Country Report: Reforms in Spain

The Spanish Council of Ministers passed on 7 March 2014 the Royal Decree-Law 4/2014, on urgent matters in relation to refinancing agreements and debt restructuring. The main purpose of the new law is to ease the successful completion of refinancing and debt restructuring processes.

Here we focus on the major reforms with updates from three separate authors, each giving us their views on different aspects of the reforms: **Agustín Bou** (pre-packs), **Dr. Bernardino Muñiz** (cramdown) and **Alberto Álvarez Marín** (moratorium), with a final update from Agustín Bou.

AGUSTIN BOU
Partner, Jausus Legal
(Barcelona and Madrid)

THE NEW REGULATION MAY BE A GOOD TOOL FOR BIG COMPANIES, BUT IT WILL NOT SOLVE THE PROBLEMS AFFECTING SMALL AND MEDIUM ENTERPRISES

Pre-packs

Royal Law Decree 4/2014, of 7 March (the "Reform"), deals among other things, with the relaxation of pre-pack schemes in Spain in order to achieve the restructuring and refinancing of indebted companies, to try to prevent viable companies filing for insolvency and disappearing, provoking an impact on the economy and the loss of many jobs.

The Reform has moved the Spanish Insolvency Law ("**LC**") closer to the Insolvency systems of surrounding OCDE country members, even though too many formalistic requirement are still in place.

Two types of refinancing agreements can be proposed under the new regulation: (i) "Individual Agreements" which may be subscribed by the debtor with one single creditor or several of them and (ii) "Collective Agreements" which would affect all financial creditors. It is important to outline that, whilst an Individual Agreement could be subscribed with any creditor, holder of a credit against the debtor, Collective Agreements apply only to financial creditors (regardless if they are financial institutions or not). As a matter of fact, only collective agreements can be considered as a pre-pack.

The main scope of such agreements is to give protection to the creditors involved against potential clawback actions that could be started in the event the debtor would file for insolvency later on, as agreements adopted according with the regulation could not be declared void or voidable.

Collective Agreements are submitted to several restrictions and have to follow formalistic requirements and can include different options, including stays of no longer than 10 years, debt write off, debt equity swaps and payments in kind. This means a lot of flexibility in order to make a tailor-made proposal that could fit all financial creditors. It is important to outline that proposals when starting the refinancing proceeding can be made only by the debtor, but once the proposal has started, creditors can also make counter offers.

LC requires several conditions to be met in order to consider the agreement non voidable, requirements that will make the agreement, in many cases, very difficult to implement. Once again, Spanish regulators have missed the opportunity to take brave decisions because of the lack of trust in the players.

Requirements range from keeping a proportionality between the new lending (fresh money) and the new assets given as guarantee in relation with previous liabilities, the value of the new warranties given by creditors and the interest rate applicable to the operations. Generally speaking, the protection given to the creditors taking part in the refinancing will be less important than the new risks taken as i.e. new guarantees cannot cover more than 90% of new financing; interest cannot be increased by more than 33%, etc.

Such requirements, included the fact that interests due, in the event of a future insolvency, will be treated as subordinated debt, do not make very attractive for lenders to assume new risks and to accept refinancing the company.

The agreements do not need anymore the report of an independent expert appointed by the Companies' Registry being replaced such requirement by a certificate issued by the company's auditor, assessing the required majority to approve the agreement has been met, so these agreements could be faster and cheaper but, in practice, it is strongly advisable to keep asking for the independent expert report as one of the key elements of the protection against clawback actions is precisely assessing the fact that not too many guarantees have been provided to the refinancing and that the agreement is fair for creditors, and this only can be achieved by means of such report.

In our opinion, the new regulation adopted may be a good tool for big companies, but it will not solve the problems affecting small and medium enterprises where the banks would be less keen to enter into refinancing agreements and it is hard for us to imagine the financial creditors entering into debt-equity swap schemes in small companies where they will never able to control the course of the business without devoting a huge amount of resources to it.

Cramdown

Significant changes in the cramdown regime of refinancing agreements (which was virtually non-existent until 2012) have been introduced by the Royal Decree-Law 4/2014 ("RDL 4/2014").

(a) Scope: Financial liabilities

RDL 4/2014 clarifies that the percentage of the creditors needed to endorse a refinancing agreement shall be calculated over the total financial liabilities of the debtor (regardless of who is the creditor). The former wording of the endorsement provision referred to claims held by "financial institutions" but did not provide a definition of such institutions.

Therefore, according to RDL 4/2014, a refinancing agreement shall be endorsed by creditors representing 51%, 60% or 75% of the financial liabilities (*pasivo financiero*) of the debtor.

For syndicated facilities, it shall be deemed that all of the lenders of a syndicated facility have voted in favour of the refinancing agreement when creditors representing 75% (or a lower percentage if so provided for in the syndicated facility agreement) of such a syndicated facility vote in favour of the refinancing agreement. This permits to override the veto power of dissenting creditors in matters which according to the facility agreement require unanimity.

(b) Value of the in rem security

Prior to the approval of RDL 4/2014 dissenting creditors holding *in rem* securities could not in principle be crammed down.

