

M&A – Buying Distressed Companies

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Spanish law perspective

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BUYING DISTRESSED COMPANIES- SPAIN

I.- Insolvency Proceedings Available in Spain

A.- Civil and Mercantile depending on the nature of the debtor

1.-Civil – for those who are not entrepreneurs.

Quita y Espera - literally take away and wait.
Creditors Meeting.

2.-Mercantile.

Suspension of payments

Law of July 26,1922

Bankruptcy

Substantive aspects are dealt with in the Commercial Code of 1885.

Requirements for bankruptcy: insolvent, a merchant, and request for declaration by merchant or some of his creditors.

Great debate over what is insolvency 1) general failure to meet debts; 2) insufficiency of assets 3) various criteria-general failure to pay, inability to make seizures; disappearance of the merchant, improper termination of suspension of payments procedure.

Principal of *par conditio creditorum*, not always applicable due to privileged creditors.

Procedural aspects are dealt with in the Civil Procedure Law of 2000, (before the Civil Procedure Law of 1881).

Penal Code may be applicable to the extent there is an insolvency that may be punished.

Special procedures available for certain companies or specific circumstances (in fact the current law on suspension of payments was specifically passed to cover the insolvency of a Catalan bank.) 1) The first law, from 1869, was designed for suspension of payments of railroads, canals and other public works. 2) The

Spanish Constitution foresees public intervention in limited liability companies and certain sectors: banking, industry, mining military production, communications to name a few. 3) there is also a possibility that the company be administered by the courts when it has been seized.

Judicial administration arises in three cases: a) when the majority of the assets of a business or its shares have been seized, b) when in the “general interest” which covers both creditors, debtors, partners and employees, and c) when it has been formally declared by a court or at the request of state’s attorney.

There are para-insolvency proceedings for banks (*Banesto case* – 1994-95), insurance companies, investment funds.

EC Regulation 1346/2000 [which was to come into force at the end of May] contains provisions concerning judicial competence, recognition and effects of resolutions dictated in insolvency proceedings and applicable law. Directly applicable and binding on the member states.

Limit discussion to mercantile issues.

Purpose of insolvency proceeding.

Bankruptcy – liquidate the assets of the debtor; a possibility of reorganization: 1) because creditors reach an agreement, or 2) because debtor applies for voluntary bankruptcy and continues business.

Suspension of payments – preserve the continuity of the business.

Many times used when there is really bankruptcy, and in fact creditors arrangements under this procedure may foresee liquidation, as a matter of settlement or in the case that the debtor fails to perform under the creditor’s arrangement.

Both proceedings can therefore come up with similar economic results.

The basic differences are in:

- 1) The procedure.
- 2) The removal of the bankrupt from the management of the business.
- 3) The threat and tremendous uncertainty that can result from the judicial retroaction of contracts between the bankrupt and third parties.

Traditional tendency towards suspension of payments procedure, (as a way of avoiding criminal liability) has given way to bankruptcy for small and medium sized companies and suspension of payments for large companies. There is no longer only penal liability in bankruptcy.

II. Possibility of purchasing shares and assets in either procedure

- A. Shares – may always be purchased with the heightened risk related to a company in distress.
- B. Assets- assets may be purchased subject to: 1) authorization of the intervenors in the case of suspension of payments; 2) formal authorization of the judge after the agreement of the liquidators or depository administrators, and report of the *comisario* in the case of bankruptcy. When the sale is made on an urgent basis either due to the cost of conservation or imminent deterioration of the property the judge will also need to authorize it using test of economic convenience. Usually an expert evaluation is attached to the application and the price offered or, set for which the property can be sold, is over the evaluation giving the *sindicados* a legitimate basis to sell for over the expert's determination; and 3) the judge in the case of a company subject to judicial administration, even though the judge may have appointed new administrators that act as his agents.

The timing of the sale is that which is most convenient from the economic point of view (for the creditors).

- C. Debt- it is not unusual for a purchaser to buy out the creditors, or buy a majority of the debt so as to be able to control the insolvency proceeding and either achieve an agreement, or convert the debt into equity.

III. With whom does the purchaser negotiate.

A.- Shares- Principally with the shareholder. There is no legal requirement for the purchaser or the shareholder to notify other persons. As a matter of prudence and practicality the purchaser should in the case of a

1. Suspension of payments:

Speak with the creditors, or at least the creditors that have the majority of the debt. Usually these are banks but can be commercial or industrial suppliers to see what type of creditors agreement they are willing to reach. The public administration, ***Hacienda & Seguridad Social***, may also need to be consulted since they have privileged credits.

