VII. Contracts and bank guarantees

Glossary

Guarantor Bank

The bank which provided the guarantee

Beneficiary

The obligee of the Base Contract in favour of which the guarantee is provided

Base Contract

The contract between the obligee and obligor required to provide the guarantee

Guarantee Contract

The contract between the Principal obligor and the Guarantor Bank under which the Principal obligor requests the provision of the guarantee and which regulates the relationship between the Principal obligor and the Guarantor Bank, in particular the Guarantor Bank's right of recourse against the Principal obligor

Bank Surety

The accessory guarantee to the bank obligation

On demand guarantee

A bank guarantee payable on first demand

Principal obligor

The obligor of the Base Contract, that requests the provision of the Guarantee from the Guarantor Bank

Decree-Law 10-J/2020

Decree-Law 10-J/2020 of 26 March, which establishes exceptional measures for protection of the credit of households, companies, voluntary organisations and other third-sector entities, as well as a special scheme of personal guarantees by the State, within the context of the COVID-19 pandemic

VII. CONTRACTS AND BANK GUARANTEES

VII.A. Background

In the context of banking, the main issues seem to be concerned with the fulfilment of loan contracts by both the bank customer and the bank itself. The impact of the pandemic may be felt, from the outset, on the commonest types of direct bank lending contracts, i.e. term loan contracts and credit facility agreements, as well as bank guarantees, which are often referred to as "credit by signature" in banking jargon.

VII.B. Loans and credit facilities fully overdrawn

In the realm of default, it matters whether the bank has already provided the principal or if it is yet to be disbursed.

It is common knowledge that loan contracts are characterised by the bank delivering the whole principal loaned amount to the customer on the date it is executed. If the contract at hand is a credit facility, however, the bank opens a line of credit to its customer, who uses such credit during the agreed period – or, in the case of a credit revolving facility, during the term of the contract.

In terms of compliance with obligations, in this type of contract (loan or credit facility), if the bank has provided the principal (under article 1142 of the Civil Code), the bank customer is obliged to repay it in the terms set out in the contract, i.e. the client cannot invoke the current situation to avoid compliance with the obligation to which he is bound (on this point, see Chapter VII.F).

WHAT ABOUT THE INTEREST?

Direct bank lending contracts (whether term loans or credit facilities) are of a commercial nature (article 102 of the Commercial Code). Interest is the essential and determining element for granting loans and the relationship between the bank and its customer: the bank only lends in exchange for the interest rate agreed with the customer, and the failure to pay interest gives the bank the right to terminate the contract (article 1150 of the Civil Code).

The close relationship between the provision of the principal and the payment of interest is found in the decisions of higher courts, especially in Supreme Court of Justice Ruling no. 7/2009 25-03-2009 (reporting judge Cardoso de Albuquerque), which harmonized existing case law. This decision held not only that the interest was the payment for the granting of the principal but also that the interest was (synallagmatic) consideration for the granting of the principal. As such, the bank customer is also obliged to pay the interest (on this point, see chapter VII.F).

AND THE FEES?

Not all fees are alike. Some fees are linked to providing the loan (for example, credit facility fees), whereas others are linked to granting and managing the loan during its lifetime (for example, management fees) and others are linked to recovering the loan. The impact of the COVID-19 pandemic on the payment of bank fees will have to be analysed on a case-by-case basis, since, in principle, these types of fees do not include the consideration inherent to the availability of the principal, unlike interest (on this point, see chapter VII.E).

VII.C. Credit facility with overdraft available

In this context, the pivotal question pertains to the bank's obligation to provide the principal yet to be used under the credit facility contract. Some credit facility contracts contain provisions

that allow the bank to suspend the use, if a material adverse change (a situation outside the control of the bank customer, with a negative impact on the customer's ability to fulfil the contracted obligations, on guarantees constituted on secured credit or on the bank customer's assets) or a change in circumstances (disturbance that may have an impact on obtaining the index interest rate or the cost of the funds to the bank itself) is verified. Some contracts may also contain force majeure clauses.

If the contract contains specific provisions in this regard, the bank's obligation to provide the loan must be analysed in light of the relevant contractual provisions.

