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Material Reform of the Spanish Insolvency Law

The Royal Decree Law 4/2014 of 7 March significantly amends the Spanish Insolvency Law, ostensibly in favor of refinancing agreements.

With the approval of Royal Decree Law 4/2014 of 7 March on urgent measures regarding refinancing and restructurings of corporate debt (the New Reform) Spanish lawmakers have taken yet another step in their continuing efforts to improve the Spanish Insolvency Law. The New Reform principally aims to allow operationally viable companies to comprehensively transform their unsustainable financial burden into sustainable debt, whilst respecting the rights of creditors to maximize the recovery of their debt from these companies. In particular, bearing in mind that the vast majority of the Spanish insolvency proceedings end in liquidation, the ultimate goal of the New Reform is to eliminate the obstacles in the Spanish legal system that currently hamper the success of many pre-insolvency[1] refinancing agreements and restructurings — obstacles that often force through unnecessary liquidations.

In a nutshell…

The New reform came into force on 9 March 2014[2] bringing drastic changes and, even, breaking with some fundamental Spanish law general principles. Given how Spanish courts have historically reached some controversial conclusions in response to reforms, needless to say this New Reform will generate plenty of discussion. We discuss the following 10 most important implications in more detail below:

1. **Pre-insolvency communication**: the reforms will freeze enforcement actions.
2. **General insolvency enforcement**: the moratorium has been (somewhat) clarified.
3. **Claw-back actions**: a new safe harbour has been added.
4. **New money**: the reforms have brought improvement, but probably not enough.
5. **The so-called Spanish Scheme of Arrangement**: the reforms include a radical transformation (including the imposition of uncapped haircuts to secured or unsecured creditors).
6. **New 'guilty insolvency' presumption**: the reforms restrict the right of directors and shareholders to veto creditors' restructuring proposals.
7. **Subordination regime**: common sense exceptions to the scheme have been introduced to protect creditors participating in restructurings/refinancings,
8. **Risk classification**: banks provisions to be released

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9. **Tax regime**: the reforms offer favorable terms for operationally viable companies

10. **Public offerings**: the reforms include exceptions for public offerings.

The pre-insolvency notification known as the 5bis communication

The general obligation to file for insolvency within two months from the date of being in a situation of actual insolvency (*i.e.* where the company cannot regularly pay its debts as they fall due) does not apply if the debtor notifies the Court that it has initiated negotiations with its creditors to obtain lock-ups to an anticipated composition agreement or to negotiate an out-of-court refinancing agreement (the so-called 5bis communication). Indeed, by means of the 5bis communication, the debtor gains an additional three month period to achieve an agreement with its creditors and one further month to file for insolvency. In addition, creditors' applications to file for insolvency during that period will not be accepted.

The New Reform reinforces this feature as now the 5bis communication will freeze court enforcement actions (even those already initiated) over those assets deemed necessary for the continuity of the debtor's business activities for a period of up to four months. This enforcement moratorium neither applies to public law claims, nor — with a literal reading of the provision — to out-of-court enforcement actions. Therefore, the question remains whether or not the 5bis communication shouldn't block *any* sort of enforcement.

In addition, the New Reform sets out that the 5bis communication will block financial creditors' individual enforcement actions (even those already initiated) to the extent that a majority of such creditor class has expressly supported the blocking enforcement as "justified"[3] because negotiations to reach a Homologated Refinancing Agreement (see section "Homologation of pre-insolvency refinancing agreements by a court" below) have commenced and creditors have committed not to start (or continue) individual enforcement actions against the debtor. Courts will need to clarify how this will apply in practice.

However, the New Reform narrows the former reference to an out-of-court refinancing agreement. The current wording specifies that the debtor will be entitled to serve the 5bis communication only once it has started negotiations to reach a 71bis First Section Refinancing Agreement (see section "Claw-back actions" below) or a Homologated Refinancing Agreement. If the purpose is to gain a 3+1 month period to reach a solution to the threatening insolvency (which does not necessarily involve a 71bis First Section Refinancing Agreement or a Homologated Refinancing Agreement), and thereby to avoid an "Apocalypse" (*i.e.* the start of insolvency proceedings), why has the scope been limited to just reaching a 71bis First Section Refinancing Agreement or a Homologated Refinancing Agreement ? Why has the reach of a 71bis Second Section Refinancing Agreement not been extended to the scope 5bis communication?

