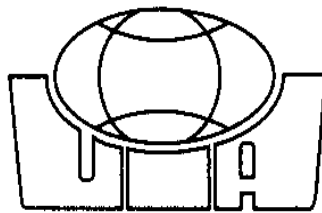


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## **COMPANY LAW COMMISSION**

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### **PUT & CALL OPTIONS OVER SHARES: ADVANTAGES AND PITFALLS**

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## **A. GRANTING**

### **1. Are put and call options expressly regulated in your legal system or do they fall under general contract law?**

An option enshrines not only the concept of a derivative security but also embodies the rights and obligations of a binding contract granting the holder of the derivative the right to buy from or sell to the writer an underlying asset for a specific price and/or before a certain date. The option's value is contingent on a future outcome of the underlying asset and holds no value of its own, however that does not prevent options and other common derivatives such as swaps and futures to be traded as if they were assets.

The agreements concerning the issuance of put and call options including the enforcement of the said agreements are governed by the general principles of contract law, provided for in the Portuguese Civil Code. It follows that listed options are governed by the Portuguese Securities Code. Employee stock options, whether related to publicly held or privately held companies, are regulated by Employment regulations.

Derivatives markets have been drivers of the Exchange industry worldwide. Under the auspices of Portugal's new Government, the so-called "Plano Tecnológico", an incentive programme, has been launched which strives for extensive research and trading in technology. It essentially consists of a broad set of policy measures whose objective it is to boost the national economy's innovative capacity and sustain a healthy rate of economic growth.

In intellectual capital-intensive industries, the buyer has a strong interest in using equity incentives to retain key talent. Hence the use of stock options consideration in M&A transactions as equity compensation awards.

### **2. Are they limited in any way?**

### **3. Is there a particular form required to validly grant an option? Are they limited in any way?**

Yes, there are different procedural requirements for the granting of options depending on their nature. Standardised stock options – that is, listed options and employee stock options issued by publicly held companies – are governed by the applicable provisions of the Portuguese Securities Code.

Stock options offered to employees or negotiated on the underlying share capital of privately held companies are governed by the rules applicable to private contracts and, in the case of employee stock options, by the applicable provisions of employment regulations.

### **Granting standardised stock options**

Listed options follow a standard form contract typically used by brokerage firms. A publicly held company shall grant standardised options in accordance with the following procedures:

The granting of listed stock options over shares is subject to the issuance of the underlying stock that must be standardised and may be carried out either by increasing the share capital or through the acquisition of own shares. Standardisation allows for the option to be traded as a security in the regulated market and to be interchangeable.

Acquisition of own shares is subject to a 10 per cent limit threshold and must be notified to the Portuguese Securities Market Commission – the *Comissão do Mercado de Valores Mobiliários (CMVM)* – disclosing the quantity, price and class of shares acquired.

Newly issued options must be registered with a financial broker or with NYSE Euronext Lisbon (entity managing and supervising the Portuguese Stock Exchange), and duly approved by the CMVM. The issuer shall mandatorily provide, *inter alia*, the following information to the latter authority: writer's identification and address, characteristics of the option including the exercise rights, number of options issued of the same class and exercise date.

### **Employee Share Option (ESO) Schemes**

Employee stock options are specific call options on the share capital of a company whose use among Portuguese companies is becoming increasingly widespread.

The rationale behind ESO Schemes is that they primarily provide an added incentive to maximise company profit while attracting and retaining key personnel in the company.

Under the Portuguese legal framework, employee call options are non-standardised calls. Essentially they are private contracts governed by the general legal provisions of contract and employment law. Interestingly, there are no legal restrictions on the number of shares that companies can issue to employees. The number of shares is apportioned among employees strictly in accordance with the company's policy and other determining factors such remuneration packages. They may not be traded on the stock exchange.

The implementation of remuneration policies is underpinned by a set of procedures concerning compensation schemes. It is recommended that in publicly held companies, salaries for top-level management should be based on independent market surveys and linked to profits. The Portuguese Companies Code stipulates that remuneration of directors shall be determined by general meeting or by a remuneration committee appointed on such occasion. A CMVM Recommendation advises that committee members should be independent from the board.

Investors must especially pay heed to legal impediments affecting options and the main clauses that are warranted in the said option contracts are illustrated below.

- a) The majority of employee stock options are non-transferable, even between employees of the same company. This clause is crucial in the contract.
- b) Employee stock options cannot be traded on the stock exchange due to their private nature and the fact that their terms are couched in non-standardised agreements.
- c) Employee call options are not immediately exercisable as their central objectives are focused on long term goals geared towards the profits maximisation and retention of key employees. Employees may only exercise the options in their capacity as employees. In case of death, the option can be exercised by the deceased's legal successors until the expiration date passes.
- d) The maturity date of employee options far exceeds those of exchange-traded stock options.
- e) Both parties are responsible for arranging the clearance and settlement of any transactions that may result from enforcement of the option.
- f) If the granting company is a public one, ESOs must be issued under an Options Plan, while complying with the aforesaid information disclosure requirements.

