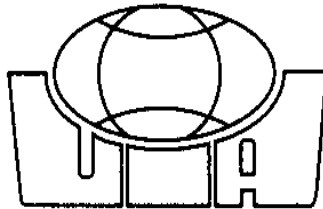


# 52<sup>ND</sup> UIA CONGRESS



## **JOINT CORPORATE LAW AND BANKING LAW COMMISSION**

### **THEME OF THE SESSION**

## **REDFLAGS, PITFALLS AND CONCERNS IN FINANCING A CORPORATE GROUP: THE SUBSIDIARIES AND BANKERS' VIEW**

**Maria Antónia Cameira**  
**mac@cameiralaw.com**

**Diogo Tavares de Carvalho**  
**dtc@imtc.pt**

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## **GENERAL INTRODUCTION**

Mandatory legal capital rules can sometimes prove to have adverse consequences such as the following: they may slow down the raising of equity capital, they may burden companies with avoidable costs and they may hinder useful corporate activities. For example, European corporations may be disadvantaged by restrictions on the repurchase of shares, when they are trying to compete in transnational markets. Equally, the fact of not allowing entrepreneurs to obtain equity capital against the promise of future services may discourage the practice of venture capital financing.

In the European Union, the Second Company Directive which sets out the legal framework on mandatory legal capital rules is, however, generally defended as a device for the protection of creditors: in other words, the function of the mandated capital is to provide a "cushion" reducing the risk of default.

The effect of this is that in some Member States it is still assumed that mandating legal capital and pre-emption rights serves a useful purpose. By contrast, other Member States would prefer to have the possibility of adopting a legal regime that is more similar to the American system.

In fact, there is no reason to prevent Member States from shaping corporate finance rules to best suit their respective needs. This is already true for private limited liability companies, for which there are no harmonised European rules. Countries like the UK can follow a liberal approach, and countries like Germany can retain their complex regimes of mandated legal capital.

# **I – BANKRUPTCY / LIQUIDATION PROCEEDINGS**

## **1. General Framework**

Economies throughout the world have become increasingly interdependent, which results from the increasing volume and variety of cross-border transactions in goods, services and capital. In particular, financial globalisation has advanced rapidly due to a surge of capital flows between industrialised developing countries.

Such processes have not been accompanied, at least at the same pace, by harmonisation of legislation among the different internal legal regimes in specific countries and economic blocs. Despite efforts by bodies such as the EU and WTO, the typical cross-border transaction is regulated by legal frameworks with conflicting priorities, especially involving proprietary rights, assignment of credits, guarantees and insolvency. In fact, the significant diversity of regimes regulating assets distributions of the bankruptcy estate becomes especially apparent at such moments as does the extent of the damage caused as a consequence of inadequately regulated commercial or financial relationships.

Given this reality, any attempt to regulate international commercial relations should attempt to isolate them as much as possible from the “intrusion” of adverse legal systems, with an increased awareness of those which are unavoidable.

Principal legal instruments with the primary objective of increasing legal harmonisation as regards bankruptcy processes include the following: the European Convention on Certain International Aspects of Bankruptcy, adopted by the European Council, in 1990<sup>1</sup>, signed in Istanbul and substituted by Council Regulation 1346/2000 of 29 May 2000, and the United Nations Model Law, drafted by a UNCITRAL working group between 1995 and 1997.

Also worthy of mention is Regulation 1346/2000 which came into force in 2002 and although constituting an important step towards greater harmonisation, the differences among internal regimes continue to be significant.

In terms of the Portuguese legal framework, a new bankruptcy code came into force in 2004 and emphasis the satisfaction of interests of creditors, contrary to the previous code that favoured the recovery of companies.

As for capital maintenance and financial assistance, community efforts have not been insignificant, to the extent that today at least the general principles of the referred regulations are identical in all Member States.

## **2. Key concepts**

### **2.1. Bankruptcy estate and debts, hierarchy of the creditors**

Underlying principles underpinning the provisions governing insolvency and recovery procedures of companies are the payment of debts and hierarchy of creditors.

Effectively, creditors of the bankruptcy estate have the right to be paid for their claims in accordance with a hierarchy established by the Portuguese Insolvency and Recovery of Companies Code (“*Código de Insolvência e Recuperação de Empresas – CIRE*”).

#### **2.1.1. Bankruptcy estate and debts**

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<sup>1</sup> This Convention has not yet come into force because it lacks the minimum number of ratifications.

Creditors of the bankruptcy estate are those with claims over the bankrupt debtor's estate and those which have credits on third parties, whether due or not, that may be guaranteed by assets making up the bankruptcy estate. In either case, the claim will be from a date preceding the declaration of bankruptcy.

The bankruptcy estate will have to pay its own debts first, as is the case with costs relating to insolvency proceedings or remuneration of the receiver among others<sup>2</sup>. Given the autonomous nature of the bankruptcy estate, which should ensure payment of its own debts, payment of credits secured by the bankruptcy estate will prevail over other credits.

The bankruptcy estate corresponds to the debtor's estate at the moment in which the bankruptcy is declared, and assets and rights acquired while the proceedings are pending are also included.

Assets relatively or absolutely exempt from liens are excluded from the bankruptcy estate (although they may also make up the bankruptcy estate if voluntarily offered).