The new regulation introduces the concept of "*Value of the in rem Security*" as a key concept for the endorsement of refinancing agreements to secured creditors. The RDL distinguishes between (i) the amount of the credit covered by the *Value of the in rem Security* and (ii) the amount of the credit which exceeds the *Value of the in rem Security* this latter part of the credit being easier to cram down since the effects of the endorsement will be applied to it as if it was an unsecured credit.

The *Value of the in rem Security* (the value shall rank between zero and the amount of the secured credit), will be an amount equal to 9/10 of the reasonable value of the asset given as collateral (depending on the kind of asset, e.g. real estate, movable asset, securities – the RDL 4/2014 provides for different procedures for its calculation) less the outstanding debt secured by the relevant collateral (provided, however, that such *Value of the in rem Security* may not be lower than zero nor higher than the outstanding balance of the secured debt).

(c) Effects of the endorsement

Creditors representing 51% of financial liabilities

If the refinancing agreement is approved by creditors representing 51% of the financial liabilities of the debtor, the agreement will be protected against clawback actions under the Spanish Insolvency Law, but cramming down dissenting lenders will not be possible.

Creditors representing 60% of financial liabilities

If the refinancing agreement is approved by creditors representing, at least, 60% of the financial liabilities of the debtor, the following terms of a refinancing agreement may be crammed down on dissenting lenders (not secured by an *in rem* security) and on dissenting secured lenders, but only with respect to the amount of debt that exceeds the *Value of the in rem Security*:

(i) stays for a term of no more than five years; or
(ii) conversion of credits into profit participating loans with a tenor of no more than five years.

The same effects may be extended to the amount of the credit covered by the *Value of the in rem Security* when the refinancing agreement is approved by creditors representing 65% of the total *Value of the in rem Securities*.

Creditors representing 75% of financial liabilities

If the refinancing agreement is approved by creditors representing, at least, 75% of the financial liabilities of the debtor, the following terms of a refinancing agreement may be crammed down on dissenting lenders (not secured by an *in rem* security) and on dissenting secured lenders, but only with respect to the amount of debt that exceeds the *Value of the in rem Security*:

(i) stays for a term of no more than 10 years;
(ii) conversion of credits into profit participating loans with a tenor of no more than 10 years;
(iii) debt write off (not limited);
(iv) capitalisation of debt (dissenting lenders may however opt for a write off instead of such capitalisation);
(v) payment in kind of debt; or
(vi) conversion of debt in convertible notes, subordinated debt, payment in kind interest loans or any other financial instrument with tenor, ranking or other features different form the original debt.

The same effects may be extended to the amount of the credit covered by the *Value of the in rem Security* when the refinancing agreement is approved by creditors representing 80% of the total *Value of the in rem Securities*.

DR. BERNARDINO MUÑIZ
Hogan Lovells International LLP (Madrid)

RDL 4/2014 CLARIFIES THAT THE PERCENTAGE OF THE CREDITORS NEEDED TO ENDORSE A REFINANCING AGREEMENT SHALL BE CALCULATED OVER THE TOTAL FINANCIAL LIABILITIES OF THE DEBTOR

ALBERTO ÁLVAREZ MARÍN
Mariscal & Asociados (Madrid, Barcelona, Palma de Mallorca)

Moratorium

The Reform recognises that there existed a degree of inflexibility within certain aspects of Spain's pre-insolvency and insolvency regimes that was discouraging financial creditors from entering into refinancing arrangements.

Hence the Reform pursues to encourage the refinancing discussions by, among others, providing a more firm pre-insolvency environment in which the main assets of the debtor are protected against enforcement by unsecured creditors.

In a nutshell, the Spanish insolvency arena has been constantly evidencing that although an insolvent company may be viable from an operational perspective, at the end it ends up in liquidation due to its excessive debt burden.

