Getting the best from Spain's bargain basement

Anthony J. Paget explains Spain's version of Chapter 11 - *Suspensión de Pagos* - and how to exploit the opportunities it can present

In Spain, if a company runs out of cash and is unable to meet its obligations, it can petition the court to protect it from its creditors while it re-organises its affairs. The court will generally grant protection to the troubled company, provided that the book value of it's assets exceeds its liabilities (i.e., the company is not bankrupt). Once the court grants such protection, the company is said to be in *Suspensión de Pagos* (SdP).

The protection afforded is very similar to Chapter 11 in the U.S. Unsecured creditors can commence legal action and even receive a favourable judgement to attach or embargo the company's assets, but it cannot be enforced as long as the company is in SdP. The purpose of this procedure is to give the company sufficient time to reorganize its affairs in order to avoid other more costly, protracted, and almost always unfavourable (i.e., bankruptcy) procedures.

Once the court has granted SdP, three *interventores* (receivers) are appointed by the court. Two of the *interventores* are auditors, and the third one is selected from among the major creditors. These *interventores* oversee the day-to-day running of the company, as well as undertaking a more comprehensive and precise valuation of the company's assets and liabilities for eventual presentation to the court. At this stage, if the *interventores* consider that the fair market value of its assets does not exceed its liabilities, the company would cease to be under court protection and the creditors would be able to commence legal action, embargo assets, etc. which would eventually lead to the company's liquidation.

Essentially, as long as the company remains under SdP, the entire unsecured liability side of its balance sheet at the time of declaring SdP is frozen, and the company's obligations to its unsecured creditors are temporarily suspended. It continues trading, but it is generally forced to pay cash for its supplies. Of course, its normal business is curtailed somewhat because it will lack access to new credit, and customers are frequently wary of dealing with companies in such a delicate situation.

Negotiating a 50% discount in the Target´s debt is not unusual

The management of the company remains in place and continues to manage, but it no longer is able to incur additional debts, nor make any payments except as authorized by the *interventores*. Allowing the management to continue running the company is in clear contrast to the UK's administration procedure, which introduces an independent trustee to manage the company.

ACQUISITION OPPORTUNITIES

During 1991, 725 Spanish companies filed for Suspensión de Pagos (representing a 222% increase over 1990).

In general, investors tend to recoil from "problem companies". In cross-border acquisitions this bias tends to be even more accentuated. Our premise is that if the target's products, markets and so on appear to coincide with the buyer's acquisition criteria, then the target should not be discarded immediately merely because it is under the cloud of SdP. The company under SdP might be able to realize its full potential under a new management, or with a different strategy, or with additional capital, or with new products or technology, or with access to a new foreign distribution network.

Of course, many companies that enter SdP are not viable propositions. Frequently, however, attractive Spanish companies with modern installations, competitive products and sound management are forced into SdP for reasons beyond their control.

For example, it could be that they lack sufficient working capital to weather even fairly minor setbacks; or as is often the case, maybe one of their major customers has declared SdP, creating a chain reaction which subsequently forces his supplier, the target, into SdP.

There are four chief advantages to acquiring a company in SdP:

- **Lower Prices**
  One can normally purchase a target for a much lower price than would usually be possible, because most potential buyers are unwilling to even consider such companies. This buyers' attitude, coupled with the shareholders' despairing mood, frequently allows an agile investor to "steal" the company.

- **A Substantial Reduction in Debt**
  It is almost always possible to reach agreement with the target's creditors that can substantially reduce the outstanding liabilities which existed at the time of declaring the SdP. It is not unusual to negotiate reductions of up to 50% of the debt's face value, paid over a number of years, at no interest, sometimes with a two or

three year grace period. In net present value terms, this sometimes means paying back less than 30% of the original debt.

- **Tax Loss Carry Forwards**
  A bonus common to this type of operation is that a company in SdP frequently has substantial tax-loss-carry-forwards that can be used to offset taxes on future profits. In Spain, such losses can be carried forward for five years.

- **Inexpensive Reduction of Labour**
  Frequently one of the problems suffered by a company in SdP, is an excess of manpower. Unfortunately, in Spain it is extremely expensive to eliminate the jobs of "permanent employees". A "permanent employee" is entitled to receive a severance payment of 45 days salary for every year he has worked in the company. However, if a company in SdP can convince the court through a well thought-out viability plan that they are overstaffed, and that reducing manpower is absolutely necessary, then the court will usually only award 20 to 30 days pay for every year worked. And in some cases the "Fondo de Garantía Salarial (a government entity) will even absorb part of this cost.

