

International Swaps and Derivatives Association, Inc.
COLLATERAL LAW REFORM GROUP

PORTUGAL

COUNTRY REPORT

Supplement to
*Collateral Arrangements in the European Financial Markets:
The Need for National Law Reform*

March 2000

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COLLATERAL LAW REFORM GROUP***PORTUGAL****Summary report on the legal framework for collateral arrangements for financial activity*

Summary of the legal analysis under the laws of Portugal applicable to collateral arrangements intended to secure financial trading activity in relation to privately negotiated derivative transactions, securities trading, securities repurchase transactions, stock lending and similar financial transactions in the wholesale financial markets. It is assumed that at least one of the parties involved is a financial institution (credit institution or investment firm) and that the collateral involved is cash, in euros or some other freely available currency, and/or fungible securities held listed on a stock exchange or recognised market and in immobilised or dematerialised form in a clearing system (“Fungible Securities”). References to “collateral” below indicate cash and Fungible Securities, unless otherwise specified.

This summary was prepared for the purpose of identifying possible areas of uncertainty or commercial impracticality arising under the laws of Portugal in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in Portugal and should not be relied on as such.

The position is stated as of December 1999.

This summary, prepared by the Collateral Law Reform Group, does not necessarily represent the views of ISDA or any of its members. It is a subjective assessment of the position in Portugal and is simply intended to encourage debate and discussion of the relevant issues.

KEY POINTS FOR CONSIDERATION FOR PORTUGAL

- (1) The interest of an owner of a share in a pool of Fungible Securities will depend on the nature of the arrangements.
- (2) The *lex loci* of Fungible Securities held through an account in a clearing system is the place where the clearing system is located.
- (3) Conflicts of law rules with respect to a holding of Fungible Securities would apply the *lex loci* to the transfer of and perfection of a security interest in Fungible Securities, and in principle the governing law of any agreement to a transfer of Fungible Securities and the creation of a security interest.
- (4) If security assets which are Fungible Securities are held in Portugal by a third party bank or custodian the security interest must be notified to the third party and registered on the account. Top-up notifications are also required. If a security interest is created over future property then a further notification must also be made when this is acquired to perfect the interest.
- (5) No official registration of a security interest in Fungible Securities with any state agency is necessary (if they are not held through a local clearing system).

- (6) A pledgee party may not use pledged assets registered in the records of the local securities clearing house as its own property.
- (7) Formal procedures apply to enforcement of a security interest but may be varied by agreement.
- (8) Enforcement of a security interest may not be delayed and is not stayed on insolvency if created under an Agreement to which the Portuguese Netting Law applies.
- (9) Title transfer arrangements will not be recharacterised.
- (10) Close-out netting under an ISDA Master Agreement is enforceable if the Portuguese entity is a corporate or bank.
- (11) Contractual set-off is not enforceable after the declaration of insolvency.
- (12) Third party claims cannot disrupt netting under the Portuguese Netting Law and may only disrupt set-off after declaration of insolvency.
- (13) Top-up collateral will not be avoided as a preference.

1. Do the laws of Portugal deal clearly with the nature of a participant's interest in a holding of Fungible Securities?

The laws of Portugal clearly provide for the holding of rights to Fungible Securities, as well as for the creation of security interests in such rights (as a pledge of such rights).

2. How would such an interest be characterised under the laws of Portugal?

The application of the laws of Portugal would depend on the location of the Fungible Securities and the documentation governing the relationship between the participant and the relevant custodian. Security interests on Fungible Securities are legally characterised as a pledge of ownership rights to such securities.

3. How would the location of Fungible Securities be determined under the laws of Portugal?

In the case of Fungible Securities, the place in which the clearing system in whose records the securities are registered is located.

4. Under Portuguese conflict of laws rules, what law would govern:

(a) the characterisation of a person's holding of Fungible Securities?

Portuguese conflicts of laws rules determine that the holding of assets, property rights and other related rights (including those arising from the creation of a security interest) are governed by the law of the place where the relevant assets are located.

In addition, to the extent these issues are the subject of an agreement between the parties, the law chosen by the parties as the governing law of that agreement will be respected so long as there is a connection between the governing law and any of the elements of the contract, or where there is no direct connection, so long as the choice

of law corresponds to a serious commercial concern of one of the parties. In the absence of any choice of express governing law, the law of the agreement will be deemed to be that of the parties' domicile, if this is the same for both, and if it is not, the law of the place in which the parties entered into the agreement.

