The Legal 500 & The In-House Lawyer
Comparative Legal Guide
Portugal: Private Equity

This country-specific Q&A provides an overview to private equity laws and regulations that may occur in Portugal.

This Q&A is part of the global guide to Private Equity. For a full list of jurisdictional Q&As visit http://www.inhouselawyer.co.uk/practice-areas/private-equity/

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1. **What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?**

   No official public data is available regarding the relevance of transactions which featured financial sponsors within the overall Portuguese M&A landscape, either as buyers or sellers.

In absolute numbers, however, it can be ascertained that the volume of private equity transactions (both buy-side and sell-side) in Portugal have on average steadily increased since the peak of the Eurozone crisis, at the end of 2011 (source: Portuguese Securities Market Commission, the "**CMVM**", annual report on private equity, 2017).

2. **What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?**

A financial sponsor in Portugal will usually privilege a "clean" exit (with as little exposure to risk as possible) from their portfolio companies; in such an instance the relevant acquisition agreements will typically feature limited representations and warranties given by the seller and may sometimes involve the contracting of "warranties and indemnities insurance" (which is currently gaining traction in Portugal) with an insurance company specialized in originating such policies. To avoid the risk of unit holders/limited partners being exposed to liability after the dissolution of the sponsor's investment vehicle (when the financial sponsor acts through fund or other type of collective investment undertaking), private equity sellers also often agree to place money in escrow accounts to fund any liabilities which may arise from breach of representations and warranties or other contractual obligations.

On the other hand, a trade seller will often be more interested in maximizing proceeds from the sale, even at the expense of more adverse terms and conditions in the relevant acquisition agreement. This will be reflected in more extensive representations and warranties, "laxer" limitations on indemnification and occasionally the acceptance of specific

indemnities.

3. **On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?**

The process for effecting the transfer of the shares, besides the execution of an agreement (which does not have to be in writing although it usually is, but with no additional formalities), is:

a) If the shares are represented by share certificates: (i) the endorsement of the share certificates and (ii) the registration of the transfer in the shares issue book;
b) If the shares are in bearer-form: (i) the registration of the debit in the securities account of the transferor and (ii) the registration of the credit in the securities account of the transferee.

Other procedural actions may be required depending on existing contractual limitations to the transfer of shares, as set out under the company by-laws or other agreements.

There is no transfer tax in the acquisition of shares. However, the balance between capital gains and losses in the sale of shares is subject to taxation: at a rate of 21 per cent, for resident corporate entities (surtaxes may apply), or 28 per cent, for individuals (capital gains income may also be subsumed within the remainder of the subject’s personal income, resulting in the application of progressive tax brackets, up to a 48 per cent rate which may be accrued of special “solidarity rates”).

Capital gains by non-resident individual persons shall be exempt provided that: (i) such individuals are not domiciled in a jurisdiction subject to a favorable tax regime (i.e. in a “blacklisted jurisdiction”, as determined under applicable regulations) and (ii) the assets of the company which equity participations are sold are not made up in over 50 per cent of real estate assets located in Portugal. If not exempt, these capital gains are taxed at a special rate of 28 per cent.

Capital gains by non-resident companies are subject to tax at a rate of 25 per cent but may be exempt if certain conditions are complied with (such as the entity not being held in over 25% by Portuguese resident entities or the ultimate beneficial owner of the former not being an entity resident in a blacklisted jurisdiction).

4. **How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?**

Special purpose vehicles, or bankruptcy-remote entities, are a method commonly used in Portugal by parent companies and collective investment undertakings (national and foreign) to isolate themselves from the risks of the transaction (as well as for other accounting and/or tax structuring reasons).

To provide comfort to the sellers involved in a transaction involving an SPV, financial sponsors may issue comfort letters, parent company guarantees or even, in some cases, bank guarantees.

In Portugal, comfort letters are issued by parent companies and provide a certain degree of assurance, to the benefit of the subsidiary and

sometimes the buyer, that the latter's obligations will be met. Comfort letters vary in their degree of "strength" and can range from mere letters of intent to full-fledged binding obligations to capitalize the subsidiary in case the latter fails to pay the purchase price or breaches other obligations under the relevant transaction agreement.