Finally, the New Reform states that only one 5bis communication may be served per year.

The general insolvency enforcement moratorium

The New Reform clarifies that the general insolvency enforcement moratorium (of up to one year) may only apply to assets deemed necessary for the continuity of the debtor's business activities.

Likewise, the New Reform establishes a special regime regarding holding companies. Sadly, this section is far from clear. As a general rule, under the New Reform the shares owned by a holding company (*i.e.* a Bidco under a leveraged buy-out (LBO) or under a dual project finance structure) shall not be regarded as 'assets deemed necessary for the continuity of the debtor's business activities,' and would thereby not be

subject to the general insolvency moratorium. With this uncertainty, we are keen on seeing if the courts will confirm this interpretation.

Claw-back actions

The New Reform has split former section 71 of the Spanish Insolvency Law into two sub-sections, the first one deals with the existing safe harbor (a 71bis First Section Refinancing Agreement) and the second covers a new safe harbor (a 71bis Second Section Refinancing Agreement; jointly with a 71bis First Section Refinancing Agreement, a 71bis Refinancing Agreement).

On the one hand, the New Reform changes the regulation of the existing safe harbor for pre-insolvency out-of-court refinancing agreements. As a reminder, a 71bis First Section Refinancing Agreement — including the legal transactions, payments and security package thereto — is not subject to claw-back actions (even if the agreement falls within the two-year claw-back period) provided that the agreement complies with the following cumulative requirements:

a) The agreement significantly increases the funds available to the debtor and/or extends the maturity and/or substitutes the debtor's obligations thereto, but only to the extent that the agreement forms part of the viability plan which allows for the continuity of the business activities of the debtor in the short and medium term.

b) Before the declaration of insolvency:

(b.i) The agreement is approved by creditors representing 3/5 of the debtor's total liabilities as at the date of the execution of the pre-insolvency refinancing agreement (excluding intragroup debt); and

(b.ii) The agreement is executed in a Spanish public document.

The above still applies under the New Reform, however, the law no longer requires the debtor to produce a report issued by an independent expert appointed by the Mercantile Registry who assesses, among other points, the reasonableness and feasibility of the viability plan and the proportionality of the new security. Instead:

(b.iii) The debtor's auditor must issue a certificate acknowledging that the majority referred to in (b.i) has been reached.

On the other hand, the New Reform has introduced an additional safe harbor. A 71bis Second Section Refinancing Agreement carried out before the declaration of insolvency not qualifying as a pre-insolvency refinancing (because the agreement fails to meet the above requirements but meets each and every one of the following conditions), will not be subject to claw-back actions either (even if it falls within the two-year claw-back period):

a) The agreement increases the previous proportion of assets versus liabilities (*e.g.* payments in kind).

b) The quantum of resulting current assets is higher than the quantum of current liabilities.

c) The value of the security interest[4] granted in favor of the creditors, added to the value of the existing security interest, does not exceed 9/10 of the outstanding creditor debt.

d) The interest rate applicable to the post-restructuring debt does not exceed the original interest rate by more than 1/3. The wording, again, raises questions. If there are several facilities agreements in place (as

is almost always the case), what should be understood as the former interest rate: the highest one, the lowest one, the average one?

e) The agreement is executed in a Spanish public document which shall expressly note the economic reasons that justify the same and shall expressly refer to the above requirements. Unfortunately, the New Reform does not clarify if the Notary has the discretion to uphold the compliance of the above requirements or would just list the economic reasons.

The above conditions shall be deemed met on the date on which the transaction is executed in a Spanish public document.

In a nutshell, those refinancing agreements which are not backed by 3/5 of the debtor's total liabilities may still be protected from a claw-back action to the extent that they comply with all the above requirements.