If these kinds of provisions are not set out in the contract, one has to distinguish loan contracts in which the principal is committed to a particular purpose or project from the contracts which do not refer to any purpose for the principal (which is very unusual) or which refer to a generic purpose, for example, cash-flow purposes, which are often provided for in revolving credit facilities.

As for contracts for loans granted to finance a particular project or to achieve a specific purpose, the issues to be settled concern the impact that the COVID-19 pandemic may have on the achievement of the aforementioned purpose or project and, in this regard, if and to what extent these are compromised.

In these cases, one also has to consider what the contracts set out regarding the documentation and/or conditions necessary for the use of the principal or regarding the conclusion of the project: for example, loans designed to finance construction (in which the loaned principal can only be used subject to the presentation of documentation or reports regarding the progress of the work), or a financed project.

We also note that if the purpose of the project is frustrated due to the COVID-19 pandemic, the bank customer may consider terminating the loan due to no longer having an interest in maintaining it.

When the contract does not set out the purpose of the loan or when only a very generic purpose is stipulated, the issue becomes discovering the effect that the adverse situation has on downgrading the bank customer's risk and/or the eventual guarantees provided to secure the loan. If the bank customer's risk is downgraded, but the bank's exposure is protected by guarantees, the use of the loan may be allowed, to the extent that the coverage contracted and accepted by the bank is maintained. If the bank customer's risk is downgraded and guarantees have not been constituted, or if those provided do not cover the customer's total exposure, the increase of this exposure due to the requested use may lead the bank to demand the constitution of new guarantees or the reinforcement of existing ones. This requirement depends on the degree to which the customer's risk is downgraded (article 780 of the Civil Code), and the requested use may be suspended until the guarantees are constituted or strengthened.

In summary, the impact that the COVID-19 pandemic may have on the Bank's relationship with its customer will involve the assessment of the customer's credit risk and the guarantees provided.

VII.D. Bank Guarantees

In an environment of economic depression and, therefore, of contractual strife, the party that benefits from bank guarantee will tend, in case of default by its counterparty, to request the payment of the guarantee available to it. In this case, the question may arise as to whether, given the COVID-19 pandemic, the Guarantor Bank can refuse payment.

Firstly, one needs to ascertain the type of guarantee provided. At issue may be an on demand guarantee, or an accessory guarantee on the guaranteed obligation, such as Bank Surety or other similar models.

In this regard, we recall that the provision of a bank guarantee involves a triangular relationship set up between: (*i*) the contract between the obligee and obligor bound to provide the guarantee – Base Contract; (*ii*) the contract between the obligor bound to provide the guarantee (the Principal obligor) and the Guarantor Bank – Guarantee Contract; and (*iii*) the contract between the Guarantor Bank and the obligee of the Base Contract who benefits from the guarantee (the Beneficiary).

ON DEMAND GUARANTEE

The bank guarantee is on demand when the Guarantor Bank has to offer the requested payment, without being able to invoke any exceptions (*e.g.*, compensation between the Principal obligor and the Beneficiary or the right to withhold performance given a counterparty's non-performance of a reciprocal obligation that the Principal could otherwise invoke against the Beneficiary) or other means of defence that the Principal obligor can allege against the Beneficiary under the Base Contract: the Guarantor Bank, upon receipt of a payment request, must make the payment without argument; if there is an improper demand for the On demand guarantee and subsequent payment, the action for restoration against the Beneficiary will have to be brought by the Principal obligor, i.e. the Guarantor Bank, in principle, lacks standing to initiate such proceeding.

Legal commentary has admitted, and the courts have held, that the Guarantor Bank may refuse payment in exceptional circumstances, as are cases of violation of public order and proper practice (the Beneficiary is not entitled to request the payment of the guarantee when the Base Contract is contrary to public order or good morals; in these cases, the guarantee itself is held to be invalid), cases of manifest fraud (the Beneficiary knows that it is not entitled to request the payment, for example, because the guaranteed obligation has already been satisfied), or abuse of rights (situation in which the guarantee payment request is not intentionally abusive, unlike in cases of fraud).

On the other hand, the Guarantor Bank may only refuse to pay on the grounds of fraud or abuse or rights if these are unequivocal and evident; mere supposition or questionable evidence of such behaviours does not suffice. The fraudulent or abusive request is related to the Base Contract and its vicissitudes, so the relevance of a force majeure event, such as a pandemic, a war or a natural disaster, as a justification for refusing payment, will have to be considered in terms of compliance with guaranteed obligations.

