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Update

Finance and Governance

Between equity and debt: the Legal Framework for Participative Loans

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1. Context

On 12 January 2022, Decree-Law No. 11/2022 of 12 January was published establishing the Legal Framework for Participative Loans (hereinafter, "PL Framework"). The PL Framework came into force on 13 January 2022.

This regime consists of the introduction of a hybrid mechanism of financing for companies, within the scope of the commitment taken by the Government of Portugal to diversify the available sources of financing and reduce their dependence on the banking system. Thus, participative loans join other types of hybrid financing, between equity and debt, or quasi-capital.

The new regime, by granting the possibility of converting credits into capital, translates into an alternative financing expedient for companies that presents several virtuosities.

2. The concept of “participative loan”

The PL Framework defines the participative loan as a *credit contract for consideration, in the form of a loan or in the form of securities representing debt, whose remuneration and reimbursement or amortization depends, albeit only partially, on the results of the borrower's activity and whose outstanding value may be converted into equity capital of the borrower* (see article 2, no. 1 of PL Framework).

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Therefore, the loan will be considered equity whenever the respective remuneration is dependent on the borrower's results and the respective reimbursement or amortization is only made with funds that, under the terms of the Commercial Companies Code, can be distributed to the shareholders.

3. Eligible Lenders and Borrowers

The PL Framework specifies the entities qualified to grant these loans (the "lenders"), restricting (a) to Credit Institutions and Financial Companies, (b) to Specialised Alternative Investment Undertaking, Venture Capital and Social Entrepreneurship Investments, (c) to Securities Investment Companies for Fostering the Economy ("SIMFE"), (d) to the Capitalisation and Resilience Fund[i] and (e) other entities which are authorised to grant credit on a professional basis. However, there is considerable latitude in the assignment of claims arising from participative loans to third parties.

On the other hand, all commercial companies in the non-financial sector (the "borrower") may take out participative loans.

4. Form, formalities, and purpose of the participative loan

Participative loans have different formal requirements depending on whether they consist of a loan agreement or the issue of securities representing debt. While the former always requires written form, the latter is subject to the regime relating to the issue of securities. It should be noted that these requirements are waived during the pendency of any company restructuring process provided for in the Insolvency and Corporate Recovery Code.

In any of cases, the conclusion of participative loans depends on the prior, express and favourable resolution of the general meeting of the borrower, and the contract or the issue of securities representing debt must expressly mention the subjection to the PL Framework.

The purpose of participative loans must be set out in the contract to be entered into or in the conditions of issue of the debt securities and may consist of the following (see article 5 of PL Framework):

a) Financing investments;

b) The reinforcement of working capital;

c) Repayment of previous debt; or

d) Any other agreed purpose, as long as it is compatible with the corporate purposes or investment policies of the parties.

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5. Insolvency regime applicable to the borrower

The system instituted by the PL Framework for ranking the claims of participative loans in the event of the insolvency of the borrower deserves particular attention. These are considered subordinated credits, graded above the credits of the shareholders and other persons especially related to the debtor (see article 7 of the PL Framework).

6. Remuneration and repayment of the participative loan

The remuneration of the participative loan is fixed freely by the parties by linking it to a share in the borrower's results. Consequently, payment of the remuneration depends on whether or not the borrower generates results. For these purposes, the profit share can be measured by any financial indicator set out in the company's profit and loss account that reflects its financial situation, namely turnover, operating profit or net profit.

This indexation may be total or partial. On the other hand, profit sharing may consist of a fixed or increasing percentage of the results or be proportional to the weight of the nominal value of the loan in the borrower's share capital. The remuneration may also have an additional interest rate component independent of the borrower's results.

If the borrower fails to pay the remuneration due, the lender has the right to call the collateral provided under the participative loan or, alternatively, to convert them into the borrower's share capital.

