Bankruptcy proceedings in Spain: Possible effect on prior leveraged buy-out operations

Mariano Jiménez examines the pros and cons of the leverage buy-out option

Concept and legal prohibition

In recent years so-called "leveraged buy-outs" (LBO) have been very frequent in Spain. These operations are characterised by being acquisitions of a majority percentage of the share capital of a target company, this acquisition being financed via loans obtained from a third party which are guaranteed with the assets of the target company itself or are repaid by being charged to corporate assets and cash flows expected from the same. It may even occur that the acquisition price is deferred and paid to the sellers by the target company itself, which is merged after its acquisition – and prior to payment of the price – with a special purpose vehicle incorporated by the investor (traditionally a risk capital fund) for the sole purpose of purchasing the shares or participations in question. That is, the result of the LBO is that the purchaser transfers to the target company the cost of its own acquisition.

In this way, LBO operations would be in contravention of the prohibition against financial assistance for the acquisition of own shares/participations established in article 81 of the Law regarding corporations and article 40 of the Law regarding Limited Liability Companies. By means of the said prohibition, the legislator attempts to preserve the integrity of the share capital, preventing it from being financed by charging it to the assets of the company itself instead of being nourished by the external contributions of the shareholders. The prohibition likewise sets out to protect the interests of third party creditors, who may see their legitimate collection rights prejudiced as a result of the high level of debt that financial assistance operations may incur for the company. Moreover, it is intended to protect minority shareholders vis-à-vis the majority shareholders and administrators. The latter may be tempted to facilitate company funds to third parties that they trust, in order that they may acquire the shares or participations they require in order to achieve success in the deliberations of the shareholders' meeting.

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Possible effects of non-compliance

Despite its contradiction with the said prohibition against financial assistance, it is highly unlikely, while the target company is a solvent company that fulfils its obligations, that anybody would show any interest in opposing the leveraged buy-out. Only the investor acquiring the shares or participations in question (generally, a risk capital fund), upon seeing its economic expectations frustrated, could have any interest in opposing the legal validity of the operation and trying to recover its investment. However, such a possibility is remote, since the legitimacy of an investor would be more than doubtful if it were to oppose as illegal an operation in which it has itself intervened actively as a party, without prejudice to the discredit that it may attract in the financial market owing to its attacking the validity of an operation that has failed financially and upholding that of other successful LBOs.

On the other hand, the appearance of parties interested in opposing the LBO would be more probable in the case of bankruptcy proceedings against the target company. Indeed, those creditors who saw the recovery of their debts endangered could establish that the opposition to the LBO and the subsequent refund to the target company of the price paid by the latter to the sellers (former shareholders) would mean a notable increase in the assets of the company – the pool of assets – with which to satisfy its debts and, therefore, the credits of such creditors.

Alternatives to opposing the LBO

The alternatives so that such creditors may achieve their aim would fundamentally be as follows.

On the one hand, the rescission of the LBO as contemplated in article 71.1 of the Bankruptcy Act. The said provision stipulates that, once bankruptcy has been declared, acts which are prejudicial for the pool of assets, carried out by the debtor within the two years prior to the date of declaration, would be rescindable, even though no fraudulent intention existed. The legal prohibition of financial assistance for the acquisition of own shares/participations would not be at stake, since rescindable acts need not suffer from any intrinsic defect, rather the grounds for rescission would consist solely and exclusively in the damage to the pool of assets. Here, those interested in the rescission would try to prove before the Commercial Court that the over-indebtedness of the target company deriving from the price to be paid to the sellers constitutes a patent impairment to its assets and that the payment of the said price, by lacking any balancing entry in favour of the target company or at least an equivalent from the perspective of the integrity of the debts in bankruptcy, was prejudicial to the pool of assets. The intention of the parties intervening in the LBO would be completely irrelevant.

On the other hand, the opposition to the LBO as contemplated in article 71.6 of the Bankruptcy Act, according to which the exercising of actions for rescission will not impede the exercise of other actions opposing the acts of the debtor that may be appropriate by law, which may be brought before the bankruptcy judge. Should they recur to this channel, the interested parties would now cite before the Commercial Court the infringement of the legal prohibition of financial assistance for the acquisition of own shares/participations, null and void in accordance with article 6.3 of the Civil Code. Unlike the previous alternative, in this case the action would not be subject to any time limit, since revocation proceedings never become extinguished by prescription.

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Consequences of a successful opposition

Obviously, the consequences of the success of the opposition to the LBO would be traumatic from both the economic and legal points of view. According to the action taken and the object of the same, one or various of the payments received in the concept of price could be declared invalid, and must therefore be repaid by the sellers to the pool of assets. The consequences of a declaration of nullity of the whole LBO operation would be especially complex: the sellers would recover ownership of the target company, the merger of the latter with the special purpose vehicle would have to be “undone” since it formed part of an illegal and void operation, etc. Moreover, the sellers, as shareholders of the target company, as well as repaying the price received as a result of the LBO could become subordinated creditors of the bankrupt target company, should they incur in the legally established circumstances.

Assessment and convenience of a specific legal solution

Various authors have criticised the categorical prohibition of financial assistance for the acquisition of own shares/participations contemplated in our commercial legislation, fundamentally because LBOs and the subsequent use of corporate indebtedness may accompany the fulfillment of perfectly legitimate objectives or company restructuring formulas. Indeed, as Vaquerizo Alonso has stated, the price premium paid to the new majority shareholder within the framework of the LBO should not necessarily be understood as an impairment of assets or a robbing of the company, since this would mean ignoring the beneficial effects planned via the operation and which are necessarily reflected in the higher value of the shares/participations at the time of acquisition. This price premium may be a reflection of the new expectations of future returns for the company arising as a result of the restructuring which is normally accompanied by the substitution of the controlling majority, such as, for example, the reduction of operating expenses, a better use of corporate assets deriving from changes in management, etc.

But this does not imply that one must overlook the enormous potential of LBOs to generate conflicts of interest between those who promote them and those who are affected by them despite their lack of intervention in the same, it being undeniable that a large part of the risk associated with the operation is borne by the creditors. For this reason it is appropriate for the legislator to establish legal solutions to the problems that may be generated by LBOs, such as – for example – the establishment of a credit subordination system, so that the pre-existing creditors before the LBO would be given preference for collection ahead of the creditors who participated in its planning.

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