Under parent company guarantees, the parent/holding company of the acquisition vehicle will guarantee compliance of the latter's obligations, in some cases to an extent where the purposes of having the acquirers being shielded from bankruptcy is defeated.

On first demand bank guarantees are, although not frequently, also issued in transactions (in relation to, for instance, construction agreements) for the benefit of sellers to guarantee payment of the purchase price.

5. **How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?**

Locked box pricing mechanisms have become very frequent in M&A transactions in Portugal over the last years.

Given the time and resources expended in the preparation and negotiation of the more traditional "closing accounts" (following the closing date, as the name implies), locked-box mechanisms have been accepted in Portugal as an easier way to structure the price payable for shares of the target.

Locked-box mechanisms are thus now widely used across the board by both private equity and industrial/strategic actors but is favored in particular by the sell-side rather than by the buy-side (as buyers will sometimes wish for the price of shares to take into account the performance of the target company until the closing date, particularly when a significant amount of time is expected to pass between the "reference" equity purchase price date and the closing date).

6. **What are the typical methods and constructs of how risk is allocated between a buyer and seller?**

The main methods in M&A transactions in Portugal to allocate risk in a transaction agreement between buyer and seller are through: (i) representations and warranties; (ii) specific indemnities; (iii) remedial actions and covenants.

Representations and warranties are the most commonly used method to allocate contractual risk in Portuguese M&A transactions. Representations and warranties usually cover a wide array of legal, financial and operational issues (when given by the sell-side) or are limited to existence, legal capacity and financial capacity (when given by the buy-side) and are generally subject to limitations on indemnification (caps, time limitations, baskets and deductibles are usually used), unless when referring to fundamental issues such as the ownership of shares by seller.

Representations and warranties are also usually limited by disclosures, either against information set out in a data room ("disclosed information") or against exceptions identified in a schedule included in the transaction agreement to that effect (commonly known as "disclosure

letter” or “schedule of exceptions”).

When material contingencies arise following the outcome of a due diligence exercise to the target company (which, depending on the activities performed, may be of a legal, financial, tax, market and technical nature) buyers sometimes are able to negotiate the inclusion of specific indemnities, allocating the risk of damages arising out of a known contingency to the seller, generally without financial or time limitations associated to the respective indemnification obligation. When dealing with private equity buyers, tax and compliance risks are tendentially retained by the sell-side through more general indemnities.

Finally, when contingencies which are less material are identified during due diligence, sellers will occasionally be obliged to execute, pre and post-closing, actions to remediate or annul such contingencies and will be responsible

7. **How prevalent is the use of W&I insurance in your transactions?**

Warranty and indemnity insurance was scarcely used in Portugal until a few years ago, but is now more common, notably in transactions involving private equity sellers (see question 2 above) which are using such arrangements to shield themselves from liability as much as possible when performing an exit.

Accordingly, while the purchaser will most times be the beneficiary of the insurance policy, the ultimate cost of the insurance is usually borne by the seller (via v.g., a deduction to the purchase price).

Insurance carriers for W&I insurance will more often than not be foreign, as there is still not a significant experience in the Portuguese market in originating these products. Policy underwriters are also usually foreign insurance companies.

8. **How active have financial sponsors been in acquiring publicly listed companies and/or buying infrastructure assets?**

   There has been only one public to private transaction in Portugal involving private equity actors: the acquisition, in 2012, of Brisa, a high-way toll-operator, by a consortium made up of an European infrastructure fund and Portuguese industrial conglomerate José de Mello.

   In what concerns the purchase of infrastructure assets, deal activity has been buoyant in the last few years, due to valuations perceived as attractive and the search for high and steady returns by institutional investors outside of the capital markets space.

   Assets in the energy, highway tolling, telecommunications and water and waste sectors have all been the object of these transactions, typically involving Portuguese groups and utility incumbents selling stakes in the aforementioned assets to yield seeking foreign investors, often due to deleveraging pressures mounted on the former.

9. **Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents**

which are typically required to be made by financial sponsors?

Financial sponsors generally do not have to obtain further consents or authorizations related to the ownership of companies and assets other than in what regards anti-trust and sector specific authorizations. However, in Portugal, if the transaction implicates a financial sponsor resident in a non-European Economic Area ("**EEA**") country, this financial sponsor may eventually have to comply with the governmental authorizations required pursuant to the regime set forth in decree-law no.138/2014, of 15 September.