SOME EXAMPLES

- Recently we assisted a Scandinavian buyer acquire a Spanish food processing company that was considered to have one of the most modern plants in Europe. The Spanish company had run into financial difficulties and was forced to seek court protection under SdP. This company was eventually bought by our client for a nominal amount; and through negotiation, the unsecured debt was bought back from the creditors at an average 50% discount from face value. Furthermore, the target's accumulated tax-loss-carry-forwards will now shelter the company's projected profits from taxes for the next three years.

- A major Spanish food company went into SdP. One year later, legal procedures were completed and their creditors were offered two alternatives, either: receiving only 70% of the original principal amount over a five-year period, with a two year grace period, and earning no interest; or, converting all of their original debt into newly-issued shares. Eventually, the creditors accepted the first option.

- A manufacturing company was able to negotiate repayment of its debts in full, over a nine-year period, with **NO** interest, with a two year grace period, with increasing yearly payments of principal ranging from only 5% of the debt (year 3) to 25% of the debt (year 9).

SCENARIOS FACING THE BUYER

There are normally two alternatives facing a potential buyer:

- Taking the initiative and trying to reach agreement with the shareholders for the purchase of the target company in SdP, and the creditors for reducing and/or rescheduling its debt, or

- Waiting for the target to go into liquidation in order to buy its assets at auction. This alternative has several disadvantages:

  - It can take a long time, even years. By the time the target's assets are eventually put on the block, the buyer runs the risk that management might have deserted the company, that machinery and installations might have deteriorated or been sabotaged, important customers might have defected to the competition, considerable goodwill might be lost, that it would be necessary to reapply from scratch for the numerous permits and licenses that a company requires in Spain. Frequently these permits must normally be upgraded to EEC levels before being renewed; and some can take longer than a year to be granted, if at all.

  - Another buyer might appear on the scene and reach agreement with the shareholders and creditors.

  - The target company may eventually successfully reorganize itself and come out of SdP.

  - Finally, all of the (sometimes substantial) tax-loss carry forwards, would be lost.

NEGOTIATIONS WITH SHAREHOLDERS

Once the potential buyer is satisfied that the Spanish company under SdP coincides with its investment and strategic criteria, the next step is to determine if the company can be acquired at a reasonable price. All of the negotiations regarding a possible investment in the target, or its possible acquisition, are handled by its shareholders, not by the *interventores*.

Assuming that agreement in principle is reached, the Letter of Intent should always state that the agreement is subject to contract (containing the standard warranties and guaranties), to a legal and financial audit, to the buyer's standard Due Diligence requirements, as well as to the requirement that the buyer be able to reach "satisfactory" agreements with all the target's creditors.

The shareholders of the SdP company are generally not in a strong bargaining position. They either must reach an agreement that is satisfactory to the creditors, or eventually face liquidation. Frequently , from the shareholders point of view, the lesser of two evils is to sell. Also, the shareholders are normally so traumatised by the debacle, that their main objective is simply to extricate themselves from their investment.

It is very common in Spain for shareholders of family-owned, closely-held companies, to be required to guarantee personally loans to their companies. In a worst case scenario, if the shareholders cannot reach agreement with their creditors, they could not only lose their original investment in the target, but also be liable for the credits which they personally guaranteed. Therefore it is critical to determine at the beginning of the negotiations whether any such personal guarantees exist, and if so, their magnitude. Obviously, the larger the personal guarantees given, the greater the probability that the target company can be acquired for a symbolic amount. Shareholders, understandably, tend to be shy about volunteering this information.

NEGOTIATIONS WITH CREDITORS

Once the buyer and the shareholders of the target have reached an agreement in principle on the acquisition price and other conditions, the next step for the buyer is to secure an agreement with the holders of the **majority** of the target's **unsecured** debt. Normally, creditors fall into four different categories:

- **Secured Creditors**
  These include, inter alia, banks holding mortgages, and financial leasing companies holding title to leased property or equipment. Such creditors are normally excluded from the SdP protection order, and therefore it is nearly impossible to extract any concessions from them. If their debts are not settled in full, they will attach and sell the secured assets.

- **Unsecured Creditors**
  These normally include raw material and equipment suppliers. They will usually agree to receive less than the full amount owed in the form of a "quita" (discount), an "espera" (rescheduling), or some combination of both.

