

Selling bonds to banks

Filipe Lowndes Marques and João Honorato take you through new trends in the Portuguese market

Recently in Portugal a new trend has arisen as an alternative to corporate financing through bank loans. Companies are structuring their bank financing through the issue of bonds (*obrigações*), which the financing banks or their affiliates then undertake to underwrite. Traditionally smaller or medium sized companies have contracted bank loan facilities when seeking bank funding, but with the recent changes to the Portuguese Companies Code, approved by Decree-law 262/86 of September 2, bond issues have become simpler and subject to less strict requirements. The rules on bond issues provided for in the Portuguese Companies Code were amended twice in 2006, by Decree-law 52/2006 of 15 March, and Decree-law 76-A/2006 of March 29.

New Framework

Portuguese companies limited by shares (*sociedades anónimas*) and under Decree-law 160/87 of April 3, Portuguese companies limited by quotas (*sociedades por quotas*), may issue bonds. Only companies with by-laws definitively registered for more than one year may issue bonds, except if: (i) they result from merger or spin-off of companies and at least

one of those companies is registered for more than one year; (ii) the state or an equivalent public entity holds the majority of the share capital of the company; or (iii) the bonds are guaranteed by a credit institution, the state or an equivalent public entity. These requirements may be waived, in whole or in part, upon ruling of the Portuguese Ministers of Finance and Justice. Bonds cannot be issued before the share capital is fully paid up or, at least, before all shareholders that have not duly paid their shares have been placed in default.

Companies cannot issue bonds in an amount exceeding twice their own funds, taking into account the sum of the subscription price of all the bonds issued and not redeemed. For these purposes, own funds means the sum of the paid-up share capital (less treasury shares), reserves, results carried over and capital adjustments in companies of the same corporate group. Compliance with these limits must be confirmed by an opinion of the auditors' board or single auditor (as the case may be) of the company. The referred issue limits do not apply to listed companies, companies that rate the issue with a rating agency registered in the Portuguese Securities Market Commission (*Comissão do Mercado de Valores Mobiliários*, or CMVM), and issues where redemption is ensured by special guarantee granted in favour of the bondholders.

The company issuing bonds shall not reduce its share capital (unless this is due to losses carried over) to an amount below the debt towards the bondholders even if the bond issue was not subject to the issue amount limits mentioned above. If the share capital of the company issuing the bonds is reduced by reason of losses carried over to an amount below the debt towards the bondholders, all distributable profits shall be applied in the reinforcement of the legal reserve until the sum of the legal reserve plus the new share capital after reduction is equal to the amount of the debt towards the bondholders; or, if the issue amount limits do not apply, the initial proportion between share capital and bond issue amount is achieved.

The issue of bonds shall be resolved by the

shareholders, except if the by-laws of the company authorise the board of directors to approve the issue. The resolution on the bond issue cannot be taken if a previous bond issue is not fully subscribed and paid up. The shareholders may authorise that a bond issue resolved by them is made in separate series, the conditions of which are determined by the shareholders or by the board of directors, but such authorisation expires in five years in relation to series not yet issued. A new series cannot be launched if the bonds of the previous series are not fully subscribed and paid up.

The issue of bonds is subject to commercial registration when made by private placement, except if listing of the bonds has occurred within the period for the request of commercial registration. When the issue is subject to mandatory registration, the respective bond certificates cannot be issued if the relevant issue is not definitively registered. The lack of registration does not make the certificates invalid but makes the directors subject to liability. We do not need to analyse in this article the requirements for bond issues that are considered public offerings, as the bonds are not sold to investors but rather subscribed directly by the financing banks as an alternative to providing the funding directly to the borrower.

