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Spain: Radical changes in the regime governing refinancing agreements aimed at avoiding insolvency proceedings

Key highlights

- **Art. 5 bis.** Notification of the start of negotiations can be used to block enforcement
- **Art. 56.** Enforcement of security. The enforcement of pledges over shares of a holding company is not restricted
- **Art. 71 bis.** The treatment of refinancing agreements protected against claw-back is made more flexible and a second scenario is introduced that does not require a report
- **Art. 84 and Second Additional Provision**. Preferential treatment of new money is extended
- **Articles 92 and 93.** A party that becomes a shareholder and finances the company at the time of the refinancing is not subordinated
- **Art. 165.** Presumption of negligence for the purposes of the insolvency proceedings for the administrators and shareholders that prevent certain refinancing
- **Fourth Additional Provision**. The scope and effects of the approval of the refinancing agreements (which could even affect secured creditors) are considerably extended and are protected against claw-back
- **Relaxing of the provisions regime**
- **Extension of the rule for calculating losses due to deterioration related to the real estate sector**
- **Public offering regime**
- **Tax regime**
- **Entry into force**

Royal Decree Law 4/2014, of 7 March, makes significant amendments to the Spanish Insolvency Law that affect refinancing transactions in particular. Most of the amendments come into force immediately.

By virtue of this reform, two major changes have been made: i) the catalogue of refinancing agreements excluded from the claw-back regime has been extended by introducing a new scenario that does not require a majority and ii) the pre-insolvency mechanisms that did not exist in Spain a few years ago now permit the majority to impose on the dissenting minority debt reduction agreements or debt for equity conversions, which in some cases will cram down even secured creditors.

As is the case with any legislative amendment of this scale, it is not possible to determine the significance of this reform until we become aware of how the courts will interpret it. The purpose of this note is not to provide an exhaustive analysis of the content of Royal Decree law 4/2014, but to point out the main changes it contains, provisionally and without any intention of giving a definitive opinion on its scope.

Additionally, we will briefly refer to significant tax modifications that aim to minimise the cost of certain transactions that are common in the context of the Insolvency Act, as well as in other debt restructuring processes for operating companies.

Article 5 bis. Notification of the start of negotiations can be used to block enforcement

As had been the case previously, the debtor is authorised to inform the judge that would hear the insolvency proceedings of the start of negotiations with creditors, whether they now refer to the attainment of a refinancing agreement of the sort established in the new Article 71 bis.1 of the Act, or the Fourth Additional Provision, or to an advance proposal for an agreement with creditors

It is possible to stipulate the confidential nature of this notification, in which case it will not be made public.

The main change of this mechanism is that it now automatically suspends: i) the enforcement of security over assets needed for the debtor’s business or professional activity (if initiated, it will be stopped, and if it was already underway, it will be suspended) and ii) enforcement over other assets when the majority of them have entered into an agreement that prevents such enforcement (such as a “lock-up agreement”).

Article 56. Enforcement of security. The enforcement of pledges over shares of a holding company is not restricted

It is made clear that the enforcement of security will only be affected by insolvency when it entails assets necessary for the continuity of the business or professional activity.

Otherwise, the new wording of this provision is confusing.

In general, the shares of companies exclusively devoted to holding an asset and the liabilities needed to finance them are not considered necessary (and therefore security could be enforced over them at any time). There is one exception: the scenario in which the enforcement of that security could cause the early termination or the resolution of contractual relationships coupled with the cessation of the activity (for example, when there is a change of control clause that results in the early termination of the obligations of the subsidiary). However, neither the rule nor the exception are clear and their interpretation is even further complicated due to the reference in the Recitals to the scenarios in which it is possible to dissociate ownership from the right of use and enjoyment.

Article 71 bis. The treatment of refinancing agreements protected against claw-back is made more flexible and a second scenario is introduced that does not require a report

Refinancing agreements and related transactions (including the assignment of assets in or for payment) that respond to a viability plan cannot be rescinded in two cases:

- The first paragraph maintains the scenario of the agreement approved by 60% (3/5) of the debtor's liabilities, although the expert report is substituted by an auditor's report, which certifies the attainment of the required majority (nothing further).
- The second paragraph adds that agreements which do not fall under the above paragraph (for example, because they do not affect all of the debtor's creditors, but only some of them), but comply with all of the following requirements also cannot be rescinded: i) they increase the ratio of the asset over the liabilities (reducing gearing); ii) the resulting current assets are greater than current liabilities (there is no short term distress); iii) the scope of the security does not increase and is not greater than 90% of the remaining debt in favour of the affected secured creditors (the creditors are not over-secured, rather the debtor still has a margin free of charges); iv) the resulting interest in favour of the intervening parties is not increased by more than one third (the creditors do not considerably raise the interest); and v) the parties enter into a public deed wherein they justify the fulfilment of these requirements.

In both cases, the debtor as well as the creditors may request the appointment of an independent expert to provide a report on the viability plan and proportional nature of the guarantees.

All of these agreements may be challenged by the Insolvency Receivers only when the above-mentioned requirements are not actually met.

Article 84 and Second Additional Provision. Preferential treatment of new money is extended

The following will be considered debt against the insolvency estate and therefore become pre-deductible: i) new money lent in the context of a refinancing agreement of the kind contemplated in Article 71 bis or in the Fourth Additional Provision, for half of its amount (except if the lender is a specially related entity) and ii) money lent in the context of an agreement with creditors, in full.

During the following two years the new money referred to in paragraph i) above will be debt against the insolvency estate for its full amount, regardless of whether it comes from a specially related entity. Surprisingly, the subordinated nature of the interest on these types of financing is maintained unless they are effectively covered by security.

