Distressed M&A Transaction (Spain)

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A Practice Note analysing the main aspects regarding the undertaking of a merger and acquisition (M&A) transaction in Spain with a target entity under financial distress. The Note focuses on the corporate aspects and also provides an overview of the employment and tax issues.

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The legal considerations of a distressed merger and acquisition (M&A) transaction necessarily vary depending on the level of distress suffered by the relevant target, which is a consequence of its shortfall in liquidity to pay off its current debts. Targets of these transactions are gradually running out of breathing space. The distressed transaction may occur during different stages of this timeline of progressive deterioration.

This Note analyses three different scenarios of distressed M&A transactions considering their position within the financial distress spectrum as follows:

- Acquiring a company or a business in financial difficulty.
- Acquiring a company or a business in a pre-insolvency stage (*pre-concurso*).
- Acquiring a company undergoing formal insolvency proceedings (*concurso*).

This Note analyses the main aspects and issues to take into consideration when structuring and executing a transaction to acquire or sell a Spanish business in financial distress. The Note focuses on the corporate and insolvency aspects of distressed M&A transactions and also provides a high-level overview of the key tax issues to take into consideration, as well as, to a lesser extent, certain employment law concerns.

This Note focuses on the acquisition of a company (through a share deal) or a business as a going concern (through an asset deal). Pure asset acquisitions (on a stand-alone basis, for example) are outside the scope of this Note. For a comparison between executing a share purchase transaction and an asset purchase transaction in Spain, see *Practice Note, Acquisition structures: comparing asset and share purchases (Spain)*.

Definition of Distressed M&A

There is no standard definition of distressed M&A. Different parties may have their own definition, which may vary depending on their particular interests and goals.

For the purposes of this Note, distressed M&A refers to a transaction where a buyer is seeking to acquire a company or a business whose available cash is not sufficient to pay off its debts and liabilities as they fall due, regardless of whether they are of a financial or corporate nature.

Opportunities to Trade

Since a company is a "living being," the deterioration of its liquidity is likely to happen progressively, which brings about a wide spectrum of financial distress situations. A company at the more benign end of this spectrum is likely to struggle to meet financing covenants or may not be able to pay relevant amortisation commitments on time. At the other end of the spectrum, a company may already be involved in formal insolvency proceedings (*declaración de concurso*), where it may be trying to reach a creditors' settlement or going directly into liquidation.

Therefore, an investor in a distressed M&A should be conscious of where the company is placed on that spectrum. It is key for an investor to understand the features of the transaction and the associated legal and business risks. It is very common for an investor to focus their efforts on a particular section of this landscape, considering the underlying complexity of each area, as well as the risk and variation in the potential upsides. For instance, an investor that is interested in a target facing formal insolvency proceedings may have a different investment focus and strategy to an investor seeking opportunities in the early stages of financial distress.

Financial distress, and formal insolvency in particular, are very harmful to the business. Suppliers may ask for upfront payments to deliver goods, and clients may doubt the quality of the products and services provided by a distressed company. Therefore, the longer the company remains in this situation, the worse business will be, even up to a point where it simply has no value left. Typically, this happens at the later stages of formal insolvency where there is no agreement with the relevant creditors to save the business.

As a result, the opportunity to find a valuable company or business becomes progressively harder further along the distress spectrum, so speed is often of essence in these transactions.

Buying a Company in Financial Difficulty

A company at the first stage of the distress spectrum is usually still functioning and is capable of paying off its business debts (for instance, its current liabilities), but struggles to meet the payment schedule under a given financing. In this situation, the company generally seeks out refinancing schemes or even alternative financing to increase its leeway. However, traditional lenders may be reluctant to refinance the existing debt to avoid increasing their exposure, and alternative financing options are usually quite expensive considering the underlying risk posed by the company.

To cope with this situation, management may either:

- Analyse potential restructuring alternatives (for example, the sale of non-core businesses or assets).
- Seek out an investor who may be willing to acquire a stake in the company and inject additional cash through shareholder loans or other debt instruments.

This situation may attract the interest of investors seeking opportunistic deals, which may generate higher returns for them or their investors. Management is usually time-pressured to find these out-of-court solutions as fast as possible, because it has limited time to delay the insolvency if the situation is severe enough (see *Directors' Duties and Obligations*).

Structuring the Distressed M&A Transaction

There are two principal methods of acquiring a business in Spain:

- **Share purchase.** The buyer acquires either 100% of the shares or a controlling stake (more than 50% of the shares) in the company which carries on the target business.

  For more information on share purchase transactions, its key documents, and other issues, see *Practice Notes, Key Documents for Acquiring a Private Company (Spain)*, *Share Purchases: Overview (Spain)*, *Warranty and Indemnity Insurance (Spain)*, and *Warranties and Indemnities: Acquisitions (Spain)*.

- **Asset purchase.** The buyer acquires a bundle of assets and rights, which may or may not qualify as a going concern or branch of activity, and sometimes assumes responsibility for certain liabilities relating to the target business.

  For more information on key documents in asset acquisitions, see *Practice Note, Asset Acquisitions Documents: Private Acquisitions (Spain)*.

Share Deal as Preferred Structure

In every M&A transaction, the parties must agree whether a share deal or an asset deal is the preferred acquisition structure. Setting aside the general considerations applicable to standard M&A deals, the typical structure for the acquisition of a company in financial difficulty is the share deal, due to the following reasons:

- A share deal is more straightforward. Except for an agreement with change of control provisions, it does not generally require third-party consent. This is because existing agreements are not assigned to the buyer and therefore no consent is necessary, unlike an asset deal.
- Time is of the essence. The complexity of an asset deal would involve a lengthier deal process.
- Lenders are either reluctant to approve an asset deal due to the potential extraction of value from the company or condition that approval to the use of the relevant sale proceeds to amortise existing debt.
- The risk of clawback actions to undo the transaction can be high if the company under distress sells a valuable portion of its business while retaining a less profitable business unit.

