot in any way impose such decision.

However, having said that, the triggering of certain types of mechanisms encompassed in the provisions

regulating companies in financial distress may under certain circumstances delay or preclude a potential liquidation scenario, and in this sense provide protection from creditors.

1. **Types of “protection”: Non-enforcement of debts vs. avoidance of liquidation**

As stated above, there is no true protection for debtors facing bankruptcy from creditors during or immediately before insolvency proceedings, as the debtor cannot act singularly to prevent or hinder liquidation of a company.

(a) Non-enforcement of debts

Nonetheless, once insolvency proceedings have been filed the debtor will be protected from further court proceedings for recovery of debts, foreclosures and repossessions. Therefore, once an insolvency process is in motion, creditors cannot enforce their rights other than those petitioned in the insolvency proceedings. Other pre-judicial debt collections are also suspended.

The institution of defence proceedings, the recourse to out-of-court conciliations and the negotiation and crafting of a strategic recovery plan may represent successful alternatives to liquidation and winding up.

(b) Defence in insolvency proceedings

The delivery of a defence by the debtor in Court, post-commencement of insolvency proceedings, may encompass steps aimed not only at opposing the declaration of insolvency but also at proving, to the Court and creditors, that it is financially recoverable or that its assets are sufficient to cover the outstanding debts. In this instance the case will be dismissed and the Company will return to the *status quo* prior to institution of insolvency proceedings. In such cases creditors must look further afield to provisions other than those governing bankruptcy to enforce their claims and credits.

(c) Out-of-court conciliations

The law offers an extrajudicial conciliation process to permit the rehabilitation of companies facing insolvency or experiencing financial difficulties. This process is conducted by a public entity, the Institute for Support to Small and Medium-sized Enterprises and Investment (IAPMEI).

The aim of this procedure is to reach an agreement between the company and all or some of its creditors that will pave the way for a viable recovery.

The fact that judicial insolvency proceedings are pending is no bar to the conciliation procedure. In that case, if insolvency has not yet been declared, the legal process can be suspended at the request of the company or of any interested party.

The agreement reached in the conciliation procedure must be set out in writing in the form of a recovery plan that allows for the distressed entity to repay its creditors over time, and a public deed is legally required in certain cases.

Commencement of this special procedure dispenses directors from their obligation to file bankruptcy proceedings.

2. **Obtaining an agreement: Insolvency plan**

As an alternative to the sale of assets and liquidation proceedings, creditors may approve an insolvency plan contemplating reorganisation or restructuring of the company. Such a plan can however only be approved and set in motion by creditors controlling at least 20% of the debts. Moreover the creditors will always have the power to decide whether or not any reorganisation program proposed by the debtor will ultimately be rejected or accepted.

3. **The triggers for protection: what tests must the business meet to justify protection e.g.**

- **must it be insolvent (or must insolvency be a strong likelihood) or can the protection be triggered on another basis**
- **must there be a reasonable prospect of recovery to justify the protection.**

As aforementioned the Portuguese insolvency regime does not offer a Chapter 11-type protection to financially distressed companies. However mechanisms exist which, under certain circumstances, may allow a recoverable company not to undergo liquidation and winding up.

Such mechanisms can be operated prior to declaration of insolvency if the debtor is able to produce evidence satisfactorily demonstrating that the company is not insolvent and is capable of generating adequate returns to cover its debts thereby ensuring the financial viability of the business.

Nevertheless the most opportune moment to avoid liquidation and winding up occurs only after the declaration of insolvency, when debtors can propose and negotiate with creditors an insolvency plan that foresees the entity's continuity.

Although this is a matter of agreement between debtors and creditors, and the recovery fully depends on the final acceptance by the latter, the fact is that the company will be obliged to show sufficient objective evidence to substantiate a reasonable prospect of recovery.

4. Describe governance of the business during the protection period. Does the protection involve appointing an official to oversee the process? Do the powers controlling the business remain with its governing body or are they transferred to an official?

Once a distressed company's insolvency has been declared, at the outset of proceedings, a court-appointed administrator will share responsibilities with the entity's original governing bodies, while dealing with the day to day aspects of the insolvency.

A creditors' committee will be central in arriving at decisions that are key to the unfolding of the insolvency proceedings while overseeing and advising the court appointed administrator.

In a recovery plan scenario an entity's governing bodies may reassume full powers although remaining supervised by the insolvency administrator and in accordance with the clauses and conditions of the plan.

In a state of insolvency, directors continue to be generally bound by special duties of due care, loyalty and independence, although fiduciary duties will extend to include the protection of creditors' rights, in whose interest it is to effectively become the enforcement agents of such duties.

5. How long does the protection last? If indefinite, who decides whether the protection has been successful or if the business should be liquidated? What criteria are applied in making the decision?

The length, duration and termination of the "protection" mechanisms are more constructively viewed from a different perspective, rather than simple and straightforward criteria, as the trigger is often impersonated by the creditors' will, if they oppose discretionarily the terms of an insolvency plan or agreement.