This statute establishes a regime for the safeguarding strategic assets essential to guarantee the security of the national defense and security and the provision of the State in services fundamental to the interest in the fields of energy, transport and telecommunications. Accordingly, transactions that include acquisitions of assets in these strategic areas by a financial sponsor from outside of the EEA should thus be subject to prior review from the Portuguese government; failure to obtain such a clearance prior to the execution of the transaction may subject the latter to the risk of being deemed null and void (if the government finds *a posteriori* that said transaction poses a risk to national security).

10. **How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?**

Under Portuguese and European law, the acquirer is generally the entity responsible for securing a merger clearance before the relevant authorities. In the transaction agreements, the risk that this merger clearance is not obtained is usually addressed by conditioning the effectiveness of the transaction to such clearances; the relevant

provisions of the agreement may then be structured either as a best efforts obligation or as a “hell or high water” clause (“**HOHW**”).

A best efforts clause, which is more common, will typically state that the purchaser will make its best efforts, with the occasional cooperation from the seller, to procure anti-trust clearance for the transaction. If by a pre-determined “long stop date” this anti-trust clearance is not obtained, the agreement will terminate without the buyer being held liable for such termination (unless it negligently or willfully did not endeavor the necessary efforts to obtain the clearance).

The HOHW clause, on the other hand, is included in purchase agreements when a seller or target company wishes the buyer to take on all the antitrust risk and other regulatory approvals (including assuming the risk of the relevant anti-trust authorities imposing divestiture of assets by the combined entity, or other structural or behavioral remedies). In such instances, if the buyer does not close until a long stop date it will be held liable for damages caused, irrespective of the circumstances and, especially, of the remedies anti-trust authorities may impose for the transaction to be closed. In Portugal, HOHW clauses are rare.

11. **Have you seen an increase in the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside?**

In the Portuguese market, minority investments undertaken by financial sponsors usually occur in the venture capital (seed, start-up and early

stage investing) space.

These investments represent approximately 20% of the total invested value of private equity and venture capital combined; this growth in the share of venture capital investments has been occurring, at least, since 2012 (source: CMVM annual report on private equity, 2017).

Such investments may be structured as equity investments, in respect of which shareholders agreements featuring minority protections (notably on anti-dilution and governance) are entered into; this occurs in more advanced stages of development of the target company.

Alternatively, investments may be structured as convertible remunerated debt instruments which, as the name implies, grant the right for principal and interests to be converted into Company equity (typically in very early stages of development of the target company). Since these convertible notes are usually not structured as securities (due to certain legal and regulatory restrictions) the conversion of the former is usually done, not via the direct exercise of the respective rights but through participating, jointly with the “seed” stage lead investors, in the (typically) first equity financing round of the target company.

12. **How are management incentive schemes typically structured?**

In portfolio companies, management incentive schemes are typically based on the earnings or structured as compensation packages. These incentives intend to align both parties’ goals.

Earn-outs are the most common earnings/contingent-based compensation and are often used in management buy-outs and other private equity transactions.

Compensation packages, on the other hand, are the combination between direct and indirect benefits that an employer provides to an employee, including salary, allowances, insurance, pension plans, vacations.

In start-up and early stage companies which have limited cash flow generation, officers' incentive schemes typically assume the form of stock options, which can either be physical (shares are granted upon physical exercise of the option – with "physical settlement") or virtual (where the beneficiary receives the difference between the exercise price and the value of the shares at the exercise date – with "financial settlement").

With regards to fund manager's incentives, in private equity funds "waterfall" remuneration schemes are often used to grant fund managers (or, more commonly, management companies) a "carried interest" on the fund's performance (to make them benefit from the upside in said performance), provided that certain hurdle rates for investors are achieved first. This carried interest remuneration is often structured as a special right granted to participation units held in the fund only by the management company and/or its affiliates.

13. **Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?**

The relatively high "top bracket" income tax rates on employment

income in Portugal coupled with the taxation regime applicable to this type of income and, in particular, stock options, have provided an additional incentive for such stock option plans to be implemented. Through these plans: (i) taxation is deferred until the exercisable moment of the option; (ii) tax shall be paid only on the difference between the price paid (if any) and the market value of the physical / "virtual" shares upon the exercisable moment.