- **Tax and Social Security Authorities**
  The amount owed by a company to these government entities cannot, by law, be forgiven or discounted. However, it is possible to reach agreements that are in effect "backdoor" concessions. It is not unusual to negotiate paying the total principal amount over a period of 10 to 20 years, with a five-year grace period, at a 1% annual interest rate.

- **Employees**
  The employees, together with the tax and social security authorities, are ranked ahead of all other unsecured creditors.

MAJORITY REQUIREMENTS

In order to have an agreement which is binding on ***All of the Unsecured Creditors***, whether or not ***ALL*** of them have agreed, the following legal requirements must be met:

- If the proposed re-scheduling period of the total debt does not exceed three years, creditors representing at least 60% of the **total unsecured debt owed**, must agree.

- If the proposed rescheduling of the total debt exceeds three years, creditors representing at least 75% of the **total unsecured debt owed**, must agree.

- If a discount is preferred to rescheduling (regardless of the size of the discount), then creditors representing at least 75% of the **total unsecured debt owed**, must agree.

Typically 90% of the debt outstanding is held by only 10% or 20% of the creditors. Given the "majority" requirements to secure a legally-binding Creditors Agreement, a buyer is best advised to confine his efforts to reaching agreement with the largest creditors since the smaller creditors will be forced to accept the agreement reached with the "majority" debt holders.

Generally, one can achieve better terms from the creditors by settling the debts in cash, but paying only a fraction of the amount owed (a "quita"); than by offering to pay the full amount owed over an extended period ("espera"). Presumably this demonstrates the prevalent attitude that "a bird in hand is better than two in the bush".

Once the target advises the court that an agreement ("convenio") has been reached with the "majority" (as defined above), then **ALL UNSECURED** creditors are bound by the agreement, whether or not they have agreed to it. Furthermore, once the target eventually emerges from SdP, if a "surprise" creditor were to appear, he would be forced to accept the same terms accepted by the "majority".

If the "majority" is unable to reach agreement with the target, then the court lifts its protection order -SdP- and allows the creditors to pursue their claims.

It should be noted that different "Majority Requirements" have to be met if the target under SdP has fewer than 200 creditors. However, given the minimum target size required by most foreign buyers, this situation is rarely encountered by foreign acquirors.

NEGOTIATION TACTICS

There are basically two ways in which agreement can be reached with the creditors, and tactical considerations will dictate the most efficient method:

- **Buyer Agrees to Buy the Target's Debt**
  The buyer can directly negotiate the terms under which he will assume the credits owed by the target with each creditor (or creditor group). It must be stressed that the agreements reached by the buyer with the target's creditors should **ALWAYS** be subject to the buyer being able to reach agreement with the creditors representing the "majority" of the debt, as well as successfully concluding the proposed acquisition with the target's shareholders. Otherwise the buyer runs the risk of holding some very deeply discounted debt, but not being able to reach a "convenio" (agreement) with the target because he does not speak for the "majority" of the debt; or having the target's shareholders back out at the last minute.

  Once the buyer has reached agreement with the holders of the "majority" of the debt, and thus becomes the single holder of the "majority" of the debt, he is in a position to, in turn, reach a "convenio" (agreement) with the target.

- **Buyer Promises to Inject Funds into Target (but stays in the background)**
  The target reaches a single agreement with the creditors holding the "majority" of the debt with fresh funds to be injected in the target by the buyer through a loan, or an increase in share capital.

Regardless of what alternative is used to reach agreement with the creditors, tax considerations will usually determine whether the buyer repays the creditors (assuming the debt is purchased rather than rescheduled) through the target by injecting new funds; or whether a new Spanish company is set up for this purpose.

IDENTIFYING OPPORTUNITIES

While all of the above may seem rather daunting to buyers unfamiliar with Chapter 11-type negotiations, in practice, it is not as difficult as it appears. While the old saying that "there is no such thing as a free lunch" is as valid as always, it is also true that some lunches represent better value than others. Knee-jerk refusal to examine targets in "Suspensión de Pagos" can lead to missed acquisition opportunities.

The first step towards taking advantage of the potential investment opportunities afforded by targets in SdP is to become aware of these opportunities as soon as they appear, and know how to exploit them. This is an area where the advice of experienced professionals, with a physical presence in Spain, can prove their worth to the buyer.

Anthony Paget is a vice-president with Redirection, Madrid, Spain