The mandatory non-enforcement of debts during proceedings and the lodging of the debtor's defence encompass two forms of protection that cannot be limited or otherwise terminated until the conclusion of the insolvency proceedings altogether. As such these mechanisms will endure until the court decides whether to liquidate the company or to dismiss the case and do not depend on whether the "protection", in this case, was either successful or unsuccessful.

PEC (*"Procedimento Extrajudicial de Conciliação"*) or Extrajudicial Conciliation Procedure and the Insolvency Plan can be viewed as protection mechanisms that commence and conclude according to the will of the parties involved, namely and principally the creditors.

The commencement of a PEC negotiation either suspends the debtor's duty to file for insolvency when the insolvency is imminent or puts on hold the formal insolvency proceedings, if they have already commenced. A successful out-of-court conciliation or PEC will also halt liquidation.

Therefore, such "protection" will cease if the negotiations fail, if the IAPMEI considers the conciliation to be impossible due to the non-economic viability of the business, if negotiations are unsuccessful (or abandoned by the creditors), if the agreed PEC conciliation plan was breached, or if it is opposed by most creditors.

Finally, as a general rule, breaching the terms of insolvency may trigger the termination of the

“protection” against liquidation. If the debtor breaches the terms of the Insolvency Plan, the non-enforcement and pardon of credits provided in such agreement are set aside and the company shall most likely be forced to undergo liquidation.

6. Is there a good success rate for the process?

Insolvency provisions that improve the success rate properly address the following aspects: speed, viable rehabilitation of companies, costs and value received by creditors and other stakeholders. They allow for rehabilitation, maximise the value recovered by creditors and are cost efficient.

The success of insolvency proceedings is measured through the computation of the average cost of proceedings, average time spent (encompassing foreclosure, reorganisation or liquidation) and the average recovery rate, i.e. the average total percentage of recovered money in relation to a debt.

Currently, Portugal ranks in 22nd place regarding closures of businesses, falling just below Austria and Cyprus and in the enforcement of contracts Portugal comes slightly lower in 25th place (Doingbusiness.com 2009)

On average, insolvency proceedings in Portugal cost nine percent of the insolvency estate and take two years to complete. The recovery rate in insolvency proceedings ending in liquidation is 69.4 cents on the dollar, which is the 22nd highest recovery rate in the world (Doingbusiness.com 2009).

These rankings show real improvement on previous years. However, despite the substantial reforms, most practitioners still perceive the current CIRE as embodying a regime that lacks the correct approach to issues.

7. Have any particular advantages or disadvantages been identified in the process in your jurisdiction? For example, if the process is not generally perceived as successful, why is this so?

(a) Advantages: Approach and philosophy

The new approach and philosophy regarding bankruptcy proceedings as enacted by the provisions enshrined in CIRE may be criticised for its tendencies to disregard options available to rehabilitate distressed companies, but its new found improvements in speed and agility ought to be praised.

Avoiding previous pitfalls

Granting new powers to creditors was part of the solution found to avoid previous pitfalls such as:

- Excessive complexity of proceedings, with excessive Court intervention.
- Delays in liquidation.
- Delays in credit graduation.
- Excessive number of proceedings due to the availability of two forms of procedure, with consequent duplication of claims.
- Delays in decision by the courts due to the need for economic evaluation of the target by the Court.
- Debtors were systematically filing for recovery proceedings in order to hinder or delay the liquidation.
- Problems in enforcing avoidance rights during the claw back period.
- Non-compliance with the mandatory filing for bankruptcy by Company directors.

Some of the main goals of a successful insolvency regime have been greatly achieved with the enactment of the new legal framework, namely those set out below.

Rehabilitation of companies vs. elimination of failing economic agents

The new code is less lenient towards incompetent management in comparison to Chapter 11, and is efficient in its detection and elimination or liquidation of failing companies. Failing economic agents are eliminated while the rehabilitation of distressed yet financially viable companies is still possible.

Speed

Several amendments have been introduced into procedural law, especially regarding creditor ranking and insolvency administrators' powers, either by tightening deadlines or by making insolvency proceedings easier, faster and less expensive. Creditors' rights to damages are more than ever safeguarded.

Protection of assets

Ensuring that debtors' assets do not deteriorate. Speeding up the proceedings reduces erosion of assets, which in turn allows for more cash to be obtained in asset selling.

Forestalling and hindrance of creditors' rights is now further limited with the streamlining and reduced instances of appeals regarding the declaration of insolvency by the court. It prevents the obstruction of creditors' rights to enforce their security (in other words to recover property or other assets upon which they hold liens) in the event of non-payment, thus increasing the economic value of collateral and decreasing the costs of secured lending.

By restricting the scope of protection offered to failing companies, unlike Chapter 11 or similar legal frameworks, the Portuguese insolvency regime intends to avoid market distortions stemming from unlawful advantages of the protected debtor in relation to its competitors. It also avoids occurrences of over-capacity in a specific industry or area by eliminating less efficient and competitive agents.