## **2.2. Hierarchy of creditors and ranking of credits**

Settlement of claims follows a hierarchy established by function of classes of credits<sup>3</sup>.

Claims paid first (after debts of the bankruptcy estate) are those which are secured, that is, those benefitting from security or collateral, including special privileges. The consignment of rents, security interest, mortgage and right of retention are all included here.

According to the rules on qualification of credit, personal guarantees do not consign the credit as secured under bankruptcy proceedings.

Claims paid next are privileged credits, that is, credits which benefit from general credit privileges (fixed or unfixed assets) that do not constitute guarantees *in rem* once they are not secured by specified assets. Sometimes these are also called priority claims and may be defined as an unsecured claim that is entitled to be paid ahead of other unsecured claims that are not entitled to priority status.

Finally, there are common credits which do not benefit from guarantees *in rem* or special credit privileges. These claims are for different reasons ranked following the satisfaction of all other credits.

The CIRE thus creates three categories of claims: secured, priority and common.

Payment of guaranteed or secured credits<sup>4</sup> takes absolute priority, followed by claims of privileged credits which is made on the basis of assets not being affected by prevailing securities<sup>5</sup>. Thereafter unsecured claims<sup>6</sup> are paid and, where a balance remains, subordinate claims<sup>7</sup> which refer to debts that are junior or inferior to other types or classes of debt.

## **3. Bankruptcy Proof Collaterals and Mechanisms**

### **3.1 Guarantees *in Rem***

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<sup>2</sup> Art. 46 and 51, CIRE.

<sup>3</sup> Art. 47 and 4, CIRE.

<sup>4</sup> Art. 174, CIRE. Note that these payments are only effected following that of the debts of the bankruptcy (art. 172) and after recognition of the insolvency by final judgment (art. 173).

<sup>5</sup> Art. 175, CIRE.

<sup>6</sup> Art. 176, CIRE.

<sup>7</sup> Art. 177, CIRE.

Guarantees *in rem* continue to be the “collateral” most often adopted for the protection of claims in a situation of bankruptcy. In fact, putting to one side bank guarantees, in frank development but which do not really fall within the scope of this paper, guarantees *in rem* are the most effective means of a creditor obtaining settlement in the case of a debtor’s insolvency and consequent bankruptcy.

In fact the underlying structure of such collaterals affords them rights of claims over certain fixed or unfixed assets for the value of their credits with priority over any other creditors of the bankruptcy estate.

The reason for such preference lies in the fact that such securities have proprietary effects, to the contrary of the majority of guarantees which are merely contractual, thus not being effective against any third parties.

These guaranties need to be constituted by written agreement or public deed and registered.

Claims on the bankruptcy estate which are secured by a guarantee *in rem* (including general credit privileges), take priority regarding order of settlement, under the same terms applicable outside bankruptcy proceedings, and they will be settled by the proceeds collected from the sale of the collateral.

Exception is made for guarantees *in rem* on fixed or unfixed assets subject to registration making up the bankruptcy estate, that may be ancillary to credits on the bankruptcy estate, already created but not yet registered or the object of a request for registration, and the guarantees *in rem* on assets making up the bankruptcy estate that are ancillary to subordinate credits (which with respect to subordinate claims are paid after unsecured credits).

A pledge of shares is a common guarantee *in rem* requested by major creditors of a company such as banks. The pledge will only be enforced in of the event of default and when executed it will give the creditor control over the company. This collateral is often used in addition to the handing over of an undated written declaration of resignation from the directors of the company in question.

### **3.2 Contractual obligations secured by rights *in rem* and rights of retention**

The general rule in any business transactions entered into by the insolvent or third party and not yet fulfilled as of the date on which bankruptcy is declared, is that the said fulfilment depends on the decision by a receiver, whether opting for execution or denying the fulfilment in question.

If the receiver refuses the fulfilment of pre-existing contractual obligations there is a duty to compensate (although in terms more limited than those applicable outside insolvency proceedings).

Where the declaration of bankruptcy affects the fulfilment of the promissory contract of purchase and sale, the refusal by the receiver to comply with its provisions is invalid, and the transfer deeds must therefore be concluded in such cases, provided that two requirements are cumulatively met:

- a) the promissory contract is effective against third parties i.e. it was entered into by means of public deed and registered as such on the land registry; and
- b) the promissory-purchaser has taken possession of the object, prior to the date on which insolvency is declared.

Therefore, the enforcement of a promissory contract, subject to certain pre-requisites of registration, may serve as an effective collateral for the transaction.

In fact, in cases in which the collateral has been handed over to the creditor, the latter’s right is strengthened through the right of retention. The promissory purchaser may exercise the right of

retention on the fixed or unfixed asset until the respective credit has been paid by the bankruptcy estate<sup>8</sup>.

This will only not prevail over debts of the bankruptcy estate, that is to say these are paid before all other debts of the same.

The situation is different when credits over the bankruptcy estate are involved. In this case, it is possible to exercise the right of retention, given that this is not one of the guarantees *in rem* that is extinguished as an effect of the declaration of bankruptcy<sup>9</sup>. It happens, therefore, that the preference conferred by the right of retention is maintained unaffected in bankruptcy proceedings.