#### **4. Are there any formal requirements, such as spousal consent under matrimonial Law?**

Family Law divides a married couple's assets into two distinct categories: common assets and personal assets.

The provisions governing the supplementary matrimonial property regime in Portugal stipulate that in the absence of a pre-nuptial agreement, all pre-existing assets and liabilities shall be deemed to remain separate following marriage. Each spouse or partner has the right in law to manage the assets (i.e. exercising or selling the stock options) that they brought into the marriage or civil partnership, without the other's consent. Whatever is earned or acquired by one of the spouses or partners during marriage (common assets) shall be

treated as being co-owned by both of them regardless of the fact that the option is held individually. Therefore, spousal consent is warranted in these circumstances.

**5. Does it make a difference whether the holder of the option is already a shareholder or not?**

There are no specific pre-requirements for a prospective holder to be granted stock options.

However, if the prospective owner is an existing shareholder of a publicly held company the granting of options may trigger duties of disclosure to the CMVM if possession of the options enables the holder to surpass a 2, 5, 10, 20, 25, 33.3, 66.6 or 90 per cent threshold of voting rights that may be exercised in the company. Such holding must be notified to the CMVM within four days of its acquisition or from the date on which the issuing company is made aware of such acquisition.

**6. Is it normal to contemplate a Grant Price in options? Are there cases where no grant price is contemplated?**

Yes, it is normal to contemplate a Grant Price in options. In the context of ESOs there is no grant price to be paid because the granting of the option forms part of the employee's remuneration or bonus.

Save for employee stock options, there are presently no instances in Portugal where no Grant Price is envisaged.

**7. Are they a common exit strategy for deadlocks in joint ventures? What alternative deadlock resolution mechanisms are available in your jurisdiction (such as giving notice of termination to the company, redemption mechanisms)?**

In the context of the present answer, a deadlock in joint ventures is the inability of the shareholders to agree on a particular decision or action relating to the joint venture – at board or shareholder level – resulting in inaction and frustration of the collective business purposes to such a substantial degree that some non-litigation mechanism (such as an exit clause or a shoot-out clause) is required to break it.

Exit strategies shall be presently analysed only in relation to a joint venture formed through the incorporation of a special purpose vehicle, or SPV.

Exit clauses and other deadlock-breaking provisions are common devices set out upon incorporation of the joint venture and will usually be laid down in shareholders agreements rather than articles of association in order to protect commercially sensitive details of privately held companies from unnecessary disclosure.

Typical clauses make provision for the decision-making process and effective exit of one or more shareholders from the joint venture through the prior granting of buy/sell rights and put and call options.

In the case of both buy/sell rights and call options, it is advisable that a formal procedure be set out pursuant to which one party gives formal notice that a deadlock has occurred and that it will exercise certain rights in response. The rights and obligations of the joint venturers during the interim period between the initiation of the deadlock and its closing should also be specified. Buy and sell rights and other shoot-out provisions will be addressed in the reply to question 8.

Put and call options should be granted upon the incorporation of the joint venture (or shortly thereafter) so that they may constitute a valid exit route. Joint venturers holding call options may exercise them, thereby buying shares from other members of the joint venture upon request. Conversely those with put options can sell shares to their counterparts, with the same consequences as a shoot-out clause. These put or call options are not standardised options and cannot be traded outside the company.

Other than put or call options the most common exit clauses for deadlocks in joint ventures are in general the following:

- a) In the absence of any share transfer restriction, a shareholder may structure an exit transaction by selling its stakeholding to a third party.
- b) A shareholder may enforce his right of withdrawal or dissociation from the joint venture, pursuant to the conditions provided for in the Articles of Association or Shareholders' Agreement.
- c) If laid down in the SPV's Articles, the exiting shareholder may request that the company redeem his shares. Payments made to redeem shareholdings will be assessed in accordance with the accounting results of the most recently approved balance sheet.
- d) If provided for in the Articles of Association the company may acquire the exiting shareholder's stake. As aforementioned, the company may also exercise a put option, effectively compelling the acquisition of such stake. In both cases, the acquisition of own shares in excess of 10 per cent of share capital is forbidden.
- e) As a last resort, if provided for in the Articles of Association, the exiting joint venture may have the option to file winding up proceedings.

#### **8. Are shoot out provisions common? Comment on advantages and pitfalls.**

Shoot-out provisions are a means of breaking deadlock by enabling one shareholder to invoke specific proceedings to oust another.

Buy and sell clauses regulating the procedure whereby an initiating shareholder serves formal notice that deadlock has occurred and through which terms the other shareholders are compelled to choose between selling their interests to him or – alternatively – buying his own interests, are other type of common exit devices potentially triggered in deadlocks of certain types of joint ventures.