However, the company under distress may be capable of engaging in restructuring by selling non-core assets, either through the sale of the relevant subsidiary or, in some instances, by carving out a chunk of its business. In the latter case, the parties need to deal with the typical constraints of an asset deal. These may be set aside if the lenders consider the divestment is in the best interests of the surviving business or the proceeds of the sale are sufficient to amortise a significant part of the existing debt. In this case, the refinancing scheme may protect the transaction from the risk of clawback actions. This is because the law provides that the scheme cannot be subject to clawback actions if the seller is under an existing or imminent insolvency situation (see *Pre-Insolvency Schemes*). Therefore, even though the typical structure at this stage is the share deal, the particular circumstances of the case may require an asset deal to be used as an alternative structure.

For more information on the differences between a share deal and an asset deal, see *Practice Note, Acquisition Structures: Comparing Asset and Share Purchases (Spain)*.

Equity vs Mix of Debt and Equity

The acquisition can be structured either as:

- An equity acquisition.
- A mix of debt and equity.

Regarding a mix of debt and equity, an investor seeking additional protection may wish to assume the position of the relevant lender in the first instance and then, depending on the positive evolution of the target business, convert that debt into equity. This can be achieved by:

- Including in the relevant transactional documentation a discretionary right of the lender to convert its debt into equity. The ability to convert could also be linked to the company's performance. This mechanism is not risk-free, because the de facto or shadow directors' liability rules may apply to lenders if they have extensive veto rights over the management of the business (see *Directors' Duties and Obligations*).
- Executing a "debt-for-control" option (a less friendly strategy to acquire a controlling stake in the relevant company).

The latter situation is likely to apply in cases where the loan is in default but the original lender lacks the incentive to pursue an aggressive strategy to collect the relevant debt. Often, original lenders, particularly banks, prefer to sell their loans to an investor with a discount over the outstanding balance than exercise the rights as a lender, including enforcement of guarantees.

In these situations, the investor may reach an agreement with the lenders to purchase the relevant debt without engaging in negotiations with the borrower, in an effort to use the mechanisms set out in the relevant loan documentation to take control of the company or a part of its business.

Given that the debtor or its shareholders frequently still believe in the business and want to prevent losing the secured assets in favour of the investor, their only option typically is seeking out formal insolvency almost as a defence mechanism. Their main objective is usually twofold:

- Prevent or stall the enforcement of the in rem guarantees (that is, guarantees secured with a tangible asset).
- Force a potential settlement with the investor or creditor.

This situation may not be necessarily detrimental to the investor if they use the guarantee enforcement as leverage to negotiate a potential acquisition of the business in exchange for their credit rights over the company.

Particularities and Issues

Limited Due Diligence

Buying a company in financial distress presents several challenges, one of which is the need to close the deal very quickly. A company facing this situation is somewhat desperate for cash to continue surviving outside of formal insolvency. Every day counts and time is of the absolute essence.

Compared to a standard M&A transaction, there may be little time to carry out a full-fledged due diligence process. This represents a huge challenge because the investor needs to quantify the potential contingencies and risks, as well as carry out a valuation of the company in an adverse scenario.

Even though there is no perfect solution, a reasonable option to deal with this may be carrying out a collaborative due diligence exercise: instead of the investor delivering to the company a large due diligence checklist and requesting a significant number of documents, it is preferable for the investor to sit down with management and openly focus the exercise on the big-picture issues.

Additionally, it is important for the investor to deploy as many resources as possible during the first few days of the due diligence process to get a sense of the important issues. Then, they should focus their investigations on a deep-dive analysis of these main issues. The investor should factor the remaining minor issues which are not covered by the materiality thresholds of the due diligence exercise into the valuation, or negotiate specific protection in the share purchase agreement (SPA). For more information on the contents and scope of an SPA, see *Practice Note, Key Documents for Acquiring a Private Company (Spain): Share Purchase Agreement (SPA)*.

If the seller is not facing the same distress as the target, the buyer should negotiate sound protection mechanisms such as deferred price or escrow schemes. In Spain, the escrow agent is not only the financial institution; notaries also often assume this role (see *Transactional Documentation*). For more information on escrow agreements in the context of an M&A transaction, see *Practice Note, Key Documents for Acquiring a Private Company (Spain): Escrow Documents*.

For more information on due diligence in a standard M&A transaction in Spain, see *Practice Note, Due Diligence on Private Acquisitions in Spain.*

Transactional Documentation

The documentation regulating the transaction, notably the relevant SPA or asset purchase agreement (APA), as the case may be, should not differ significantly from a regular M&A transaction. Therefore, generally the buyer could expect to gain reasonable protection under the agreement, including a reasonable set of warranties and indemnities and price adjustment mechanisms.

The investor should be aware that the seller would not wish to give specific warranties relating to the situation causing the financial distress (for instance, no breach of financial covenants) and may, in some instances and depending on the impact of the situation, be reluctant to give any meaningful warranties at all. Even so, this should not be an issue, as the investor should have factored that into the company's valuation.

