International Corporate Rescue

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Centre for Commercial Law

UCL LAWS

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

www.chasecambria.com

Annual Subscriptions:
Subscription prices 2015 (6 issues)
Print or electronic access:
EUR 730.00 / USD 890.00 / GBP 520.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

ARTICLE

Transfer of Credits: Highlights on Insolvency-Related Issues

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Background

This article aims to analyse the main features of the transfer of credits under Portuguese insolvency law and its connection, *inter alia*, with the relevant complex Portuguese insolvency regime on clawback. It seeks to address some of the concerns that both sellers and buyers may have and some points that they may want to consider including in their 'check lists' before signing and closing a transaction.

Further to novation ('*novação*'), the act of replacing an obligation to perform with a new obligation and the assignment of a contractual position ('*cessão de posição contractual*') as a way of selling credits under Portuguese law, the assignment of credit rights ('*cessão de créditos*') nowadays constitutes a typical and common transaction. In fact, through an assignment of credits the seller (originator) may obtain a source of funding by means of converting future receivables into cash, being entitled to receive an amount as opposed to receiving the respective receivables as they become due, with the advantage of being released from both the risk and the underlying collection cost. The main advantages arising, *prima facie*, from the so-called 'true sale' are: for the seller it naturally improves cash flows, maximising the recovery of the respective receivables; for the purchaser, as an investor he aims at buying receivables at a discount (haircut) and be vested with the full benefits of ownership of the receivables (right, title and interest) in strict reliance upon the warranties, representations and covenants of the seller, while never neglecting the eligibility of such credits according to certain contractually agreed criteria.

Eligibility criteria

The 'cherry-picking' process related to the receivables implies an understanding of the nature of the receivables whenever the purchase of a pool of assets is at stake and assessing whether they are (ultimately) eligible for the sale.

From a commercial standpoint, it is important to assess the net value of such receivables for the purpose of determining the relevant purchase price (valuation process of the receivables).

The nature and quality of the assets must be duly considered, i.e., the buyer should evaluate the assets and the future streams of flow, including all matters in connection with the collection of the credit (e.g. the existence of an arbitration convention, a jurisdiction clause and an enforcement title). A credit shall only be deemed an 'eligible receivable' to the extent that it is *inter alia* legally and contractually freely saleable, assignable and transferable by its holder and its sale, assignment and transfer to the buyer does not in any way contravene or conflict with any agreements or applicable laws.

The conduct of due diligence will make possible (to a certain extent) to determine whether the credits to be assigned meet the above-mentioned requirements and the receivables are free and clear of any adverse claim by third parties.

Careful due diligence, therefore, plays a significant role.

Transfer of credits

Under the general civil law regime, a creditor may transfer (totally or in part) his credits to a third party, irrespective of the consent of the debtor, provided that the assignment is not prohibited:

(i) by virtue of law;

(ii) by an agreement between the parties; and

(iii) the credit is not intrinsically attached to the assignor by virtue of the specific nature of such credit or identity of the assignor.[2]

Notes

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2 This limitation shall apply in cases where the credit is connected to the person of the creditor and therefore it would be unreasonable to transfer the credit to a third party and compel the debtor to perform before such third party.

Generally speaking, restriction (ii) is the most common as far as assignment of credits is concerned.

As to the formal requirements to assign credits, Portuguese law does not generally impose on the parties any particular requirement, therefore it may be executed either in a private document or in a document executed before a notary public. However, if the credit is secured by a mortgage, notarisation is required.

We reiterate that due diligence should be carefully carried out in order to identify (i) the relevant legal/contractual limitations to the assignment of credits, for instance, anti-assignment provisions; (ii) the eligibility of the transferee to benefit from financial collateral arrangements in place (e.g., financial share pledges); (iii) the stamp duty payments in connection with the prior granting of security; and (iv) the security package in order to confirm that perfection requirements have been complied with.