The standard buy and sell clause is commonly known as a Texas Shootout clause – there is no specific Portuguese name for it. The initiating member of the joint venture sends a sealed bid to a pre-determined third party, or a normal bid to the other party, stating the price for which it is willing to buy out the other party. The other party either accepts the offer and sells or offers a higher counter bid. Where sealed bids are concerned, the other party also sends a sealed counter bid and the two bids are opened together. The highest bid will be enforced, and the bidder must then buy his counterpart out of the joint venture at the price indicated in the winning bid or sell his own interests at the same price.

It is possible to contemplate a simplified Texas Shootout clause whereby one party notifies the other of its intention to sell at a specific price. This offer must then be accepted; otherwise the declining party is obliged to sell its stakes to the proposer at the same price.

This clause is most commonly applied where each member owns half of the share capital. Since it is a relationship-ending clause, the rights and obligations of the joint venturers during the interim period between the start of deadlock and its termination, namely arrangements concerning operations management, are also set out.

The following two clauses, albeit less common, may still be deployed to resolve deadlock.

Under the Russian Roulette clause, one party offers either to buy the shares of the other party or to sell its own shares to the other party (but not both) at a specified price. The party in receipt of the offer can either accept or reverse it at the same price. This risk of reversal acts as an incentive to the offering party to put forward a fair price.

The Dutch-auction is sometimes adopted as a shoot-out clause in Portuguese joint ventures. It is a variation of the Texas shoot-out, also applicable in joint ventures with two parties of broadly equal financial standing. In this case the parties submit only sealed bids indicating the minimum price for which they would be

prepared to sell their interests. The higher bidder shall then acquire the other party's stake at the lower bid's price.

### **Advantages and disadvantages of such deadlock resolution clauses**

The advantages of the Texas Shootout clause derive from the incentive this method provides in ensuring that a realistic price is fixed by the proposer, at which such party may either have to sell its holding, or buy the other's. Another advantage is that the administration costs of termination are likely to be low, without the involvement of any arbitrators. This deadlock provision is quick and final.

The main disadvantage lies in the potential obligation that the bidder may have to face in order to acquire assets that were not required initially, only to protect its overall investment in the company.

In fact, the initial bid may be intentionally lower than the fair market value of the assets in order to force the other member to sell at an unfair price. It is now common to require the initiating member to act in good faith (using a fair market value) when setting the offer price.

The Texas Shootout clause can operate in a very arbitrary way and it is more openly susceptible to abuse where one or other party does not have the resources or desire to buy, requiring strong negotiating power (prior to the shootout clause being triggered) in order to maximise an otherwise potentially low opening price.

Russian Roulette's main disadvantage lies in the fact that if a party knows that the other cannot buy, that party could take the risk of offering to buy at a low price. Its advantage over other clauses is its relative quickness.

There are other principles and clauses that can be used as well. It is important to remember that each has its own unique advantages and disadvantages. The method agreed upon should therefore be considered carefully.

### **9. Does a hostile bidder have to disclose the options it holds?**

Both hostile and friendly bidders are subject to the same disclosure duties during the period of a takeover offer.

The Portuguese Securities Code sets out specific information that must be included in both the preliminary announcement and in the takeover bid prospectus. This encompasses the obligation to disclose the effective or future number of shares, as well as the actual or future percentage of voting rights that can be exercised by the bidder in the target company (Articles 20º and 138º, Portuguese Securities Code).

### **10. When several shareholders grant an option to a third party, are obligations generally joint and several?**

Options contracts entered into between shareholders and any third party are tantamount to private contracts which fall under the remit of the principles of contract law.

Unless stipulated otherwise in the agreement between the parties, the general provisions on contract law provided that the parties' obligations and liabilities are several and not joint.

### **11. If not, what happens if a minority shareholder wants to comply with its obligations to sell and the others do not?**

If a minority shareholder wants to sell its stake in compliance with the option contract's provisions, the sale

can be concluded but there is no legal mechanism that the same shareholder may put in place in order to force the remaining shareholders to also do so.

Under privity of contract, only the option holder can enforce the contract and compel the shareholder to sell by filing specific performance proceedings.

**12. Is the holder of the option obliged to buy from the complying shareholder and become a minority shareholder?**

By definition, a call option is the right (not obligation) to buy shares in the future at a fixed price and a put option is the right (not obligation) to sell shares in the future at a fixed price. Therefore, unless otherwise expressly agreed in writing, the holder of the option is not obliged to buy the shares from the complying shareholder.

**13. Are put and calls treated in the same manner?**

With the exception of the issues addressed in the reply to question 14 below, the applicable legal provisions do not generally differentiate between a put or call option. Therefore they are both legally treated in a like manner.

**14. Are put and calls on all types of companies treated in the same manner?**

No, options relating to publicly held and privately held companies are subject to distinct disclosure requirements.