In these scenarios, it is somewhat important to discover whether the Base Contract contains a force majeure clause. If there is no clause of this nature, the Guarantor Bank's refusal to pay will have to be based on evidence that the force majeure situation prevents the fulfilment of the guaranteed obligation (which is arguably very difficult given the high evidentiary burden thrust upon the Guarantor Bank so as to allow it to refuse performance). In the cases where such provision is contained in the contract, the focal points of the analysis will be the enforceability of the requirement to comply with the guaranteed obligation, as well as determining the survival of the Base Contract, given the force majeure event provided for therein.

We should note that there does not appear to be solid guidance from the courts. The Lisbon Court of Appeal, in its ruling of 17-05-2012, case number 376/12.7TVLSB-A.L1-6 (Reporting Judge Fátima Galante), made in the context of an injunction, held that the force majeure event at hand (*i.e.*, war in Libya) could constitute just cause for refusal to pay the bank guarantee.

It is difficult at this stage to predict how the courts will treat the impact of a pandemic of this kind.

BANK SURETY

The accessory nature of the surety means that this guarantee has the content of the principal obligation (article 634 of the Civil Code) to its full extent (covering the obligor's fault and default), but it may, however, be less onerous than the obligor's obligation (article 631(1) of the Civil Code). The invalidity of the main obligation determines the invalidity of the surety (article 632(1) of the Civil Code), and the discharge of the obligation guaranteed by surety determines the discharge of the guarantor's obligation (article 651 of the Civil Code). As the guarantor's obligation is shaped by the main obligation, it is natural that the guarantor can also use, besides the means of defence inherent to the guarantor relationship, the means of defence that the obligor can use against the obligee (article 637 of the Civil Code).

The fact that the surety is provided by a bank does not change the order or the nature of the surety. The Guarantor Bank is liable to the Beneficiary, just as the Principal obligor is liable to the former. As such, everything takes place at Base Contract level, and the Guarantor Bank's payment is decided in accordance with the rights and means of defence that the Principal obligor can invoke against the Beneficiary under the Base Contract.

AND WHAT ABOUT THE FEES FOR PROVIDING THE GUARANTEE?

As is common knowledge, the Guarantor Bank only provides a guarantee for a price (fee) that usually corresponds to a percentage of the amount guaranteed and that is paid on the dates agreed in the Guarantee Contract. Thus, once the guarantee has been provided, the Principal presumably remains bound to payment on the agreed terms.

VII.E. The principle of good faith and compliance with loan contracts

The exercise of rights and performance of obligations must be considered in light of the principle of contractual good faith, contained in article 762(2) of the Civil Code. The obligee, in exercising its rights, and the obligor, in complying with its obligations, must proceed with good faith. This principle must be observed by both the bank (as obligee) and the bank customer (as obligor) regarding the obligations set out by the parties, such as:

REPRESENTATIONS AND WARRANTIES

The representations and warranties provided by the bank customer in favour of the bank often cover situations of force majeure, material adverse situations, legal or contractual compliance and solvency, which may be affected by the COVID-19 pandemic.

One will have to ascertain the effects of the COVID-19 pandemic on the accuracy, completeness and truthfulness of the representations and warranties provided.

FINANCIAL COVENANTS

These are obligations which seek to ensure (*i*) control of the bank customer's financial capacity to satisfy the payment obligations arising from the loan contract expressed in the determination of financial indices (for example, EBITDA) or financial ratios (for example, the debt service coverage ratio or the debt ratio), or (*ii*) the control of the revenues generated by the financed project, including its long-term monitoring (for example, the loan life coverage ratio) which must be fulfilled during the term of the loan contract.

ASSETS

The bank customer's assets are, or were, typically essential for ascertaining its creditworthiness and for the decision to grant a loan. On the other hand, loans for the acquisition

of certain assets, in particular buildings or rights over real property (for example, surface rights), contain financial ratios in which the value of the asset or right is the essential element of coverage of the loan (for example, the Loan-to-Open Market Value or LTV ratio).