Articles 92 and 93. A party that becomes a shareholder and finances the company at the time of the refinancing is not subordinated

Debt owed to a party that becomes a specially related entity as a result of transforming debt into capital in the context of a refinancing process established in Article 71 bis.1 or in the Fourth Additional Provision will not be subordinated.

Unless proven otherwise, creditors that have entered into one of the refinancing agreements will not be considered shadow directors.

Article 165. Presumption of negligence for the purposes of the insolvency proceedings for the administrators and shareholders that prevent certain refinancing

Negligence is presumed when the administrators have refused to sign a refinancing agreement of those mentioned above that entails transforming the debt into capital or a convertible instrument, without reasonable cause (this will be understood to happen when an independent expert has certified this in advance).

In this scenario, the shareholders, in addition to the administrators, that have prevented the refinancing agreement could be made responsible for the insolvency.

In any case, in order for the refusal of the conversion to be determined negligent in insolvency proceedings, the proposed agreement must acknowledge in favour of the debtor’s partners a preferential acquisition right over the securities subscribed by the creditors by virtue of the conversion in the event of subsequent transfer thereof (except to entities in their group or to companies holding participations in other entities).

Fourth Additional Provision. The scope and effects of the approval of the refinancing agreements (which could even affect secured creditors) are considerably extended and are protected against claw-back

- The majority needed to apply for homologation has been lowered (which, as mentioned, no longer needs an expert, but an auditor's report) to 51% of financial liabilities (this special majority displaces the 60% of the total liabilities, which is not required).
- Judicial approval in itself excludes the risk of claw-back; to apply the content of the agreement to dissenting creditors, the largest majorities referred to below must be met.
- The doubt regarding the concept of "liabilities held by financial entities" has been clarified. Financial debt will be considered as such (i.e. excluding commercial liabilities and that of public administrations), even though its holder is not subject to financial supervision. Debt held by specially related persons is excluded.
- For the purposes of calculating the majority, it will be understood that all of a syndicate votes in favour when 75% support has been reached within the syndicate or, if less, the majority required to adopt such an agreement.

By virtue of the approval, the following can be applied to the dissenting minority:

- With the support of 60%: extension of debt maturity for a term less than five years and conversion of debt into a participating loan during that time.
- With 75% support: extension of debt maturity of between five and ten years, conversion of debt into a participating loan or similar instrument for an equal term, converting the debt into capital or a participating loan, assignment of assets.

The approval can even affect the secured financial creditors provided that this is agreed by a qualified majority of the creditors (65% for a maturity extension or a transformation into a participation loan for a term of up to five years; 80% for the rest of the effects considered in the Fourth Additional Provision).

Approval corresponds to the Judge that is competent to declare the insolvency proceedings, i.e., the Spanish Judge when the centre of principal interests (centro de intereses principals) ("COMI") is in Spain (it is presumed that the COMI coincides with the registered address).

Relaxing of the provisions regime

Reform of banking legislation is envisaged in order to be able to reclassify at a normal risk the result of a refinancing transaction of the Fourth Additional Provision when three months have elapsed since the approval without a breach.

Extension of the rule for calculating losses due to deterioration related to the real estate sector

The exclusion of losses deriving from deterioration related to the real estate sector from the calculation for the purposes of the existence of an obligatory reason for dissolution will be extended during 2014.

Public offering regime

The scenario of acquiring a significant stake deriving from the transformation or capitalisation of credits in listed companies that are in serious or imminent danger has been excluded from the need to launch an initial public offering. These were meant to provide long-term viability subject to the CNMV’s prior authorisation (which will not be necessary when the refinancing agreement has been subject to judicial approval).

Tax regime

The tax measures can be summed up as follows:

- **Capitalisation of debts:** For the purposes of the Spanish Corporate Tax, capital increase transactions carried out by offsetting credits will be assessed by the corporate amount of aid increase, and not the accounting amount, which would entail, in principle, that there will be no tax revenue in this scenario, except in cases in which the creditor has acquired the credit from a third party and for an amount less than its face value.
- **Tax deferral of the revenue deriving from the debt reduction:** A tax deferral of the income obtained as a result of the reduction and moratorium of debt is established, allowing its allocation for the purposes of the Spanish Corporate Tax to be carried out while the debtor registers financial expenses deriving from the debt that is subject to the debt reduction. This allows the offsetting – in the same financial year – between the income deriving from the debt reduction and the financial expenses that are paid as of that time, minimising therefore the immediate tax impact that otherwise could be generated by the debt reduction.

- **Exemption in the Transfer Tax and Stamp Duty:** An exemption is established in relation to the Transfer Tax and Stamp Duty (*Impuesto sobre Transmisiones Patrimoniales y Actos Jurídicos Documentados*) (ITP-AJD) for public deeds that document debt relief or reductions of financial obligations, provided that such transactions are included in the refinancing agreements or in the out-of-court payment agreements established in the Insolvency Act. Additionally, the debtor must also hold the capacity of taxpayer. In contrast to the exemptions contained in Law 2/1994, of 30 July, which regulates the subrogation and modification of Mortgage Loans, the exemption that is now approved refers to any type of financial transaction, whether it is a loan, credit or other obligation of the debtor. Thus, for this new exemption there are no interpretive doubts regarding the possibility of applying said exemption according to the nature of the financing transaction.

Entry into force

The entry into force of the Royal Decree Law has been immediate upon publication, with some exceptions. For example, it does not apply to the refinancing processes in which the appointment of an expert has been requested prior to its entry into force, unless otherwise voluntarily sought. As regards the Spanish Corporate Tax, the approved amendments will apply to financial years begun as of 1 January 2014.

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