### **3.3 Securities granted as collaterals and financial guarantee contracts**

Collaterals given within the scope of the payment and liquidation of the securities system will not be affected by bankruptcy of any of the issuers provided that the underlying contracts were entered into before bankruptcy proceedings were filed.

Equally, contracts of financial guarantees will not terminate on filing or declaration of bankruptcy by either of the parties.

### **3.4 Financial collateral contracts**

The incorporation of the Collateral Directive<sup>10</sup> into the national legislative framework brought about the implementation of forfeiture contracts in financial collateral agreements.

In this context two new types of collaterals are triggerable within the scope of and with the same force as guarantees *in rem*: financial pledge and fiduciary transfer as collaterals.

### **3.5 The granting of powers of attorney as a means to give specific guarantees**

Special attention should be given to the position of powers of attorney in the Portuguese bankruptcy legal framework which provides that any such powers in force will immediately expire upon declaration of bankruptcy by the grantor. In practice it often happens that credit institutions merely require the promise of a creation of a guarantee *in rem*, adopting for this effect a power of attorney. Effectively, in such cases these creditors will see their claims unsecured in a situation of bankruptcy proceedings.

## **4. Exclusion of assets of the bankruptcy estate**

In light of the Portuguese provisions governing bankruptcy proceedings, it becomes apparent that it is extremely difficult to exclude assets of the bankruptcy estate from the insolvency proceedings.

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<sup>8</sup> Arts. 413, 755, 758 and 759<sup>o</sup> of the Civil Code

<sup>9</sup> In principle, the maintenance of the right of retention would be incompatible with the right and duty of the receiver to proceed to the immediate seizure of assets of the bankruptcy estate (observing the exceptions provided for in art. 149(1) of the CIRE). However, the Supreme Court of Justice provides that although “the bankruptcy estate is not obliged to enter into definitive contracts (in this case a promissory contract), the right of retention of the promissory acquirers is legal and triggerable. The holders of such right, preceding the filing of bankruptcy proceedings, may refuse to hand over properties without being paid compensation for a definitive non-fulfilment of the contracts (art. 759(1) of the Civil Code). However, once the insolvency has been declared, with the corresponding seizure of assets, they will only have the right of, by the product of these assets, being paid with inherent priority”, STJ Decision of 28/05/2002, Faria Antunes (in [www.stj.pt](http://www.stj.pt))

<sup>10</sup> Directive 2002/47/EC of 6 June

In fact, in the absence of the concepts of *trust* and *floating charge*, and the existence of *numerus clausus* of guarantees *in rem*, any attempt at protection of credits through less traditional mechanisms often becomes ineffective.

In this regard, only assets that may not be the object of enforcement are explicitly excluded from the bankruptcy estate, which in general terms covers only assets of public domain of the State, and non-transferrable rights.

### **5. The specific case of the trust within civil law systems: Developments**

The Anglo-Saxon concept of the *trust* (fiduciary ownership), that permits the creation of a type of autonomous estate with the specific aim of settling specific claims, is not found in civil law. Some countries, such as France and Germany, have been introducing similar concepts to the *trusts* – *Fiducie* e *Treuhand*, respectively – which do not yet have an equivalent in the Portuguese legal framework. In fact there was a recent draft in April 2008 to introduce the trust into the Portuguese legal framework, however, due to the great reluctance of the lawmaker in relation to this legal device this did not proceed.

At the international level, the Hague Convention on Trusts, which regulates the law applicable to trusts, in force since January 1992, was not ratified by the Portuguese State.

There are devices in the Portuguese legal framework which have been compared to the trust, even though none of them are capable of fulfilling the same goals as the former in an insolvency scenario. Among these there are the donation subject to conditions precedent, the mandate and contract in favour of a third party.

In light of the above, it may be concluded that the trust would bring about advantages to creditors as it would facilitate the creation and management of credits belonging to several creditors, as in syndicated loans, permitting the floating pool of creditors to be protected and changed without the need for assignment of credits and the respective guarantees which always results in costs and delays.

## **II – MANDATORY CAPITAL MAINTENANCE RULES**

### **1. Share capital and its protection.**

#### **1.1. The role of share capital**

Capital maintenance rules serve the purpose of protecting companies' share capital. Share capital must be disclosed in the company's articles of association, represents the initial sum total of all shareholder contributions to the company's funds and serves a triple purpose:

- (i) To ensure the viability of the company's activities;
- (ii) To guarantee the interests of the creditors and other stakeholders.
- (iii) To limit the liability of shareholders to the value of their nominal holdings.

Effective payment of the share capital by shareholders is ensured through the statutory definition of the percentage thereof that may be postponed following the company's incorporation, in accordance with the legal timeframe allowed for it to be made.