In these kinds of loans, obligations are also set out so as to strengthen guarantees once the downgrading of the assets given or promised as collateral occurs.

EARLY TERMINATION AND FULL REPAYMENT

In commercial practice, the instalments set out in loan contracts may become due early by virtue of breach of the obligations set forth therein. It is also normal for banks to be able to declare termination of the loan and demand full repayment based on situations external to the fulfilment of the contract, especially cross-default clauses (*e.g.*, financial obligations to third parties), the occurrence of force majeure events or the demonstration of the borrower's incapacity to fulfil its obligations to third parties.

VII.F. Decree-Law 10-J/2020 – credit protection

Decree-Law 10-J/2020 establishes exceptional measures for protection of the credit granted to households, companies, voluntary organisations and other third-sector entities, as well as a special scheme of personal guarantees by the State, within the context of the COVID-19 pandemic.

The application of the measures set out in this act, regardless of whether the requirements for them to be invoked are met, will have to be considered in light of the effects that the COVID-19 pandemic has on the financial capacity of companies, families, associations and other entities covered by the act to fulfil the obligations assumed under the credit transactions it covers.

Under article 10(1) of Decree-Law 10-J/2020, the general conditions applicable to the approved measures will be defined in an ordinance to be approved by the minister of finance. The new regime, which we shall now analyse in detail, came into force on 27-03-2020 and will last until 30-09-2020.

BENEFICIARIES

The measures set out in Decree-Law 10-J/2020 apply to the following economic agents:

- **Companies**: under article 2 (1a), the protection regime applies to companies that are classified as micro, small or medium-sized enterprises, and, under paragraph 3 of the same article, other companies which, regardless of their size, at the date the legislation in question was published (26-03-2020), met the conditions set out in items *a)*, *c)*, and *d)* of paragraph 1, excluding companies in the financial sector (including, among others, banks, other credit institutions, finance companies);
- **Other legal persons**: under article 2 (2b) of the said act, the protection also covers voluntary organisations, non-profit associations and other third-sector entities, except those that meet the requires under article 136 of the Mutual Associations Code, approved in an annex to Decree-Law 59/2018 of 2 August, which, on the date the said Decree-Law was published, met the conditions set out in items *c)* and *d)* of paragraph 1 and have their domicile or registered office in Portugal.
- **Traders:** sole traders enjoy protection under article 2 (2b);
- **Individuals:** the act protects individuals who have residence in Portugal and are in self-isolation, either as a precaution or due to infection, or are caring for children or grandchildren, as set forth in Decree-Law 10-A/2020 of 13 March, or have had their working hours reduced or their employment contract suspended, due to the crisis

in business, or are unemployed and registered with the Portuguese Work and Vocational Training Institute; it also covers self-employed workers who are eligible for extraordinary support due to the reduction in economic activity, under article 26 of the act, and workers for entities whose establishment or activity has been subject to a shut-down order during the state of emergency, according to article 7 of Decree 2-A/2020 20 March;

ELIGIBILITY REQUIREMENTS

Under article 2 (1 and 2b) of Decree-Law 10-J/2020, protection is granted based on the following criteria:

- **Territoriality**: legal persons who have their registered office or domicile or perform their economic activity in Portugal;
- **Situation in terms of compliance with obligations contracted in the scope of credit transactions**: legal persons and individuals only enjoy the protection laid down in Decree-Law 10-J/2020 if they were not, on 18-03-2020, in default or nonperforming financial payments to credit institutions for more than 90 days or, in case they are, they do not meet the materiality criteria set forth in Banco de Portugal Notice 2/2019 and EU Regulation 2018/1845 from the European Central Bank of 21 November 2018, and are not insolvent, or have suspended or ceased payments, or, on that date, were already subject to enforcement proceedings by any of the institutions;
- **Beneficiary's situation in terms of compliance with tax and social security obligations**: legal persons and individuals only enjoy the protection laid down in Decree-Law 10-J/2020 if they are in compliance with the Tax and Customs Authority and Social Security, under the terms established in the Tax Process and Procedure Code and the Social Security and Pension Contribution System Regimes, though debts created during the month of March 2020 shall not be taken into account for this purpose until 30-04-2020.