**Privately held companies**

In a nutshell, privately held companies are not subject to specific disclosure requirements. As such ESO Schemes and any other type of options negotiated on the underlying share capital of privately held companies are governed only by the rules applicable to private contracts and, where employee stock options are specifically concerned, by the applicable provisions of employment law.

Privately held companies are not subject to disclosure duties and do not report to any regulatory or supervisory authority. However, they are still under the legal duty to disclose specific mandatory information to the Portuguese Tax Authorities, mainly regarding ESO Schemes.

**Publicly held companies**

The CMVM Corporate Governance Code and the Portuguese Securities Code set out the rules governing disclosure obligations intended for publicly traded companies. Essentially, the core disclosure requirements are as follows:

- a) Publicly held companies shall report to the CMVM the approval of all ESO Schemes and allotment of shares within 7 days from the allotment date. Detailed information must be provided illustrating the scheme and pertinent matters such as granting criteria, strike price, underlying share price, exercise time, number and characteristics of the shares, existence of stock options incentive plans and the appointed entity that will supervise its execution.
- b) CMVM Regulations also impose a “say on pay” (or “comply or explain”) policy addressing the annual disclosure of information regarding the salary of directors, other top-level management and general members of corporate bodies, which can be paid through the granting of stock options.
- c) If a publicly held company issues listed options, which are not related to some ESO Scheme, the Securities Code stipulates that it is legally compelled to disclose material facts that may exert influence on share prices. Notification should be made accordingly to the CMVM.

- d) Failure to comply with the abovementioned rule is a serious offence which is punishable in law by a fine. Furthermore, asset recovery orders can be made to freeze or seize the proceeds of offence. In order to maintain market confidence, the CMVM has the authority to publish information relating to market-related offences, including the identity of perpetrators.

By and large, shares from companies that do not qualify and do not meet the listing requirements of the major exchanges may be traded over the counter (OTC) by an off-exchange mechanism in which trading occurs directly between parties. Such operations are deregulated and not subject to disclosure requirements.

**15. What issues would generally be addressed within a rather usual option clause agreement? Focus on those issues that you consider particular to your jurisdiction of which a foreign counsel should be aware.**

In order for a put/call agreement to operate effectively there must be certainty about the scope of conditions to which the agreement is subject, the timeframe for their fulfilment, as well as non-fulfilment consequences. Non-fulfilment issues are better analysed below in C. Enforcement.

Failure to address specific issues may result in disputes or, in extreme cases, may render the agreement void due to uncertainty. Issues regarding exercise time (i.e. American or European option), price and consideration, option period, completion, and delivery should be addressed as paramount.

Clauses regarding the exercise of an option should clearly set out the contents and formal requirements of the notice. Alternatively, wording of the exercise notice should be agreed by the parties in advance and set out in a schedule to the option agreement. One advantage of this method is that both parties will have considered in advance what formalities they require for the exercise of the option.

A general provision pursuant to which any notice under the agreement must be given, and the time at which the notice is deemed to have been received, is always included. Such clauses are vital because they determine when other rights under the agreement are triggered. Certain forms of communications such as e-mail due to evidential difficulties will be advantageously excluded.

In put options, namely in those pertaining to a joint venture agreement, detailed conditions are often included, further limiting the exercise of an option.

The option period must also clearly be set out in the agreement, as some types of options such as Employee options tend not to be exercisable immediately.

To clarify matters with regards to the type of consideration most option contracts normally assume that it will be satisfied in cash at completion. Consideration may otherwise be satisfied in other ways, such as in shares. If the consideration is to be satisfied by the issue of shares by the writer, the call holder will often obtain comfort from the writer that it will, at all times during the option period, ensure all the necessary requirements are fulfilled and regulations are complied with.

The comfort should be in the form of an undertaking from the writer which is included in the agreement. Consideration should also be given as to how any consideration shares will be valued.

If the option can be exercised on more than one occasion, it may be appropriate to include provisions for calculation of the option price by reference to a price per share. Furthermore, if the option extends to more than one class of security, it may be appropriate to include an aggregate price payable on exercise of the option.

In specific cases it is possible for the parties to agree upon a completion clause which provides that consideration will be paid to a third party as the seller directs.

Reorganisation clauses often also form part of the option contract, seeking to protect the call holder's

potential shareholding in the company from dilution or the call writer's ability to sell all of its shares in the company. They also seek to ensure that, if any of the events contemplated by the definition of reorganisation do occur, the appropriate amount of additional consideration is paid.

Reorganisation and consideration/price clauses may give rise to disputes. It is advisable that such clauses also provide for forms of alternative dispute resolution. The use of arbitration provides an alternative forum for disputes as to the consideration and reorganisation. A dispute resolution mechanism in relation to the consideration will only be appropriate in circumstances where the consideration is calculated by reference to a formula or to a fair market value.

Warranty clauses set out the limited warranties that the seller gives in connection with the option shares. These include warranties as to the seller's ability to enter into the agreement, ownership of the shares, the percentage of the company's issued share capital that the option shares represent and that the seller has disclosed all material information in relation to the company of which it has knowledge. The clauses should be non-controversial.