With regards to carried interest in private equity funds, there is still uncertainty as to how to qualify this type of income tax-wise (as business income, ultimately subject to the progressive rates of personal income tax, or as capital gains, which can be taxed at a final withholding tax rate of 10%). Some commentators argue that there may be reasons to sustain that "capital gains" treatment should apply to this income, as the absence of specific rules, namely treating the carried interest as business income, points to the need to promote and develop the private equity industry in Portugal and compete with other locations for the attraction of capital.

14. **Are senior managers subject to non-competes and if so what is the general duration?**

Senior managers (who are company employees) may be subject to non-compete provisions which have a maximum duration of 2 years, provided a compensation is paid. The duration of a non-compete clause for members of board of directors may be, depending on the circumstances, longer than 2 years.

15. **How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?**

The most commonly used measures to give a private equity fund a level of management control include: (i) restrictions on the management's actions without the consent of the private equity fund, until “exit” is achieved (veto rights and negative covenants), (ii) right to be represented at the board level of the target investment and subsidiaries, (iii) limitations preventing the management from developing competing businesses for a period after the investment.

Control rights are usually included in shareholders agreements (as opposed to the by-laws or articles of association, since not all investor protection rules in Portuguese companies can be included in the latter). Nevertheless, the by-laws also feature key provisions such as rights granted to special class shareholders and supermajority provisions at board and shareholder meeting level.

16. **Is it common to use management pooling vehicles where there are a large number of employee shareholders?**

It is not a common practice in Portugal, but we have knowledge, within the context of growth private equity investments, of corporate structures being set-up to provide several “level 2” officers with an equity participation in the target or portfolio company.

17. **What are the most commonly used debt finance capital structures across small, medium and large financings?**

Debt finance capital structures in Portugal commonly involve a high degree of leverage, with debt to equity ratios reaching 80%/20%.

On the debt side, financings will typically involve senior secured loan facilities (usually composed of an acquisition facility and a revolving facility) with securities granted over movable assets, property and (when the financing has recourse to shareholders) parent company guarantees or shareholder equity subscription obligations.

On the equity side, shareholder loans and other forms of subordinated debt/quasi-equity are very often used to meet banks' equity ratios.

In what concerns especially the private equity sector, since the average value of private equity transactions in Portugal is small, deals involving private equity investors are made usually through a fund's equity, raised from its investors. Consequently, debt financing of transactions is less frequent, and it is usually reserved for the largest transactions.

18. **Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?**

Financial assistance legislation is applicable to debt financing arrangements and practitioners should take care to structure investments so as not to fall foul of such provisions.

As a general rule, a company may not grant loans or in any other way provide funds or give guarantees for a third party to subscribe or in any other way acquire shares of its capital. However, this prohibition shall not apply to transactions which are part of day-to-day operations of banks or other financial institutions, nor to transactions carried out with a view to the acquisition of shares by or on behalf of the staff of the company or of a company affiliated with it.

Financial assistance in financing transactions is sometimes dealt with by avoiding the target company directly granting security (for the ultimate purposes of the acquirer granting its shares) and replacing it with alternative structures such as the granting of security by an acquisition special purpose vehicle (such as financial pledges over shares of the target company itself).

19. **For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?**

Even though no established template is used for credit agreements, there is extensive experience among practitioners (legal advisors, banks and borrowers' financing teams) in the Portuguese jurisdiction regarding the structure of debt financings and in the negotiation of facility agreements and ancillary agreements thereto.

20. **What have been the key areas of negotiation between borrowers and lenders in the last two years?**

Key areas of negotiation between borrowers and lenders in financing agreements include, among others: definition and mechanics of distributions, market disruption provisions, breakage costs and order of repayment upon triggering of a voluntary repayment. Material representations and warranties and certain borrower covenants are often discussed, as well.

21. **Have you seen an increase or use of private equity credit funds as sources of debt capital?**

Credit funds (and more broadly the granting of loans by collective investment undertakings directly to portfolio companies) are not allowed/contemplated in the Portuguese legal system; notwithstanding, in general nothing restricts private equity funds from investing in portfolio companies via shareholder credits (which will become, however, necessarily subordinated credits if they exceed a maturity of 1 year). In what concerns on the other hand foreign credit funds, we have no knowledge of the latter being active players in the Portuguese (private) debt market.