The new regulation's claw-back safe harbor regime appears much tighter than the previous criteria on which the Spanish courts have been lately relying. Under such criteria, legal construction of the "justified sacrifice" argument has proved opportune for refinancing agreements and courts[5] have widely followed this construction. Since the New Reform ostensibly supports restructurings/refinancings, this new regime begs the questions, why did Spanish legislators develop new — and more stringent — regulations and will the courts follow by tightening the requirements of a "justified sacrifice"?

The existing Spanish Insolvency Law set forth that only the insolvency receiver may bring claw-back actions against a 71bis First Section Refinancing Agreement, however the Spanish Insolvency Law was silent as to the grounds on which the claw-back could be brought. The New Reform also allows only the receiver to bring a claw-back action to a 71bis Second Section Refinancing Agreement, but clarifies that the grounds for such an action would be lack of fulfilment of the requirements above. While this amendment brings certainty, we expected the New Reform would have stated that the insolvency receiver can only bring claw-back actions against a 71bis Refinancing Agreement on grounds of fraud.

New money

The New Reform aims to encourage the granting of new money to companies facing comprehensive financial problems, an important tool in warding off undesirable liquidation. Funds granted under the umbrella of a Homologated Refinancing Agreement will now be covered by the New Money regime.

The New Reform sets out a more beneficial, though temporary, regime. Until 9 March 2016[6], 100 percent of the new money in a refinancing will be regarded as an estate claim, and thus will be paid out ahead of nearly all other claims, other than specially privileged claims (*i.e.* secured creditors[7]). New money provided by a "specially related person" will benefit from the estate claim protection but only until 9 March 2016. However, the New Reform language about the interest arising from new money (or at least the amount not covered by the security) remains unclear, but appears to treat the interest as subordinated claim.

These reforms are welcome. Nevertheless, in our opinion the New Reform does not solve the main "hurdle" of the new money regulation in that insolvency receivers retain their discretion to alter the payment order of the claims to the extent that they believe that the insolvency estate will not be sufficient to pay all claims against it. In addition, we believe the subordination of interest (or at least the amount not covered by security) during the temporary regime may prove to be a disincentive for the granting of new money. Finally, we believe that it might be worth extending the scope of the new money, that is to say not

limit the same to financing granted in the context of a 71bis Refinancing Agreement or a Homologated Refinancing Agreement but to any other new money available in the context of any restructruring/refinancing.

Homologation of pre-insolvency refinancing agreements by a court[8]

Following the Celsa case, Spanish lawmakers have taken another step to incorporate portions of the UK scheme of arrangement — which is completely foreign, and even illegal according to the former Spanish Law[9] — into Spanish Insolvency Law. This incorporation may finally stop the exodus of Spanish viable companies with financial difficulties to the UK, to be rescued by the UK courts. The New Reform radically changes this nascent section of the Spanish Insolvency Law.

Notably, with respect to the pre-insolvency refinancing agreements homologated by a court (a Homologated Refinancing Agreement) all of the following conditions now apply:

a) The homologation requisite approval rate has been lowered from 55 percent to 51[10] percent.

b) The New Reform states that the support must be given by creditors that own financial liabilities whether or not subject to financial supervision (that is to say the Law excludes creditors of commercial transactions, *i.e.* trade creditors, specially related persons and public law claims). This amendment has eliminated certain prior doubts regarding who has to approve the stated threshold; apparently alternative investors, such as hedge funds are no longer excluded. Nevertheless, in some cases the distinction between a trade and a financial debt is not entirely clear. For instance, should a lease agreement over an operative asset or a claim stemming from a volume discount be regarded a trade or financial claim?

c) A Homologated Refinancing Agreement may not be subject to a claw-back action.

d) In the case of syndicated facility agreements the New Reform assumes that if the lenders thereto subscribe to the pre-insolvency refinancing agreement once 75 percent (or, if lower, the percentage set out in the syndicated facility agreement) of the syndicated facility amount support the agreement.

e) The New Reform establishes a mechanism to value the security interest held by the creditors by means of the following formula: (9/10 of the reasonable value of the collateral[11]) minus (debts with senior security over the collateral).

f) The following effects of a Homologated Refinancing Agreement may be imposed on dissenting unsecured creditors or on secured creditors (to the extent of that part of their **claim not covered** by their security interest, as valued in accordance with the rules set out by the New Reform):

(f.1) If a Homologated Refinancing Agreement is supported by creditors representing at least 60 percent of the debtor's financial liabilities, maturity may be extended for up to five years or the debt converted into so-called profit participation loans (*préstamos participativos*)[12].