Prior framework

Before the Decree-laws entered into force, the requirements for the issue of bonds by Portuguese companies provided for in the Portuguese Companies Code were much stricter than those described above, and this served as a disincentive for companies that were planning to structure financing in this fashion. In the past, only companies with by-laws definitively registered for more than two years (instead of one year) could issue bonds. Furthermore, companies could not issue bonds in an amount exceeding the paid-up share capital under the terms of the last approved balance sheet plus the amount of share capital increased and paid up after the date of that balance sheet (instead of the current limit of an amount up to twice their own funds). In addition, the former issue amount limit could only be increased on the ruling of the Ministers of Justice and Finance and in the following cases: (i) when the financial situation of the company so justified up to the amount of the existing legal reserve; (ii) when the purpose of the issue was the financing of projects of national interest requiring immobilisations of exceptionally large dimensions as long as an adequate debt/equity ratio was duly ensured, notably through an adequate participation of own funds in the investment; and (iii) when the

“With the recent changes to the Portuguese Companies Code, bond issues have become simpler and subject to less strict requirements”

bonds paid interest and had a variable redemption plan in accordance with the company's profits. These exceptions were rarely utilised. It was rare for small or medium sized companies to seek funding in this manner.

Advantages of the new framework

Since, under Portuguese law, companies may not be incorporated for the sole purpose of issuing bonds (other than the specific securitisation companies and private equity companies that need not concern us here), and therefore the issue of bonds would have to be instrumental in relation to the corporate purpose of the Portuguese company, it is essential that the time periods for allowing the issuance of bonds be reduced, as was the case with the Decree-laws, reducing the former limit of two years to one year. On the other hand, corporate financial needs usually go far beyond amounts corresponding to the paid-up share capital. It may be argued that even the existing limits (twice the own funds of the company) may not be high enough for many enterprises.

With the new exceptions created by the Decree-laws, in which there is no limit on the amount of the bond issue (that is, bond issues by companies with listed shares, issues that are rated, and issues whose redemption is ensured by special guarantees granted in favour of the bondholders), companies may now raise funds through bond issues in amounts that in the past were traditionally financed through bank loans. This means that companies can now get finance, if the current less strict legal requirements are met, under the tax regime for bond issues and coupon payments, instead of being subject to the tax regime for bank loans and corresponding interest payments.

Companies in traditional bank funding would normally have to ensure the creation of security in favour of banks granting the loans. Now, companies may create such security in favour of the bondholders, and have access to financing through bonds with no specific amount limits.

Tax on bank loans

Pursuant to the Portuguese Stamp Tax Code, for the utilisation of credit granted under loan facilities of any type, the following stamp tax over the amount of the credit is payable: (i) 0.04% per month for loans with maturity of less than one year; (ii) 0.5% for loans with maturity of, or greater than, one year; and (iii) 0.6% for loans with maturity of, or greater than, five years. Also, pursuant to the Portuguese Stamp Tax Code, stamp tax is due at a 4% rate over the amount of interests under bank loans.

Author biographies



Filipe Lowndes Marques

Morais Leitão, Galvão Teles, Soares da Silva

Filipe Lowndes Marques joined Moraes Leitão, Galvão Teles, Soares da Silva in 2001. He is a partner in the banking, finance and project finance practice group. Filipe Lowndes Marques has extensive experience in the area of project finance, having worked since 1995 on several types of projects, including bridges, motorways, power plants, wind farms, football stadia, LNG terminals and natural gas concessions. He has also been active in the field of capital markets, advising on securitisation

transactions (including the first under the new law and the first synthetic securitisation). He has also worked on IPOs of state-owned companies. His investment fund team was considered by *Chambers Europe* as "Portugal's top practice in investment funds". He is regularly cited in publications such as *Chambers*, *Legal Business* and *IFLR* and was chosen as one of the winners of the "40 Under 40 Award" given by the magazine *Iberian Lawyer* in 2007.

Filipe Lowndes Marques obtained his law degree from the Catholic University Law School (1994) and a Magister Juris in European and Comparative Law from the University of Oxford (1995). He is a member of the Law Society of England and Wales, the Oxford Law Society and a director of the British Portuguese Chamber of Commerce. He has published a number of chapters in books on securities law.



João Honorato

Morais Leitão, Galvão Teles, Soares da Silva

João Honorato joined the firm in 2002. He now works with the banking, finance and project finance practice group. João Honorato focuses on banking and financial law and has been involved in several types of corporate and project finance transactions and commercial paper issue programmes. He has also advised on factoring structures. His experience includes structuring, negotiating and executing the project finance of the Portuguese emergency forces' communications system, and

the financing of wind farms, motorways and football stadia. In addition, he provides legal advice on financial derivatives and on the incorporation and marketing of national and international mutual and real estate investment funds.