Another exception to the standard M&A contractual remedies is where the seller is facing a similar situation of distress to that of the target. In this case, the buyer should be aware of the risk of the seller being unable to comply with the terms of the agreement. Therefore, in those pre-insolvency situations, the contractual documentation should address this issue by, for instance, seeking the approval of the insolvency court under refinancing or pre-pack schemes (see *Pre-Pack*).

In any case, considering the inherent risk of distressed M&A deals, the likelihood of the buyer demanding effective liability protection is of course much higher. The buyer may wish to retain a significant part of the purchase price to offset any damages suffered. The buyer may also prefer to structure this as a deferred payment subject to the absence of damages, and for the longest time possible. The seller may request to keep the amount deferred in an escrow account at a bank or notary. In Spain, notary escrows have increasingly become a good alternative to standard bank escrows. The main reason for this is that a notary is much more flexible and does not require such onerous paperwork to set up the escrow. Even so, investors are often reluctant to use a notary because of the notary's potential insolvency risk. However, this is more a theoretical risk than a practical one.

Another potential option to safeguard the investor's position is a warranty and indemnity (W&I) policy. This is becoming very common in standard M&A deals that have sufficient size for it. In mid-market transactions, W&I insurance is less common, given that the cost of the premium is proportionally high in comparison to the common deal ticket. However, even in large distressed deals, a W&I policy faces some issues linked mainly to a lack of comprehensiveness of the due diligence exercise, including the Q&A and disclosure process. Therefore, the insurer may struggle to hedge the underlying risk, which ultimately results in a disproportional insurance premium. As such, extensive usage of W&I in these deals is yet to be seen. For more information on W&I insurance protection in Spain, see *Practice Note, Warranty and Indemnity Insurance (Spain)*.

Directors' Duties and Obligations

The involvement of directors is crucial to complete a distressed M&A transaction. Directors must be proactive in the due diligence phase (see *Limited Due Diligence*) to provide the investor with enough security to proceed with the deal, particularly given the limited time available to carry out the due diligence.

However, the pressure on directors is huge, because they cannot set aside their fiduciary duties towards the company during the pre-deal process. Of these duties, the obligation to file for insolvency within two months of the date on which they became aware, or should have been aware, of the insolvency status is particularly significant (*article 5, royal legislative decree 1/2020, of 5 May, approving the restated text of the Insolvency Act* (*real decreto legislativo 1/2020, de 5 de mayo, por el que se aprueba el texto refundido de la Ley Concursal*) (*Insolvency Act*)). The consequence for failing to comply with this duty is severe. The insolvency may be regarded as intentional and, therefore, the court could rule that the directors have to pay the shortfall of unsatisfied insolvency debts out of their own assets. For more information on compliance with this obligation, see *Practice Note, Directors' Liabilities and Relief From Liability (Spain): Liability for Company's Debts in Event of Objective Cause of Dissolution*.

Directors then have to assess if they should continue to support the potential transaction or back out of the deal and seek insolvency, which would change the picture completely and potentially scare away the investor. The Insolvency Act gives directors the option to extend the two-month period, which may be a useful tool. Directors can communicate to the court that they are negotiating with creditors to reach a settlement or a refinancing scheme, in which case the law affords the company

an additional term of four months (*articles 583 and 595, Insolvency Act*). The debtor may request that the communication is private, otherwise it is made public. However, this is a no-return mechanism, as the company has to file for formal insolvency if no solution is adopted within the four-month period.

Another aspect for the directors to consider is the potential examination of the terms and conditions of the transaction if the company goes into insolvency within two years of closing the deal. This two-year period is established by the law as the period in which it is reasonable to be suspicious about the acts and contracts carried out by the debtor. This is because, at that time, the directors may be aware that the company may face difficulties in the medium term. In the case of a transaction that is detrimental to the creditors, directors are exposed to liability as part of the insolvency. This happens as long as it can be argued that the transaction caused or worsened the company's insolvency situation, that is, when it can be evidenced that it would have been better for the debtor not to carry out the transaction at all. (For example, when a more advantageous transaction could have been concluded within the insolvency process.)

Therefore, directors should make sure at least that the transaction closes on an arm's length basis. The best way to achieve this is by organising a competitive sale process (for information on the auction process and documents, see *Practice Note, Key Documents for Acquiring a Private Company (Spain): Auction Documents*). If that is not possible because, for example, there is only one interested bidder, the second-best option is getting an independent expert report validating the terms and conditions of the transaction.

From the seller's perspective, it is logical to assume that they may put pressure on the directors to support the potential transaction, instead of requesting formal insolvency. Normally, their primary goal is ensuring that the transaction closes successfully and the role of the directors is key to this. However, the seller should also consider that too much involvement in the management of the company might backfire on them. Shadow directors are liable for the insolvency deficit under the same terms as the regular directors (*paragraph 1º, article 455.2, Insolvency Act*). This means that the seller should refrain from taking too active a role in the management of this complex situation to avoid being considered as a shadow director.

Lastly, the investor may be interested in retaining management after the deal, so they may focus on establishing a good relationship with the directors throughout the transaction. Even if they are considering changing management, it is very important to request that the directors stay in the company for an interim period after the deal closes. After all, the directors know the lenders and major clients and suppliers, which are key to ensure a smooth transition and steer the company towards profitability.

Pre-Insolvency Schemes

For a company further along the distress spectrum, other deal types and structures may occur: the so-called pre-insolvency schemes. At this stage, the target is approaching formal insolvency, and so the parties prefer to adopt some of the existing paths set out under the Insolvency Act to mitigate the main insolvency risks. These risks involve potential clawback of the transaction, if it is successfully challenged by creditors, and liability for the directors.