(f.2) If a Homologated Refinancing Agreement is supported by creditors representing at least 75 percent of the debtor's aggregate financial liabilities:

(f.2.i) maturity extensions for up to 10 years

(f.2.ii) haircuts (note that a cap has not been established)

(f.2.iii) capitalization of debt

(f.2.iv) conversion of debt into profit participation loans of up to 10 years, convertible obligations, subordinated loans, payment in kind (PIK) facilities, or in any other financial instrument with a ranking, maturity and features different to the original debt

(f.2.v) assignment of assets or rights as total or partial payment of the debt

g) Additionally, the effects of a Homologated Refinancing Agreement described in paragraph (f) may also be imposed on dissenting or non-participating secured creditors in the **amount covered** by their security interest (valued in accordance with the rules set out by the New Reform) to the extent that the majority threshold set out below (calculated bearing in mind the proportion of the value of the security interest approving the effects over the total value of security interest granted) approved the agreement:

(g.1) 65 percent in respect of the effects listed in paragraph (f.1) above

(g.2) 80 percent in respect of the effects listed in paragraph (f.2) above

These clearly involve a radical transformation as uncapped haircuts can be imposed not only on unsecured creditors but also on secured creditors.

In the case that a Homologated Refinancing Agreement is breached, creditors may enforce their security and the proceeds will be subject to the usual waterfall. Notably haircuts, or the value given to security within the homologation process, will in that case be voided; thus the amount of the debt will revert to the original amount.

Guilty insolvency

An insolvency may be regarded as "guilty" (not accidental) if the debtor's directors, shadow directors and liquidators (including those in that position within the two years prior to the declaration of insolvency) caused or aggravated the insolvency of the debtor through their gross negligence or wilful misconduct. A guilty insolvency may bring serious consequences for the responsible persons (*e.g.* disqualification to manage a third parties' assets for up to 15 years or personal liability for unpaid claims).

The New Reform inserts the following additional rebuttable presumptions regarding gross negligence or willful misconduct, including vis-à-vis shareholders of the debtor: (i) unreasonable rejection to a capitalization of its debt or the issuance of securities frustrating the achievement of a 71bis First Section Refinancing Agreement or a Homologated Refinancing Agreement and (ii) the stated transactions grant the debtor a preferred acquisition right in the case of sale of the shares or securities thereunder[13] to third parties or to non-holding companies. For these purposes, an independent expert (appointed by the Mercantile Court where the debtor is domiciled) will need to have determined whether or not a capitalization would have been reasonable, before the debtor rejected it. This raises the curious possibility that creditors might request the opinion of an independent expert as regards the reasonability of the capitalization proposal before discussing it with its debtor. The debtor and its creditors are entitled to request the appointment of an independent expert. The New Reform recognizes the possibility of the existence of several independent expert reports and states that if such a situation were to arise, the opinion of the majority of the expert reports would prevail as to the reasonability of the capitalization proposal. Such a case could lead to yet another curious possibility that a single party could request more than one report. The New Reform does not address questions of how to set deadlines or handle the potentially ensuing chaos.

Leaving aside the above uncertainties, in our opinion the "guilty insolvency" provision could be interpreted as a material change to one of the more fundamental principles of Spanish Insolvency Law. Before the

New Reform there was no point at which a ‘duty shift’ on directors (or shareholders) arose, as it occurs in other jurisdictions. This new regime has changed the situation (for better or worse) for participants to restructurings where directors and/or shareholders are blocking potential restructurings solutions. The Spanish lawmakers, to support the viability of Spanish companies, have now limited the right that directors and/or shareholders previously had to veto creditor-led restructurings proposals.