In the case of listed options and options pertaining to joint ventures, option contracts seldom include bilateral agreements on behalf of the holder and writer to maintain confidentiality with regard to certain ancillary aspects of the contract, as the existence of the contract in such cases must be disclosed. The scope of the information covered and reasonableness of the obligations are likely to be key factors in determining enforceability.

In view of a specific deal embodying the transfer of shareholders, these must be firstly offered for purchase to existing shareholders in order to allow for exercise of their pre-emption rights. Sometimes these rights are heightened and extended in other documents such as a shareholders' agreement. Before the option is granted, the company's articles of association should be reviewed to ascertain whether a waiver of these rights is required from the company's shareholders. Without such a waiver, there may be a technical breach of the target company's articles of association or other document granting pre-emption rights.

## **B. EXERCISE**

### **1. Can you freely agree on the conditions of the exercise of options, in particular on the purchase price? Can you agree to a price in a currency other than the currency of the parties, of the jurisdiction of the company, any other?**

Portuguese provisions governing stipulation of the purchase price, payment and completion provide that the parties are allowed to freely agree a purchase price with regard either to its amount or the chosen currency, provided that such stipulation does not go against the *bona fide* principle.

The price may be set in a specific foreign currency, either by indexing it to a specific amount in national currency at the exchange rate in force at the time of the agreement, or without such correlation.

Any currency may be chosen to fix the price, regardless of the company's jurisdiction or the parties' domicile or nationality. It is also possible for more than one alternative currency to be chosen. If the chosen currency becomes unavailable, insufficient or is no longer in circulation, the acquirer may either resort to national currency at the exchange rate given at the date of completion or to the new replacement or revalued currency in circulation.

However, it is not permissible to 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 one of the parties they shall be voided by the court for breach of good faith and public order and where unlawful pressure is construed as coercion or duress.

#### **Are escalation clauses possible? Are they limited in any way?**

One of the guidelines of Portuguese contract law is freedom of contract, enabling the parties to freely set up escalation clauses with few restrictions. Escalation clauses are where a predetermined increase (whether through fixed increments or not) in price is agreed in the event of a rise in value of the underlying.

Although escalation clauses are rarely included in put and call options contracts due to the latter's specific nature, where the contract itself provides for the parties to either exercise the option or not – depending on the underlying value – it may be necessary for such clauses to be provided.

Holders of put and call options, entitled to request the exercise of the option but not obliged to do so, are protected against unfair deals and therefore against the misuse of a badly constructed escalation clause.

On the other hand, put writers are not able to adjust their position to unforeseen circumstances as they are obliged to acquire an underlying without being able to control or decide upon a non-predetermined or fixed and constantly or excessively increasing price. In such cases, where there is an obligation to buy regardless and without the power to influence the price, caps are necessary to prevent the voidance of such clauses due to violation of the *bona fide* principle and their unfair and unbalanced nature.

### **2. May exchange control regulations limit payments under the option in any manner if the parties are in different jurisdictions and the transaction is cross-border?**

Initially, restraints on money transactions were aimed at preventing money laundering crimes and drug dealing transactions. In the aftermath of 9/11 and the 2004 Madrid Bombing, in the midst of the war on terrorism and other global conflicts, European Regulations and Portuguese applicable provisions have been tightened and exchange controls and restrictions expanded and imposed on transactions to several countries in order to cut down on potential financing of terrorism.

At present, transfers and transactions of any type or size to or involving SDNs (Specially Designated Nationals) included in the UN, EU and USA lists (Iran, Myanmar, North Korea, Sudan, Syria and Cuba) or to any “Politically Exposed Individuals” or political entities from Belarus, Democratic Republic of Congo, Iraq, Ivory Coast, Lebanon, Liberia, Sierra Leone, Somalia, Uzbekistan and Zimbabwe, or to related parties (i.e. entities connected to the abovementioned SDNs, countries or entities) are automatically perceived as suspicious and subject to several restrictions and prohibitions.

Transactions involving securities, mergers and acquisitions, exports and imports, and financial transactions of any type are also to be scrutinised in the first instance by commercial banks and then by the supervisory authority, the Bank of Portugal. Banks will block, not receive or make payments to SDNs except if certain conditions (where applicable) have been fulfilled, such as with regard to currency requirements or compliance with prohibitions, filing of specific justifications or disclosure of information. Banks will also report the transaction to the competent authorities.

Disclosing transactional and customer information may breach company privacy policies, privacy regulations, and nondisclosure agreements. Such disclosures are mandatory and will fall under the “legally compelled disclosure” exception common in most privacy policies, regulations and nondisclosure agreements.

Companies doing business with entities from specific countries or related to SDNs must first conduct thorough due diligence to make sure the other party in the transaction is not listed as such and the transaction is not blocked.

