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Investment in distressed assets

Miguel Esperança Pina and Diogo Horta Osório of Cuatrecasas Gonçalves Pereira discuss insolvency proceedings and related M&A opportunities

Insolvency proceedings are regulated by the Portuguese Insolvency and Restructuring of Undertakings Code (*Código da Insolvência e Recuperação de Empresas*) (CIRE or the Insolvency Act), as well as by Regulation (EC) 1346/2000.

These proceedings can only be initiated if the debtor is in such a situation that it is impossible for him to comply with the obligations that have become due. When the debtor is a legal entity, the criterion that enables the establishment of the fact that there is a situation of insolvency is the fact that the liabilities exceed the assets (based on an accounting criterion). Article 20 of the Insolvency Act lists a number of facts that are indicative of the debtor's insolvency, the verification of which may constitute grounds for the insolvency claim.

Legitimacy

In accordance with Articles 19 and 20 of the Insolvency Act, the declaration of insolvency may be required by the social body responsible for the legal person's management, or, otherwise, by any of its managers, by any creditor, or by the public prosecutor, on behalf of entities whose interests are legally entrusted to it (for example, the tax and social security authorities).

Jurisdiction

In general, the court having jurisdiction to analyse the application for the declaration of insolvency is the one of the registered office of the debtor – see Article 7 of the Insolvency Act and Article 3 of Regulation (EC) 1346/2000. However, the declaration of insolvency may also be applied for with the court of the place where the debtor has the centre of its main interests, which shall correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.

Apart from as otherwise provided in the Regulation, under its Article 4, the law applicable to insolvency proceedings and their effects shall be that of the member state within the territory of which such proceedings are opened.

Cross-border insolvency

According to Article 16 of the Regulation (EC) and Article 288 of the Insolvency Act, any judgment opening insolvency proceedings

handed down by a court of a member state that has jurisdiction pursuant to Article 3 shall be recognised in all of the other member states from the time that it becomes effective in the state of the opening of proceedings.

This means that every creditor who has his habitual residence, domicile or registered office in the Community should have the right to lodge his claims in each of the insolvency proceedings pending in the Community relating to the debtor's assets. This should also apply to tax authorities and social insurance institutions. However, in order to ensure equal treatment of creditors, the distribution of proceeds must be coordinated. Every creditor should be able to keep what he has received in the course of insolvency proceedings but should be entitled only to participate in the distribution of total assets in other proceedings if creditors with the same standing have obtained the same proportion of their claims.

Where insolvency proceedings have been opened, any proceedings opened subsequently shall be secondary proceedings – according to Article 3 of the EC Regulation and Article 272 of the Insolvency Act.

Insolvency qualification

Upon the declaration of the insolvency and the creditors' assembly, the procedural issue of its qualification is addressed. This may (or may not) be qualified as faulty conduct – where the insolvency situation is created or made more serious by a fault or gross-fault conduct of the debtor or its managers, *de iure* or *de facto*, in the three years before the insolvency proceedings were initiated.

Insolvency assets and debts

According to Insolvency Act, the insolvency mass is composed of all of the assets of the debtor as of the date of the insolvency

declaration, as well as all the assets and rights acquired by the debtor while the insolvency proceedings are pending.

There is a ranking of the credits priorities in relation to the payment of the credits (Articles 47 and 48 of the Insolvency Act): guaranteed, privileged, common and subordinated credits.

There is also a special and prior category of credits against the bankrupt's assets. As a general rule, these are those credits that arise after insolvency is declared, including the legal costs and expenses resulting from the proceedings.

Under Article 173 of the Insolvency Act, the payment of the credits over the insolvency shall only consider the credits that have been duly claimed and verified by a judgment having the force of *res judicata*.

Insolvency declaration effects

The declaration of insolvency generates some effects with interest to a potential purchaser of a distressed company, as follows.

Effects on deals in progress (Article 102 of the Insolvency Act)

With regard to deals that have not been concluded by any of the parties, the respective compliance shall be suspended until the insolvency administrator decides whether to carry out the execution or the refusal to comply.

The other party may, however, determine a reasonable time limit for the insolvency's administrator to exercise the abovementioned option, at the end of which it shall be considered that compliance was refused.

Termination on the benefit of the insolvent estate

The insolvency's administrator may terminate, for the benefit of the insolvent estate, all acts that are detrimental to it, where the same have been carried out or have failed to be carried out in the four years before the date of initiation of the insolvency proceedings. This category of acts covers the acts that decrease, compromise, make difficult, endanger or delay the satisfaction of the insolvency creditors.

The termination may be subject to the fulfilment of certain requirements (Article 120 of the Insolvency Act) or be unconditional (Article 121 of the Insolvency Act), where it has retroactive effects and obliges the reinstatement of the situation that would exist if the act had not been performed.

The termination may be made by the insolvency's administrator by registered letter

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Author biographies



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Miguel Esperança Pina is a partner at Cuatrecasas Gonçalves Pereira. His main areas of practice are dispute resolution and arbitration, civil law, company law, commercial law and insolvency proceedings.