Subordination

The New Reform aims to provide comfort to signatories to a 71bis Refinancing Agreement or to a Homologated Refinancing Agreement. The New Reform states that a creditor who becomes a shareholder of the debtor by means of a capitalization of its claims in the context of a 71bis Refinancing or a Homologated Refinancing Agreement shall not be regarded as a 'specially related person' to the debtor (*i.e.* meaning the claims of the creditor-turned-shareholder will not become subordinated and the creditor-turned-shareholder will not lose its right to vote on a composition agreement nor lose its security). In addition, the New Reform states that unless proven otherwise, creditors who have subscribed to a 71bis Refinancing Agreement or a Homologated Refinancing Agreement shall not be deemed a shadow director of the debtor in respect of those obligations assumed by the debtor as part of the viability plan (*e.g.* the creation of a steering committee). This welcome amendment mitigates the risk for creditors to be regarded as a shadow director (and hence subordinated) within a restructuring process. Nevertheless, the last reference to the viability plan does not seem fully appropriate as under the new 71bis Second Section Refinancing Agreement a viability plan is not required. We understand the New Reform intended to make reference to the 71bis Refinancing or a Homologated Refinancing Agreement itself rather than to the viability plan.

Other related provisions

The Bank of Spain shall — by no later than April 2014 — issue the criteria for the classification of the transactions restructured by means of 71bis Refinancing Agreement or a Homologated Refinancing Agreement as 'normal risk.' This shall presumably deter banks from making similar provisions. Further, we expect guidance will be forthcoming on how this would fit in with Basel III.

The New Reform also provides for certain relevant tax provisions related to debt capitalization transactions. Prior to the New Reform, certain debt-for-equity swaps could lead to the recognition of book (and tax) income at the debtor entity level. The New Reform amends the Spanish Corporate Income Tax (CIT) Act and provides for a special rule that allows a debtor entity not to be taxed upon debt capitalization transactions regardless of the transaction’s accounting treatment and of the capitalized debt’s fair market value. To the extent that the amount of the share capital increase performed as a consequence of such capitalization matches the amount of the liability corresponding to the capitalized debt in the books of the debtor entity, no taxable gain should be recognized. This is good news for debt-for-equity swap transactions. Nevertheless, capitalization transactions might trigger a taxable gain at the level of the creditor party, if the capitalized debt was acquired from a third party at a discount.

Furthermore, the New Reform provides for a special rule whereby the recognition of income derived from haircuts and enforcement stays (implemented in accordance with the Insolvency Law) is deferred until the moment the debtor entity is required to book financial expenses relating to such indebtedness. In other words, such income may be offset with matching financial expenses accrued in respect of such debt, thereby reducing the taxation that would have otherwise arisen. In case the amount of income required to be recognized exceeds the amount of pending financial expenses, such income should be recognized for CIT purposes following a pro rata formula. Public deeds providing for debt haircuts or reductions as a consequence of refinancing agreements and out-of-court payment agreements pursuant to the Spanish Insolvency Law, are already deemed exempt from Spanish stamp duty.

Some exceptions to the Spanish public offering regime have also been introduced. For example, a creditor which obtains a relevant participation in the debtor's share capital by means of a Homologated Refinancing Agreement does not need to obtain dispensation from the Spanish market stock regulator to launch a public offering. Note that the debtor does not necessarily have to be in insolvency proceedings.

The New Reform clearly sets out that the scope of application of the Spanish Insolvency Law (as amended) does not comprise the security granted by Royal Decree Law 5/2005, of 11 March (which implemented in Spain Directive 2002/47/CE of 6 June 2002 on financial collateral arrangements). In this sense, Royal Decree Law 5/2005 of 11 March is to be regulated by its own provisions which provide secured lenders with material enforcement advantages and insolvency protection. That is to say, neither the general insolvency moratorium nor the moratorium stemming from a 5bis communication shall affect a security governed by Royal Decree Law 5/2005 of 11 March.

Pending ....

We are all seeing that business sales (à la pre-packs in the UK) are currently gaining momentum within insolvency proceedings (whether or not within the liquidation phase) as they are probably the most effective way to maximize the debtor's assets' proceeds of sale. However, the Insolvency Law remains unclear, in particular, as to whether the subrogation of Social Security claims is mandatory or not. There have been contradictory court rulings in this regard and the consequences may be quite material. Consequently, we had been expecting a clarification in this regard.