A pre-insolvency situation is when the debtor is under an existing or imminent insolvency (that is, it is unable to regularly comply with its due obligations or it believes that that inability will arise), but has not filed for formal insolvency yet (*article 583, Insolvency Act*). The definition is subjective: a case-by-case analysis is necessary to determine whether the company is already in a pre-insolvency situation or it is still situated at a prior stage on the distress spectrum.

The Insolvency Act tends to favour pre-insolvency resolutions as opposed to formal insolvency. The reason is simple: formal insolvency usually causes serious distress to the business to the point where the company is no longer viable. The great majority of formal insolvencies end with the liquidation of the company.

Once the company falls within the scope of the pre-insolvency proceedings because it has communicated its situation to the competent court, the available pre-insolvency resolutions are the following:

- Implementing a refinancing scheme (see *Deals Under Refinancing Schemes*).
- Implementing a pre-pack scheme (see *Pre-Pack*).

Deals Under Refinancing Schemes

The main purpose of a refinancing scheme is to reach a settlement agreement with the creditors representing at least 51% of the financial liabilities (as determined in articles 606 and 607 of the Insolvency Act), which may give the company more leeway. Under certain circumstances, a refinancing scheme can be subject to court approval. If court approval is granted, the court cannot rescind the refinancing scheme if a clawback action is ultimately triggered (*article 698, Insolvency Act*). This protection includes the refinancing scheme and any transaction that is part of or derives from it.

An investor intending to acquire a company or business in a pre-insolvency situation is not usually involved in a refinancing scheme. However, if part of the refinancing scheme involves the carve-out of a particular part of the business as a way to obtain additional cash flows, a third party may be ultimately involved in the refinancing scheme. In that case, the investor is likely to want the court to approve the refinancing scheme to be covered by the anti-clawback protection.

However, obtaining the anti-clawback protection can be difficult. The court's approval is subject to several requirements, including a viability plan that shows that the M&A deal is beneficial to the creditors.

While the refinancing scheme is ongoing, the debtor may list the assets it considers necessary and the court may order that enforcements against those assets are frozen.

For more information on refinancing agreements under the Insolvency Act, see *Practice Note, Restated Insolvency Act: Spain: Refinancing agreements (convenio)*.

Pre-Pack

The pre-pack is a flexible tool that allows the parties to an M&A deal to negotiate the terms of the agreement before the formal insolvency, get the court to approve the transaction, and then liquidate in a formal insolvency the part of the business not included in the scope of the M&A deal.

Compared to other European jurisdictions or the US, the Insolvency Act does not provide for the so-called pre-pack sale. Consequently, the sale of business units or assets in the context of insolvency proceedings (which could not be structured in a refinancing scheme) have to take place within formal insolvency (see *Insolvency M&A*). This typically results in the relevant business losing value, often frustrating the proposed deal.

Considering the increasing risk of the COVID-19 pandemic creating new insolvencies in Spain, the courts of Barcelona have issued guidelines on how a pre-pack should work in the context of the cases submitted to their jurisdiction. These courts took inspiration from *Directive (EU) 2019/1023 on preventive restructuring frameworks*, which regulates a similar mechanism. This Directive should be enacted in Spain no later than 17 July 2022.

Under these guidelines, debtors that have filed for pre-insolvency proceedings (*article 583, Insolvency Act*) may trigger the so-called preliminary actions for the pre-pack by:

- Notifying the insolvency court that they are preparing the relevant transactions for the sale of the company's assets (whether this is the sale of the whole business, of certain business units, or a global sale of assets).
- Requesting the appointment of an independent expert or "restructuring receiver" to assist with these sale transactions. It is highly recommended to seek this appointment because the receiver supports the seller in this process and acts as a de facto insolvency administrator.

During this preliminary phase, the company and the independent expert explore the most suitable transaction considering the rules under the Insolvency Act applicable to the sale of business units. This phase concludes with the preparation of a report by the independent expert outlining the terms of the envisaged transaction and providing a supporting fairness opinion.

Then, the debtor must file for formal insolvency (*solicitud de concurso*), enclosing the independent expert report. The court declares the insolvency giving notice to any creditor or concerned party that may wish to challenge the pre-pack during the period of ten days. After ten days have passed, the insolvency administrator (*administrador concursal*) issues its liquidation report and the judge either approves or rejects the pre-pack and the transactions contemplated in it. If the pre-pack is rejected, then the insolvency resumes its normal terms and any potential M&A transaction is subject to the Insolvency Act (see *Insolvency M&A*).

There is no certainty that once the ten-day period has passed the judge will approve the transfer. However, if the requirements are satisfied, it is reasonable that the transfer will be approved. The buyer usually includes the right to back out of the deal if no approval is given as a condition precedent to protect them in the event the transfer is not approved. As this route occurs within an ordinary insolvency proceeding, directors are protected from personal liability for debts incurred.

If the judge approves the pre-pack, this is a much faster alternative than any other transactional insolvency schemes to source a distressed deal.

Even though Barcelona courts have been approving pre-packs since July 2020, this is still a new and relatively untested route for carrying out an M&A deal. It would be useful for pre-packs to be expressly regulated by the Insolvency Act in the near future to afford legal certainty to the parties interested in pursuing this course of action. Otherwise, courts will not have an obligation to approve pre-packs and the sale of business units will have to be made during the insolvency process. This path is actually included in the new draft Bill that will amend the Insolvency Act.