Miguel graduated from the Portuguese Catholic University of Lisbon (1991). He was a lecturer on the law of obligations at Universidade Internacional and on economic law at Universidade Autónoma. He has been a lecturer on interdisciplinary legal practice at Universidade Nova of Lisbon since 2004. He is a

member of the Portuguese Bar, a founder member of the Portuguese Arbitration Association and a member of the Concórdia Conciliation and Mediation of Disputes Centre.



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Diogo Horta Osório is a partner at Cuatrecasas Gonçalves Pereira. His main areas of practice are M&A (distressed transactions), commercial law and energy and transport law.

Diogo graduated from the Portuguese Catholic University of Lisbon (1991) and holds a master's in M&A (leveraged buyouts) from the same university (2000). Until 2006, he was assistant and visiting professor on commercial law, labour law and banking law at the Lusíada University of Lisbon. He is a member of the Portuguese Bar.

with acknowledgment of receipt within six months of becoming aware of the act, but never more than two years after the declaration of insolvency.

The aforementioned reveals that any business (purchase or sale) performed with an insolvent party may be non-fulfilled or even terminated by the insolvency's administrator, once the assumptions foreseen in the applicable legislation are verified. Accordingly, these businesses have benefits and risks, as shown in the following paragraphs.

M&A involving distressed companies

The knowledge of the risks of acquiring a distressed company can be invaluable for the purchaser or the seller.

Private equity houses know that acquiring distressed companies or businesses at a very competitive price substantially increases the upside after a turnaround or simply the recovery of the economy.

The legal issues that should be addressed in these kinds of transactions include: (i) reviewing the potentially problematic financial statements or carrying out legal due diligence on the intangible (has goodwill had been affected or damaged irreparably?) and tangible assets (title and security given); (ii) the employee relationships; (iii) directors' liability; and (iv) tax duties or other payments due in order to appraise the assets adequately and to limit the contingencies and liabilities to be transferred with the acquisition.

In Portugal, the purchaser should try to acquire the distressed business before the insolvency proceedings begin: otherwise it is

very difficult to control negotiations with the creditors.

There will almost certainly be an auction, and one must consider all the costs associated with the purchasing through the insolvency courts. Portuguese law provides an ideal mechanism for these kinds of transactions. It is called the *Plano Extra-judicial de Conciliação* (PEC), ruled by Decree-Law 316/98 of October 20, amended by Decree Law 201/2004 of August 18. However, the PEC does not prevent the creditors of the seller from challenging the transaction on the grounds that the seller did not receive fair consideration (fraudulent conveyance). The transaction and price rationale should be construed so as to make the price paid more defensible if challenged in court. Independent appraisals of the business and a proper legal and financial due diligence should be carried out. The payments to the owners of the distressed companies should also be avoided.

The representations and warranties clause in an out-of-court sale and purchase agreement is essential but often ineffective when the seller files for the insolvency proceedings. Even the pledge of part of the purchase price to secure those representations and warranties is not sufficient to protect the purchaser. As stated previously, the indemnification claim would receive no priority and would be lumped in with the claims of other creditors of the distressed company. Furthermore, the pledge, depending on the timing of the purchase regarding the insolvency filing, may be declared null and void by the court.

As an alternative to this pre-insolvency proceeding, the prospective purchaser could

consider acquiring the distressed company through the insolvency proceedings with the possibility of off-loading some liabilities and debts, unwanted contingencies, obtaining a clean balance sheet and, under certain terms, selecting employees. It is also possible to acquire only the assets or substantially all of the assets, the goodwill or a business (without legal personality), depending on the power to convince the creditors that this transaction maximises the debt recovery.

The ideal setting for these kinds of distressed transactions always depends on a case-by-case analysis. However, we can provide the following recommendations, taking Portuguese law into account.

- Analyse the debt structure of the distressed company, as well of the target company if it is a subsidiary.
 - Use the possibility to assign the debts with the clauses *pro soluto* or *pro solvendo* in order to acquire the company through an increase of share capital by way of converting the debts into share capital (exchange debt for equity). This should be done before acquiring the status of a shareholder to avoid being rated as a subordinated creditor in the event of an insolvency proceeding.
 - Assess the timing of the acquisition to prevent the fraudulent conveyance rule.
 - Avoid being qualified as a special related party to the insolvent entity.
 - Previously negotiate with all of the creditors, including the state and financial creditors, in order that the transaction will be secure and safe regarding the challenge of the conveyance. If you are purchasing the pre-insolvent company itself, please note that the banks would appreciate it if you put good money, as a shareholder, into a distressed company so as to subordinate debt. Avoid transactions that are substantially financed with the pre-existent debts.
 - Study the possibility of acquiring the company itself or the business within the insolvency proceedings as a way of liquidating the company or to make a turn-around.
 - Use the management buy-out legal incentives (Decree Laws 14/98-01.28 and 81/98-04.02) in order to acquire the company or substantially all of its assets with a management buy-in mechanism.
 - Avoid the financial assistance prohibition through proper structure and financing.
 - Maximise the existing tax benefits for these distressed transactions.
 - Study the legal consequences to the directors of the acquired distressed companies.
- Finally, bear in mind that the Portuguese distressed market is becoming more attractive but that the legislative framework will be tested in this new economic environment.