(b) Disadvantages

The enactment of CIRE was both well-intentioned and welcomed by the legal community. However, a number of disadvantages of the new regime are commonly recognised. These are set out below.

Empowering creditors against recovery

One of the main objectives of legislative reform in the shape of CIRE was to promote the reorganisation and recovery of distressed yet economically viable businesses while at the same time permitting creditors to assume a leading role in deciding whether it might be preferable to pursue such option or to proceed with liquidation.

Indeed, CIRE has attracted criticism from certain quarters for what some regard as the excessive empowerment of creditors particularly through the inherent loss of initiative by creditors in choosing recovery over liquidation.

Negative economic aspects

Another recognised disadvantage of the system is that the excessive leeway given to creditors may ultimately prove to have considerably adverse economic impact on businesses and the wider economy in the long run, such as:

- Raised unemployment.
- Reduced market confidence.
- Excessively straightforward liquidation of companies based on simple insolvency tests established under stable market conditions and not in the middle of a severe economic recession such as the present one.
- Subsequent downstream triggering of insolvency of other entities locked into complex relationships of interdependence with distressed debtors.

CIRE may also adversely affect creditors who might otherwise potentially achieve better satisfaction of their credits with a more "debtor-friendly" regime.

In fact, a business's value will often be greater if reorganised and sold as a complete unit than if the company is rapidly sold off piece by piece under a forced liquidation scenario. Recovery may often prove to be a more favourable option for creditors under most circumstances, unless they rapid satisfaction of their credits for reasons of their own low liquidity. If indeed a viable possibility, therefore, corporate restructuring and removal of potential agents of mismanagement would allow a much better medium to longterm recovery of outstanding credits.

It is hoped that Portuguese lawmakers will urgently recognise the need to moderate the new bankruptcy regime, in view of the exceptionally severe constraints imposed by current market conditions, to permit a greater degree of preservation of distressed companies and to maximise the value they represent by remaining as going concerns wherever possible.

8. Have you seen any other solutions emerge as alternatives to distressed sales or protection from creditors? E.g. defensive mergers, MBOs, co-operation between competitors etc.

Defensive mergers, Management Buy Outs and Leveraged Management-Led Buy Outs are valid alternatives to distressed sales. Decree-Laws 14/98 and 81/98 regulate and provide for legal incentives to MBOs undertaken in order to acquire a distressed company or all of its assets.

Management-led acquisitions, regardless of whether an MBO or LBO, have as their the objective the revitalisation and recovery of the insolvent company.

MBOs are promoted by company directors or by company employees and are largely viewed as a means to rescue potentially viable companies on the verge of insolvency, rather than as a tool for corporate acquisition *per se*.

The target of an MBO must be a financially distressed company and the MBO must take place within the context of a plan to recover the target company, either through a financial consolidation contract (debt rescheduling, granting of additional financing or share capital increases) or a corporate restructuring contract (improving profitability by restructuring through orderly disposal of a company's assets).

In Portugal, most LBOs are leveraged as they rely on a minimum investment by the buyers and almost entirely on external financing. External financiers will later be refunded at the expense of the target company's securities and/or assets. The target company may also assume the debt incurred by its managers in the acquisition process, provided that such amount is contemplated in the consolidation agreement and is approved by shareholders representing at least 75% of the total voting rights.

Recovery plans underlying a financial consolidation contract or a corporate restructuring contract must be overseen by IAPMEI, the Institute of Support to Small and Medium Enterprises and Innovation ("*Instituto de Apoio às Pequenas e Médias Empresas e à Inovação*"), a governmental body whose functions include the assistance of companies in dealing with financial and operational difficulties.

Such assistance encompasses several programmes such as the abovementioned PEC ("*Processo Extrajudicial de Conciliação*") and SIRME.

SIRME ("*Sistema de Incentivos à Revitalização e Modernização Empresarial*") or Incentive System for Business Restructuring and Modernisation is a specific incentivisation programme to support mergers and acquisitions of distressed companies. This incentivisation programme works together with FRME, a Fund for the Revitalization and Modernization of Businesses ("*Fundo para a Revitalização e Modernização do Tecido Empresarial*").

Through the SIRME programme, FRME will acquire or hold part of the applicant's share capital, which in return will provide the necessary bridging finance to buy or merge with a distressed company and proceed with its reorganisation. This includes the provision of capital for Management Buy-Ins or Buy-Outs.

FRME is an SGPS – *Sociedade Gestora de Participações Sociais* or Pure Holding Company, whose main corporate object is the management of holdings in other companies.

This financial assistance may be combined with the granting of the following tax exemptions:

- Fees;
- Municipal property tax;
- Stamp duty;
- IRS/IRC (individual income tax/ corporation tax)

II. Distressed Sales

Please highlight any important issues in your jurisdiction covering distressed sales. In this context, a distressed sale is by a seller who has little choice but to sell, even in a poor market.