Particularities and Issues

Asset Deal as Preferred Structure

The preferred acquisition structure is, to a large extent, the asset deal over the share deal (compared to acquiring a company or business in financial difficulty (see *Share Deal as Preferred Structure*)). Some of the main factors that favour the asset deal are:

- Provided that a court approval is granted, there is no underlying risk of clawback, and they cannot be challenged by creditors. (There is an exception in certain specific situations, such as fraudulent transactions, although in practice the court approval decreases the risk of a challenge even in those cases.)
- The investor may cherry-pick the business and relevant assets and debts that they wish to purchase, leaving behind specific liabilities and other assets.
- Creditors see an immediate injection of cash in the selling company or reduction of its liabilities if the investor is taking on some liabilities as part of the business.

Less Contractual Protection for Buyer

Given the involvement of the insolvency court and creditors, executing a transaction in the context of a refinancing scheme or a pre-pack sale affords less contractual protection for the buyer. This is an implicit trade-off for the benefit of limiting the risk of clawback actions. As a result, in the absence of standard representations and warranties (R&W), and given the probably limited due diligence, an investor often focuses on price to protect themselves.

A potential alternative that allows an investor not to reduce the price so much could be W&I insurance. In theory, this could be the area to explore so-called synthetic policies. These policies are taken out without being backed by a set of R&W agreed in the transactional documentation. However, they are not that common in standard deals in Spain (if the seller is a public authority, it may be easier to enter into a policy of this nature), let alone in a distressed M&A framework. For more information on W&I insurance protection and synthetic policies in Spain, see *Practice Note, Warranty and Indemnity Insurance (Spain): Scope of Coverage: Traditional Versus Synthetic Coverage*.

Directors' Duties and Obligations

The involvement of directors is key. They need to be at the helm of the process to ensure that the request for the approval of the insolvency court is obtained. However, the directors are much less exposed to directors' liability thanks to the insolvency court involvement and coverage, which is often why they wish to execute the deal using this process.

Insolvency M&A

Once the target has declared insolvency, it is still possible to carry out an M&A transaction. However, the process becomes much more complex since it is necessary to involve the insolvency receivers and even the judge.

Phases of Insolvency Proceedings

Spanish insolvency proceedings are structured in three phases:

- **Common phase:** aims to ascertain the company's assets and liabilities.
- **Creditors' arrangement phase:** aims to approve an agreement between the insolvent company and its creditors to overcome the insolvency situation.
- **Liquidation phase:** aims to sell the company's assets so that the proceeds are distributed among the creditors in an orderly manner.

Selling the Company's Assets: Timing

Before the judge approves either a creditors' arrangement or the liquidation plan:

- Generally, a court authorisation is required to sell any assets. The reason is that, within the insolvency process, the main purpose is to maintain the activity and the assets of the insolvent company and not to sell them.
- It is common for the company's directors to still be in office. However, the insolvency receivers must always approve the decisions affecting the company's assets. Even at this stage, the insolvency receivers may have an even more active role if the court has decided that they company's directors must be replaced by the insolvency receivers.

Transactions Before a Creditors' Arrangement or the Liquidation Plan are Approved

No Court Authorisation Required

The following transactions can be undertaken during the common phase without the authorisation of the court. However, they require the notice from the insolvency receivers which includes the rationale for their execution:

- Transactions whereby the company is carrying out actions aimed at retaining the activity (for example, the sale of the insolvent company's stock).
- Transactions required to cover the expenses caused by the insolvency process.
- Transactions required to ensure the viability of branches or business units within the company.
- The sale of assets that are not required for the activity to continue, as long as the price is, at least, 80% (movable assets) or 90% (real estate assets) of the value allocated to the assets.

  In this case, the insolvency receivers must relay the offers to the judge and justify that the assets are not required for the activity. The transaction will be automatically approved unless a better offer is filed within ten working days.

The sale of a business as a going concern generally falls beyond these exceptions. Therefore, it is highly unlikely to undertake a distressed M&A acquisition in the context of formal insolvency proceedings without the involvement and ultimately consent of the court (see *Court Authorisation Required: Sale of a Business Unit*).

Court Authorisation Required: Sale of a Business Unit

The Insolvency Act has regulated in detail the sale of business units since it intends to safeguard jobs and goodwill if the company is no longer viable (*subsection 3º, section 2, chapter III, title IV, Insolvency Act*). A business unit for insolvency purposes is an organised grouping of resources which has the objective of pursuing an economic activity. This notion of business units seems to refer to asset deals only, although some receivers have sustained that the rules for business units must also be applied to share deals, provided that the subsidiaries are the owners of business units themselves.

The insolvency receivers must file the request to sell before the insolvency judge. Once filed, the parties to the insolvency proceedings may challenge the request for a period ranging between three to ten days. After the offers are received, the employees have a 15-day period to present their objections to the offers filed. In practice, insolvency receivers may request that the buyer guarantees the payment of regular expenses. However, the buyer is generally reluctant to do so if there is a chance that other parties are allowed to file competitive offers.

The decision granting or dismissing the authorisation to sell business units cannot be appealed. The system is quite flexible and the authorisation may adapt the method to sell to the specific case.

The standard method to sell a business unit during the common phase of an insolvency proceeding is a public bid. The public bid may be conducted by the court or by a notary. The authorisation provides the details on how to conduct the public bid.

Alternatively, the judge can authorise the direct sale of the business unit rather than the standard bidding process. The direct sale of the asset is generally authorised by the court if it covers the value of the secured debt. However, the sale conditions must be made public so that third parties may improve the offer.

The judge may also directly award the secured asset to the secured creditor while simultaneously cancelling the secured credit.