TRANSACTIONS COVERED AND EXCLUSIONS

With regard to legal persons and entities, under article 3(1) of Decree-Law 10-J/2020, the following credit transactions are covered: loans granted by credit institutions, financial credit companies, investment companies, financial leasing companies, factoring companies and mutual societies, as well as those granted by branches of credit institutions and financial institutions operating in Portugal, to entities which benefit from the said decree-law.

For individuals, under article 2(2a) of the Decree-Law 10-J/2020, loans relating to their permanent residence are covered.

In any case, under article 3 of the act, transactions relating to the following are excluded:

- Credit or financing to purchase bonds or to acquire positions in other financial instruments, whether or not guaranteed by these instruments;
- Credit granted to beneficiaries of schemes, subsidies or benefits, especially those that are tax-related, for establishing headquarters or residence in Portugal, including for investment activity, except for citizens covered by the Return Programme "Regressar";
- Credit granted to companies for individual use through credit cards by members of their boards of directors, supervisory boards, workers or other employees.

PROTECTION REGIME - MORATORIUM

Under article 4(1), beneficiary entities enjoy a moratorium in relation to bank operations on the following terms:

- **Extension**, for as long as the current measures are in force, of all loans with payment of the principal at the end of the contract, in effect on the date the legislation comes into force, together with all its associated elements, including interest and guarantees, in particular those provided through insurance or in negotiable instruments;
- **Suspension**, with respect to loans with partial repayment of principal or with partial maturity of other cash benefits, during the period in which this measure is in force, of the payment of the principal, rents and interest expected to fall due until the end of that period; the contractual payment plan for the instalments of the principal, rent, interest, commissions and other charges is automatically extended for a period identical to that of the suspension in order to ensure that there are no charges other than those that may arise from the variability of the interest rate underlying the contract. All elements associated with the contracts covered by the measure are extended, including guarantees.

The entities which benefit from the moratorium may request that it should cover only the principal or a part thereof.

On the other hand, under article 4 (3d), the **guarantees** granted by the beneficiary entities or by third parties, especially insurance policies, sureties and/or endorsements are maintained.

The following is also laid down:

- **Loans granted based on financing**, total or partial, or guarantees provided by entities based in Portugal: the moratorium will apply without needing to obtain authorisation from the financing or guarantor entities;
- **Form and authorisation**: under article 4(6), the extension of the guarantees referred to in previous paragraph, namely insurance policies, sureties and/or endorsements, do not require any other formality, opinion, authorisation or prior act from any other entity as otherwise provided for in other legislation and are fully effective and enforceable against third parties. The respective registration, when necessary, must be carried out by the institutions, based on provisions of Decree-Law 10-J/2020, without the need to submit any further document and waiving the report of chain of registered transactions.

PROTECTION REGIME - LIMITS ON THE EXERCISE OF RIGHTS AND EXCEPTION

The following also form part of the protection mechanisms for credit exposure laid down for this exceptional period:

- **Cancellation of contracts**: article 4(1a) forbids the total or partial cancellation of lines of credit contracted and loans granted in the amounts contracted on the date of entry into force of Decree-Law 10-J/2020 and during its effective term;
- **Breach of contract**: under article 4 (1a), the moratorium cannot give rise to breach of contract;
- **Early repayment**: under article 4(1b), the moratorium cannot give to rise to the declaration of required full repayment of the debt;
- **Coverage**: the moratorium applies to the obligation to restore the degree of coverage for credits secured by financial guarantees and to the creditor's right to execute stop loss clauses;
- **Exception**: under article 6, if the beneficiary entity is **declared insolvent** or placed under a **special revitalisation process**, institutions can exercise all the actions inherent to their rights under the applicable legislation.

ACCESS TO THE MORATORIUM

Access to the moratorium is set out in article 5, which regulates the following matters:

- **Form**: according to article 5(1), entities seeking to benefit from the moratorium should send the lending institution a physical or digital declaration of adhesion to the moratorium, signed by the borrower, for individuals or sole traders and, for companies, private social welfare organisations, non-profit associations and other third-sector entities, signed by their legal representatives;
- **Necessary documentation**: under article 5(2), the declaration of adhesion must be accompanied by proof of compliance with tax and social security obligations;
- **Moratorium activation deadline**: under article 5(3), lending institutions will apply the protection measures within a maximum of five working days after receipt of the declaration of adhesion and the necessary documentation, backdating the protection measures, if granted, to the date the declaration is delivered;
- **Denial of protection**: under article 5(4), lending institutions must inform the applicant of the refusal to grant protection within a maximum of three working days, through a communication sent through the same means as the applicant entity used to send the declaration of adhesion.

