Slovakia: Bankruptcy or reorganisation following mergers

Martin Provazník takes a retrospective look at mergers in Slovakia where the legal successors ended up in bankruptcy or reorganisation between 2012 and 2019

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> *Mergers were often prepared with the intent that the legal successor would file for bankruptcy (reorganisation) after the merger*

Slovakia saw a huge increase in the number of merged companies between 2012 and 2017. Thousands of companies were merged into fewer than 200 successor companies, which subsequently ended up in bankruptcy.

Abuse of the merger process

A merger is a procedure that is quite common in M&A transactions and is often the desired way to dissolve companies. However, when a merger is carried out in order to avoid liquidation, bankruptcy or reorganisation, the insolvent company is often merged with a successor company and liabilities of the insolvent company are transferred to the legal successor. Thus, the creditors' claims cannot be satisfied in the liquidation, bankruptcy or reorganisation of the dissolved company and the liabilities of the dissolved company remain with the legal successor.

Moreover, the merger is often planned so that the legal successor is also insolvent or becomes insolvent by the merger itself. As a consequence, the legal successor files for bankruptcy after the merger. In the subsequent insolvency proceedings of the legal successor the insolvency administrator has difficulty obtaining information about the dissolved company. If the bankrupt successor company is the legal successor of a large number of dissolved companies (10 or more), it is almost impossible for the insolvency administrator to get the essential information about the dissolved companies.

In addition, under this merger "model", the sole shareholder of the successor company is often a person who has no funds and/or is difficult to find, often a foreign national from an Asian or African country, making it extremely difficult to communicate and hold them accountable.

Creditors thus have nothing to satisfy the claim, leaving them with only one option: to ask the police for help.

In the context of criminal proceedings, the investigation focuses on whether the debtor has reduced its assets with the intention of harming the creditor or whether there has been an attempt to prevent the winding-up of the business.

Emergence of the merger problem in 2012

The sharp rise in these "special purpose" mergers occurred due to a legislative change in 2012. Previously, when someone needed to get rid of a company, they transferred its shares to a penniless and often uncontactable person. The abandonment of this "model" and the focus on company mergers indirectly resulted from an amendment to the Slovak Commercial Code. As of 1 October 2012, the law changed and the registration of a majority shareholder now also requires the consent of the tax authority. This consent applies to both the transferor and the transferee, with a few exceptions (e.g. foreign entities). The amendment spurred a massive increase in corporate mergers aimed at getting rid of company debts. The law allowing this type of merger remained in force until 2017. During this time period (especially 2014 and 2015), there was a significant increase in company mergers in Slovakia. The Slovak Ministry of Justice was aware of this development and initiated a change of laws in 2017.

Correcting the problems with abuse of merger process in 2017

Effective as of 8 November 2017, the amendment to the Commercial Code incorporated new conditions for mergers to reflect the frequent occurrence of mergers deliberately aimed at preventing debt recovery or getting rid of insolvent companies and avoiding bankruptcy proceedings.

From this date, companies should not merge if doing so would create a situation where the value of the legal successor's liabilities would exceed that of its assets. An addition, an auditor's certification is required. Furthermore, none of the merged companies can be in liquidation, bankruptcy, reorganisation or dissolution proceedings. If such a merger were to take place, all members of the bodies that carried out the merger could be held liable.

This new law also introduced the obligation to inform the tax authority of the merger in advance.

Today, it is possible to merge with a company that has financial difficulties but is not bankrupt. However, the legal successor must have enough assets to cover the debts of both companies.

Evolution of merged companies by merger period from 2011 to 2019

During the period from 1 January 2011 to 12 December 2019, a total of 3,309 companies were merged into 158 successor companies, which were later subject to bankruptcy or reorganisation.

The trend of company mergers started to increase in the last months of 2013 and peaked in 2015. Chart 1 shows the number of merged companies in each month in the period from 2011 to 2019.

After a peak in mid-2015, the number of merged companies started to gradually decline until mid-2016, only to turn around and peak again in late summer 2017. It is likely that this increase in 2017 may have been caused by state efforts to change the merger law. After a significant number of mergers in January 2018, corporate mergers were essentially completely muted by mid-2018, with no mergers taking place in 2019.

The merger trend was only halted in 2017 by the aforementioned change of law. Although this change of law came into force on 8 November 2017, 170 more companies were merged in 2017 and 2018, either due to the probable antedating of merger agreements and subsequent registration after the effective date of the law, or due to late registration.