The bidders may agree to purchase the secured asset without getting a release of the relevant guarantees attached to it, which would therefore travel with the asset (in which case the relevant price would be lower).

If the secured asset is included within a business unit, the parties must consider the following:

- If the buyer does not assume the secured debt, the creditors may have a veto right if the price does not cover the value of the secured debt. This veto right only applies if secured creditors representing 75% of the affected secured debt reject the transaction.
- If the buyer assumes the secured debt, there is no veto right and the secured debt is excluded from the creditors' list.

Transactions During the Liquidation Phase

When acquiring a business unit from a company undergoing insolvency proceedings, the liquidation phase is from a pure procedural stand point the best time to do so, as its purpose is to liquidate the remaining assets or business. Indeed, insolvency administrators have the certainty that the company cannot survive any longer and it is their duty to sell all of the company's assets at that time, which is why no court authorisation should be required (see *Phases of Insolvency Proceedings*).

The liquidation phase starts with the approval of the liquidation plan, a document drafted by the insolvency receivers and approved by the insolvency judge. During the approval process, creditors are allowed to submit objections to the plan. The directors of the company are dismissed once the liquidation phase starts. Therefore, during this phase, the insolvency receivers are in charge of the liquidation process.

A liquidation plan typically establishes how the different assets included in the inventory of the insolvent company must be sold.

Any transaction carried out in accordance with the procedure included in the liquidation plan does not require any further court authorisation. However, if the liquidation plan does not include any provision on the sale of assets or business units, article 421 of the Insolvency Act sets out that the branches and business are sold as a whole in accordance with the procedure set out in act 1/2000, of 7 January, on civil procedure (*ley 1/2000, de 7 de enero, de Enjuiciamiento Civil*) (*Civil Procedure Act*). This means that the primary objective of the law is selling assets and liabilities as a going concern, avoiding the individualised sale of assets to the extent that this is possible.

Particularities and Issues

A formal insolvency M&A deal may vary significantly depending on many factors, including the stage of the insolvency, the characteristics of the business (notably, the amount of employees affected), the type of debt and relevant lenders, the business's cash needs, and so on.

In any case, this type of distressed M&A deal shares certain particularities with the pre-insolvency deals (see *Pre-Insolvency Schemes*), in particular:

- The due diligence is less organised and access to documentation is limited.
- The inability to get standard M&A protection under the transactional documents, such as a set of R&W, deferred prices, or earn-outs.

Therefore, the negotiation of the SPA or acquisition document should not be too complex. In contrast, the timing of these deals is often extended for a much longer period than deals that occur in the pre-insolvency stage. There is less pressure to close the transaction within a short timeframe and the involvement of the judge usually adds additional time to the deal. The ongoing business activities are generally financed by the company, although the potential buyer may also grant bridge loans or other similar sorts of financing as part of their offer.

Another important aspect to consider is that the insolvency is an open procedure in which many parties have interests. Therefore, the risk of one of these parties either submitting a competing bid or challenging the transaction is very real. To deal with this situation, the parties to the transaction must consider this risk beforehand and design the bid so that this risk becomes remote. One way to achieve this is getting the consent of a creditor whose authorisation is needed for the transaction's outcome (for example, if the business relies on a lease agreement or an administrative concession).

Tax Issues

In Spain, there is no specific, differentiated tax regime depending on the phase in which the distressed M&A transaction is carried out. A company in any of these phases continues to be a taxpayer for the purposes of all taxes, and is obliged to continue to comply with their tax obligations under practically identical terms.

Share Deal vs Asset Deal

The tax advantages and disadvantages of share and asset deals relate to a wide variety of issues ranging from either:

- The direct and indirect taxation of the transaction itself.
- The liabilities assumed by the buyer.
- The "inheritance" of latent gains.
- The financing of the acquisition.

The first two points are usually the most decisive: share deals are generally not taxed, unlike asset deals, but the buyer becomes liable for all of the seller's tax debts under share deals and not under asset deals (where the liability can be limited). Due diligence work is essential for these purposes, and it is necessary to take into account the degree of due diligence that is feasible depending on the phase of the insolvency situation in which the target finds itself.

Share Deals

In a share deal, a 95% exemption can be applied to the seller's corporate income tax (CIT) under certain circumstances (*article 21.3, act 27/2014, of 27 November, on corporate income tax* (*ley 24/2014, de 27 de noviembre, del Impuesto sobre Sociedades*) (*Corporate Income Tax Act*)). Indirect taxation (value added tax (VAT) and transfer tax (TT)) does not usually arise either because of the application of a general exemption, unless real estate not linked to an economic activity is concerned (*article 314, royal legislative decree 4/2015, of 23 October, approving the restated text of the securities market act* (*real decreto legislativo 4/2015, de 23 de octubre, por el que se aprueba el texto refundido de la ley del mercado de valores*) (*Securities Market Act*)).

The buyer inherits the seller's position in relation to any target's unrealised capital gain in relation to CIT and local tax. The buyer needs to carefully check latent gains. This is typically tackled as an adjustment in the value of the shares (a "price chip"). In connection to this, the acquired underlying assets remain in their tax base, losing potential additional depreciation or amortisation capacity.

The Constitutional Court has declared the regulation of the local tax null and void, and the Spanish Government has recently amended it via Royal Decree-Law 26/2021, of 8 November. The future of this tax is uncertain.

The buyer assumes the seller's position in relation to the liability for all of the target's tax debts and potential contingencies.

Efficiently financing the acquisition of shares may be difficult due to the financial assistance rules and tax deductibility restrictions.