SUPERVISION

The Banco de Portugal is responsible for oversight and supervision of access to the moratorium set out in Decree-Law 10-J/2020. Infringement, by credit institutions, of the duties set forth therein or in the regulation adopted by the Banco de Portugal, constitutes an administrative infraction punishable under article 210 of the General Regime for Credit Institutions and Financial Entities. The substantive and procedural rules established in the General Regime are applicable in order to determine liability for administrative infractions.

Credit institutions will report the exposure covered by the moratorium to the Credit Liabilities Centre.

VII.C. Personal guarantees provided by the State

Decree-Law 10-J/2020 also sets out a special scheme for personal guarantees provided by the State as a means of economic support during the COVID-19 pandemic. This special scheme can be summarised in general terms as follows:

- **Entities which can provide the guarantee**: under article 11(1), the State or other legal entities of public law, can provide personal guarantees within the maximum limit contained in the State Budget;
- **Power to provide the guarantee**: article 11(2), the member of government responsible for finance is empowered to provide the personal guarantee from the State;
- **Beneficiaries of the personal guarantee from the State**: under article 11(2), companies, voluntary organisations, non-profit associations and other third-sector entities or any other entities based in the European Union, including European institutions, European instruments or mechanisms may request a personal guarantee from the State;
- **Transactions covered by the personal guarantee from the State**: under article 11(2), in particular, credit transactions or other finance transactions of any kind to ensure liquidity or any other purpose are covered by the general State guarantee;
- **Procedure**: in terms of legal procedure, this exceptional mechanism applies the rules contained in Law 112/97 of 16 September, which sets forth the legal regime for provision of personal guarantees by the State or other public entities, with the exceptions contained in articles 11(3) and 12.

AUTHORS

David Noel Brito
Junior Lawyer

Pedro Gorjão Henriques
Partner

Member
Lex Mundi
World Ready

MORAIS LEITÃO
GALVÃO TELES, SOARES DA SILVA & ASSOCIADOS

Supporting clients, anywhere, anytime.

MORAIS LEITÃO, GALVÃO TELES, SOARES DA SILVA & ASSOCIADOS

LISBOA
Rua Castilho, 165
1070-050 Lisboa
T +351 213 817 400
F +351 213 817 499
mlgtslisboa@mlgts.pt

PORTO
Avenida da Boavista, 3265 – 4.2
Edifício Oceanvs
4100-137 Porto
T +351 226 166 950 - 226 052 380
F +351 226 163 810 - 226 052 399
mlgtsporto@mlgts.pt

FUNCHAL
Av. Arriaga, n.º 73, 1.º, Sala 113
Edifício Marina Club
9000-060 Funchal
T +351 291 200 040
F +351 291 200 049
mlgtsmadeira@mlgts.pt

mlgts.pt

ALC ADVOGADOS

LUANDA
Masuika Office Plaza
Edifício MKO A, Piso 5, Escritório A/B
Talatona, Município de Belas
Luanda – Angola
T +244 926 877 476/8/9
T +244 926 877 481
geral@alcadvogados.com

alcadvogados.com

HRA ADVOGADOS

MAPUTO
Avenida Marginal, 141, Torres Rani
Torre de Escritórios, 8.º piso
Maputo – Moçambique
T +258 21 344000
F +258 21 344099
geral@hrlegalcircle.com

hrlegalcircle.com

MdME LAWYERS

MACAU
Avenida da Praia Grande, 409
China Law Building
21/F and 23/F A-B, Macau
T +853 2833 3332
F +853 2833 3331
mdme@mdme.com.mo

HONG KONG
Unit 2503 B
25F Golden Centre
188 Des Voeux Road
Central, Hong Kong
T +852 3619 1180
F +853 2833 3331
mdme@mdme.com.mo

Foreign Law Firm

mdme.com.mo