As regards reimbursement, the borrower may at any time repay the participative loan with funds that, under the terms of the law, may be distributed to the shareholders, at the nominal value of the loan, plus the remuneration due and not paid, and that which would fall due until the beginning of the quarter in which the reimbursement occurs, taking as a reference the respective financial statements that allow the calculation of results.

Consequently, payment of the loan's remuneration, or its reimbursement, is prohibited in the circumstances in which **(a)** the borrower's equity is or would, by virtue of the payment, become less than the sum of the share capital and reserves, **(b)** when the profits of the financial year are necessary to cover losses brought forward or to form or reconstruct reserves imposed by law or by the articles of association, in accordance with articles 32 and 33 of the Commercial Companies Code.

For the duration of the contract, several conditions are established to prevent the undercapitalisation of the borrower and the frustration of the credit. Thus, during that period, the borrower is forbidden to alter the profit-sharing conditions established in the articles of association, the granting of privileges to existing shareholdings, the repayment of shareholder loans, additional or supplementary payments, the amortisation of shareholdings and the resolution to reduce the respective share capital.

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7. Conversion of the loan into share capital of the borrower

Without prejudice to any more stringent terms laid down in the contract or in the terms and conditions of the issue of debt securities, the lender is entitled to have the participative loan converted into share capital of the borrower whereas **(a)** the repayment has not been made in full, after the agreed repayment period, due to the absence of distributable funds **(b)** the borrower has not paid the remuneration due for more than 12 months, consecutive or interpolated, in a period fixed in the participative loan, **(c)** the borrower's management body does not present the lender with proof of approval of the accounts and deposit at the Commercial Registry after 12 months have elapsed since the legal deadline for this, **(d)** or in other situations established in the contract. (see article 14 of PL Framework).

If any of these situations occurs, the lender may present a proposal for the conversion of the participative loan into share capital of the borrower, duly accompanied by a report prepared by a Statutory Auditor containing the valuation of the credits to be converted. The conversion proposal shall describe, namely, the concrete content of the operation, the forecast, when applicable, of the reduction of the share capital of the borrower and respective justification, the amount of the share capital increase to be subscribed by the lender, through the conversion of the participative loan into share capital, and a project for the amendment of the borrower's articles of association. When the borrower is a micro or small enterprise, the costs incurred with the report prepared by the Statutory Auditor are of the responsibility of the lender.

The share capital increase of a borrower may be preceded by a prior reduction of the borrower's share capital (see article 16 of the PL Framework), in order to cover losses, on the initiative of the lender, if it is assumed that, in the case of full liquidation of the borrower's assets, there would be no remainder to be distributed among the shareholders. In this scope, the reduction of the share capital to "zero" or another amount inferior to the minimum established by law is allowed.

After the presentation of the conversion proposal, a general meeting must be immediately convened, which must take place within sixty days of the date of receipt of the proposal, for the purpose of approving or rejecting the resolutions referred to therein. It is also established a pre-emption right in the capital increase, in favour of the shareholders of the borrower who, in case they exercise this right, the increase shall be made in cash, which shall be mandatorily applied in the amortisation of the credits. In the event of non-exercise of such right, the remaining pre-emption shareholders may subscribe to the part of the capital that would belong to the others, in proportion to their shareholdings.

The shareholding acquired by the lender in the share capital of the borrower resulting from the conversion of the participative loan is proportional to the value of the unpaid loan, plus the nominal value of the remunerations that have not been paid as well.

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Finally, it is required that, after the share capital increase, the borrower's equity is greater than the value of the share capital at the date of the proposed conversion of the loan into share capital.

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[i] The Capitalisation and Resilience Fund was set up under Decree-Law no. 63/2021 of 28 July, to provide temporary public support to strengthen the solvency of commercial companies operating in Portugal that have been affected by the impact of the COVID-19 pandemic and to support the capital reinforcement of commercial companies in the initial phase of activity or in the process of growth and consolidation.

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