### **3. What are the parameters to prevent exercise, if there is a disparity between the price resulting from application of an agreed upon formula and fair market value.**

Portuguese provisions governing payment terms and consideration assessment conditions provide that if the parties to a contract freely agree upon a formula determining the future exercise price, such formula shall be enforceable, even if there are disparities in relation to the fair market value.

Therefore, considering that each party has previously accepted to bear the risk of price fluctuations in accordance with future economic devaluation or inflation of the asset, the exercise of options may occur even if the price paid differs from the market price.

In most cases, exercise of options cannot be prevented as there is complete freedom for writers and holders to organise the sale of shares through the granting of options in the manner and on the conditions they deem appropriate, provided that they act fairly and in good faith and there is agreement on any aspect of the transaction. In such cases the price may be indirectly set, through a predetermined formula, below its reasonably expected fair market value.

Nonetheless, in specific cases the exercise of options can be prevented as there are general principles laid down in the Portuguese Civil Code on pre-contractual and contractual duties and the *bona fide* principle which are applicable to contracts in general and to options contract holders specifically, and that if breached may affect the validity of exercise.

According to these principles, the parties to an agreement are obliged to fully disclose all material facts and conditions upon which a deal is constructed, to not deliberately conceal defects and liabilities that may have an impact upon the price or value of the underlying, and to not exert unlawful pressures on the other party that may be construed as coercion or duress. In such cases, exercise of the option may be prevented.

Additionally, 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. The manner in which the option was granted or acquired may also have some bearing on the assessment of whether a contract’s completion is disproportionate or unbalanced and, if so, invalid, non exercisable and

unenforceable. One such legal provision enshrined in the Portuguese Civil Code is the *clausula rebus sic stantibus* – analysed below.

**Are they, for instance, subject to the *clausula rebus sic stantibus*? Can you somehow sidestep it?**

Portuguese Contract Law enables parties to freely and willingly enter into contracts that are disproportionate or which assign greater risks to one of the parties. However, any contract may, in theory, be terminated or amended in accordance with the *rebus sic stantibus* provision of the Portuguese Civil Code, thus rectifying the unfairness for one or both parties with regard to the enforcement of a contract after a fundamental change in circumstances.

Although a complete and in-depth legal definition of material adverse conditions is not provided for, guidelines about what constitutes a relevant change in circumstances are given and the requirements for the application of such provision may be loosened or heightened through the introduction of a material adverse clause, to a contract.

Portuguese Case Law always considers that only an extensive, unforeseeable, abnormal and extraordinary change in the circumstances existing at the time the contract was entered into will objectively have a detrimental impact upon its essential base. In addition to the aforesaid requirements changes must produce, upon completion, an unbalanced and unfair result for one or both parties.

A change in circumstances is not deemed abnormal (and therefore not considered to be fundamental) if the contract contemplates, encompasses or previously allocates the relevant specific risks.

Common business risks, and those relating to a positive or negative economic shift and/or similar changes beyond the parties' control, are not considered to constitute a relevant or fundamental change in circumstances due to the fact that the price is predetermined at the time the option is granted, therefore enabling put and call options to act as hedging instruments through the pre-assignment and/or mitigation of risk pertaining to movements in value of the underlying stock.

The party seeking to avoid completion of a transaction based upon an option contract on the basis of a materially adverse change in circumstances bears the burden of proof that such occurrence has taken place. Termination of contract is only permissible if rectifying the contract in order to restore balance is deemed impossible.

**4. Do put and call options raise competition law issues? Do they have to be notified (upon their exercise of when granted)?**

Portuguese competition law prohibits all restrictive practices which may prevent, restrict or distort healthy competition within the national market, i.e. any kind of agreements or concerted practices between companies irrespective of their form. Certain mergers and acquisitions that may occur through the exercise of put and call options may be deemed anti-competitive if they result in a concentration of companies which offsets market balance.

Such concentrations cannot proceed without the approval of the Portuguese Competition Authority – *Autoridade da Concorrência* (AC) – and the exercise of put and call options in these circumstances must be notified immediately.

Prior approval by the AC is required where the concentration results in a 30 per cent or higher share in the national market for specific goods or services, or in a substantial part thereof; or where the combined turnover (net of directly related taxes) of the companies concerned, in the preceding financial year, exceeded €150 million and if the individual turnover in Portugal of at least two of these entities exceeded €2 million.

Operations subject to this requirement include mergers of two or more previously independent companies and the acquisition of direct or indirect control of a company or a part of one or more companies. A situation of control is deemed to exist if a certain act implies the possibility of exerting, single-handedly or not and in light of the existing factual and legal circumstances, a determinant influence over the activity of another company.

In particular, this constitutes the acquisition of a controlling shareholding in the target's share capital, or of rights or contractual positions that grant a predominant influence over the composition or decision-making of its corporate bodies.

