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Insolvency & Restructuring - Portugal

Insolvency Proceedings and Investment Opportunities

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Insolvency proceedings are regulated by the Insolvency Act and the EU Insolvency Regulation (1346/2000). They can be initiated only if the debtor is unable to meet financial obligations that have fallen due. If the debtor is a legal entity, the criterion for establishing insolvency is whether the entity's liabilities exceed its assets. Article 20 of the act lists a number of factors that constitute grounds for an insolvency claim.

Declaration of Insolvency

In accordance with Articles 19 and 20 of the act, a declaration of insolvency may be sought by:

- the legal entity's managers (or the body responsible for its management);
- a creditor; or
- the public prosecutor (acting on behalf of entities whose interests are legally entrusted to it, such as the tax and social security authorities).

Jurisdiction

In general, the court of the place where the debtor's registered office is located has jurisdiction to analyze the insolvency application under Article 7 of the act and Article 3 of the regulation. However, a declaration may also be sought from the court of the place where the debtor has its centre of main interests. Article 3 defines this as the place where the debtor regularly conducts the administration of its interests and is ascertainable by third parties. Under Article 4 of the regulation, the law applicable to insolvency proceedings and their effects is that of the member state where such proceedings are opened, except where the regulation provides otherwise.

Cross-Border Insolvency

According to Article 16 of the regulation and Article 288 of the act, if a court of an EU member state (having jurisdiction under Article 3 of the regulation) opens insolvency proceedings, they must be recognized in all member states from the time that the court's order becomes effective in the state where proceedings are opened. Thus, every creditor that has a habitual residence, domicile or registered office in the European Union can lodge a claim in each of the insolvency proceedings pending in the European Union and relating to the debtor's assets. This right also applies to tax authorities and social insurance institutions. However, in order to ensure that creditors are treated equally, the distribution of proceeds must be coordinated. Every creditor can retain what it has received in the course of insolvency proceedings, but is entitled to participate in the distribution of the total assets in other proceedings only if creditors of equal standing have obtained the same proportion of their claims. Article 272 of the act mirrors Article 3 of the regulation in providing that where insolvency proceedings have been opened, any proceedings opened subsequently are secondary proceedings.

Fault of Debtor or Managers

Upon the declaration of insolvency and the creation of the creditors' committee, the procedural issue of qualification is addressed. The insolvency may be deemed to be the result of a fault if it was caused or deepened by conduct for which the debtor or its managers were at fault, in law or in fact, and which took place in the three years before the insolvency proceedings were initiated.

Assets and Debts

The act provides that the insolvency estate is composed of all of the debtor's assets on the date of the declaration, as well as all assets and rights acquired by the debtor while the insolvency proceedings are pending. Articles 47 and 48 establish a priority ranking that distinguishes between guaranteed, privileged, common and subordinated credits. There is also a special and prior category of credits - generally, these are credits that arise after insolvency is declared, including the legal costs and expenses arising from the proceedings. Article 173 states that only credits that have been duly claimed and verified by a definitive judgment may be considered for payment.

Effect of Declaration

Declarations also affect potential acquirers of distressed companies. With regard to deals that have not been concluded, Article 102 of the act states that compliance must be suspended until the insolvency administrator decides whether to proceed or issue a refusal to comply. However, the other party may set a reasonable time limit within which the administrator must exercise this power; if no decision is made, this is deemed a refusal to comply.

Detrimental Acts

The administrator may terminate all acts that are detrimental to the insolvent estate. This potentially applies to acts up to four years before the proceedings were initiated, whether or not they have been completed. The provision covers acts that have the effect of reducing, compromising, obstructing, endangering or delaying the satisfaction of creditors. The termination may be subject to the fulfilment of certain requirements (under Article 120 of the act), or may be unconditional (under Article 121), in which case it has retroactive effect and requires that the estate be put in the position that would have existed had the act not been performed. In all cases, the administrator may make such an order only if it is in the best interests of the insolvency estate.