#### **1.2. Capital Maintenance Rules**

The main capital maintenance rules which prevent companies' assets from falling below the minimum statutory share capital are the following:

- (a) Prohibition of the distribution of company assets without prior resolution passed at a general meeting, except in specific circumstances as statutorily provided for;
- (b) Prohibition of the distribution of company assets wherever the net situation of the company, as confirmed in the accounts, is either less than the sum of the capital and the non-distributable reserves, or else it will become so as a consequence of such distribution<sup>11</sup>. The only exception allowed to this rule is the possibility of a reduction in the company's share capital, if specific conditions are met;
- (c) Distribution of profits cannot be approved, wherever these are necessary to cover losses incurred during the previous year or to form or reconstitute statutory reserves, and, wherever the costs of incorporation, or R&D, have not yet been completely discharged. The exception is wherever the sum of the free reserves and the previous year's accounts are, at least, equal to the amount set aside for the discharge of these costs<sup>12</sup>;
- (d) Specific devices triggered wherever half of the value corresponding to the company share capital has been lost (for further detail please see Part IV below);

#### **1.3. Thin capitalisation rules.**

Thin capitalisation rules provide that whenever a loan made by a non-resident entity (except if resident in another EU Member State) to a resident entity, in which the former holds a specific business interest, is deemed to impose a situation of excessive indebtedness on the latter, any interest consequently paid on the part of the loan deemed to be excessive is not tax-deductible.

- (a) An entity is deemed to hold a specific business interest with another if it can exert over the other a power to influence its decision-making process in the following situations:

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<sup>11</sup> Art. 32, Portuguese Companies Code.

<sup>12</sup> Art. 33(2), Portuguese Companies Code.

- (i) Where an entity has a 10% or higher holding in the share capital or voting rights of a resident entity, or when the holders of the share capital, their spouses or other certain members of their family hold 10% or more of the resident entity's share capital or voting rights;
  - (ii) Where the resident entity is a subsidiary of the non-resident entity;
  - (iii) Where the majority of board members of the non-resident entity are also board members of the resident entity (this includes their spouses, ascendants and descendants);
  - (iv) Wherever the resident entity depends on the non-resident entity in respect of management decisions, price-setting or market distribution, on account of their commercial, financial or legal relationship;
  - (v) Wherever the other entity is located in a tax haven.
- (b) A non-resident entity (except if resident in another EU Member State) outside the abovementioned situations is also deemed to have a special relation with the resident entity if the loan in question is secured or guaranteed by a third entity with which the lender maintains a special relation, as defined above.

A debt/capital ratio of 2:1 is deemed to constitute a level of excessive indebtedness for the purposes of thin capitalisation rules.

However, except in cases of the other company being located in a tax haven, interest paid on the part of the loan can be deducted as costs, upon proof that a similar loan could have been granted by an independent entity. This proof will be analysed taking into consideration the type of activity, size of the company, respective economic sector and any other relevant factors.

## **2. Conflicts of interest prevention rules: Company vs. management and shareholders vs. company**

Conflicts of interests may arise between company and management, and shareholders and company. These may be prevented through provisions defining typical situations that will trigger a conflict of interest situation, setting out the consequent voidability of any acts or contracts carried out in breach of such provisions and triggering civil liability for the parties involved.

Such provisions range from mere procedural techniques – namely, prohibiting a member of the board to take part in the discussion and voting of matters where there are personal conflicting interests at stake – to more substantive mechanisms – such as the overall prohibition of self-dealing preventing directors from engaging in certain types of transactions, e.g. contracts, loans, securities, with the company or affiliated companies and of exercise of competing activities unless duly authorised by shareholders.

### **2.1. Conflicts of interests between the company and its management**

The granting of contracts between board of directors members and the company which are beyond the scope of the company's corporate purpose, or which confer special advantages on any director will also have to be duly authorised by the board and approved by the board of auditors. Such authorisation must be expressly mentioned in the annual management report.

The company cannot grant loans to directors, make payments on their behalf, provide guarantees for directors' debts or advance them more than one month's remuneration. Directors cannot carry out activities in competition with the company, whether on their own name or on the behalf of others, unless duly authorised by the General Meeting.

Publicly held companies are in addition bound by specific corporate governance provisions referring to the disclosure in the annual corporate governance report of the details of any business concluded between the company and the members of its corporate bodies, or shareholders with a qualified shareholding, if the business is considered to be economically significant to the parties involved.

The acquisition and transfer of shares by board members must be notified to the Stock Market Supervisory Authority (“*Comissão de Mercado de Valores Mobiliários – CMVM*”) and to the company. This information must be included in the board of director’s annual report.

## **2.2. Conflicts of interests between the company and its shareholders**

Portuguese company law framework provides for a non-comprehensive list of situations where conflict of interests between the company and individual shareholders may occur and voting rights may be excluded. This preventive mechanism is triggered in particular when a decision is being taken on:

- The shareholder’s exclusion from the company;
- Granting the shareholder a right;
- Releasing the shareholder from certain obligations, either as a shareholder or as a director of the company;
- Waiving or settlement of the corporate claim for damages and vice versa;
- Dismissal with just cause of a shareholder from the board of directors.

The articles of association and contract of subordination may frame other situations deemed to constitute a conflict of interest and provide further preventive mechanisms against such conflicts of interest.

Publicly held companies are also bound by the duty to disclose to the public the details of any business concluded between the company and the dominant shareholders provided that this business is economically significant for the parties involved.

### **III – FINANCIAL ASSISTANCE PROHIBITION RULES**

#### **1. Introduction**

It can be argued that whether or not a company provides financial assistance for the acquisition of its own shares or those of its holding company, in the absence of legislative intervention, is a matter strictly to be decided by its directors. Objectively speaking, decisions to grant this kind of assistance would be an unusual exercise of discretion but not necessarily improper, which has led several legal commentators to call for the repeal of existing regulatory provisions.

