Insolvency reforms under the RD Act 4/2014 regarding the status of real security

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This paper sets out to make some considerations on the position of creditors holding real security (security in rem) within para-insolvency and insolvency refinancing procedures introduced or modified by Royal Decree Act (Order in Council) 4/2012 adopting urgent measures on business debt refinancing and restructuring. I will avoid the new scope of the avoidance of preinsolvency transactions under arts. 71 bis and 72 of the Spanish Insolvency Act (IA), which will be the subject of a subsequent paper. Nor will the calculation of the "value of (real) security" be discussed here.

Non-commencement and stay of enforcements during the "notice of negotiations" under art. 5 bis IA

There is little difference with unsecured creditors.

1. Until the entry into force of the RD Act, secured creditors could proceed with enforcement on ordinary terms as long as insolvency proceedings had not been opened and remaining conditions under art. 56 IA were met. Neither notice of the commencement of negotiations to reach a refinancing agreement or an early composition with creditors, nor an application for appointment of an insolvency mediator for the purpose of attempting an administered out-of-court settlement with the creditors, entailed a stay in the enforcement of security. In fact, one might think that such is still the rule after the reform, because art.5 bis (4)(III) is careful to clarify that "*(t)he provisions of the preceding two paragraphs shall not prevent secured creditors from exercising actions in rem against the property and rights over which the security rests*".

   "The provisions" in the aforementioned two paragraphs provide that *from filing of the notice* [under art. 5 bis itself] *and until the refinancing agreement under article 71 bis (1)* [but not the "atypical plurilateral" agreements under art. 71 bis (2)] *is formalised*, *or the court order giving the application for court homologation of the refinancing agreement permission to proceed is made, or the administered out-of-court settlement is adopted, or the necessary support for a court to make an order giving the early composition with creditors permission to proceed is garnered or insolvency proceedings have been opened, enforcements against property necessary for the continuity of a debtor's business or professional activity cannot be initiated*. Consequently, the wording of the rule leads one to believe that this reversal of the prohibition of art. 55 IA did not affect real security.

2. But this first impression is soon revealed as erroneous. Art. 5 bis (4)(III) continues to be expressed as follows: *notwithstanding that, once the proceedings have commenced, such are stayed while the statutory periods specified in the first paragraph of this sub-article have not elapsed*. The result seems nonsensical as ultimately the rule rejects what was initially suggested. *Once the proceedings have commenced*, the enforcement (execution) is

stayed *while the statutory periods* provided in general for the rest of the enforcements *have not elapsed*..

3. The proceedings *are stayed* whether the enforcement starts *after notice* or if such had started prior to the moment in time determined by art. 5 bis (1).

4. The structure of art. 5 bis 4 raises another problem. The enforcements, which we could call "singular", to which the first paragraph refers, are executions that would be levied against "necessary" property. But the enforcement of financial claims under the second paragraph are not subject to this restriction. Note that the rule here states that enforcements are stayed *provided it is proven that a percentage not lower than 51 per cent of financial liabilities have expressly supported the initiation of negotiations aimed at the conclusion of the refinancing agreement, undertaking not to initiate or continue individual enforcements against the debtor during the negotiations*. This generalised stay occurs even before the court gives the draft agreement approvable under the 4th additional provision permission to proceed, sufficing the existence of this *initial undertaking made* by the 51% majority; undertaking that *voluntarily* extends to the non-initiation of enforcements. If this distinction is correct, the question arising in the context of real security is whether the third paragraph of this sub-article (the enforcement of real security may be initiated, but is stayed) also includes the enforcement of security over unnecessary property within the meaning of the first paragraph, but affected by the circumstances and scope of the collective undertaking of the second paragraph. In my opinion, no, not even if the 51% attained comprises 51% of the claims holding real security.

Practical effects of the special rule

5. Either way, the result is that the enforcement is stayed. And this is what actually happened with enforcements in general, so it is unclear in what sense the general rule *does not prevent* secured creditors from bringing an enforcement action, since it obviously prevents the same, as if we were talking about an unsecured creditor. In *effective* terms, the only advantage that these secured creditors enjoy is that their enforcement is regarded as *initiated* (though stayed) before the insolvency proceedings, with the important consequence provided in art. 57(3) IA (cf. now first final provision RD-Act 4/2014) in the event of the insolvency proceedings plunging into liquidation. That is, they commence only to "secure" priority for the purpose of not being swallowed by the tide of collective enforcement on liquidation.

6. Therefore, the appropriate incentive is created for a secured creditor to file as soon as possible his claim to enforce, even if the parties are negotiating. This claim increases the creditor's future prospects of priority, as well as his bargaining *leverage*.

7. In the case of secured creditors, the 2014 reform not only produces a (simple) anticipation of staying effects, but also the imposition of an *ad interim* or *pro tempore* staying effect that makes no sense, as (necessarily) it will not be perpetuated when the agreement under the 4th additional provision is homologated or the (non-homologated) refinancing agreement under art. 71 bis is reached or the administered out-of-court settlement is approved. Only the effective opening of insolvency proceedings stays the enforcement of security. If in other cases this staying effect would not occur even with the successful conclusion of the various para-insolvency proceedings, the grounds that would justify the imposition of the stay as a protective measure slide away.

What does it affect and who exerts control?

8. The stay of enforcements at issue in art. 5 bis involves property *necessary for the continuity of a debtor's business or professional activity*. Although the rule does not explicitly mention this fact in the third paragraph and, as mentioned below, it is almost certain that the stay of enforcements under the 4th additional provision extends to all types of real security; here it is advisable to limit the scope of a restrictive rule with scarce rational basis.