João Honorato obtained his law degree from the University of Lisbon Law School (2002). He completed postgraduate studies in International Financial Transactions at the University of Lisbon Law School (2007). He has been a member of the Portuguese Bar Association since 2004.

Except when security is materially accessory to agreements specially subject to tax under the Portuguese Stamp Tax Code, and granted simultaneously with the secured obligation, the granting of security is subject to the same rates as set out above for loans. Therefore, if security is granted simultaneously with a bank loan and is accessory to it, no stamp tax is due over the security, since stamp tax is already payable over the amounts loaned.

When structuring bank financing, stamp tax is usually one of the major factors taken into account, with companies anxious to minimise their exposure. In transnational financings, these rates have meant, in our experience, that in many cases loans are not made into Portuguese companies; this factor is absent from most of the other European jurisdictions.

Payments of interest may also be subject to

withholding, if made to entities that are not credit institutions domiciled or with a branch in Portugal. This has meant that foreign banks have found it harder to lend into Portugal, as Portuguese borrowers, due to the usual imposition of gross-up rules, prefer to borrow from Portuguese lenders so as to avoid the added withholding charge. The standard withholding rate on payment of interest is 20%, but this may be reduced by applicable double taxation treaties.

Tax on bond issues

The payments arising from subscription of bonds and interest due are not subject to stamp tax in Portugal. This is a major advantage for companies seeking financing, compared with the traditional option of contracting bank loan facilities. However, for a company to issue bonds in an amount

greater than twice its own funds, its shares must be listed, the bond issue must be rated, or special security must be granted in favour of the bondholders. This means that for unlisted companies that do not want to seek a rating for the bonds to be issued, the only option for exceeding the referred issue amount limit is if special security in favour of the bondholders is granted. Since subscription of bonds and respective interest payments are not specifically mentioned in the Portuguese Stamp Tax Code and thus are not subject to stamp tax, security created to guarantee the obligations arising from the bond issue will be subject to stamp tax, even if materially accessory and simultaneous to the bond issue.

In relation to withholding tax, it is important to differentiate between bonds held through Interbolsa, Sociedade Gestora de Sistemas de Liquidação e de Sistemas Centralizados de Valores Mobiliários, SA (the Portuguese central settlement and clearance system) and those held through Euroclear and/or Clearstream. To investment income on bonds held through Interbolsa paid to a holder of bonds, the regime applicable is that foreseen in Decree-law 193/2005 of November 7, as amended, which is in full force and effect from January 1 2006. According to this legislation, investment income paid to holders of bonds, and capital gains deriving from a sale or other disposition of such bonds, will be exempt from Portuguese income tax, and consequently from withholding tax, provided that: (i) the holders of bonds have no residence, head office, effective management or permanent establishment in the Portuguese territory to which the income is attributable; (ii) they are not domiciled in a country, territory or region subject to a clearly more favourable tax regime included in the list approved by the ruling issued by the Portuguese Minister of Finance and Public Administration (*Portaria do Ministro das Finanças e da Administração Pública* 150/2004 of February 13) with the exception of central banks and agencies of a governmental nature of blacklisted jurisdictions; and (iii) they are non-resident entities that are not held directly or indirectly in more than 20% by Portuguese resident entities.

To benefit from the taxation regime contained in Decree-law 193/2005, the bonds must be integrated in a centralised system for securities recognised under the terms of the Portuguese Securities Code and complementary legislation (such as Interbolsa). Decree-law 193/2005 defines specific instruments in respect of the provision of evidence of non-residence by the holders of bonds for the purpose of the above tax exemptions. The direct register entity

(that is, the entity affiliated to the centralised system where the securities are integrated), as the entity holding the relevant account with the relevant centralised system in which the bonds are integrated, will be under the obligation to obtain and maintain evidence that the effective beneficiary is a non-resident entity.