Although the assignment of credits is immediately effective between the parties, the debtor must be notified thereof or such transfer be accepted by the debtor in order to be effective against him and to avoid having the debtor raising material exceptions upraising under Portuguese law against the assignee, for instance set off or payment to the assignor.

The transfer or amendment of credits does not trigger Portuguese stamp duty, unless: (i) the transfer is not a 'true sale' (i.e., if the buyer has recourse against the seller in case of default by the debtors of the corresponding credits); and (ii) the transfer gives rise to a novation (i.e., termination of the original obligation and its replacement by a new one). This is the main reason why novation is not commonly used to transfer credits.

In the event of the existence of an underling security, under Portuguese law, unless otherwise agreed, an assignment of credits implies its transfer to the assignee. Accordingly, the transfer of the security package would not be impaired, remaining in place between the seller and the buyer. Under certain circumstances formality requirements will need to be complied with in order to maintain enforceable security by the buyer, especially when dealing with credit rights secured by registered security.

Novation causes the extinction of the underlying security package, unless otherwise expressly agreed between the parties. Therefore, in the case of novation the relevant obligors should expressly acknowledge, agree and accept in writing at the time of the novation that the full security package will remain in place.

The insolvency regime

What are the main insolvency issues a buyer should take into account prior purchasing credits?

Under the Insolvency and Corporate Recovery Code, which was approved by Decree Law No. 53/2004 dated as of 14 March ('CIRE', as amended):

(i) any company that is in a difficult economic situation (the 'Insolvent') – i.e., unable to meet its obligations because its available assets are insufficient to satisfy its liabilities – must file before the court an insolvency request within 30 days following the date it becomes aware of the insolvency status (an insolvency declaration request may also be filed by third parties, notably creditors and the Public Prosecutor);

(ii) the prejudicial transactions (acts that diminish, frustrate, make it difficult for, jeopardise or delay the satisfaction of the creditors) performed by the insolvent Company during the period of two years prior to the date of beginning of the insolvency proceedings, may be clawed back by the insolvency administrator for the benefit of the insolvency estate;

(iii) it is deemed an act of bad faith by the third party, when there is knowledge (at the date the action is performed) that (a) the debtor was facing an insolvency situation; or (b) the action is prejudicial and the debtor was under an imminent insolvency situation; or (c) the insolvency proceedings had already started;

(iv) there are certain transactions which are subject to clawback (assumption *iuris et de iure*) regardless of any question of bad faith or prejudice to the debtor): (a) non-onerous transactions executed by the debtor during the period of two years prior to the date of the beginning of the insolvency proceedings; (b) granting by the debtor of guarantees *in rem* in relation to pre-existing obligations or other guarantees which have replaced them, during the period of six months prior to the date of the beginning of the insolvency proceedings; (c) personal guarantees (e.g. sureties) which the debtor has granted during the six months prior to the date that the insolvency proceedings began and which do not relate to transactions with a real interest for the Insolvent; (d) granting of security *in rem* simultaneously with the constitution of guaranteed obligations within sixty days prior to the opening of the insolvency proceedings; (e) onerous acts carried out by the debtor within the year prior to the beginning of the insolvency proceedings in which the obligations undertaken by the debtor clearly (significantly) exceed those of the counterparty.

To the extent there is no significant risk that the seller may be viewed as insolvent on the date of the transfer of the credit (financial information made available would allow such assessment), the possibility of clawback (as described above) based on the buyer's bad faith would in principle be precluded.

Consequently, clawback would only be possible under specific circumstances where bad faith is not required and the understanding of the insolvency administrator would be that:

(i) the obligations undertaken by the seller in the relevant assignment agreement *clearly exceed* those undertaken by the buyer; and

(ii) the insolvency request is filed within a year following the execution of the assignment agreement.

