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A way of business rescue: the Spanish pre-pack administration (Distressed M&A)

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Restructuring procedures are aimed to restructure viable companies by negotiating contractual modifications with creditors, generally extensions and partial or total write-off of debts, solution that maintains the debtor legal entity and grants higher creditor recovery percentage[1]. However, the tough reality is that around 90% of 'concursos de acreedores' ends up in liquidation. That is, in the vast majority of cases the restructuration is unfeasible on account of creditor reluctance to reach agreements and/or corporate unviability, being the liquidation of the company the most probable outcome.

Considering that reality, the use of pre-pack administration (the so-called "venta de unidad procudtiva") can be the best resort against the alternative of selling the business into pieces at break-up prices, taking place the sale of a distressed company's business and ensuring that the business keeps trading and preserve jobs benefiting furthermore customers and suppliers. In fact, the appearance of the words 'venta de unidad productiva' on Spain's national newspapers has become quite common, affecting this type of transaction popular businesses across every sector. A few examples could be the sale of the following business: Grupo Blanco, Cacaolat, Indo o Cubigel.

1. Main characteristics of pre-packing in Spain

Aware the Spanish lawmaker of the important role that pre-packing can play in insolvency procedures, some new amendments has been made in the Spanish Insolvency Law (IL), firstly, by the Spanish Royal Decree 11/2014 and, at second stage, by the Law 9/2015. The main consequence has been the introduction of a new article (Article. 146 bis IL), which deals with some specialties as to the transfer of distressed businesses, trying to make smoother the transaction so as to facilitate the continuity of the activity together with the avoidance of contingencies. What follows is a brief description of the main Spanish pre-pack administration, tool that can be especially interesting in cases where the buyer is a strategic or financial investor.

2. A court over-sight approach

The transfer of a distressed company can take at any stage of the insolvency procedure, at the first stage when the insolvent company is still alive or later on once this is being liquidated. Moreover, the legislator has provided a faster procedure when the insolvency claim attaches a liquidation plan with a binding offer over the company business (Article 190.3). The reason behind that speciality is due to the consideration that distressed companies/businesses are like ice cubs exposed to melt, where assets are at risk of being irrevocable damaged.

In conclusion, the pre-pack is subject to scrutiny by the insolvency practitioner, creditors and the competent commercial court, requesting either the authorisation of the court through the judicial decree governed by Article 43 IL or through the decree approving the liquidation plan (Article 148.2 IL). An equal approach is used in the overwhelming European Union

[1] Pursuant to the World Bank, the highest recovery rates are recorded in economies where reorganization is the most common insolvency proceeding, since this insolvency remedy provide solution for all type of creditors, secured and unsecured, assuming that the company as a legal entity is viable (World Bank Group, 'Doing Business 2014. Understanding Regulations for Small and Medium-Size Enterprises' (doingbusiness.org 2014) <http://www.doingbusiness.org/reports/global-reports/doing-business-2014> accessed 24 March 2014).

Member States with pre-pack sale or equivalent, where some sort of creditor and/or court involvement is required[2].

To determine the best procedural moment to propose the transaction can have a great impact on the final aftermath since depending on that the system of appeal is different. While an authorisation pursuant to Article 43 IL is appealable against the same commercial court ('recurso de reposición'), to find for the transaction in the liquidation plan can lead to a long appellation procedure before the second instance, affecting the effectiveness of the business's purchase. In addition, the characteristics of the business at hand may demand an accelerated sale on the bases that further delays would cause an irrevocable damage over the business.

Although the pre-pack administration shall be conducted following some procedural formalities, our experience is that commercial judges in charge of insolvency procedures are completely aware of the relevant impact of these transactions, giving priority to their resolution. Likewise, the approval of the mercantile court can give rise to certain consequences that are not available for a non-bankruptcy acquisition, as can be seen in the following sections.

3. Novation of contracts

Following a pro-debtor position, the IL contains special provisions on the execution of contracts once the company has went into insolvency, making difficult to terminate pending trading relationships and facilitating simultaneously the resolution of unfavourable contracts. Firstly, Article 61.3 IL declares that contractual stipulations recognising the possibility of terminating the contract ought to the mere insolvency declaration of either party are invalid in contractual terms. Secondly, the resolution of the contract alleging any type of breach is possible, though this cannot be accorded unilaterally but recourse to the commercial court is necessary. If this resolution claim is brought, the debtor can claim against the petition of contractual resolution 'the interest of the state' by arguing that the contract shall be fulfilled due to its impact in the insolvent company survival and the greater satisfaction of creditors (Article 62.2 IL).[3]

In accordance with this methodology used in the Spanish Insolvency Law regarding the contractual effects of the insolvency declaration, the RDL 11/2014 added a new section (Article 146 bis IL) stating that, except otherwise agreed between the seller and the buyer, in transfers of the company's business the rights and obligations under agreements needed for the continuity of the business will be assigned to the transferee when their termination has not been requested, without necessity of further consent from the other contract party. Space constraints do not permit a detailed analysis of Article 146 bis IL, so just to mention

[2] In this regard, the unique exception can be found in the UK, with the pre-pack takes places in a quicker manner, without necessity of creditor meeting and court involvement. Though this is beyond of the scope of this note, just to point out that the out-of-court UK approach has triggered some a impropriety perception as to the use of this business rescue mechanisms, since major scrutiny is being claimed by some insolvency professionals and certain categories of creditors –unsecured creditors-. Certainly, the avoidance of court and creditor intervention can speed up the formalisation of the transaction, but that does not give rise to a perfect system. In fact, in the Spanish system is possible to appreciate some advantages to investors that a closely connected to the intervention of the mercantile competent court.