In essence, financial assistance is a problem because it does not fit neatly into established regulatory categories. An exercise of discretion is ordinarily sufficiently regulated by the concept of fiduciary obligation and related penalties for misuse of powers. An exercise of discretion is ordinarily sufficiently regulated by the concept of fiduciary obligation and related penalties for misuse of powers. However a wrongful or misguided exercise of the power to grant financial assistance by the directors may deprive existing creditors of the company, who had dealt with it upon a particular assessment of the company's financial strength, of the right to levy execution over the company's former assets. Nevertheless a decision to grant financial assistance, unlike the decision to return company capital to shareholders, with which it is sometimes compared, does not necessarily result in any diminution of company assets.

One argument goes that if the practice is to be regulated it therefore should be regarded as a less risky activity than a share buyback and the prime role of regulation should be to ensure that creditors receive due notice of the company's intention to undertake a financial assistance transaction and opportunity to oppose the dealing, if it could significantly affect the solvency of the company. Nevertheless, in many jurisdictions, the barriers to a grant of financial assistance are higher than for a return of capital.

Within this scope, the European Commission put forward a proposal to relax the ban on financial assistance through the provision of a gateway procedure allowing companies to sanitise the granting of financial assistance. This legislative process has finished at the EU level and now it is up to the Member States to decide whether or not they will permit financial assistance under the conditions of the Directive. Nevertheless, except in truly exceptional circumstances, it is unlikely that any company would choose to follow such procedure due to a number of factors which include the following: it is time consuming, costly, runs the risk of being disrupted by minority shareholder actions and exposes directors to excessive personal risks.

#### **2. Regulation at European Union level**

European Union legislative developments have brought about a new regime for the granting of financial assistance by targets to their potential acquirers through the implementation of Directive 2006/68/EC of 6 September 2006<sup>13</sup> which amended the Second Company Directive.

Outright prohibition is replaced by moderate regulation of such mechanisms providing that the value of financing does not exceed the amount of the target's distributable reserves.

The granting of financial assistance must otherwise comply with the following requirements: (i) the transaction takes place at the initiative and under the responsibility of the board; (ii) market conditions are fair, especially in terms of the negotiated interest rate and guarantees of repayment offered; (iii) the credit rating of the third party is duly investigated; (iv) the company granting the financial assistance is notwithstanding capable of maintaining its liquidity and solvency; (v) the transaction is submitted to the general meeting for approval in accordance with special majority requirements; (vi) the board

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<sup>13</sup> *This directive should have been brought into force by 15 April 2008.*

submits a written report to the general meeting approving the transaction; (vii) the aggregate financial assistance does not reduce the net assets below the company's capital and non-distributable reserves. Moreover, minority shareholders must be afforded adequate defensive mechanisms to oppose the operation.

These pre-requisites have been made the object of much criticism for being overly restrictive and burdensome in relation to the specific demands of time-sensitive corporate finance transactions. Furthermore, they may also be considered disproportionately protective of minority shareholders, namely, in relation to the transaction-by-transaction *ex-ante* approval by shareholders, any shareholders' right to contest such a resolution taken at the general meeting, as well as the burden of responsibility placed on directors. The argument goes, therefore, that, as a consequence of such, the granting of financial assistance, under the proposed new legal requirements, will not in practice become widely adopted by companies.

### **3. National Legal Framework**

Financial assistance i.e. the guaranteeing or financing of an acquisition by the target is highly restricted within the Portuguese legal framework.

In certain circumstances, however, it is possible to mitigate the restrictions and specific self-financing acquisition structures may be deemed compatible with the provisions in force.

As of the date of writing, Portugal has not yet incorporated the Directive into its national legal framework and there is still no official indication as to what direction it is likely to take when doing so. The Directive does not impose on Member States an obligation to incorporate such provisions and therefore some States may decide to opt out. Despite the lack of official position on this matter, taking into consideration the present view on financial assistance matters and the modest application of the financial assistance prohibition, we are inclined to believe that Portuguese legislator will opt for a less limitative approach to financial assistance than the one presently in force.

### **4. Financial Assistance**

#### **4.1. The General Prohibition Rule**

As aforementioned, Portuguese legal provisions on financial assistance enshrine the general rule of prohibition.

In this regard, joint stock companies cannot 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.

If the principal purpose of the transaction (i.e. the determinant motive) is the actual provision of financial assistance, in those circumstances such assistance will be prohibited even in the cases where it would generally be allowed by the provisions in force.

Where financial assistance is forbidden, pushing down the acquisition debt will not be allowed. 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.

#### **4.2. Exceptions to the general rule:**

The applicable Portuguese provisions expressly enshrine two major exceptions to this prohibition:

- (i) Transactions carried out by banks and other financial institutions in the normal course of business;
- (ii) Transactions carried out with the purpose of the acquisition of the shares by the company's (or holding company's) employees.

Financial assistance provided under these exceptions cannot however make the current company's assets fall lower than the underwritten amount plus retained earnings.