Sales by banks who have enforced security create their own issues and are outside the scope of this paper. Please assume that the sale is by the owner of the business not by a bank.

Important issues affecting the sale of distressed companies in Portugal

The casualties of current market turbulence are bringing about a fresh wave of mergers and acquisitions opportunities in the form of distressed M&A. The extent and variety of distressed M&A opportunities will naturally be strongly influenced by the eventual duration of the present credit crunch and just how deeply into the economy it spreads.

The capital structure of many companies is now considerably more complex than even in recent times. In addition to a general increase in loan syndications, which has resulted in multiple holders of a particular loan, a company may also have additional levels of second and junior lien debt, a myriad of other debt instruments and a complicated set of inter-creditor arrangements. On the equity side, private equity firms, hedge funds and pension funds have in recent years become key players in the marketplace.

These changes may hugely complicate the dynamics of business restructurings. Such new players, with different liens and priorities, will have differing objectives. As a result, insolvent companies are faced with much greater challenges in negotiating with and reaching a consensus among these diverse stakeholders.

From both economic and business perspectives, distressed firms may not have the luxury of time or sufficient funding to endure a long, formal restructuring process. For them, abandoning the restructuring option and opting instead for a quick going-concern sale of all or part of the business may be a more practical solution to their immediate financial woes. From an M&A standpoint, this is a favourable development that will increase opportunities for distressed sales.

The acquisition of distressed companies typically will take place within the context of one of three distinctive scenarios, where the matters and issues surrounding each of them are rather specific.

Scenario A

The sale of a financially troubled yet, under the scope of the applicable legal and financial criteria on insolvencies, recoverable and ultimately viable business, encompasses this scenario A. No additional issues, other than those of an ordinary M&A transaction will be expected to arise.

Scenario B

Under scenario B, sale of the company or its assets takes place during the claw back period.

If the parties enter into a non-concluded deal immediately before insolvency proceedings are launched and the target is subsequently declared insolvent, compliance with the terms and conditions of any such agreement is suspended until the insolvency administrator has decided whether or not to complete.

The insolvency administrator may terminate all transactions detrimental to the insolvent estate that were carried out in the four years prior to judicial declaration of insolvency.

A creditors' committee will vote and approve any deals in an insolvency scenario. However, the insolvency administrator will always have the option of whether or not to proceed with such deals.

Scenario C

In this last scenario, either the directors or the creditors have already filed for insolvency proceedings. The company did not enter into liquidation but is now being either reorganised or put out for auction sale.

The Portuguese Insolvency and Corporate Recovery model does not permit debtor control or "debtor in possession". Therefore once insolvency proceedings have commenced the debtor no longer has the option to obtain finance for a reorganisation sale or to be in charge of any asset sale. Judicial selling will be directed by the insolvency administrator.

- (i) **Does the law in your jurisdiction allow a buyer fully to exploit his position of strength and negotiate an unreasonable price with the seller and impose stringent and unfair conditions on a seller? Alternatively, does the law impose a general requirement of fairness and good faith or restrict the buyer in certain areas?**

The sale of private companies is not specifically regulated. Nonetheless there are general principles laid out in the Portuguese Civil Code, namely regarding pre-contractual duties and the *bona fide* principle which are applicable to contracts in general.

The parties to an agreement are obliged to disclose fully all material facts and conditions upon which a deal is built. Each should reveal the exact nature and potential risks that will be transferred to the other(s), thereby allowing the potential contract to fit the needs of all. Sellers are not permitted to deliberately conceal latent defects.

In principle, there is complete freedom for sellers to organise the sale of shares and assets in the manner and on the conditions they deem appropriate. However, such sales should always be conducted fairly and in good faith. Buyers must also disclose all reasonable information in order to minimise potential damages to sellers.

Stringent and unfair conditions

In a pre-bankruptcy scenario, buyers are not allowed to fully exploit a potential position of strength thereby negotiating an unreasonable price and imposing unfair conditions on a given seller. Where conditions are deemed unreasonable and excessively burdensome for the latter they shall be voided by the court for breach of good faith and public order.

For example, are there restrictions on the buyer in relation to:

- a) The price to be paid or can it be an unfair price, below the normal market value of the business**

Provided there is no unlawful pressure in a sale, exerted by a buyer or third parties on the seller, and there is mutual agreement on every aspect of the transaction, the price may be set below its reasonably expected fair market value. When assessing such cases unlawful pressure is construed as coercion or duress.

Creditors are, however, entitled to challenge a below market price transaction on the grounds that the seller did not receive fair consideration or if the sale is deemed unreasonable. The absence of fair consideration in such sales could reduce, hinder, harden, risk or delay enforcement of creditors' claims or could unfairly benefit a specific creditor (who acts as a buyer).

Therefore a sale can and will be challengeable if it can be demonstrated that there was an induced loss of value on the debtor/seller's estate.

Regardless of what has been said above, agreements which only benefit the buyer and are disadvantageous to the seller are null and void according to the Portuguese Civil Code's provisions on good faith and *bonos mores* as well as provisions regulating consideration which must have some degree of adequacy and tend to go against disproportion.