Finally, a specific conflicts of laws rule also requires that a foreign law otherwise applicable in accordance with these rules will not apply if it involves the violation of fundamental principles of Portuguese public order and that no equivalent remedy applies under the foreign law. In that latter case Portuguese law will be deemed applicable.

(b) the creation of a security interest in cash or Fungible Securities?

To the extent that “creation” relates to the contractual aspects of the security agreement between two parties, the law governing the relevant contract, which would normally be the law chosen by the parties will apply.

(c) the formal validity or perfection of a security interest in cash or Fungible Securities?

To the extent that “perfection” relates to the proprietary aspects of the security agreement between two parties and the rights of third parties in relation to the assets subject to the security interest, the law of the place where the relevant collateral is located will apply.

(d) the effectiveness and formal validity of a transfer of title to Fungible Securities?

As to contractual aspects of the transfer agreement, the law governing the relevant contract, which would normally be the law chosen by the parties will apply. As to proprietary aspects of any transfers under that agreement, particularly in relation to the rights of third parties, the law of the place of location of the relevant collateral will apply.

In relation to (b), (c) and (d) the considerations detailed in our answer to (a) above also apply.

5. What types of security interest may be created under the laws of Portugal in:

(a) cash?

(b) Fungible Securities?

Where more than one type of security interest is possible, please indicate which type(s) would typically be used for collateral arrangements involving cash and/or Fungible Securities, and why.

Under Portuguese law, a pledge (*penhor*) may be created over cash or Fungible Securities. There are two types of pledge, civil and commercial. A commercial pledge is a pledge entered into between entities or individuals subject to the regulations of the Commercial Code. These will be individuals with capacity to carry out commercial acts and other entities which engage in commercial activities. In general, the requirements for a civil pledge are somewhat stricter than those for a commercial pledge. A civil or commercial pledge may be

used depending on the status of the parties. In practice, a civil pledge is more likely to be used.

- 6. In relation to each of these types of security interest, describe briefly any filing, registration, notification, notarisation or other formal requirement necessary to ensure validity of (or “perfect”) the security interest? In relation to each type of security interest, please indicate the consequence of failing to comply with the relevant requirement.**

In relation to Fungible Securities or cash, in the case of a commercial pledge a written security agreement is required. In such a case, the pledgor may retain possession of the collateral, but is unable to deal with it freely. In the case of a civil pledge, delivery of the Fungible Securities (or of documents conferring exclusive control of them) or cash to the pledgee or its agent is required.

In relation to Fungible Securities, if located in Portugal, the pledge must be registered in the records of the relevant custodian (the central securities depository operating the relevant clearing system). It is only possible to do this in relation to each actual transfer of collateral when it occurs. It is not, in other words, possible to make a registration of the pledge which applies to future transfers of collateral as well. Also this registration is subject to periodic renewal while the security interest subsists. Failure to register means the pledge will not be effective against *bona fide* third parties.

- 7. In relation to each type of security interest, indicate whether the collateral receiver is entitled to use the collateral as though it were the absolute owner of the collateral, including the right to sell, lend or re-pledge (rehypothecate) the collateral to a third party.**

In relation to Fungible Securities registered in the records of the local securities central clearing house, the collateral receiver would not be permitted to sell, lend or re-pledge (rehypothecate) the collateral because registration of the pledge in the records of the local custodian is required. This registration effectively blocks such use, even if permitted under the express terms of the security agreement.

- 8. Briefly describe the enforcement procedures for each type of security interest commonly used for collateral in relation to financial activity. For example, is court approval required before the security interest may be enforced and/or is some form of auction procedure required. Indicate any practical difficulties typically encountered and also the relative efficiency and speed (or lack of same) of such procedures. Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

In the case of Fungible Securities, assuming the security agreement expressly provides for a power of sale, the pledgee may sell the Fungible Securities without court approval or intervention.

In the case of cash, the pledgee may set off the secured obligations against cash collateral provided that it does so prior to any declaration of insolvency in relation to an insolvent Portuguese pledgor. After a declaration of insolvency, set-off is prohibited. Contractual netting may be possible if Portuguese netting legislation applies.

Note that some security agreements (such as the ISDA Credit Support Annex under New York law) may fall within the Portuguese netting legislation, provided that the security

agreement relates to derivative transactions entered into under an industry standard master agreement such as the 1992 ISDA Master Agreement.

- 9.a. In relation to local law collateral arrangements based on transfer of title, please indicate whether there is a risk that the courts of Portugal would recharacterise the transfer of title as the creation of a form of security interest? If so, please give some indication of the degree of that risk (for example, very low, low, medium, high, very high). Please indicate the consequences of such a recharacterisation.**

The risk of recharacterisation is very low and is likely to be limited to recharacterisation by the tax authorities for tax purposes only.

