Amendments to the Portuguese Insolvency Act

Catarina Serra asks if it is much ado about nothing?

The recent amendments to the Portuguese Insolvency Act, which came into force last May, were awaited with great interest and were preceded by public debates and speculation[1]. Like the German Insolvency Act, the Portuguese Act was oriented, from the start, to the winding-up of companies and provided no easy means of recovery. It was widely recognized that there should be a thorough revision of the Insolvency Act, particularly in what concerns the framework of the restructuring tools.

A provision in the Memorandum of Understanding on Specific Economic Policy Conditionality (the so-called Troika Memorandum), released and signed by the Portuguese Government one year before (in May 2011), provided the missing pretext to carry out the reform. The Troika Memorandum specifically required that, "[to] better facilitate effective rescue of viable firms, the Insolvency Law [should be] amended by end November 2011 with technical assistance from the IMF, to, inter alia, introduce fast track court approval procedures for restructuring plans". The provision gave rise to great expectations, but the actual amendments turned out to be quite disappointing.

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There is no doubt that the Portuguese Insolvency Act was modernized: the legislator created a new pre-insolvency proceeding and updated the terminology of Insolvency Law, making it more compatible with a rescue culture. But the truth is that he left out the case of insolvency: it remains equally difficult for an insolvent though viable company to escape assets liquidation.

At the end of the day, one could say that the Portuguese Government simply paid a lip service to the Troika. The question now is: will it pay off? Put in other words: it goes without saying that the amendments are insufficient to achieve the goal of rescuing insolvent companies; are there any chances that the amendments will achieve any (other) goals at all?

Let us take a closer look at the amendments.

The reduction of the term to file for insolvency

The duty to file for insolvency, which was formerly fixed to sixty days after the company's directors become aware (or should become aware) of the company's insolvency, has been dramatically shortened to thirty days. Understandable as it is that the insolvency proceeding should commence timely, the reduction does not strike as the most adequate measure, especially if one bears in mind that, as widely known, the Portuguese economy is undergoing a severe crisis and there is (there will be for the next few years) a considerable number of companies entering insolvency.

In the first place, the majority of the Portuguese companies boils down to small and medium-sized enterprises, which do not keep organised accounting and, therefore, may experience some difficulties in establishing rigorously if (and when) they are insolvent. Moreover, a thirty-day period is clearly not enough to allow the company directors to think of ways to avoid liquidation, let alone negotiate an insolvency (restructuring) plan with the creditors.

If one takes a look around, one finds a whole set of alternative and more flexible tools likely to accomplish successful results in dealing with the timing problem. Take, for instance, the German Insolvency Act. In Germany, there is no mandatory filing in some over-indebtedness cases, to begin with (when having taken account of all the relevant circumstances the undertaking is more likely than not to continue trading).

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Then, in order to promote the timely commencement of the insolvency proceeding, the German Act facilitates self-management and, above all, grants certain companies (those which are over-indebted or in imminent insolvency and file voluntarily) a "protective shield" of a period up to three months to prepare a restructuring plan before opening the insolvency proceeding.

The truth is that, in times of hardship, flexibility may be the most efficient means of dealing with distress situations. On the other hand, strictness may turn out to be counterproductive. More precisely, the reduction of the sixty-day term to the thirty-day term may produce a risk-chilling effect: the company's directors, fearing the consequences of non-compliance, will not be willing to take any risks; actually, they will feel tempted to "leave the boat" at the first signs of distress. In short, the measure may well maximize compliance with the duty to file for insolvency but it will imply the wasting of an ideal occasion to attempt a turnaround. Do the gains indeed outweigh the costs?

The changes regarding the classification of insolvency

In what concerns the classification of insolvency (a procedure aimed at ascertaining whether the insolvency was due to a guilty behaviour on the part of the company's directors), there are several changes worth pointing out.

In the first place, the procedure is no longer mandatory; from now on, the procedure will only be opened if the judge concludes there is evidence of guilty behaviour. The recognition that the procedure was not always useful (the proof of a guilty behaviour is always a difficult one) justified the restriction.

In the second place, the set of consequences that fall upon the company' directors, whenever they are found guilty of causing or deepening the company's insolvency, has been renewed. It used to imply, first, the restraint from managing their own assets (with the appointment of a curator by the court), second, the restraint of trade and the disqualification from being appointed as a directors in other public or private companies and, finally, the loss of all the claims they might hold against the company and the duty to repay all the amounts they might have received. The last two consequences still stand but the first has been softened: the company's directors will be simply restrained from managing other peoples' assets. This measure seems quite redundant since the restraint of trade and the disqualification from being appointed as directors already leads to the restraint from managing other people's assets.

On the other hand, the company's directors will be submitted to a new consequence: liability towards creditors for the claims left unpaid throughout the insolvency proceeding. This is a good and long awaited novelty. The reasoning is quite simple: if insolvency is an undesirable (unlawful) situation it is mainly because there are damages at the level of certain public interests, particularly those associated to the credit market and trade. The only way confidence in the credit market can be restored is by providing the most adequate remedies – adequate for the extent and the severity of the damages produced. What could be more appropriate to the satisfaction of these interests than the possibility of compensating creditors?[2]

Finally, the scope of application of the provision has been widened: besides the company' directors (both *de facto* and *de jure)*, these consequences may also attain the statutory auditors (whenever it is established that the company's insolvency was caused or deepened due to their misbehaviour).