- b) Obtaining personal guarantees secured on other assets of the seller even where this could affect the seller's ability to survive economically**

In fact, according to the Portuguese Companies Code in this regard, joint stock companies ("*Sociedades Anónimas*" or S.A.) are not permitted to issue loans or by any means grant capital or provide guarantees for the purpose of a third party underwriting or by any other means acquiring their own shares.

This prohibition applies to any type of transaction entered into by the target and the beneficiary of the financial assistance, whenever it has the effect of creating a financial liability for the target by the beneficiary's debt, including transactions regarding distressed assets.

However, financial assistance will only be prohibited if given in connection with the acquisition of shares in the company providing the assistance and not those of holding companies.

This rule has a specific rationale: to prevent assets of the insolvency estate that may be required to satisfy creditors' claims from being made available to finance the debt resulting from the acquisition.

The target will be permitted to give financial assistance for the purchase of its own shares, if it is incorporated under the legal form of a limited liability company ("*Sociedade por Quotas*" or Lda.). In effect, only joint stock companies are expressly forbidden by the applicable provisions of the Portuguese Companies Code to grant financial assistance to any prospective acquirers.

Although a minority of experts have raised the possibility of the prohibition being extended to limited liability companies, it is presently commonly accepted that this is not the case.

c) Imposing wide ranging and longterm non-compete provisions on the seller

Non-compete pacts are valid so long as they do not unlawfully impede or hinder competition. Non-compete provisions may be viewed as agreements that restrict free trading and competition between economic agents, with potentially negative consequences for a free competitive market. Wide ranging and longterm non-compete provisions are considered void wherever excessively burdensome for the seller.

Also, such clauses shall only be legally binding as long as they establish reasonable limitations concerning the period of time in which the seller must not compete.

A reasonable period of time would be the duration necessary to protect the buyer in order to ensure the usefulness of the transaction by adequately securing the transfer of all of the business' profitability and value to the buyer.

d) Obtaining warranties and indemnities

Except for the aforementioned prohibition of financial assistance by the target to the buyer, there are no specific restrictions on obtaining warranties or indemnities relating to companies' acquisitions or mergers.

e) Obtaining pre-determined very high levels of compensation for breaches of warranty or covenant

There are no restrictions on a buyer obtaining pre-determined high levels of compensation for breaches of warranty or contract. The pre-determination of compensation is effectively a penal clause ("*cláusula penal*").

The Portuguese Civil Code nevertheless stipulates that compensation may not be exaggerated or superior to the damage itself. Furthermore, in court, pre-determined compensation cannot be accumulated or combined with further compensation for damages, even if the final assessed damages are superior to the amount contemplated in the penal clause.

(ii) Are there particular considerations to be borne in mind in acting for a distressed buyer?

Fundamentals of purchasing distressed businesses

There are obvious financial benefits associated with purchasing a distressed business provided that the buyer truly: (i) understands why the business is currently in trouble, (ii) knows how to turn it around, and (iii) has an exit strategy... whether right in its assessment or, equally importantly, wrong. The universal starting point is to dispel the myth that the purchase of a troubled business is a guaranteed bargain. The old adage, "if it looks too good to be true, it usually is," applies here.

Buyers will of course need to build in assumptions and projections relating to when it might be possible to build or flip the asset, and assessments regarding readiness to sell will be determined by core factors such the entity's debt structure, payments falling due, default on a financial covenant, out-of-court release of collateral.

Developing a buying strategy

When determining a buying strategy, a first and foremost precise identification of the assets the client intends to buy is paramount. Transactional costs and financing will be key factors whether to the transaction is ultimately to be structured as a stock or an asset purchase.

Detailed knowledge of the distressed business's creditors and their potential strengths and weaknesses, and therefore which party is most approachable in terms of negotiating the sale, may be a key determining factor in the acquisition process.

Another essential factor will be the precise nature of the seller's tax position with regard to its assets, in assessing the scope for minimisation of the tax burden with regard to all parties involved. Other relations with third parties and enforcement of contracts or leases, and laws regarding the hiring and/or redundancy of current employees will also be important considerations in view of the fact they may incur significant financial costs.

Due diligence and buying strategies

Another crucial issue is efficient information disclosure. Distressed sellers will often need to sell as fast as possible while buyers will also be aiming to ensure a quick acquisition for similar reasons, where there is a distinct possibility that any delays may result in substantial loss of value in the target business.

This inevitably increases the pressure over the parties and the risks involved in such transaction from the buyer's perspective. Therefore, as an essential component of their risk mitigation strategy, buyers will often negotiate the involvement of warranties and representations in the acquisition of a business.

It is worth noting that the consideration value will generally fall directly in line with the scope of such warranties and representations, as sellers react to them.

Other mechanisms employed in transactional risk management will typically include the following:

- Escrow account

Setting up an escrow account generally funded by a holdback from the purchase price that can compensate the buyer is an option.