- 9.b. If the agreement is governed by a foreign system of law that does not recharacterise, would the risk of recharacterisation under domestic law still be present?**

The position remains the same as that outlined in the answer to Question 9.a.

- 10. Is close-out netting, for example, under a 1992 ISDA Master Agreement, enforceable under the laws of Portugal? If so, but subject to certain limitations (for example, as to the nature of the counterparty or types of transaction included within the netting), please indicate briefly what those limitations are.**

Under the Portuguese netting legislation, enacted in 1997, close-out netting under a master agreement such as the 1992 ISDA Master Agreement is enforceable against a party subject to Portuguese bankruptcy proceedings (whether reorganisation or liquidation proceedings) in relation to “financial instruments”. The term “financial instruments” would be broadly construed to cover all cash-settled and physically-settled derivatives. The Portuguese entity subject to bankruptcy proceedings must be a corporation or a bank.

See also the netting opinions provided to ISDA by Abreu & Marques of December 1997 and November 1998.

- 11. Is contractual set-off and/or insolvency set-off enforceable in the event of formal insolvency proceedings in the courts of Portugal in relation to a counterparty organised in Portugal? Please indicate the answer in relation to each type of formal insolvency proceeding (including rehabilitation or reorganisation proceedings such as administration or redressement judiciaire) possible in Portugal in relation to a corporate entity (including a financial institution). Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

There are two types of insolvency proceedings under Portuguese law, reorganisation or “recovery” (*recuperação*) proceedings and liquidation (*falência*) proceedings. Note that the prohibition on set-off referred to above applies only from the date of declaration of insolvency and not from the commencement of the relevant insolvency proceedings. Set-off is still permitted during this period.

The exercise of contractual rights of set-off agreed prior to the suspect period would not fall within the definition of payments during the suspect period. After the declaration of insolvency any rights of set-off will be subject to the rights of preferential creditors and secured creditors.

- 12. Would the exercise of netting or set-off rights under a title transfer collateral arrangement be vulnerable to the rights of third parties in the event of the insolvency of the collateral giver? For example, would it be possible for the collateral giver to disrupt (deliberately or inadvertently) the netting or set-off by assigning to a third party creditor its right to redelivery of equivalent collateral under the collateral arrangement? Could that right to redelivery be attached by a third party creditor of the collateral giver free of the collateral taker's netting or set-off rights under the collateral arrangement?**

There is a low risk that any collateral giver or third party could disrupt transfer of title collateral arrangements validly created and perfected under the applicable law of the agreement. Rights of contractual set-off and netting would operate as agreed.

- 13. In relation to mark-to-market collateral arrangements, is there any risk under the preference (or similar) rules of Portugal that “top-up” deliveries of collateral would be vulnerable to avoidance if made during a relevant period prior to the insolvency of the collateral giver?**

The risk is low to non-existent that such payments would be preferential under current Portuguese preference rules, assuming the collateral arrangement was entered into at the same time as the agreement for which it is providing credit support and that both were agreed prior to the relevant suspect period.

- 14. Please add any additional comments on the general legal framework for collateral arrangements under the laws of Portugal, whether based on creation of a security interest or on title transfer, highlighting any difficulties that should be addressed in any project for collateral law reform in Portugal.**

The difficulties associated with the pledge (whether commercial or civil) route, relate mostly to the nature of the registration requirements. It may be impractical in the financial markets for a pledgee to be able effectively to register each transfer of collateral in the records of the relevant custodian (clearing system). Also a security interest in after-acquired property is not enforceable against third parties.

The prohibition on use by a pledgee of collateral in the form of Fungible Securities is also an impediment to efficient collateralisation.

Title transfer collateral arrangements, although not expressly sanctioned under Portuguese law should in principle be accepted if allowed under the law applicable to the relevant agreement. If Portuguese law is deemed to apply, re-characterisation risk is low (and limited to tax considerations).

Explicit protection of title transfer arrangements from prohibition on insolvency set-off would be desirable, perhaps via expansion or clarification of Portuguese netting legislation to cover such arrangements.

Although set-off is prohibited after a declaration of insolvency there is normally a considerable delay between commencement of the insolvency proceedings and any declaration. Set-off is permitted during this period.

Set-off is also permitted during reorganisation proceedings up until a declaration of insolvency (if one occurs at the end of such proceedings).

The Collateral Law Reform Group acknowledges the assistance of Abreu, Cardigos & Associados, Lisbon in the preparation of this report. That firm, however, accepts no liability in relation to this report.