## **C. ENFORCING**

### **1. Are options readily enforceable in your jurisdiction or are they problem children? Are there any particular enforcement issues?**

Option contracts are regulated by the applicable provisions governing promissory contracts. As such, they are promptly enforceable when the obligation falls due (the agreed exercise date) and the writer, despite having been notified to comply with the exercise within a reasonable period of time, fails to fulfil such obligation.

### **2. Are options enforceable in the event of bankruptcy of the person granting the option? If so, by whom?**

In the event of the writer's bankruptcy, once proceedings are filed and regardless of whether the company is to be liquidated or recovered, creditors may not enforce rights other than those petitioned in the insolvency proceedings within 30 days from the date of notification by the Court of the preliminary decision to put the company into administration.

During such period, the debtor (writer) is deprived of any powers to administer or dispose of assets making up the estate until a final decision is made on whether to recover the company or proceed with liquidation. Such powers will be vested in the court appointed administrator, who will act as the company's representative for all matters of a financial nature and is entitled to terminate all transactions that may harm creditors. Acts undertaken in breach of these arrangements are ineffectual.

As such, it will be left to the administrator's discretion whether or not to allow for the enforcement of debts and obligations, which includes options, depending on whether such deal has a negative or positive impact upon the bankruptcy estate.

A call option holder will certainly not enforce it, given the insolvency status of the company. Put holders, on the contrary, may have a legitimate interest in enforcing their options so that their own stock is acquired by bankrupt company at a set price, therefore being considered creditors. Enforcing the option is, however, dependant on fulfilment of the following requirements.

According to Portuguese Insolvency Law provisions, derivative transactions are automatically terminated and liquidated upon declaration of insolvency. If the option was already exercisable at the time, the creditor will be entitled to claim the value of the difference between the exercise price and the current fair market value (based on the market or stock exchange prices at the time of adjudication of bankruptcy). On the contrary, if the option is not yet exercisable, the creditor shall not be entitled to a claim at the time of insolvency.

Portuguese insolvency proceedings claims are hierarchal and divided into four categories: secured, preferential, unsecured and subordinated claims. Where the option holder is entitled to claim the abovementioned value and given the fact that he may already be a shareholder, such claim will be considered unsecured or even a subordinated claim, and rarely settled in full.

### **3. Are options among shareholders equally enforceable whether they are included in a shareholder's agreement or in the by-laws of the company?**

Put and call options are not often granted through shareholders' agreements but, instead, through private option contracts entered into by the shareholders alone. Granting of options through such mechanisms is, however, a viable alternative. Granting of stock options in the company's by-laws is very rare as these are filed with the Companies Registry and follow an inflexible and often cumbersome process of issue and

registration. Furthermore, by being readily available to the public, it would to a large extent hamper confidentiality and secrecy of commercially sensitive matters, especially where privately held companies are concerned.

Both shareholders' agreements and by-laws are equally enforceable, although companies are not bound by the former; such type of agreement is fully enforceable between the shareholders.

**4. Can you force the heirs of a partner, or the divorced spouse who is not a partner as to his/her share of marital property, to sell the shares to the other shareholders, if this was provided in a shareholder's agreement consented by such spouse or in the by-laws of the company?**

Options granted in a shareholders' agreement or in the company's by-laws are equally valid and enforceable.

Only parties entering the stock option contract, i.e. the holder and writer, will be bound by its clauses.

Contractual positions of such option contracts may, however, in certain circumstances be assigned. Such assignment is permissible and will be subject to the fulfilment of determined conditions, depending on the nature of the contract, the parties involved and whether there has been a division of the original writer's assets following a judicial ruling on divorce or in the event of death.

In a nutshell, option contracts are exercisable against the spouse of the original writer of the said contract that gives her or his consent. The contractual position of a writer of a put option contract can be assigned to the deceased's successors provided certain requirements are fulfilled, as follows.

#### **Death and heirs**

According to the applicable Contract Law and Inheritance Law provisions, obligations and liabilities enshrined in promissory contracts entered into by the parties are enforceable against the same and their heirs provided that the rights and obligations of each contract are not entered into as result of the *intuitus personae* nature of the parties.

Put options contracts, whereby the deceased shareholder promised to sell a specific amount of shares at a given price, may be exercised and enforced against the heirs.

#### **Divorce and spouses**

Provisions governing the supplementary matrimonial property regime in Portugal stipulate that whatever assets are earned or acquired by one of the spouses or partners during marriage are deemed to be common and, as such, shall be treated as being co-owned by both spouses regardless of the fact that the option is held individually by the writer. Upon divorce, common assets are distributed equally between the spouses. It is possible, although rare, for shares to be distributed in such manner, where the shares would be awarded to the divorcing spouse that was never a party or consented to the option agreement.

If shares are awarded, as a result of the division of common assets in a divorce, to the original writer's spouse, who was not party or consented to the stock option contract, the option contracts is not exercisable against him or her. Consequently, if the underlying shares are disposed of following a divorce, the stock option holder may only enforce the option against the original writer.