Speak with the “*interventores*”, (the “Liquidators”, under Council Regulation (EC) 1346/2000), to see what the situation of the company is. The liquidators (there are three appointed by the judge) are the persons who act as an aid to the judge in controlling the company in order to reach an agreement with the creditors. The third liquidator is appointed by the judge from among the top third of creditors.

The functions of the *interventors* are numerous. Their principal task is to control the transactions of the entity in suspension of payments in order to preserve its assets. They help the judge qualify the proceeding, resolving objections regarding the creditor’s list and the processing of the agreement.

2.- Bankruptcy:

Speak with the “*depositario-administrador*”, or the “*sindico*”, the creditors meeting and the “*comisario*”, which fill the shoes, amply, of the Liquidator”. Final authorization is obtained from judge.

If at beginning of process and purchaser is interested in having the business continue, then judicial authorization must be requested; it is required to have an “open bankruptcy” i.e. to permit the business to continue, albeit administered by the *sindicos*. The request is made by the bankrupt when making a voluntary application or upon occupation of the property of the bankrupt. It must be justified by an economic interest for the creditors and ratified by the creditors meeting.

Comisario acts as an agent for the judge. 1) Presides over the judicial committee taking possession of the property and documents of the bankrupt. 2) Presides over the creditors meetings. 3) Examines the books and papers of the bankrupt. 4) Authorizes any removal of property from warehouses or accounts of bankrupt that have been occupied. 5)

Authorizes urgent sales and necessary expenses for the conservation of property. 6) Generally oversees the work of the depository and the *sindicós*.

The participation of the *comisario* throughout the proceedings makes him a necessary player. 1) He draws up the list of creditors for the first creditors meeting. 2) Reports on the inventory drawn up by the depository and the monthly accounts of the *sindicós*; reports on the expenses that need judicial approval and presents the proposals for settlement that must be approved by the judge. 3) He must authorize the exercise by the *sindicós* of retroaction proceedings. 4) Close the account on the credits drawn up by the *sindicós* and agree to the gradation of credits made by the *sindicós*. 5) The entire proceeding begins with the report on the books and papers that he draws up.

Depository administers the assets of the bankrupt until the *sindicós* take over. He may propose the sale of assets that may not be conserved.

Creditors meeting exclusively represents the interest of the creditors. It is held by resolution of the judge, *sua sponte* or upon the request of the *comisario*. It has competence to 1) appoint the *sindicós*. 2) recognize the credits and their gradation. 3) Approve the agreement. 4) Approve the final rendition of accounts by the *sindicós*. 5) Resolve any extraordinary issue, such as staying in business.

The *sindicós* are chosen at the first creditors meeting. Their duties include: 1) Administer the property of the bankrupt. 2) Legally represent the bankruptcy in the sense of representing the creditors and the assets of the bankrupt 3) Draw up the list of credits and gradation of credits. 4) Procure the sale of property to pay off creditors. 5) Present accounts of liquidation.

Remember that Hacienda and Social Security have certain levels of privilege regarding credits they may have. So they may need to be dealt with. Determination of privilege is a jungle.

General order of privilege: 1) Employee salaries. 2) Credits with privilege over a specific good. a) Employees over products created by them. b) Taxes periodically charged on certain goods and rights or the transfer of real estate. c) Naval and maritime mortgages. d) Mortgages and Pledges. 3) Privileged labor claims. 4) Taxes in general 5) Creditors of article 913 of the ComCode a) singularly privileged creditors, b) creditors privileged under commercial law, c) creditors privileged by common or civil law, d) credits

reflected in a public deed, e) common creditors of commercial operations, f) common civil creditors.

B.- Assets

1. Suspension of payments:

The administrators or directors continue at their posts in a suspension of payments, and may carry out all normal transactions. Assets may be sold in payment or for the payment of debts. But these are subject to intervention of the liquidators. The liquidators must agree to any sale of assets. Without this the transaction can be null.

Prescription period of 4 years.

Speak with the creditors, or at least the creditors that have the majority of the debt. Usually these are banks but can be commercial or industrial suppliers, to see what type of creditors agreement they are willing to reach. If necessary, Hacienda & Seguridad Social need to be spoken with.