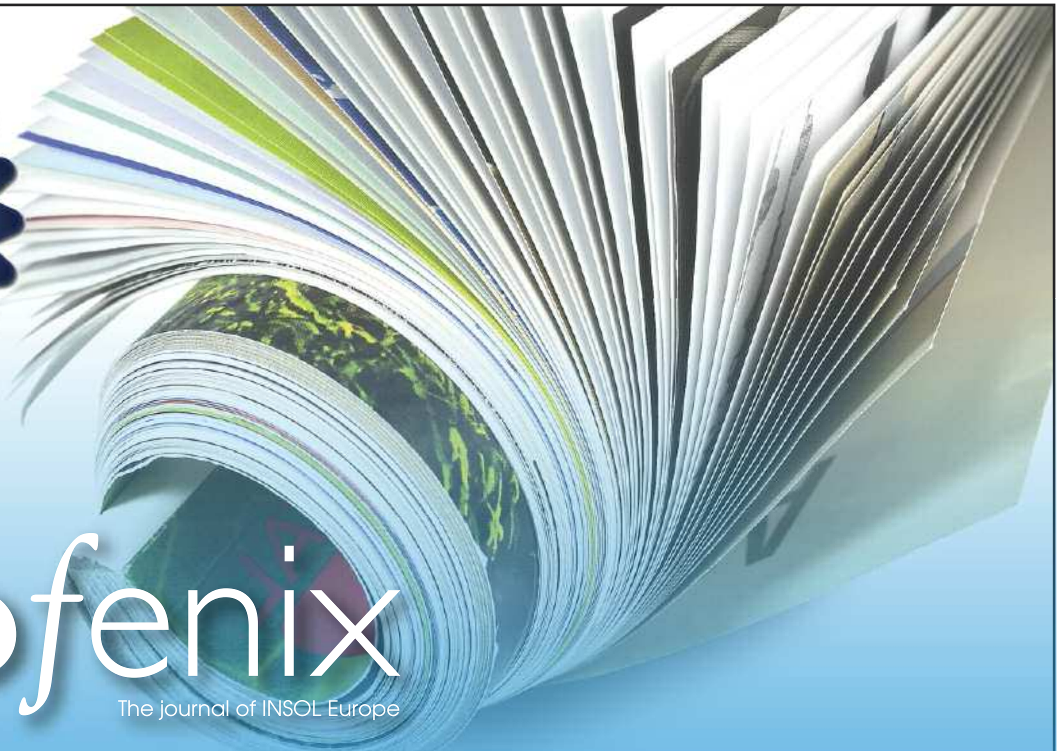
Under the Spanish Insolvency Law, directors of a company are obliged to file for insolvency within a period of two months from the date when they knew or should have known that the company is unable to regularly comply with its obligations when they become due and payable (the so called "*liquidity test*"), being in a situation of actual insolvency (*insolvencia actual*).

As an exception to the directors' obligation to file for insolvency, Section 5 bis of the Spanish Insolvency Law (the "**5bis Communication**") provides that if a debtor notifies the Court that it has started negotiations with its creditors to seek support for either (i) an out-of-court refinancing agreement or (ii) an early composition agreement, it will have a three months additional grace period to reach the agreement and one more to file for insolvency, provided that it files the notice with the Court within the two-month limitation period (the so called "*2+3+1 rule*").

In the event directors breach their duty to file for insolvency, the insolvency may be declared guilty and the directors may be held liable.

Traditionally, the main effect of filing for pre-insolvency by means of the 5bis Communication has been the protection of the debtor from having only a two-month grace period to file for insolvency, and even the advantage of not filing for insolvency at all.

Under the new drafting of the 5bis Communication pursuant to the Reform, the 5bis Communication may also stay (i) any judicial enforcements over assets which are necessary for the continuity of the debtor's activity, (ii) any enforcement of security rights encumbering assets necessary for the continuity of the business, and (iii) any enforcement of financial claims provided that creditors representing at least 51% of such financial debt have expressly supported the commencement of negotiations under Section 5 bis.



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Further Bankruptcy Act reforms ahead...

Agustin Bou adds a final update: Merely one month and a half after the reforms of the Spanish Insolvency Law ("LC") were introduced, as already talked about in the preceding pages, a new and substantial amendment to LC has been proposed to the Parliament.

Up until now, the public creditors had been left out of the reform. These privileges of public creditors have received criticism from the International Monetary Fund itself, who reminded the Spanish Government that most of the debts of small and medium-sized companies are to public creditors.

Moreover, this Reform is intended to be applied to refinancing processes that are initiated from its entry in force, which took place on 9 March 2014, so it may not apply to companies that had already filed for insolvency, such as Pescanova, or in cases where an agreement with grave difficulties of compliance has been approved, as happens with the quoted real estate company Martinsa Fadesa.

Moreover, following the approval of the Reform, the European Union Gazette published the Commission Recommendation of 12 March 2014 concerning a new approach to insolvency and business failure, which urges the European countries not only to establish a framework for the efficient restructuring of viable companies with financial difficulties, goal that the RDL 4/2014 pursues, but also to provide the system with mechanisms that provide a second chance to frustrated entrepreneurs, allowing for total debt forgiveness, except in cases of dishonest acting or bad faith. However, the Spanish insolvency framework lacks efficient mechanisms to ensure this vital second chance.

In order to solve these loopholes, although the official argument shows the willingness to make improvements, the Government has decided to deal with RDL 4/2014, and validated in the House of Representatives on 20 March 2014 (BOE No 74 of 03.26.2014), a bill which will also be used for improving the liquidation proceedings in the sense of providing for the assignment of contracts, permissions and licenses without the consent of the contracting parties in case of sale of the production units and allowing for the same restructuring and refinancing schemes applicable on pre-insolvency to apply during the insolvency.

However, the sticking point of this new reform will be the abolition of the privileges held by the public creditors.

The new reform is expected to be approved by the Parliament next fall, merely five months after the last amendment. Thus, since 2009, four main reforms of the Spanish insolvency law have been approved, but this has not prevented 95% of insolvent companies in Spain from going into liquidation. Only time will tell if the next reform will be able to provide the ultimate solution to this alarming destruction of the Spanish network of businesses. ■

SPANISH LAWMAKERS HAVE NOT YET REACHED A FORMULA THAT PREVENTS THE 95% OF INSOLVENT COMPANIES IN SPAIN GOING INTO LIQUIDATION

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