The amendment to the Spanish Insolvency Law carried out in 2011 introduced a new section 90.1.6 regarding pledges over future credits rights. The stated 2011 reform introduced a further change pursuant to which pledges over future credit rights need to be registered in order to be recognized within an insolvency proceeding. Sadly, section 90.1.6 suffers from extremely inconsistent drafting which has generated a debate regarding pledges over future credit rights. A missed opportunity, we feel.

Conclusion

The New Reform aims to reinforce the pre-insolvency stage and add to the available restructuring tools so as to avoid, to the extent possible, the start of insolvency proceedings and ensuing liquidations. An additional safe harbor has been built-in which does not require a majority support, the so-called Spanish scheme of arrangement has been materially strengthened, and it now appears that the debtor's directors and shareholders have a duty to consider the interests of creditors.

The New Reform is generally welcome as one step further in the right direction, but is probably not the last one. We look forward to seeing how the courts will apply this new regime. Theirs will not be an easy task, as implementation will most probably cause controversy as the New Reform raises some fundamental questions and leaves some unfortunate gaps.

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Endnotes

[1] In this Client Alert references made to pre-insolvency shall be read as a stage prior to the commencement of the insolvency proceedings.

[2] Nevertheless, the new provisions regarding the 71bis Refinancing Agreements will not apply to those refinancing agreements entered into pursuant to the former section 71.6 of the Spanish Insolvency Law (now a 71bis First Section Refinancing Agreement) where the debtor has already requested to the Mercantile Registry the appointment of the independent expert (unless the parties thereto agree to submit the stated refinancing agreement to the new rules brought by the New Reform).

[3] It seems that just a mere representation by the debtor will not suffice but neither is it clear what sort of proof the court will request.

[4] The value of the security interest must be calculated in accordance with the rules set out by the New Reform in respect of the Homologated Refinancing Agreement (see paragraph (e) of section Homologation of pre-insolvency refinancing agreements by a court below). This means that the maximum loan-to-value is 123.46 percent.

[5] An act should not be regarded as detrimental (and thus subject to a claw-back action) if it necessarily accompanies a "justified sacrifice." Courts generally understand that a transaction involves a justified sacrifice if it can be considered the most

reasonable course of action to prevent further deterioration of the insolvency estate, even if it comprised the granting of new security, for instance.

[6] As from 9 March 2016, the former regime will apply again (i.e. 50 percent of the new money in a refinancing will be regarded as an estate claim) and the remaining 50 percent will be regarded as a general privilege claim).

[7] Therefore, this might be a useful tool if the new money is not secured or if the value of the available collateral does not cover the new money.

[8] As certain effects of pre-insolvency homologated refinancing agreement by a court may be imposed into certain dissenting or not participating creditors, these agreements have been known as the Spanish Scheme of Arrangement. Please review our previous Client Alerts **Spanish Insolvency Law Amendment: Refinancing Agreements Homologation Majority Rate Lowered to 55 percent** and **Mercantile Courts of Catalonia to Follow "Celsa" Rationale**.

[9] Indeed, the Spanish Insolvency Law initially did not contemplate a procedure similar to the UK schemes of agreements by means of which an agreement approved by the requisite majority of creditors and sanctioned by the court may be imposed on dissenting parties.

[10] Note that until last September 2013 the threshold was 75 percent.

[11] The New Reform sets out rules to assess the reasonable value of the collateral depending on the nature of the same.

[12] Profit participation loans (*préstamos participativos)* are a type of loans subordinated to common creditors by virtue of Royal Decree Law 7/1996, of June 7 1996 which, should they meet the necessary requirements to be classified as such, mainly offer the advantage of being considered as equity for certain corporate purposes (capital impairment situations). Another notable characteristic of the profit participation loans is that they must set a variable interest linked in some manner to the performance of the borrower's business.

[13] This may raise potential logistic difficulties in respect of, for instance, block trades.