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EQUITABLE SUBORDINATION IN SPANISH INSOLVENCY PROCEEDINGS: A NECESSARY REFORM

The regime for classifying the credits of specially related parties ("**SRPs**") as subordinated has been an impediment in refinancing processes. This could soon change.

Key issues

- Specially related persons in insolvency: subordination and loss of guarantees
- The difficulty avoiding the regime applicable to SRPs
- The Covid-19 regime
- Imminent reform of the Insolvency Act
- Conclusion

1. SPECIALLY RELATED PARTIES IN INSOLVENCY: SUBORDINATION AND LOSS OF GUARANTEES

The concept of SRPs was introduced in Spain with the Insolvency Act of 2003. To summarise, when a company is declared insolvent, SRPs refers not only to the *de facto* and *de jure* directors, but also to shareholders with a stake of more than 10% or 5% (depending on the type of company) and group companies.

In both cases, the special relationship must have existed when the credit came into being. Accordingly, creditors who later become shareholders will not be considered SRPs on the basis of their original credit.

The main consequences of the SRP status are as follows:

(i) the classification of credits as subordinated: SRP creditors do not vote if there is an insolvency arrangement or refinancing agreement; and

(ii) the automatic cancellation of *in rem* guarantees (pledge or mortgage) created in favour of the SRP.

There are no exceptions to this equitable subordination regime, which is counterproductive in a refinancing context. It is often only related persons or entities that are willing to support continuity in the face of financial difficulties, but the expectation that credits will be classified as subordinated if things do not turn out well can dissuade them from providing financial aid.

2. THE DIFFICULTY AVOIDING THE REGIME APPLICABLE TO SRPS

Various ways of channelling the money contributed by a SRP while avoiding equitable subordination have been considered, but, for one reason or another, none of them represent a secure path.

It has sometimes been suggested to bring in a bank to act as lender, with a guarantee from the SRP. However, this mechanism would become evident in the event of insolvency, when the bank enforces the guarantee and the SRP becomes a creditor of the insolvent party, with the effects described.

The incorporation of apparently independent companies for the purposes of granting financing (whether a vehicle with opaque shareholders or an orphan

structure) is also a risky option, since the link may be considered to be confirmed given the impossibility of proving the identity of the shareholders.

The assignment of credits is not viable either: if the SRP grants the financing and then assigns it to a third party, the subordination rule will apply regardless if insolvency is declared within the two years following assignment. If the financing is granted by the third party and later assigned to a SRP, a judge may classify it as subordinated, understanding that the intent is to skirt the rule.

This being the case, the only sure way to avoid tainting new money would be to lose the status of SRP before refinancing (i.e. reducing the stake below 10% or 5%). However, this is not always possible.

3. THE COVID-19 REGIME

To prevent these issues, Act 3/2020, of 18 September, was passed at the height of the Covid-19 pandemic, recognising loans granted by SRPs after the declaration of the state of emergency as ordinary (or preferential, as the case may be), provided that insolvency is declared by 14 March 2022.

However, there are two conditions for applying this special regime:

(i) the financing must have been granted after the state of emergency was declared. That being said, the law does not clarify whether this includes only financing granted during the state of emergency (19 March to 9 May 2021) or also financing granted thereafter; and

(ii) most importantly, insolvency must be declared by 14 March 2022; if declared later, the general regime will apply.

4. IMMINENT REFORM OF THE INSOLVENCY ACT

This scenario could change in the future. While Spain has yet to transpose the European Directive on restructuring frameworks (Directive EU 2019//1023), the government has published a first draft reform to the Insolvency Act, which introduces new provisions in relation to the credit of SRPs (the "Draft Bill").

The changes would only apply to court-sanctioned debt refinancing. They would not apply to financing or refinancing concluded without court involvement.

The current Restated Text of the Spanish Insolvency Act establishes that new money in a refinancing process benefits from preferential treatment in subsequent insolvency proceedings (Article 704): 50% of its amount will be credit against the insolvency estate (pre-deductible) and 50% will be preferential credit (with preferential collection). However, the law expressly excludes new money granted by an SRP.

Articles 242 and 280 of the Draft Bill would allow SRPs to access this preferential treatment like any other creditor, provided that the credits affected by the restructuring represent more than two thirds of the total debt (deducting the credits held by SRPs). In other words, if a broad majority supports the restructuring, the subordination rule would not apply to the credit of SRPs.

Consequently, if the reform goes ahead, which is expected to occur in the second quarter of 2022, new money granted by an SRP in the context of

court-sanctioned refinancing (which will now be called interim or new financing) will finally avoid the rigid insolvency subordination rule.

5. CONCLUSION

The reform will be welcome. That being said, we question the reasoning behind limiting this treatment to court-sanctioned refinancing, which is always more complicated. We also do not understand the reasoning behind requiring the support of a qualified majority of creditors (refinancing already requires majority backing).

In any event, it is clear the time has come to revisit the rigid equitable subordination rule, beginning with the refinancing context, where adverse effects are notorious.

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