The special revitalization proceeding

In what concerns restructuring, a brand new instrument was introduced: a hybrid proceeding, only applicable to pre-insolvency situations (economic distress and imminent insolvency) that goes by the name of "*processo especial de revitalização*" (special revitalisation proceeding).

It comprehends a period of negotiations between the company and its creditors (up to three months) and is intended to devise a restructuring plan. It may be supervised by the court – through a preliminary insolvency administrator – from the beginning ("*typical proceeding*") or merely afterwards ("*abbreviated proceeding*").

Despite its contractual basis, the restructuring plan enjoys the benefits of a final judicial intervention (the court approval of the plan) which makes the plan binding to all creditors (dissident and absent creditors included), provided it is agreed upon by a qualified majority and a certain minority protection is ensured (no creditor is in a worse position with the plan than without it and no creditor receives a financial value exceeding the value of his claim).

The greatest advantage of the new proceedings is the possibility to carry out a restructuring scheme without the company being declared insolvent by the court, therefore preventing the loss of value that such a declaration necessarily implies. On the other hand, if negotiations do not turn out as expected (an agreement is not reached), the company risks to be declared insolvent and submitted to the opening of the insolvency proceedings. In order to prevent this from happening, the company will have to give its creditors, throughout the proceedings, clear signs that the restrictions they will have to endure will be worthwhile.

The problem is, in the first place, that it is almost impossible to predict the behaviour of every creditor, hence to anticipate the outcome of the negotiation process. This is usually solved through the granting of benefits to the creditors, namely to those who provide financing to the debtor during the period of negotiations (also known as "new money"). Unfortunately, the provisions concerning new financing are particularly imprecise and, therefore, not easy to interpret.

The Guiding Principles for the Out-Of-Court Debt Restructuring, approved 25 October 2011, and consequently the Global Statement of Principles for Multi-Creditor Workouts (Insol Principles), who served as a model, have an important role to play in the interpretation of these provisions. Still, some doubts remain[3].

It is not clear, for one, if the provision granting a priority applies exclusively to the creditors who provide new money and payment delays (financial creditors). The text of the provision points towards a restricted application but this would be both unfair and inefficient. If there are any creditors who supply new assets or services (employees, suppliers of goods) they are helping to preserve the business as a going concern and therefore they deserve to be included in the scope of the provision.

And what about the old creditors (those who were creditors even before the opening of the proceedings): shouldn't they be given a pre-emptive right with regard to new financing? They should be the first to provide new financing if they want to, so as to preserve their relative position. Given the similarity between their situation and the situation of the shareholders (who, under the Portuguese Company Law, are granted a pre-emptive right in all capital increases), one is bound to provide an affirmative answer.

The most important doubt concerning new financing is, however, of a different nature. It has to do with the sufficiency of the guarantees: are or are they not sufficient to encourage creditors to grant new financing and therefore support the rescue of the company? The priority granted to them ranks ahead the priority granted to employees but does not rank ahead of other priorities granted to creditors like the State and most banks. It is doubtful that this will be enough.

Final remarks

Quite surprisingly, the recent amendments to the Insolvency Act did not touch the provisions concerning the only means of promoting rescue in corporate insolvency cases (the insolvency plan), despite the flaws of the regime and the undisputed need of a reform.

The strengthening of self-administration, the involvement of the company's shareholders in the insolvency proceeding and the streamlining of the insolvency plan are some of the obvious measures that the Portuguese legislator could have taken if he had decided to carry out a meaningful revision of the Insolvency Act.

The absence of amendments to the insolvency plan suggests that, as far as the Portuguese legislator is concerned, insolvent companies do not deserve to be rescued. Let us hope this is not final and that there will be further amendments in the near future.

> **THE GREATEST ADVANTAGE OF THE NEW PROCEEDING IS THE POSSIBILITY TO CARRY OUT A RESTRUCTURING WITHOUT THE CORPORATION BEING DECLARED INSOLVENT**

FOOTNOTES

1. See Catarina Serra, "Portugal under the spotlight: Will there be a new Insolvency Act?" (2011), 44, Eurofenix, pp. 22-25, and also "Portugal: New Portuguese Insolvency Act" (2012), 47, Eurofenix, pp. 40.
2. See Catarina Serra, "The Portuguese Classification of Insolvency from a Comparative Perspective", Chapter 1 in Rebecca Parry (Ed.), *Papers from the INSOL Europe Academic Forum / Milan Law School Joint Insolvency Conference, University of Milan Law School, Milan, Italy, 31 March-1 April 2011 (2011)*, pp. 3-16.
3. The following doubts and questions were first present at the INSOL Europe Academic Forum / Nottingham Law School Joint International Insolvency Conference, which took place at Nottingham Trent University, in 28 and 29 June 2012. See Catarina Serra, "The rescue of large corporations – How suitable is the Portuguese Insolvency Act?" in Rebecca Parry (Ed.), *Papers from the INSOL Europe Academic Forum / Nottingham Law School Joint International Insolvency Conference* (forthcoming).