**5. What are the standard sureties that can be contemplated to enhance enforcement? Is it common to pledge the shares or to leave them in escrow to guarantee compliance? Comment on the best/most used guarantees.**

Well designed option contracts will include specific clauses to enhance enforcement, so that the shares are effectively acquired or sold, and specific clauses to provide for swift remedies and/or compensation in the event of non-fulfilment or breach of contract, thus creating interwoven layers of protection.

In order to guarantee compliance it is advisable, where there is a strong and justified uneasiness toward the writer, to agree upon a pledge of the underlying shares or to deposit the shares with a broker until such time as the option is exercised. The pledgee, who may be the call option holder, will be entitled to retain the assets as security against the underlying obligations of the option contract (but cannot sell the shares) and may refuse to return them until the contractual conditions have been fulfilled.

Although they are not mechanisms to increase compliance, sureties and other guarantees will increase the option's enforceability and improve the chances of recovering losses and damages in cases of non-fulfilment or breach of contract.

Personal and bank guarantees, whereby one party (a person, company or bank) assumes responsibility for payment of damages and losses resulting from breach of option contract provisions, may be agreed upon. Rarely, where put options are concerned, if the guarantor is also a shareholder it is also possible for the guarantor to uphold the contractual obligations and perform on the writer's behalf with the holder's consent. Depending on the desired level of protection and on the guarantor's willingness to provide written consent, sureties may be joint and primary or ancillary and derivative.

Penal clauses and liquidated damages clauses are also available to increase the recovery of losses and damages, but will not provide for additional compliance.

#### **6. How is the holder protected in the cases of disposal of shares in violation of the option?**

For the most part, option contracts are regulated by the applicable provisions of Portuguese Contract Law governing promissory contracts. As such, remedies are only provided for breach of contract when the writer cannot or will not fulfil his duties under the contract upon exercise of the option.

Provided the parties are not obliged to fulfil any other ancillary conditions and clauses potentially enshrined in the contract prior to the exercise date, the writer is not considered to be in breach if he disposes of the shares subject to a certain option before such time. The writer shall be deemed to be in breach of contract only where exercise on the specified exercise date cannot be complied with. In fact, solely non-fulfilment due to an unavailability of own shares to sell – at the time of the option's exercise – is capable of triggering the following remedies to protect and, primarily, compensate the holder.

Specific performance proceedings, filed by the holder of the option, will either compel the writer to acquire, resell or issue own stock and sell it to the former or, where impossible or excessively costly for the writer, to award a sum to restore the holder to the same economic position he was in at the time the option was granted, or would be expected to be in, if fulfilment of the contract had been performed.

However, the disposal of shares in violation of a certain share option contract is not challengeable. Provisions governing the fulfilment of contracts provide that the voidability of agreements and reversion of assets can only be triggered where a debtor, acting in bad faith, has imperilled, diminished or eliminated the estate thus endangering creditors' guarantees and satisfaction of their credits.

The parties may, however, agree to award liquidated damages (or similar, under a penal clause) following breach of contract.

#### **7. Mention legal issues that may be typical in your jurisdiction worth noticing.**

Legal issues, other than those previously analysed elsewhere in the present questionnaire, regard Tax issues arising from the granting and exercise of options.

The particular stock options taxation regime will vary according to their nature and type.

Employee stock options and listed options are taxable on exercise as employee's income and capital gains respectively under the rules of the Personal Income Tax Code. Tax will be levied on capital gains arising from the difference between the exercise price and market value on the exercise date at a progressive tax rate varying between 10 and 22 per cent. Non-resident individuals will be subject to a final withholding tax at the rate of 20 per cent.

Capital gains earned by corporate entities and arising from the exercise of listed options will be levied at a flat tax rate of 20 per cent. On the exercise date, expenditure incurred by the writer will be tax deductible as employee's related remuneration.

**8. Mention practical problems that you faced when enforcing put and call options in your jurisdiction that may be good tips for lawyers in other jurisdictions when negotiating an option in your jurisdictions.**

Practical issues may arise where employees exercise options after termination of their employment contracts, in the absence of a clause providing that such exercise is not permissible where the employment relationship no longer exists. Litigation has arisen out of such circumstances mostly in the case of dismissals.

Imprecise conditions or clauses on the exercise of the option will give rise to misinterpretations and ultimately render the option's exercise invalid. Typical practical issues may arise when the option price extends to more than one class of security and the aggregate price payable on exercise of the option may be uncertain.

Another typical practical issue may be brought about by the absence of a necessary waiver of pre-emption rights by existing shareholders, when granting options over shares mostly in privately-held companies. The exercise of the option contract under such circumstances may encompass a potential breach of shareholders' agreements or by-laws of the target.

In summary, practical issues arise mostly in enforcement of the options contract where its clauses and conditions do not clearly address the range of sensitive issues surrounding the granting and exercise of the option.

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