If the insolvency is provisional or the delay proposed in satisfying debts is less than three years (usually not the case), then the majority required is half plus one of the creditors attending the meeting representing 3/5 of the debt. If the insolvency is definitive or the delay in payment is greater than three years, then the majority required is half plus one of the creditors attending the meeting representing 3/4 of the debt. If a majority have voted in favor of the agreement, but not $\frac{2}{3}$, then the judge may call another meeting which may approve the agreement if the majority in attendance representing 2/3 of the debt approve it.

2.- Bankruptcy:

Speak with the “*depositario-administrador*”, or the “*sindico*”, “*comisario*” and the creditors meeting. Final approval is obtained from judge.

IV. **Whether the proceedings may be cancelled in the case of purchase.**

A. General rule in practice is that an agreement must be reached with the creditors. A share purchase would not be cause for cancellation, one unfortunate shareholder would

be exchanged for another! An asset purchase may result in a total or partial liquidation of the assets of the insolvent entity.

B. Bankruptcy.

1.- Declaration of end of bankruptcy preceded by final rendition of accounts by the *sindicós* which must be approved by the creditor's meeting. Declaration is obtained once the assets have been liquidated and payment made.

2.- The bankruptcy proceeding can be cancelled if an agreement is reached with the creditors, something favorably looked up by the law. The principle of freedom of contract is applied. It must be authorized by a judge. And the agreement can not just be reached with some of the creditors, it must be with all. The initiative for an agreement can come from the bankrupt or the creditors. Needs approval of 3/5 majority of all debt.

3.- Withdrawal, both common debtor in voluntary bankruptcy and creditors in forced bankruptcy may do so prior to the resolution declaring bankruptcy.

4.- Expiration, through paralización of proceeding by the parties for two years. Common reason is failure to appoint *sindicós* by the creditors.

5.- Non-existence of plurality of creditors- if prior to the declaration of bankruptcy it should halt the proceeding. If subsequent, due to the purchase of credits by one person, then procedure could end because of expiration if *sindicós* are not appointed, or because an agreement is reached with the bankrupt and the sole creditor.

6.- Lack of assets to sell.

C. Suspension of payments

1.- The proceeding is lifted with a definitive agreement between the creditors and the entity in suspension of payments decided by the majorities legally established. The agreement is contractual in nature and as a result the parties are free to agree as they deem convenient, although there is a process set out to establish the agreement in order to protect the public interests. The agreement as in a bankruptcy can involve a reduction in the debt, a delay in its payment, liquidation of all or part of the property in order to settle debts or a combination of the above.

Objections to the agreement are limited and strictly interpreted. They relate to the possibility of an undue approval of the agreement rather than formal issues, although these can seem to merge.

The judge merely approves the agreement without entering into its viability (given the freedom to contract between the debtor and the majority of the creditors) as long as the procedure has been followed. The resolution may not be appealed.

Once the resolution approving the agreement has been published the liquidators shall cease their functions within 10 days. Compliance with the agreement will be controlled by a creditor's commission, established in the agreement.

2.- The proceeding may be cancelled if the shareholders do not approve the application for suspension of payments presented by the board.

3.- The proceeding may be converted into a bankruptcy proceeding if there has been a ruling of definitive insolvency, the entity has not presented within fifteen days a bond guaranteeing the difference between the debts and assets and 2/5 of the debt vote within five days to either cancel the proceeding or declare bankruptcy.

4. The proceeding may be cancelled if the entity does not appear at the creditors meeting to vote on the agreement or 3/5 of the debt is not present or represented.

5.- If the creditors meeting is validly constituted and the necessary majority fails to vote for the agreement it shall be understood as rejected and consequently the judge will file the proceeding.

6.- If the agreement is not approved by the necessary number of creditors within the period given by the court when the proceeding is written in nature the procedure shall be terminated.

There is no appeal from the decision referred to in 2.-5. above.

V. What alternatives are available for the restructuring of the business.

During the insolvency proceeding the agreement of the creditors must be obtained.

A. Purchase of credits, compensate with equity.

- B. Lay off files – Salary Guaranty Fund.
- C. Contracts in bankruptcy situation- No specific legislation. A conflict of interests. If *sindicis* do not assume obligations for the *masa* (assets of insolvent entity) subject to bankruptcy, then third party can resolve contract. Generally speaking the solution will depend on the circumstances. If the contract is resolved due to bankruptcy, then the third party may become another creditor.

Specifically:

- 1.- *Intuitu personae*- may be resolved if partnership, commission or mandates.
- 2.- *Tracto sucesivo*- may be resolved if agency, insurance, employment and lease of real property.
- 3.- Repurchase options- may be resolved.
- 4.- Public Administration-can be a cause of resolution or prohibition to contract.