There is no exception equivalent to the common law "*private company whitewash*" which permits the financial assistance to the bidder by the target (to the parent by the subsidiary), provided there are no public companies involved.

#### **4.3. Deal structures and corporate vehicles not covered by the financial assistance prohibition**

The restrictive Portuguese regime on financial assistance has nevertheless allowed the development of specific deal structures which may be used in acquisition finance without breaching the financial assistance rules.

Moreover, specific corporate vehicles will fall outside the scope of the general rules of the financial assistance prohibition regime.

##### **4.3.1. Types of corporate vehicles and deal structures not covered by the financial assistance prohibition**

###### **4.3.1.1. Limited liability companies**

Specific types of corporate vehicles when used as targets of M&A deals are under certain circumstances exempt from this prohibition.

In this regard, 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. In effect, only joint stock companies are expressly forbidden, by the applicable provisions of the Portuguese Companies Code to grant financial assistance to any of their prospective acquirers. In fact, despite a minority of experts having raised the possibility of extending the prohibition to limited liability companies, it is presently commonly accepted that this prohibition does not apply to them.

The difference in regimes is justified by the structural difference between the two types of companies which spans over the need for the company's consent to transfer the company's shares (quotas), more flexible regime of holding own shares and in general a major intervention by the shareholders in the corporate decision-making process of private limited liability companies by contrast with joint stock companies where the board takes the lead role.

However, even though the legal regime on the granting of financial assistance by limited liability companies to third parties for the acquisition of their own shares does not encompass specific restrictions, the upholding of the companies' best interests and the compliance with the general rule on the preservation of the ratio between the assets and the sum of the minimum share capital and the statutory legal reserve must be observed (capital maintenance rules – for further detail please see II above).

##### **4.3.2. Deal Structures**

The structures described below range from situations that are outright considered as falling outside of the financial assistance prohibition scope to more elaborate devices which have been discussed in recent years and are considered as compliant with the governing prohibitions and used in practice in the Portuguese M&A market.

#### **4.3.2.1. Asset purchase deals**

In certain circumstances it may be advantageous to structure a deal through the acquisition of certain assets instead of equity in the target. In such cases, financial assistance by the target will not be hampered by any type of statutory prohibitions.

#### **4.3.2.2. Leveraged Buyouts**

(i) Leveraged buyout without merger

An LBO transaction without merger whereby the target assumes the debt for its own acquisition, or issues any type of collateral thereof, without consideration will be forbidden by the statutory provisions in force regarding financial assistance.

(ii) Merger leveraged buyout

In a traditional merger LBO, the finance to the purchase of the target's shares will be provided to the *newco* by financial institutions (not directly by the target) and guaranties will be provided after the acquisition or merger.

A merger LBO does not include directly the acquisition of own shares or a direct financial assistance by the target to the acquirer as specified in the financial assistance prohibition provisions, and in this instance will not be hampered by financial assistance provisions.

In the case of a forward merger, whereby the *newco* incorporates the target company, any finance or guaranties provided after the merger will be formally provided by the *newco*, not by the target, as the latter has ceased to exist. The target does not have any intervention on the deal but to be the object of it and therefore is not covered either by the rules governing financial assistance.

In addition, the fact that the target company's assets (merged with those of the *newco*) are allocated to reimburse the costs of the LBO in a post-merger phase is simply a consequence of the merger and cannot be perceived as financial assistance granted by the target company to the *newco* for the purposes of carrying out the transaction.

In the case of a reverse merger, the opposite happens, as the *newco* is incorporated into the target company. In this case, the transaction may involve the acquisition of own shares upon the merger, as the assets of the *newco* (which will comprise the target's shares) will be incorporated into the target's assets and that might trigger the financial assistance prohibition rules.

However, this specific situation is expressly excluded from the financial assistance concept and own shares acquisition regimes<sup>14</sup>. The only circumstance where this acquisition structure cannot be utilised will be the case where the articles of association of the target provide for a prohibition of the acquisition of its own shares.

#### **4.3.2.3. Upstream Transfers**

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<sup>14</sup> Art. 317(2), Portuguese Companies Code

Other options to transfer funds from the target to the acquirer are the so-called upstream transfer techniques. The underlying pre-requisite of such techniques is the effective existence of a shareholder relationship between the target and the *newco* so that the transfer is made viable.

The most common upstream transfer techniques are dividends distribution and shareholders loans:

(i) Dividends distribution:

Dividends distribution inevitably requires a pre-existing parent-subsidiary relationship. The target may distribute dividends to the *newco* as long as this distribution is approved by the General Meeting and they correspond to effective profits or free reserves and must comply with additional rules applying to capital maintenance rules and groups of companies.

(ii) Shareholders loan:

Shareholders loans are always a viable option provided that they are structured avoiding recharacterisation as financial assistance and the funds are not used directly to repay the acquisition debt.

#### **4.3.3. The special case of incentives for MBO'S and LBO's of financially troubled companies: Another exception to the rule**

Acquisition of companies through corporate financing schemes like the management-led buyout (MBO) or leveraged management-led buyout (LBO) apply to acquisitions led by managers, regardless of whether they are connected to the company or not, or by company employees. Whenever these aim at modernising and revitalising the company, within the scope of a financial consolidation contract (*contrato de consolidação financeira*) or a corporate restructuring contract (*contrato de reestruturação empresarial*) a special incentives regime will apply.<sup>15</sup>

The financial consolidation contract is entered into between a financially troubled company and credit institutions and other interested parties, with the objective of improving the company's financial status via debt rescheduling, the granting of additional financing or increases to the share capital.