The termination may be made by the administrator by registered letter within six months of the administrator becoming aware of the act, but not more than two years after the declaration. Thus, the sale or purchase of a business involving an insolvent party may be halted or even reversed by an administrator.

Transactions Involving Insolvent Companies

Knowledge of the risks involved in acquiring a distressed company can be invaluable for acquirers and vendors. Private equity houses know that acquiring distressed companies or businesses at a competitive price substantially increases the upside after a turnaround or once the economy recovers. However, the legal issues to be addressed in such transactions include:

- reviewing potentially problematic financial statements and carrying out due diligence on intangibles (eg, in determining whether goodwill has been affected) and tangible assets (eg, title and security);
- employment relationships;
- directors' liability; and
- tax duties or other payments.

The acquirer should try to acquire the distressed business before insolvency proceedings begin; otherwise, it is difficult to control negotiations with creditors. There will almost certainly be an auction and an acquirer must consider all of the costs associated with an acquisition in the bankruptcy courts.

Portuguese law provides an ideal mechanism for out-of-court transactions. The *plano extra-judicial de conciliação*, a form of restructuring plan, is subject to Legislative Decree 316/1998 (as amended by Legislative Decree 201/2004). However, the plan does not prevent creditors from challenging the transaction on the grounds that the vendor did not receive fair consideration (ie, fraudulent conveyance). The rationale for the transaction should be carefully considered, as the price must be defensible if challenged in court. Independent appraisals of the business and proper legal and financial due diligence are necessary. Payments to the owner of the distressed company should be avoided.

The representations and warranties clause in an out-of-court sale and purchase agreement is essential, but it is often ineffective when the vendor files for insolvency; even the pledge of part of the purchase price to

secure the representations and warranties is insufficient to protect the acquirer. The indemnification claim has no priority and will be classed with the normal creditors' claims. Furthermore, the pledge may be declared null and void by the court, depending on the timing of the purchase.

As an alternative to this pre-insolvency procedure, a prospective acquirer may consider acquiring the distressed company in the insolvency proceedings, allowing it to offload some of the liabilities, debts and unwanted contingencies, obtain a clean balance sheet and, in certain circumstances, select employees. An acquirer may be able to acquire the assets alone or substantially all of the assets and the goodwill of a business (without its legal personality) if it can convince the creditors that this is the best way to maximize debt recovery. Such transactions depend greatly on the circumstances, but a purchaser would be well advised to:

- analyze the debt structure of the distressed company (and the controlling company, if the target is a subsidiary);
- use its ability to assign debts *pro soluto* or *pro solvendo* (ie, with or without recourse) in order to acquire the company through an increase of share capital by converting debts into share capital (ie, exchanging debt for equity) - the acquirer should do this before acquiring shareholder status to avoid being rated as a subordinated creditor in the event of insolvency proceedings;
- assess the timing of the acquisition to avoid the fraudulent conveyance rule;
- avoid being identified as a special related party;
- negotiate in advance with all creditors, including state and financial creditors, in order to safeguard the transaction in respect of challenges to the conveyance. If an acquirer is purchasing a company that is not yet insolvent, the banks will prefer it to put money into the distressed company as a shareholder to subordinate the debt. Acquirers should avoid transactions that are substantially financed with existing debt;
- explore the possibility of acquiring the company or the business in the insolvency proceedings as a way of liquidating the company or achieving a turnaround;
- use the legal incentives for management buy-outs (in Legislative Decrees 14/1998 and 81/1998) in order to acquire the company or substantially all of its assets with a management buy-in mechanism;
- avoid the financial assistance prohibition through proper structuring and financing;
- maximize the tax benefits for distressed transactions; and
- consider the legal consequences for the directors of the acquired distressed companies.

Above all, acquirers must remember that the Portuguese distressed market is becoming more attractive, but that the legislative framework will be tested in the present economic climate.

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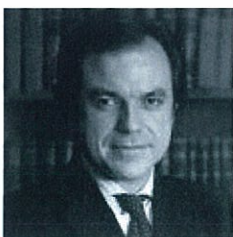
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