- Insurance

Obtaining insurance to transfer some of the risks involved in the deal to a third party can increase the cost of the transaction, nevertheless it may be advisable to do so.

- Warranties and representations

Agreements on warranties and representations obtained directly from top directors and executives provide for the possibility of claims being produced against their personal assets in case of breach.

- Payment of purchase price over time

This form of payment offers the buyer a way of deducting, from the sale price, any loss of value associated with the discovery of hidden liabilities in the target entity during the payment period.

Buyers' concerns

Purchasers of a distressed business should be aware of several potential issues resulting from the contemplated transaction.

Generally, buyers of assets do not assume the liabilities of the selling entity. Instead, those liabilities remain with the seller. There are nonetheless certain instances in which the liabilities of the seller are forced upon the buyer such as where the buyer expressly or implicitly agrees to assume liabilities; the transaction is a *de facto* merger; or the successor is a mere continuation of the predecessor (there is no change in beneficial ownership).

- Transfer of employees

Buyers may have concerns with regard to the target business's current employment obligations. It needs to be considered whether all contracts will be transferred, if all key employees are subject to contracts or even if there are non-compete clauses for other workers.

- Litigation arising

Buyers need to be particularly aware of any possible litigations arising in the future in relation to the purchase of distressed assets or companies.

Where creditors remain unpaid, there is naturally a strong possibility of insolvency proceedings being filed in the future, which creates additional causes of action to undo or *avoid* the sale. The causes of action arising from the legal framework on insolvencies can serve as an important component of any agreement for the sale of a business in the context of an insolvency case.

- Fraudulent transfers

Under specific provisions regulating insolvency proceedings, transactions may be considered as actually or constructively fraudulent where applicable.

Actual fraud involves transfer of assets from the debtor's estate made with actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted.

Constructive fraud differs from actual fraud in that the debtor's intent is of no import. A transfer is constructively fraudulent if the debtor received a less than fair consideration and was insolvent on the date of the transfer, became insolvent as a consequence thereof, or was inadequately capitalised or equitably insolvent.

Expert opinions sought contemporaneously with the transfer that validate the transferor's solvency, adequate capitalisation, or the fact that it received reasonably equivalent value can serve as important evidence in defending an allegedly fraudulent conveyance action. An investment bank, for example, will often determine the enterprise value of a company being sold and issue a fairness opinion, helping to establish that an independent, disinterested third party reasonably believed that the transferor was solvent, adequately capitalised or received reasonably equivalent value at the time of transfer and would not as a consequence be rendered insolvent.

The various methods of purchase and sale of distressed assets each present their own set of advantages and disadvantages. Interested parties will need to analyse each potential transaction on an individual basis, bearing in mind their main objectives and expectations with respect to the transaction, so as to determine the most advantageous way to structure a particular deal.

a) Are there alternative methods of reducing risk for the buyer e.g. is it safer to purchase the business rather than a corporate entity or is it possible/usual to purchase insurance against breaches of warranty/indemnity?

Share vs. asset deals

Potential purchasers of a distressed business must first of all identify precisely which asset(s) they intend to acquire and what purchase method is most suited to the transaction in question.

Associated purchase price and other costs are clearly of the essence when opting either for an asset or a share deal.

While a share deal may sometimes be more attractive in terms of price and costs, the inevitable liabilities, embedded and potentially hidden within balance sheets, may weigh in favour of an asset deal through cherry picking whenever legally acceptable.

The downside of an asset deal in a pre-bankruptcy scenario lies in the potential for subsequent challenges to such transactions (please see point b), below).

In a post-declaration of insolvency scenario the transaction will, as a general rule, always take the shape of an asset deal limited and regulated by the rules governing asset sales, according to which the transaction takes place under the supervision of an appointed insolvency administrator and will therefore in those circumstances be deemed free and clear of all charges, liens, encumbrances or any other type of liabilities.

Purchase of insurance

The purchase of insurance as a means to protect buyers can be very useful especially when the seller refuses to give warranties or else gives very limited ones. In a jurisdiction such as Portugal it is possible to take out insurance to compensate a buyer for loss on breach of the types of warranties or representations typically given on M&A transactions.

However, it should be considered that while many risks may be insurable (such as hidden liabilities, tax treatment or valuation surprises), the cost involved will depend theoretically on the degree of risk perceived and assumed by the insurer.

b) Are creditors allowed to challenge the sale of distressed assets carried out by their debtor? Is it possible for them to request the sale to be reverted? If so, under which conditions? If a Court rules that a sale of distressed assets shall be reversed, is it possible to comply by paying its price rather than by returning the asset?

Although insolvency administrators always have powers to call off any deal entered into by the debtor, under certain circumstances creditors will have similar powers to challenge the sale of distressed assets.

If a transaction is challenged and subsequently voided, the acquirer cannot oppose the return of the asset by paying its purchase price. Generally, the asset itself must be returned to the insolvency estate thereby reinstating the situation that would exist if the transaction had not been completed.