Chart 2 gives a general overview of the monthly trend of mergers in which the legal successor's bankruptcy or reorganisation request was filed.

According to the chart, in 2018, bankruptcy or reorganisation requests were filed for the 30 companies with the largest number of merged companies in the period from 2012 to 2019 (1,097 legal predecessors). On average, 37 companies merged into a single successor that was subject to a bankruptcy or reorganisation request. In 2018, the number is significantly affected by the bankruptcy of Eurotransfer, spol. s r.o., a legal successor of 42 predecessors, which in turn were legal successors of 698 other companies.

Conclusions

It can be concluded that there has been a trend in Slovakia to get rid of indebted companies. Prior to 1 October 2012, it was mainly a share transfer, where the initial shareholder transferred its shares to a new shareholder. If this new shareholder was uncontactable and the company was insolvent, the debt recovery process became much more difficult. This was prevented by prohibiting share transfers without the consent of the tax authority in 2012.

However, as the merger of a non-asset-bearing company with a successor company was not subject to the tax authority's consent, and the original shareholder could transfer its share via merger, the number of "abused" mergers started to increase. Such mergers were often prepared with the intent that the legal successor would file for bankruptcy (reorganisation) after the merger.

In this time period, instead of more than 3,000 indebted companies, only less than 200 successor companies have been included in the bankruptcy statistics (3,383 companies merged into 178 successors, all of which filed for bankruptcy or reorganisation between 1 January 2011 and 31 December 2019). This created a negative impact in the following areas:

- Creditors' rights violation (insolvency regulation).
- Tax avoidance (tax statistics and payment).
- Misreporting on the number of bankruptcies (insolvency statistics).

The massive increase in the "abuse" of the merger regulation between 2012 and 2016 resulted in a change of law in 2017.

We believe that advisers helping entrepreneurs to dispose of companies with financial difficulties realised the shortcomings of the 2012 law change and started to offer special purpose merger services. The main wave of abused mergers occurred between 2012 and 2018, peaking in 2014 and 2015. However, a significant number of mergers continued even after the amendment came in force on 8 November 2017, with another 170 companies merged in 2017 and 2018. It is probable that the registration of mergers in 2018 where the legal successor ended in bankruptcy or reorganisation occurred not only for administrative reasons, e.g. delayed registration, but also due to the antedating of merger agreements. ■

Chart 1

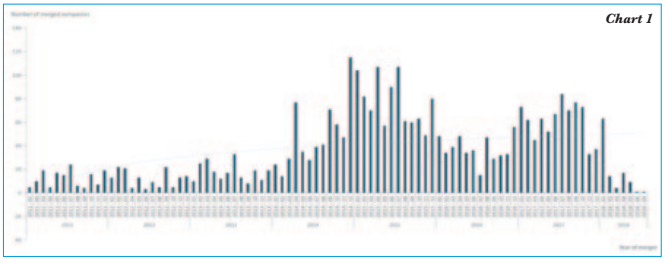
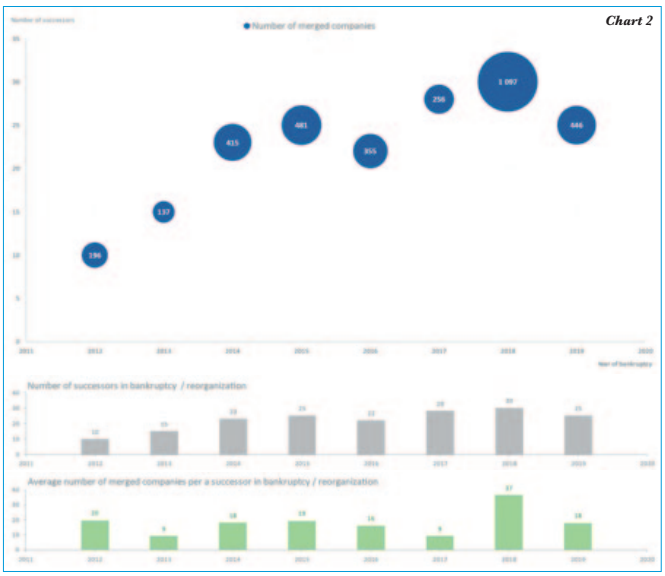


Chart 2



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