

LEGAL ALERT

LEGAL FRAMEWORK FOR PROFIT PARTICIPATION LOANS

Within the scope of the efforts towards diversifying the sources of funding of companies and the reduction of their dependence on the banking system, [Decree-Law no. 11/2022](#), which provides the legal framework applicable to profit participation loans, was published on 12 January. We highlight below the key features of this framework, which **has entered into force on 13 January 2022**.

What are these loans?

The framework defines profit participation loans as onerous financing agreements, undertaken as **loans or debt securities, the interest/coupon and repayment or redemption of which depend (even if only in part) on the results of the activity of the borrower, and amounts due thereunder may be converted into share capital of the borrower.**

These loans shall be **classified as equity** for the purposes of corporate law, if the following conditions are met:

- Interest/coupon depends on the results of the borrower;
- The repayment or redemption of the loans is subject to the satisfaction of the requirements provided under articles 32 and 33 of the Companies Code.

In case of insolvency of the borrower, profit participation loans are classified as subordinated debt, ranked above shareholders' credits and credits of entities especially related to the debtor.

Who can grant these loans?

The framework provides a list of **entities that may grant profit participation loans**:

- Credit institutions;
- Financial companies;
- Specialised alternative investment undertakings:
 - in credits;
 - in venture capital; and
 - in social entrepreneurship;
- investment companies for the development of the economy; and
- Capitalisation and Resilience Fund (*Fundo de Capitalização e Resiliência*).

However, the framework also generically allows entities which are qualified for credit granting on a professional basis to grant participating loans.

Who can be a borrower of these loans?

The framework restricts the access to these loans to commercial companies outside the financial sector.

What are the formalities to watch out for?

These loans must be formalised in writing, and those undertaken through the issuance of debt securities are subject to the general framework applicable to securities' issuances.

Profit participation loans must be previously and expressly approved by the general shareholders' meeting of the borrower and must expressly mention that this framework applies.

How are Interest/Coupon and Repayment fixed?

Parties may freely establish applicable interest/coupon, as long as totally or partially indexed to the results of the borrower.

Repayment may occur at any time, together with unpaid interest/coupon and interest/coupons that would be due until the beginning of the quarter in which the repayment occurs.

Repayment may only be made out of funds which, pursuant to corporate law, may be distributed to shareholders.

Both interest/coupons and repayment are subject to the limitations established under corporate law, such as the maintenance of reserves or the relation between own funds and the sum of share capital and reserves.

Parties may stipulate an interest rate/coupon ensuring a minimum internal rate of return to the lender.

In order to protect the lenders' credit, this framework prohibits the borrower from amending the conditions applicable to profits sharing provided in its articles of association, redeeming or granting privileges to existing shares, repaying shareholder loans or other shareholder financings, or resolving on the reduction of its share capital without the lender's previous consent.

How and when can the conversion of the credit into equity occur?

If the borrower is in one of the default scenarios foreseen in the framework or the agreement, the lender may convert its credit into equity.

Without prejudice to others agreed between the parties, the requirements for the conversion of the lender's credit into equity include, amongst others, the expiration of the repayment deadline without it having occurred in full and failure to pay interest/coupons for more than 12 consecutive or interpolated months.

Should any of the requirements be met, the lender may submit a proposal for the conversion of the profit participation loan into equity. This proposal shall be accompanied by a report issued by a statutory auditor.

Once such proposal is received, the borrower shall immediately call a shareholders' meeting to consider the proposal, which must take place within 60 days.

If the proposal is refused, the shareholders' meeting does not take place or the resolutions are not approved or enforced within 90 days from the date of receipt of such proposal, the proposing lender

may require a judicial decision on the matter from the court which is competent for deciding on insolvency proceedings.

The shareholders of the borrower are entitled to a pre-emption right in case of an increase in share capital. The amounts arising therefrom shall be used to redeem the credits which would be converted into equity pursuant to the lender's proposal.

Parties may also establish, with certain limitations, a direct right for the conversion of the participating loan into equity in favour of the lender. The circumstances and terms under which such right may be exercised must be expressly defined.

[Maria Soares do Lago \[+info\]](#)
[António Magalhães Ramalho \[+info\]](#)

This publication is purely informational and is not meant to be a source of legal advice, nor does it contain a comprehensive review of all aspects of the law and practice referred to. The information contained herein refers to the date of first publication, readers being warned to take legal advice before applying it to specific issues or transactions. The contents of this publication may not be copied, disclosed or distributed in whole or in part without prior consent. For more information please contact us at com.pr@mlgts.pt.