Investment income on bonds held through Euroclear and/or Clearstream paid to a holder of bonds (the effective beneficiary) considered resident for tax purposes in the Portuguese territory is subject to withholding tax at a rate of 20%, except where the beneficiary is either a financial institution or an exempt entity as specified by Portuguese tax law (a system similar to that applicable for interest payments on bank loans made to non-resident credit institutions). Investment income on bonds paid to beneficiaries considered non-residents in the Portuguese territory is also subject to withholding tax at a definitive rate of 20%. Relief may be available to reduce the marginal rate in accordance with any applicable double taxation treaty, subject to compliance with all relevant conditions imposed by the tax authorities in Portugal and the jurisdiction of the beneficiary.

Bank loans versus bond issues

Although companies, by issuing bonds, may avoid stamp tax that would be applicable if they choose to finance themselves through bank loans, they must pay stamp tax on security granted for the compliance of their obligations under the issue. And since the amount of the financing is usually the same as the amount of the secured obligations, stamp tax obligations tend to be the same in the case of secured bank loans and in the case of secured bond issues (except as noted below).

Regarding stamp tax, the major advantage of this structure relates to the interest payments: interest payments under bonds are not subject to stamp tax, as opposed to the stamp tax payable on interest payments under bank loans. This is an advantage to be taken into account when deciding whether or not to contract bank loan facilities. In relation to withholding, as we saw above, if the bonds are held with Interbolsa (which is the clearly preferred alternative), non-resident credit institutions that hold the bonds will not be subject to withholding, a clear benefit in relation to the traditional bank loan alternative.

Interbolsa

As we discussed above, for the bond structure to be most beneficial, the bonds should be held through Interbolsa as operator of the *Central de Valores Mobiliários*, a central securities depositary (CSD). Interbolsa holds

securities through a centralised system (*sistema centralizado*) composed by interconnected securities accounts, through which such securities (and inherent rights) are held and transferred, and which allows Interbolsa to control at all times the amount of securities so held and transferred. Under the procedures of Interbolsa's settlement system, settlement takes place on the third business day after the trade date and is provisional until the financial settlement, which takes place at the Bank of Portugal on the settlement date.

The bonds are in book-entry form and title to the bonds will be evidenced by book entries in accordance with the provisions of the Portuguese Securities Code and the applicable CMVM regulations. No physical document of title will be issued in respect of bonds held through Interbolsa. The bonds may be registered bonds or bearer bonds. Each person shown in the records of an Interbolsa participant as having an interest in bonds shall be treated as the holder of the principal amount of the bonds recorded. Bonds held through Interbolsa may be transferred to a person who wishes to hold such bonds, subject to compliance with all applicable rules, restrictions and requirements of Interbolsa and Portuguese law.

Bond issue documentation

Structuring bank financing through the issue of bonds entails the execution of a set of agreements that may be described in general terms as follows. A bond subscription agreement is entered into between the issuing company and a bank (or several banks) in the capacity of bondholder. Under this agreement the company agrees to issue bonds and the bank undertakes to accept and subscribe for the bonds on a determined issue date and at a specified issue price among other agreed terms and conditions. Security agreements are put in place to guarantee compliance of the obligations of the company towards the bank in its capacity as bondholder under the issue. The company also executes a paying agency agreement under which a bank (normally a different entity from the subscriber) is appointed for the rendering of payment agent services in connection with the bond issue. In addition, if that is the case, an agreement for the rendering of services for the physical settlement and integration of the issue in the CSD is entered into between the issuing company and a bank. The bank also undertakes to request the registration of the bond issue with the CSD and to represent the company to this entity, on behalf of the company.

MORAIS LEITÃO, GALVÃO TELES, SOARES DA SILVA

ASSOCIADOS
SOCIEDADE DE
ADVOGADOS

PORTUGUESE LAW
FIRM OF THE YEAR

IFLR AWARDS 2008

PORTUGUESE LAW FIRM OF THE YEAR
IFLR AWARDS 2007

PORTUGUESE LAW FIRM OF THE YEAR
IFLR AWARDS 2005

CLIENT CHOICE AWARD
INTERNATIONAL LAW OFFICE 2005

www.mlgts.pt

