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CORPORATE & GOVERNANCE

CONVERSION OF CREDITS INTO CAPITAL
IN COMPANIES WITH A MINIMUM TURNOVER OF €1 MILLION

Law no. 7/2018, of 2 March 2018 was published last Friday, establishing a new legal framework for conversion of credits into capital.

Approved as part of the *Programa Capitalizar*[1] (Capitalize Program) and effective as of 3 March, the Act affords companies and their creditors an extrajudicial recovery and restructuring avenue to act swiftly with regard to the capitalization of companies in a weak financial position but that are economically viable.

I. Scope

The new statute foresees the conversion into capital of debt of commercial companies (or civil law companies having a commercial form) based in Portugal and with a turnover equal to or greater than one million Euros (as shown in the most recent accounts approved for the relevant financial year).

The following debt cannot be converted into capital:

- Debt of publicly held companies and privately held open capital companies, credit institutions, financial companies, investment companies, insurance companies and state-owned companies[2];
- Credits held by government entities other than entities in the public corporate sector;
- Credits held by creditors not wishing to convert their credit claims, who are not even required to express their intentions or lack thereof.

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[1] Strategic program to support company capitalization, investment rebound and economic recovery, approved by Council of Ministers Resolution 42/2016.

[2] All entities comprised in the public corporate sector. In order for the statute to apply to these entities, the member of Government in charge of Finance must give its prior approval and the principles and rules applicable to the public corporate sector must be observed.

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II. Conditions

Credits conversion into capital may be proposed by creditors holding credit claims in eligible amounts if all these conditions are satisfied:

- **Demonstrated equity reduction**: when the most recent final or interim accounts for the financial year, prepared by the executive body of the company and approved in the last quarter show that the company's equity falls below its share capital; and
- **A substantial part of liabilities are outstanding**, i.e., in the event that non-subordinated credits in an amount greater than 10% of the total credits of that category has been in default for more than 90 days, or if instalments for partial repayment of principal or interest are at issue, provided that they pertain to non-subordinated credits representing over 25% of the total credits of that category[3].

This represents a substantial shift in paradigm as regards the capital loss framework.

Although Article 35 of the *Código das Sociedades Comerciais* (Portuguese Companies Code) ("**CSC**") already establishes a capital loss framework, it only applies in the event of "serious" capital loss, i.e., in the event of loss of half of the share capital (differently put, in the event that the company's equity is equal to or lower than half the share capital). This Article basically establishes a duty of information: the executive body must call or cause the general meeting to be called promptly to inform the shareholders of these circumstances (who are entirely free not to correct the situation or even to do nothing).

Contrary to Article 35 of the CSC, which establishes more stringent requirements for the declaration of capital loss and is primarily internal – essentially protecting the shareholders (against risk of losing their paid-in capital, for instance) –, Act 7/2018 foresees a reactive, external system, which is triggered when the company's equity falls below its share capital and is primarily aimed at protecting the creditors' interests.

III. Share capital increase

Under the new statute, proposals for converting company debt into capital must be accompanied by the following items:

- A report prepared by a chartered accountant, certifying that all necessary requirements are met;
- A document containing the share capital modification proposals, which must (i) detail the contents of the operation; (ii) if applicable, set out the share capital reduction – share capital may be reduced to an amount below the minimum amount provided for by law for the relevant type of company –, which needs then to be aligned with the subsequent share capital increase by conversion of credits into capital; the reduction must be justified and is only possible if it is expectable that in the event of full liquidation of the company's assets there will be no remaining assets to distribute to the shareholders; and (iii) set out the amount of share capital increase to be subscribed by the creditors through conversion of credits into capital, and the justification for the conversion ratio; and
- Draft amendments to the articles of association and, where applicable, a provision that the company will be transformed into a different type of company, and the removal of all shareholders provided that their shareholdings are devoid of value.

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[3] See Articles 47 and 48 of the *Código da Insolvência e da Recuperação de Empresas* (Insolvency and Business Recovery Code).

Following the share capital increase, the company's equity must be greater than its share capital at the time of the proposal.

If no general meeting is held within 60 days as from the day when the company receives the proposal, if the proposal is rejected by the general meeting within the same period, or if the resolutions therein are not approved or enforced within 90 days as from receipt, the relevant creditors are free to file for the judicial enforcement of the resolution in lieu of the company before the court competent for an insolvency order.

IV. Protection of shareholders' position

In order to ensure their position, Act 7/2018 affords shareholders a pre-emption right in the share capital increase by means of cash contributions – fully or partially in lieu of third-party credit claims to be converted –, allows shareholders to agree with the creditors on changes to the conversion proposal, and establishes a possibility that the shareholders or any third parties appointed by them may acquire the shares subscribed by the creditors (in the event of judicial enforcement of the resolution in lieu of the company).

V. Final notes

The new statute does not expressly or specifically address many of its effects: it fails to define, for instance, the concept of shareholdings "devoid of any value" (Article 3.10). It also fails to explain how the act will align a possible "removal" of shareholders and the specific framework of *sociedades anónimas* (limited liability companies by shares) as "capital companies" where the shareholder *per se* plays no significant role, or what rights are afforded to the removed shareholders (considering that their shares are deemed as "devoid of any value").

VdA remains available to provide more detailed clarifications regarding the effects of this new act.