Asset Deals

An asset deal generally generates taxation both for direct and indirect purposes, unless it:

- Can benefit from the so-called neutrality regime set forth in articles 76 to 89 of the Corporate Income Tax Act (under which latent gains can be deferred until a subsequent transfer).
- Qualifies as a transfer of a going concern (TOGC) within the terms of article 7.1.º of act 37/1992, of 28 December, on VAT (*ley 37/1992, de 28 de diciembre, del Impuesto sobre el Valor Añadido*) (*Value Added Tax Act*). (In this case, no VAT would apply, although TT or stamp duty could arise if real estate assets are concerned.) Local tax could also be levied at the level of the seller.

The buyer may assume liability for tax debts specifically linked to the asset (subsidiary liability) and for tax debts corresponding to the ongoing concern acquired (joint and several liability). However, the general joint and several liability applicable to buyers of ongoing concerns does not apply to the acquisitions made within the framework of insolvency proceedings (*article 42.1.c) (last paragraph), act 58/2003, of 17 December, on general taxation* (*ley 58/2003, de 17 de diciembre, General Tributaria*) (*General Taxation Act*)). As for tax liens, the buyer is only deemed secondarily liable for unpaid real estate tax or TT if the relevant taxpayer (the previous owner of the real estate asset) is declared in default (subsidiary liability) (see *Liability Regime*).

The buyer does not inherit any of the seller's unrealised capital gains in relation to CIT and local tax. Due to the direct purchase, there is a step up in the value of the asset and its yearly tax depreciation expense increases.

Financing is usually easier in an asset deal

Liability Regime

There are two types of tax liability (joint and several and subsidiary) that may affect:

- Generally, any person or company that causes or actively collaborates in a tax infringement.
- Particularly, and with regards to a company's tax debts, the directors (including shadow directors) and the insolvency receivers and liquidators, when they may be deemed to have been insufficiently diligent in the performance of their duties.

(*Articles 42 and 43, General Taxation Act*.)

The most relevant liability scenarios provided for in the General Taxation Act in the context of a distressed M&A transaction are:

- For **joint and several liability:**
    - those who cause or actively assist in the commission of a tax infringement;

- those who succeed in the exercise of a business, except when this business is transferred within the framework of formal insolvency proceedings (see *Insolvency M&A*). (However, with the consent of the seller, the buyer may request a certificate of outstanding debts to limit this liability to the items listed in that certificate.); and
- those who intervene in the concealment of assets or rights to prevent the action of the Spanish Tax Authorities or fail to comply with their obligations in relation to seizure orders.

- For **subsidiary liability:**
  - directors (including shadow directors) who have not carried out the necessary actions to fulfil the company's tax obligations;
  - directors (including shadow directors) that have ceased their activities, for the tax obligations pending at the time of the cessation, provided that they have not taken the necessary actions for their compliance;
  - insolvency receivers and liquidators that have not taken the necessary actions for the full compliance of the tax obligations accrued before those insolvency situations. (For the tax obligations and penalties accrued afterwards, they could be liable as directors if they have been attributed those functions.)

    Unlike the consequences for the directors (who may be guilty of non-compliance with the company's tax debts), insolvency receivers and liquidators cannot intervene in that non-compliance. Instead, they are punished for the lack of diligence with regards to managing the priority of the tax credit. Indeed, the configuration of this subsidiary liability, independently from the directors' liability, makes it possible for the Spanish Tax Authorities to address both subjects (with them all being joint and severally liable for the common tax concepts); and
  - the buyers of assets subject by law to the payment of the tax debt (tax liens).

Mainly in relation to acquisitions carried out before the commencement of insolvency proceedings, a company belonging to a consolidation tax group is joint and severally liable for any tax liabilities concerning the group in relation to the tax periods when that company was part of the group. While sometimes it proves unfeasible or impractical to carry out a tax due diligence of a complete tax consolidation group, the company should take action to assess or mitigate this potential issue.

Net Operating Losses (NOLs)

As a general rule, any company can offset its own net operating losses (NOLs) against positive results of subsequent fiscal years without any time limitation (*article 26, Corporate Income Tax Act*). (Quantitatively, that offsetting is generally limited to 70% of the taxable income, before the application of the so-called capitalisation reserve, if any, and with a minimum offset amount of EUR1 million per fiscal year in any case.)

Exceptionally, a total restriction to the offset of NOLs applies in those cases in which there is a change of control of the company that generated the NOLs (target) and the following circumstances apply:

- More than 50% of the target is acquired after the NOLs were generated.
- The buyer held less than a 25% stake in the target at the end of the fiscal year in which the NOLs were generated.
- The target is in one of these circumstances:

- it did not carry out any economic activity within the terms of article 5.1 of the Corporate Income Tax Act in the three months before the change of control;
- it modified its business (or added a new one) in the two years following the acquisition, and this new or additional business represents a net turnover in those two subsequent years greater than 50% of the net turnover of the two previous years;
- it is an asset holding company (*entidad patrimonial*) within the terms of article 5.2 of the Corporate Income Tax Act; or
- it has been removed from the Spanish Index of Entities (*Índice de Entidades*) (either for being declared insolvent for tax purposes or for not having filed the CIT return for three consecutive years).

Given that a company in financial distress has usually generated NOLs in the years before its acquisition (losses that, precisely, have given rise to this difficult financial situation), it becomes advisable for the buyer to take into account the restriction clause above with regards to change of control scenarios to determine whether or not these NOLs could be jeopardised. In the context of a restructuring transaction where there is universal succession and the CIT neutrality regime applies, the acquiring entity can subrogate to the credit rights (including NOLs) of the transferring entity (*article 84, Corporate Income Tax Act*).