However, in the event the asset no longer exists or cannot for any other reason be reinstated to the insolvency estate, applicable provisions on avoidance of contracts stipulate that the acquirer shall instead return the asset's equivalent value.

The subject of such avoidance rights will vary according to the following potential scenarios.

Scenario 1 – Transactions occurring in the “claw back period” - the exercise of avoidance rights by the insolvency administrator

Transactions carried out by the debtor immediately prior to the commencement of insolvency proceedings are challengeable by the insolvency administrator.

The period preceding the commencement of insolvency proceedings during which deals can be voided and sales reverted, the so-called claw back period, may vary between six months and two years prior to the institution of insolvency proceedings.

The underlying criterion subject to the unwinding of such deals is, as a general rule, decrease in value of the debtors' net assets. The consequence of reverting a deal is the return of the assets to the insolvency estate together with the cancellation of any other effects of the deal on the debtor's estate.

CIRE provides for an extensive list of deals that are challengeable and revocable, with retroactive effect and without the fulfilment of additional requirements, by the insolvency administrator, thus reinstating the situation that would exist if the deal had not been completed.

Such list encompasses, namely:

- acts performed by the debtor without consideration;
- constitution, by the debtor, of rights *in rem* in respect of pre-existing obligations;
- surety, sub-surety, guarantee and credit mandates, provided they were issued by the insolvent debtor within the legally required period and do not relate to transactions in which it has an interest *in rem*;
- simultaneous constitution of rights *in rem* with the creation of guaranteed obligations;
- payments or other acts that perform obligations, whose maturity date was subsequent to the commencement of insolvency proceedings;
- execution of payments or of other acts that terminate obligations which were not conducted in accordance with commonly accepted commercial practices;
- acts performed by the insolvent debtor against a given consideration if the obligations it undertakes significantly exceed those of its counterparty; and
- reimbursement of shareholders loans.

Deals other than those listed may also be voided where deemed disadvantageous or detrimental to the insolvency estate, if they were undertaken within 4 years prior to the start of insolvency proceedings, and the third party involved acted in bad faith, i.e. had knowledge of the debtor's insolvency, the detrimental nature of the deal or the commencement of insolvency proceedings.

Scenario 2 – “Impugnação pauliana”

Under this scenario the transaction takes place prior to commencement of insolvency proceedings and is challengeable as such on the basis that the deal in question diminished, decreased, hindered, frustrated, aggravated or delayed the enforcement or settlement of creditors' claims with regard to a financially troubled company.

The appropriate court action to challenge such deals is the so-called “*Impugnação Pauliana*” which petitions for voidance of the deal and reversion of the assets in question to the debtor's estate.

An essential requirement for the admission of a claim under “*Impugnação Pauliana*” is the possibility that the debtor, in having entered into such transaction, may have acted in bad faith.

For the purposes of such court action bad faith shall be construed as any instance where a debtor has acted in full knowledge and with deliberate intent to deprive creditors of their rights.

Scenario 3

Under this scenario the sale of assets takes place after the insolvency proceedings have already commenced, and within the scope of such proceedings.

Declaration of insolvency deprives the debtor immediately of the power to administer and dispose of assets making up the estate. Those powers are instead vested in the insolvency administrator, rendering acts undertaken by the debtor in breach of the applicable provisions to be ineffectual and generally void.

c) Do labour creditors have special rights in regard to sale of distressed assets?

No, workers do not have a say in M&A transactions concerning the company as they are only preferred creditors in case of insolvency. If the company files for insolvency they shall be entitled to claim their credits as with other preferred creditors.

d) Do creditors have a right of first refusal or similar right to be considered as potential purchasers even if the owner of the assets is not willing to sell them to his creditors? Are there restrictions on creditors buying the assets?

No, creditors do not have rights of first refusal or similar rights in a potential sale of distressed assets. Equally a creditor of a financially distressed company cannot impede the sale of a given asset to another party or force the debtor, instead, to sell it the asset. Rather, the debtor is entitled, in a free market, to sell the asset to any buyer of its own choosing provided that such transaction does not entail an illegal endangerment or diminishment of the insolvency estate or the debtor's estate.

While the underlying rationale of such transactions may encompass the intention to compensate for previous debt incurred by a financially troubled company, the acquisition of its assets by a creditor may be viewed as detrimental to the satisfaction of claims of other creditors and as such may be subject to the filing of legal proceedings to void the deal.

Only if subsequently deemed to be detrimental to other creditors' enforcement of debts can the transaction be halted.

Where insolvency proceedings are already in motion specific set-off provisions will be applicable.

In such cases the enforcement of set-off rules will be subject to fulfilment of the following criteria: credits must be reciprocal, enforceable, due and payable, prior to commencement of insolvency proceedings.

e) Is Court approval required to sell distressed assets? Is it advisable? Is it possible?

