Acquisition of a business from an insolvent company

Madrid, January 2014

I

Acquiring a business from a distressed company that has not been declared insolvent (as opposed to acquiring it from an insolvent company) entails a number of disadvantages, some of which are common to any M&A deal.

If the transaction is done as a purchase of the shares in the company running the business, the acquirer takes control of the company and, by doing so, it indirectly "acquires" all of the debts and liabilities of the acquired company, including those that have not been disclosed.

However, if the transaction is done as a purchase of assets and rights, the acquirer usually does not assume liabilities other than tax liabilities and those *vis-à-vis* the employees and the Social Security.

In addition, when the business is acquired from a distressed company, the acquirer runs the risk that the transaction is rescinded in case the former is later on declared insolvent and the transaction is deemed to be detrimental to the insolvency estate (claw back).

II

However, the acquisition of a business from a company that has been declared insolvent is done under court supervision and so cannot be clawed back.

When the transaction is done through a purchase of the shares in the insolvent company, the acquirer takes over the company with all of its debts and liabilities, including those that remain hidden. And, more importantly, it assumes the burden of dealing with the insolvency proceedings and the risk that the latter does not result in a satisfactory and timely arrangement with the insolvency creditors.

For this reason, the most common way to acquire a business from an insolvent company is by acquiring a set of assets (tangible and intangible), rights and contracts that, by themselves, form a business. This type of transaction benefits from a special regime, according, *inter alia*, to section 149.2 of the Spanish Insolvency Act (SIA) and the interpretation given to this legal provision in some leading court cases.

Indeed, the acquirer of a business from an insolvent company does not assume the tax and Social Security liabilities associated to the business. As to debts *vis-à-vis* the employees of the business, the general rule is that acquirer becomes jointly and severally liable with the insolvent company. However, section 149.2 of the SIA enables the court to make an exception and carve out from this rule part of those debts (namely those that the state entity FOGASA should pay).

In addition, some courts resolutions have also ruled that there is an automatic subrogation of the acquirer in the contracts associated to the business, regardless of whether the counterparties to the relevant contracts consent or not. This is not something that the SIA expressly provides for, but some courts have taken the view that for an acquisition of a business to be viable in practice, the automatic subrogation effect is an essential element. The importance of this interpretation is clear for those contracts that are strategic or essential to the business (e.g. lease and franchising agreements), because otherwise (following the general rule under Spanish contracts law) the counter parties to those contracts would need to expressly consent the subrogation and so could request a renegotiation of the terms to their own benefit.

III

The general rule under the SIA is that the acquisition of a business unit from an insolvent company is authorised by the court only once the liquidation phase has been opened.

However, given the way insolvency proceedings is designed in the SIA and the enormous workload that Spanish courts currently have, the liquidation phase is usually opened only after a long period (at the very least some nine to twelve months from the declaration of insolvency). By that time, it is likely that the business has deteriorated substantially and so the chances to find a company willing to acquire it are much lower. And even if there are investors ready to make a transaction at that phase, the price they are willing to pay to the insolvency estate decreases dramatically.

The reason is that insolvency proceedings erode enormously the position in the market of any business, and so the investment required from any potential acquirer to put the business back on track is much higher, all the more in the current economic environment. As a result, before the time to dispose of the business comes, it is likely that the insolvent company has been forced to restructure the business and lay off employees.

For these reasons, Spanish courts are increasingly open to authorise disposals of businesses at an early stage, during the so called common phase, pursuant to section 43 of the SIA (e.g. Cacaolat, Mecanotubo, Seda Soluble, Marco Aldany, Blanco).

In other words, Spanish insolvency administrators and courts face the dilemma of waiting until the liquidation phase is opened (and see how the business gradually collapses) or authorising the sale at an early stage, with much higher chances to break a good or at least a decent deal for all or most of the insolvency stake holders (employees, creditors, suppliers and even the national economic welfare).

IV

The two main objectives of the SIA are to maximize the satisfaction of creditors and to preserve as much jobs as possible. These two principles and, in particular, the latter explain why a number of Spanish courts have resolved the above dilemma by agreeing to make an exception and authorise the disposition of a business before

the liquidation phase has started when it becomes clear that waiting until the liquidation phase will seriously damage the business.

When authorising this type of transaction courts apply analogically the principles set by the SIA for the disposition of assets within the liquidation phase, and in particular the need to carry out a public, transparent and competitive process.

Such a competitive process needs to be relatively swift, given that time is of essence. In certain cases, interim financing can be sought from bidders so that the business can keep running. Such a financing ranks ahead of all other claims and can even be granted collateral security.

The process is directed by the insolvency administrators under court supervision, and its purpose is to achieve the best possible deal for the insolvency estate and the interests of the stakeholders, and in particular those of the employees and the national economic welfare.

However, the purchase price offered by the bidders is not the most important element. The decision is taken by the court based also on the undertakings of the bidders as to the voluntary assumption of certain liabilities (e.g. debts *vis-à-vis* the estate creditors), the future activity of the business, their plans in relation to the employees, etc.

These elements can become more important than the purchase price, which, in certain instances, has been rather low in absolute and relative terms.

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