Despite this, the application of this regime requires that the transaction is carried out for sound business reasons (*motivos económicos válidos*), for instance, other than obtaining a mere tax advantage. Therefore, it must be proven that the M&A deal is not being carried out with the sole purpose of taking advantage of NOLs but mainly for economic and business reasons. Additionally, the transfer of NOLs to the absorbing company may be limited in certain circumstances (*article 84.2, last paragraph, Corporate Income Tax Act*).

Deductibility of Interest Linked to the Acquisition

There are certain limitations for the deductibility of net financial expenses (interest) for CIT purposes ("earning-stripping rules") (*article 16, Corporate Income Tax Act*). The buyer must consider these limitations when driving its financial model under an M&A deal. Generally, interest can be deducted with a limit of 30% of the company's adjusted operating profit (earnings before interest, taxes, depreciation, and amortisation (EBITDA)), with a minimum of EUR1 million per year (the unused deductibility headroom can be carried forward in the five subsequent fiscal years).

Specific limitations exist for financial expenses generated from debts incurred to acquire interest in the capital or equity of a company. (This interest is subject to an additional limitation of 30% of the buyer's operating profits, excluding the operating profits on any company that may merge into the buyer or that may join its tax group during the four years following the acquisition. There is an exception if the debt incurred is paid back within the timeframe under article 16.5 (last paragraph) of the Corporate Income Tax Act.)

Tax Groups

An entity must be excluded from the CIT group (if applicable) if:

- It is under formal insolvency proceedings (see *Insolvency M&A*).
- It has losses that leave the net equity reduced to less than half of the share capital, unless this circumstance is resolved by the end of the year (*article 363.1.e), royal legislative decree 1/2010, 2 July, approving the restated Companies Act*

(*real decreto legislativo, 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la ley de Sociedades de Capital*) (*Companies Act*)).

(*Articles 58.4.c) and d), Corporate Income Tax Act.*)

Therefore, it is appropriate for the buyer to analyse in the corresponding due diligence any contingency that could arise in relation to the target as a result of being excluded from the tax group and continuing to apply the group rules without taking into account this exclusion clause.

Tax-Sharing Agreements

In both general and distressed M&A deals, it is common for the parties to establish mechanisms for sharing the payment of the taxes applicable to the transaction, for example, in relation to the real estate tax or the local tax (or even, as mentioned above, price chips with regards to existing latent gains). These agreements are perfectly valid from a tax point of view, although they only affect the parties privately.

In this regard, article 18 of the General Taxation Act expressly establishes the unavailability of the tax credit (*indisponibilidad del crédito tributario*), which implies the obligation of each of the parties to comply with their respective obligations, regardless of whether they agree on a different economic distribution. That is, the Spanish Tax Authorities are entitled to claim the payment according to what is established by the applicable law; the negotiations of the parties remain absolutely private.

It is not unusual for company groups to execute tax-sharing agreements between their constituent companies. These agreements should be reviewed during the due diligence process.

Acquisition of Debt or Conversion into Equity

Debt transfers at a discount or at a different value from an accounting and a tax perspective, as well as debt capitalisation transactions, may have significant tax implications. They depend on the very specific circumstances of the parties involved and the debt concerned. The parties should consider these implications before the execution of a distressed M&A transaction. Generally, taxation follows Spanish GAAP. It is highly recommended that an auditor verifies the applicable accounting treatment on a case-by-case basis.

Indirect Tax Issues

There are many other provisions related to insolvency situations within the different Spanish tax laws (for example, those related to the modification of taxable bases for VAT purposes or the CIT deductibility of credit impairment). These provisions may not directly affect an M&A transaction but the parties should take them into account when identifying potential contingencies within the framework of the target's due diligence.

Temporary COVID-19 Regulation

The fourth paragraph of the seventh final rule (*disposición final séptima*) of the royal decree-law 5/2021, of 12 March, on extraordinary measures for the support to the corporate solvency in response to the COVID-19 pandemic (*real decreto-ley 5/2021, de 12 de marzo, de medidas extraordinarias de apoyo a la solvencia empresarial en respuesta a la pandemia de la COVID-19*) (*RDL 5/2021*) amended act 3/2020, of 18 September, on procedural and organisational measures to face COVID-19 (*ley 3/2020, de 18 de septiembre, de medidas procesales y organizativas para hacer frente al COVID-19 en el ámbito de la Administración de Justicia*) to extend the deadline for a company under distress to request the declaration of insolvency until 31 December 2021.

In this sense, the failing company is obliged to request the declaration of insolvency before 1 September 2022 (inclusive), regardless of whether or not it has notified the court of the commencement of negotiations aimed at a refinancing agreement, an out-of-court payment agreement, or adherence to an early proposal for a composition agreement. The two-month period for requesting the declaration of insolvency proceedings will begin to run again on 1 July 2022.

Additionally, from 14 March 2020 until 30 June 2022 (inclusive), the insolvency court will not accept applications for compulsory insolvency.

As a result, the main incentive driving distressed M&A deals is currently on hold. The lack of this incentive, together with all the other approved measures, such as public financing and debt moratoria, is acting as a deterrent to execute these deals. Directors of potential targets do not feel the pressure to request insolvency and investors are not finding the opportunistic transactions to deploy capital. The main question right now is whether the current environment is robust enough to ensure a smooth transition after June 2022, avoiding turmoil and a huge amount of insolvencies that would otherwise happen without these measures.

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