There is no requirement to seek court approval for the sale of any given asset(s). The court may however be requested to analyse and approve a transaction carried out within the scope of insolvency proceedings.

f) Which are the main differences if the sale of distressed assets is made before the debtor files a petition for Chapter 11 type protection or after such petition?

As aforementioned, in Portugal there is no Chapter 11 type of protection.

(iii) Are there particular considerations to be borne in mind in acting for a distressed seller?

When acting for a seller it is considered to be a strategic advantage to engage in negotiations with several potential buyers in order to select a stalking horse bidder. This process will take place beforehand, picking a preliminary winner (known as the “stalking horse”). Once such bidder is selected the debtor will then enter into negotiations with that party, expecting that further higher and better bids will be submitted. Those additional bids will, at least, trigger an auction.

The debtor’s advantage in such selection process is the setting of a price floor: one party is bound and locked in as buyer, and uncertainties inherent in the sale transaction will be decreased. Once an agreement is negotiated it shall form the basis for any future bids, thus resulting in a clear picture of the deal and future bidding.

At the same time, however, other bids may be discouraged by the stalking horse’s head start. There lies the potential downside in that bid protections could preclude potentially more favourable bids on a portion of the debtor’s assets included in the stalking horse’s bid.

a) Attempting to limit recourse to the seller once the assets have been sold.

When acting for a seller one of the central keys to negotiations is to limit liabilities arising from potential breaches of warranties and indemnities. Effective limitation of potential future claims is of the essence.

Specifically, the breach of a general bona fide principle may encompass the breach of duties referring to contractual information such as duty of advice or recommendation as long as there is underlying negligence or intent to cause damages.

Sellers will generally try to limit their liability on the breach of any warranties or representations up to, at the most, the amount equivalent to the proceeds of sale. Successful negotiations on behalf of a seller may achieve a lower fixation of this level, depending essentially on the levels of due diligence undertaken by the buyer prior to completion.

The focus when negotiating the survival period of such representations and warranties is to reduce it to the absolute minimum with the insertion of as many conditions as possible.

Challenging the legality of the survival period clause may prove a useful exercise when defending the interests of a seller, on the basis of breach of good faith and public order, if such clause is deemed excessively burdensome.

b) Advising on the consequence (e.g. personal bankruptcy) of giving and defaulting on payment under warranties and indemnities with a consequent focus on full disclosure of any issues concerning the business.

When acting for a seller there are different scenarios to consider, depending on whether an asset or share deal is the chosen method of purchase.

In a share deal the seller falls under full control and ownership of the buyer and, regardless of the warranties provided by a third party, such as a bank or any other financial institution, the enforcement of such guarantees will be limited.

If an asset deal is considered the seller may warrant the transactions with additional guarantees over different assets and in those circumstances provide further security in case of default.

Where a third party provides a warranty, the aforesaid limitations will not be applicable given there are other assets that the buyer can use to enforce such warranties.

c) Risk of having a transaction somehow invalidated if it occurred during a “claw back period” should the seller be subsequently declared bankrupt.

Transactions regarding a distressed business entered into before insolvency proceedings have been filed are always overshadowed by such future possibility and subsequent evocation of avoidance rights. For an extensive analysis of avoidance rights and voidance of transactions regarding distressed assets during a claw back period please see point b) Scenario 1, above.

(iv) Does your legislation contemplate any specific procedure for out-of-court agreements convalidated by the courts?

Yes, Portuguese provisions on insolvency contemplate the negotiation and settlement of out-of-court agreements to be negotiated by the debtor and some or all creditors, through an Extrajudicial Conciliation Procedure or PEC.

Only insolvency plans regulating the liquidation of the debtor must be validated by the Court and imposed upon all creditors.

For more on PECs (*"Processo Extrajudicial de Conciliação"*) please see Section I point 5, above.

(v) Does your legislation contemplate cram down or similar processes?

Portuguese provisions governing insolvency contemplate limited cram down processes, allowing in specific cases for the imposition of an insolvency or recovery plan over dissenting creditors.

Out-of-court insolvency agreements obtained through a PEC cannot, however, be imposed on the remaining creditors that did not take part in the negotiation of the recovery plan.

As far as court-sponsored recovery agreements are concerned, a distressed business's turnaround relies on the mandatory approval of an insolvency plan by 2/3 of creditors, encompassing a majority of non-subordinated credits.

Dissenting creditors that did not concur with the contents of the plan, and therefore did not approve it, are obliged to accept unless they can prove that such plan will produce a considerably worse result for them than would the debtor's liquidation.

Nonetheless, the Court may still refuse acceptance of the insolvency plan if specifically petitioned by any creditor; provided that the creditor in question did not propose the plan and has submitted its opposition prior to the approval stage. Under certain conditions, debtors and shareholders are entitled to file such petitions on a similar basis.

A successful outcome will depend on providing sufficient evidence that if the plan is enforced and accomplished it will place the petitioner in a far less favourable situation than if such plan were not implemented, or if according to the plan a creditor will receive assets or cash with lower economic value than the amount contemplated by the court.