The corporate restructuring contract aims at recovering the company's profitability, by restructuring it, disposing of company assets or businesses, changing its legal type, merging or splitting up the company.

Financing for this type of acquisition must target financially troubled companies and take place within the overall plan to recover the target company.

This specific incentive regime for financial troubled companies expressly foresees the repayment of the debt resulting from the acquisition of its shares by the target company, subject to specific requirements.

#### **4.4. The provision of guarantees**

The provision of guarantees by companies to other entities is forbidden, as it is considered to fall outside the scope of the company's corporate object. Exception will be made for the granting of guarantees between parent companies and their subsidiaries, provided they are in a *controlling* or a *group relationship* or if such action is considered to be in the specific self-interest of the granting company.

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<sup>15</sup> Decree-Law 81/98 of 2 April 1998

In this instance, whenever the acquirer is part of a group of companies, the guarantee eventually required by financial providers can be given as follows:

Upstream guarantee – whenever the guarantee is given by a subsidiary in relation to the borrowings of the parent company.

Downstream guarantee – whenever the guarantee is given by the parent company in relation to the borrowings of a subsidiary.

## **5. Cross-border mergers**

Cross border mergers of companies of different jurisdictions are generally allowed in Portugal. The legal framework stems from similar provisions to the rules enshrined in European Parliament and Council Directive 2005/56/EC of 26 October 2005 on cross-border mergers, which aims to implement the necessary mechanisms to make cross-border mergers between European companies fast and straightforward.

In fact, although Portugal has not yet specifically incorporated these provisions into its national legal framework, it already enshrines the majority of the principles and mechanisms provided for by the Directive. This is the case of the preparation of a merger project document by the companies' boards of directors, and its approval by the shareholders at the general meeting, creditors' and shareholders' information and veto rights.

In this instance, cross-border mergers should be governed by the same provisions as national mergers, unless where stated otherwise. Each of the companies should be governed by the legal framework of its own jurisdiction, with exception made for the final stage of the merger which will be governed by the provisions in force in the jurisdiction of the company resulting from the merger.

## **IV – LEGAL CONSEQUENCES OF CONTRADICTION WITH MANDATORY CAPITAL MAINTENANCE AND/OR FINANCIAL ASSISTANCE LIMITATION RULES**

### **1. Contradiction with Mandatory Capital Maintenance Rules**

#### **1.1. Consequences of breach of mandatory capital maintenance rules**

##### **1.1.1. Recovery of the distributed assets**

The distribution of assets in a situation of breach of the capital maintenance rules will differently affect the shareholders receiving the assets, the management and the company.

Distribution of assets in breach of capital maintenance rules will trigger the return of such assets.

However, should they have been distributed as dividends or reserves, the shareholders will be allowed to keep them unless it can be proved that they were aware of or could not have ignored that such distribution was effected in breach of capital maintenance and preservation provisions.

Both creditors and the company may commence legal proceedings to recover the assets distributed in breach of the above mentioned rules.

##### **1.1.2. Winding-up**

Distribution of the company's assets, in breach of the legal provisions governing the preservation of subscribed share capital and non-distributable reserves, will encompass winding-up proceedings.

In fact, should the company's mid-year and year-end results indicate that the company's net assets have fallen below the minimum threshold of 50 per cent of the share capital, its directors are bound to call a general meeting in order to pass one of the following resolutions:

- to wind up the company;
- to reduce share capital (to an amount not less than the legally required);
- to accept payments of additional capital contributions by the shareholders as reinforcement of the share capital.

The present regime provides a balanced and realistic approach and correctly incorporates into the Portuguese legal framework Article 17 of Directive 77/91/EEC of 13 December 1976.

### **1.2. Management Liability**

Management liability will encompass the breach of directors' activities underlying the duty to act with *the diligence of a prudent businessman*, in the interests of the company and of its shareholders. Any breach of such duty may trigger directors' civil liability.

In respect of the abovementioned general duty of diligence, directors are bound by several duties, such as maintaining the integrity of the assets of the company, whose breach may trigger their civil liability.

Directors who breach the aforementioned duties may be liable towards the company, individual shareholders, and company creditors if, due to the wilful non-compliance with legal or contractual provisions aimed at protecting those creditors, the company's assets become insufficient to satisfy their claims.

Notwithstanding, directors will not be deemed liable if:

- they did not vote in the approval and execution of the harmful resolution;

- they voted against the harmful resolution and stated such opposition in the respective minutes of the board of directors specified meeting; or
- they did everything within their power to prevent the resulting damages.

The Portuguese Companies Code and the Insolvency Code provide for the criminal liability of company directors.

In fact, management may incur a criminal liability whenever there is an unlawful distribution of the company's assets or in the case of culpable insolvency of the company.