As for (i), a case-law analysis leads to the conclusion that it is the court's understanding that for the clawback to be justified it is necessary that the imbalance between the parties' obligations is manifest, unequivocal and unjustified and, in addition, that it does not correspond to the normal course of business. The analysis of the imbalance is made on a case-by-case basis, taking into account the market value of the asset that is transferred, as well as the total amount of the Insolvent liabilities. A few court decisions point out that the parties' obligations are considered to be imbalanced if the difference in value (i.e., difference between the price paid and the value of the assigned asset) exceeds 20% (one court decision in particular determined that a 16% difference was not enough to consider the parties' obligations imbalanced).

Some contractual approaches could be taken into consideration in order to try to strictly mitigate (and not obviously eradicate) the potential risk of clawback.

To the extent the seller conducted a thorough market analysis of potential buyers and has obtained the best price possible under the existing market circumstances (for instance, the buyer's proposal was at the end of the process shortlisted by the transferor as a result of the analysis by the assignor's management of proposals received and selected), a contractual representation issued by the seller could be made setting forth that the value of the consideration to be received for the sale of the receivables is in all circumstances *fair and reasonable* and an express contractual reference describing the competitive procedure undertaken for the sale of such credit, with the aim of obtaining the best available conditions for the sale.

From an insolvency perspective, it is also important to ascertain whether the debt purchase results from loans granted by shareholders to the company which establish a term of repayment of over one year. These loans, which are qualified as '*suprimentos*' under Portuguese law, are subordinated and therefore their buyer purchases a subordinated credit, i.e., they shall rank behind the other credits in the event of insolvency.

Additionally, shareholders loans which do not qualify as '*suprimentos*' but are granted by entities in a group or control relationship are also subordinated. Portuguese insolvency law uses the concept of control as set forth in the Portuguese Securities Code, according to which control is deemed to exist between a legal entity and a company when, regardless of whether the domicile or headquarters is located in Portugal or abroad, the said legal entity is capable of exercising, directly or indirectly, a dominant influence over said company.

In any case, control exists when a legal entity: (a) holds the majority of voting rights; (b) may exercise the majority of voting rights according to the terms of the shareholders' agreement; and (c) may appoint or dismiss the majority of the members of the board of directors or supervisory board.

Subsequent sale of the credit?

An interesting point of analysis is whether a subsequent sale would mitigate the clawback risk. In such case, in order to reduce the risk of clawback (or at least to reduce the risk that a court confirms it in a judicial action filed by the buyer to dispute the insolvency administrator's clawback actions) the subsequent buyer would need to prove that it did not act in bad faith, i.e., that it was not aware that the transaction between the original seller and the initial buyer was prejudicial to the seller.

Furthermore, the fact that the second buyer is not in any way connected to the initial buyer and the clear existence of a transaction between the initial buyer and the second buyer that justifies the transfer of the credit may provide additional grounds for the non-existence of bad faith.

Nonetheless, by acquiring the credit from the original buyer, the second buyer would almost necessarily have to be aware that the initial buyer had acquired the credit for a certain amount; thus, clawback could be based on the fact that the obligations undertaken by the initial seller in the relevant assignment agreement *clearly exceed* those undertaken by the buyer. This means that it is possible that an insolvency administrator of the seller, and subsequently a court of law, would take the view that the awareness of the amount of the credit transferred to the buyer and the price paid for it is sufficient evidence of the second buyer's bad faith. Therefore, a second buyer could not be fully protected against clawback actions.

A clawback action would then have to be challenged by the second buyer through a judicial proceeding that is joined to the insolvency proceedings and is decided by the insolvency court; the transaction between the seller and the new buyer which justifies the transfer of the credit shall have to be proved in court. However, the transaction may lead the court to be suspicious that the only reason for the existence of a second transfer is precisely the protection against clawback actions. It could be even possible that this second transfer increases the clawback risk. This could be the case where the court could hypothetically consider that the only purpose of the second transfer was to avoid the success of a clawback.

International Corporate Rescue

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