[3] It can be found an equivalent in the US Bankruptcy Code, which allows the debtor to continue with the most profitable contracts and disregard those which are burdensome. See J. Fried, 'Executory Contracts and Performance Decisions in Bankruptcy' [1997] DuckLJ 517, 520.

the inclusion of exceptions regarding public contracts and authorisations. Firstly, the assignment of public contracts will be governed by the special public legislation (article 226 of the Public Sector Contracts Law). Secondly, as long as the transferee continues the business at the same premises, the sale will include the assignment of any public authorisation needed for the continuity of the business as included as part of the productive unit.

Nevertheless, even bearing in mind the exceptions embedded in Article 146 bis IL as to the compulsory contractual transfer, this amendment is hugely positive, since this allows the novation of contracts that can be critical for the continuity of the business activity, goal at the heart of pre-pack transactions. Without this possibility of compulsory novation many company business sales could be put at stake, since the termination of certain contracts linked to the productive unit could lead to the strangulation of the economic activity[4].

4. Shedding liabilities through pre-packing

The Spanish Insolvency Law, Article 146.4 bis IL, points out that the buyer of the company's business shall not be considered as liable of previous debts of the seller, unless the purchaser decides to pay them voluntarily or exists any provision stating the opposite. Consequently, at a first sight, the new management team can run the business free of any liability to pay off the creditors of the previous business's owner. Having said that, we will move onto some peculiarities that should be dealt with:

- ☑ There is no doubt that the Spanish system is not favourable for transactions in which the involved buyer is a connected party with the insolvent company. Article 146 IL provides a special rule when the purchaser of the business is a connected person, which can include natural and legal entities. Under these circumstances, the purchaser will be held liable of the insolvent's debts, which include the totality of pre-insolvency credits. Tough this is not an express prohibition to connected parties; the consequence of buying the company business would be identical to rescue the insolvent company with disbursement of the whole debts, having this article the same effect than a prohibition.

- ☑ The recent amendment introduced by the RDL 117/2014, has provided legal basis to what was common practice in the mercantile courts. The current Article 43 (3) IL entitles to the application of liquidation supplementary rules (Article 149.2 IL) even in situations where the sale takes place before that stage and, consequently, judges can authorise the pre-pack transaction together with the agreement that the transferee will not subrogate in the position of the transferor as to a certain type of employment credits. Some authorities have claimed that the lawmaker was persuaded by the employees' interest; because the extension of employment contracts can be more beneficial than the frustration of productive unite transfer aimed to the maintenance of the business.

[4] By contrast this type of legal effect cannot be provided in systems where contractual termination or interruption clauses when company goes into administration are not prohibited, such in the UK. The only contractual insolvency speciality is regarding essential supplies (gas, water, electricity and communication services), where Section 233 of the Insolvency Act provides that, if a continuity request is done by the office-holder, the supplier may seek a personal guarantee from the insolvency practitioner before continuing to supply, but shall not demand payment of pre-insolvency debt as a condition. Consequently, the general rule is that contracts can resolve whenever the other party wants in accordance to law, even applying automatic termination or interruption clauses.

- ☑ The new owner of the business is not liable of the Treasury's credits against the insolvent company, legal consequence issued by the General Law of Taxation. Article 42.1.c IL exonerates of any liability to "the purchasers of exploitations or business activities own by an insolvent debtor when the acquisition takes place under an insolvent procedure"

- ☑ Finally, to highlight that the current Insolvency Law does not provide protection against the liabilities of the insolvent company before the General Treasury of the Social Security (Article 149.4 IL). Hence, this organism could have the possibility to declare the buyer's liability, risk that would be necessary to think through during the preparation of the offer and acquisition of the business, finding out contractual devices that protect the investor position if an unexpected contingency arises.

5. Conclusions

Although this type of transactions are quite time consuming and involve potential troubles that should be pondered, the existing Spanish framework is a step forward. Greater security and a smoother transition in order to make easier the continuity of the business's activity have been provided by the legislator.

Without doubt, to buy a distressed business under the scope of the Insolvency Law is more attractive than to do so through a non-bankruptcy acquisition for the reasons listed as follows: **(i)** the court is able to approve the sale of the business free of the insolvent company's debts, except the buyer has agreed the opposite or there are certain liabilities that cannot be legally set aside and **(ii)** the purchaser is entitled to cherry-pick those contracts that are still strategic for the business and to disregard others which would be a burdensome, except for certain types of contracts where is not possible that compulsory transfer. As a final point, it is important to mention that this type of transaction following a judicial scrutiny diminishes the possibility of any subsequent fraudulent challenge.

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