### **1.3. The Liability of the Parent Company and its Directors**

Applicable provisions of the Portuguese Companies Code, provide that the parent company in "Group Relationships" must cover all annual losses and is jointly liable for settlement of the subsidiary's debts, namely those resulting from a distribution of assets in breach of the aforementioned capital maintenance rules.

Given the almost *unrestricted power of direction* held by the parent company's board of directors over management of the subsidiaries' affairs, directors may be held liable whenever they issue instructions in matters unrelated to its management, instructions contrary to the dispositions of the subsidiary's articles of association, instructions on *intragroup* transfers of assets without appropriate compensation, or, generally, instructions that are disadvantageous to the subsidiary's interests.

Directors of the Parent Company are bound by a general duty of diligence regarding the entire group.

## **2. Consequences of non-compliance with financial assistance prohibition / limitation rules**

### **2.1. Consequences for financial assistance and related transactions**

Breach of financial assistance provisions will result in the transaction in question being declared void.<sup>16</sup> As a consequence, the transaction's effects should be erased "*ex tunc*".

Any guaranties granted in breach of the aforementioned provisions will also be deemed void. Where the obligor is the target company and the guarantee is void, if there is no group relationship between the companies, the security may be ratified after the acquisition, i.e., when both companies enter into a group relationship.

### **2.2. Management Liability**

Management liability will be triggered in the same manner as described above in IV 1.2. In addition, board members who provided the funds or guaranties on behalf of the company in breach of financial assistance provisions, i.e., with the intention of providing someone else with the means or necessary assistance to purchase company's shares, will be subject to fines.<sup>17</sup>

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<sup>16</sup> Art. 322(3), *Portuguese Companies Code*

<sup>17</sup> Art. 527(1), *Portuguese Companies code*

## V – KEY ISSUES

- Choice of corporate vehicle and targets
  - Determines the relative abilities of target companies to take on the debt of the bidder in order to finance the acquisition.
- Degree of “leverage-friendliness”
  - Certain types of operations are more open to a greater degree of leveraging of the transaction through the assets of the target.
- Availability and types of securities for credit facilities
  - Guarantees *in rem* as the most effective form of collateral in protecting against bankruptcy; play a predominant role in obtaining funding from third parties.
  - Collateral is not affected by bankruptcy of issuers provided that the underlying contracts were entered into prior to filing of bankruptcy proceedings.
  - The use of powers of attorney is not recommended in transactions due to the expiry of powers in a situation of bankruptcy.
- Shareholders loans vs. issue of share capital
  - Shareholders loans are preferred over equity as a means of raising funds, as interest paid back can be offset as tax deductible costs; not the case with distribution of dividends.
  - Withholding tax on payment of interest is lower than in the case of dividends.
- Thin capitalisation rules are a stop
  - Excessive interest paid on a loan between two entities with a specific business interest relationship is not tax deductible
  - A debt:capital ratio of 2:1 is deemed to constitute a level of excessive indebtedness for the purposes of thin capitalisation rules.
- Prohibition on financial assistance
  - Portuguese provisions enshrine the general rule of prohibition; joint stock companies cannot issue loans, issue capital or provide guarantees for a third party to acquire their shares.
- Exceptions to the general rule
  - Transactions carried out by financial institutions in the normal course of business, and carried out with the purpose of the acquisition of shares by the company’s (or holding company’s) employees.
- *“Bending the Rules”*
- Upstream transactions and financial assistance
  - Upstream transactions are the preferred route as they allow prohibitions in the legal framework to be circumvented and the deal to be done; the acquisition may be guaranteed with the assets of the target.
- Other deal structures outside the scope of the financial prohibition rules
  - Asset purchase deals.
  - Merger leveraged buyouts (merger LBOs).
  - Incentives regime for MBOs and LBOs of financially troubled companies.
- *“Breaking the Rules”*
- Non-compliance or breach of the financial assistance prohibition rules

- This will result in the transaction and its effects being declared void as well as any respective guarantees.
- Management liability may also be triggered and board members may be subject to the application of fines.

## **VI – FINAL REMARKS**

### **Financial Assistance: Pros and Cons**

The legal framework for the prohibition of financial assistance has arisen in response to the perception that such rules are necessary to safeguard the capital integrity of companies. In other words such a regime provides for an additional layer of protection for creditors, shareholders and other key stakeholders to reduce the risk of default.

On the other hand, these rules can prove disadvantageous to companies trying to compete in the international market and may even significantly discourage the practice of venture capital financing. Another view is that the current prohibition on financial assistance creates potential traps for the unwary without effectively protecting creditors against the abuse of limited liability by the dishonest.

Arguments such as these eventually led to the amendment of the Second Company Law Directive which relaxes certain rules in the financial assistance regime. Nevertheless, the new procedure still involves a number of factors such as excessive costs, susceptibility to disruption by minority shareholders and the exposure of directors to excessive personal risk which in practice may discourage companies from utilising it.

Given this, the most effective option may be for Member States to adopt corporate finance rules that best suit the effective needs and circumstances of their own particular economies and jurisdictions, as is the case with private limited companies for which there is no harmonised European legal regime. Certain Member States will be able to follow a liberal approach while others can retain their complex systems of mandated share capital.

In the meantime the adoption of certain deal structures and corporate vehicles in acquisition transactions are an effective work-around that allow the financial prohibition rules to be circumvented.

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