9. Assuming that jurisdiction has not been taken yet by an insolvency judge, who will determine such a thing? It will have to be determined by the judge over the enforcement itself, as

results from the first final provision of the RD Act. The judge will refuse to grant an order of enforcement in these cases[1]. But this is only feasible in court enforcements of security, essentially only mortgages. Remaining real security - and especially the most liquid – is, to a greater or lesser extent, self-enforceable. Such cannot be stayed by any court order, and it is ridiculous to imagine that a creditor who has carried out self-enforcement should immediately retract, leaving it just *initiated*, though stayed. Even if a notarial enforcement (of pledges) were to apply, it does not seem that the legislature intended to confer on the notary competence to decide whether or not property is necessary for continuance as a going concern. In such a case the notary should recuse himself from acting, whatever the nature of the security.

10. Ordinarily, the civil judge over the enforcement will not have sufficient knowledge of the debtor company to be able to determine the necessity of an asset. Since there is no centralised decision either, different judges have made conflicting rulings. The problem still remains though the competent judge is the commercial court to whom the communication of art. 5 bis is made.

The stay of enforcements over "necessary" property with the opening of insolvency proceedings

Attached property and necessary property

11. The RD Act gives a new wording to art. 56(1) IA. In the new text, *creditors with security in rem over property of a debtor, subject to insolvency proceedings, that is necessary for the continuity of a debtor's business or professional activity, may not initiate the enforcement or compulsory realization of security until approval of an agreement, the content of which does not affect the exercise of this right, or until a year elapses from the opening of insolvency proceedings without the opening of the liquidation stage. In particular, shares of companies exclusively involved in the holding of an asset and liability necessary for its financing shall not be regarded as necessary for continuance of the activity, provided enforcement of the security granted over the same does not entail grounds for termination or amendment of the contractual relationships that, binding the referred company, allow the debtor to continue to exploit the asset*.

12. The first amendment does not appear to be a simple slip. In the text of the rule resulting from the reform by Act 38 /2011, the enforcements whose initiation was prohibited fell upon *property attached to the debtor's business or professional activity*. Only when it came to enforcements already begun, the stay was conditional on the property *not being attached to or necessary for the continuity of the debtor's business or professional activity*. It is true that the 2011 reform had made both phrases almost interchangeable, but in the original text of 2003 the aim of distinguishing the scope of both qualifications was clear. Indeed, for an enforcement to be initiated after the insolvency, it would have to fall on non-attached property. If enforcement had already been initiated, it would only be stayed if, in addition to attached, it was necessary for continuance. Consequently, even if it was just property *simply* needed for continuity, enforcements were not restrained or stayed if the property was not attached to the activity.

13. *Attached* property may exist that is not *necessary* for continuity. But in such a case, according to logic a material detachment occurs. On the other hand, there may be property *necessary* for the business activity that is not attached to the exploitation.

Effects of the reform

14. Today it is said that property necessary for business continuity, even if not deserving to be classified as attached to the exploitation, cannot be the subject matter of enforcement once insolvency proceedings have been opened. This resolves the old dilemma, the subject of disparate court pronouncements, as to whether the enforcement of real security over *money* on hand or on deposit or over *immovables* wherein the company is established, or from which ordinary administration work is conducted or the

[1] Unless it be understood that it is the commercial court judge who is notified under art. 5 bis. This point is not clear.

buildings or plots constituting goods for sale (e.g. housing) of such development activity can be stayed or restrained.

Also resolved in the affirmative is the question as to whether enforcement of a pledge over *negotiable securities* held by the company whose object is not the holding or management of negotiable securities can be stayed or restrained. It suffices that the thing (*res*) is necessary, in whatever way, for the company to continue as a *going concern*. Not much real security can aspire to escape this restriction. Consequently, the new rule states in plain terms that, in general, real security enforcement cannot be initiated or continued once insolvency proceedings have been opened, subject to the exceptions contained in other laws (e.g., in the RD Act 5/2005).

15. This denounces the *ratio* (reason) behind the change of rule stated in the Explanatory Notes as follows: *an amendment to article 56 is made to limit the cases of enforcement against property charged with real security to those necessary for the continuity of the business or professional activity*. Well, with this formula, the circumstances allowing for a stay of enforcement are *not limited but expanded*.

Assets unnecessary for business continuity

Shares of an asset holding company

16. The second reform that the RD Act formulates in art. 56(1) reads as follows. *In particular, shares of companies exclusively involved in the holding of an asset and liability necessary for its financing shall not be regarded as necessary for continuance of the activity, provided enforcement of the security granted over the same does not entail grounds for termination or amendment of the contractual relationships that, binding the referred company, allow the debtor to continue to exploit the asset*.

The above is regulatory text at its most convoluted. Not even the Explanatory Notes are able to clarify the intended purpose[2].

17. The most plausible interpretation is to understand that the insolvent debtor is the shareholder with shares or units in the company holding an asset. Encumbered assets would be shares, and the insolvent debtor shall be the holder of the same, not the target company in question. The company in question is a company exclusively involved in the holding of *an* asset and liability necessary for its financing. It is of scarce import whether the insolvent debtor is a core shareholder or a minority shareholder of the target company. Let us fix our attention on this. What one can deduce is that the creditor with security over the shares may "sell" the operating company through the enforcement over the shares and that the thing may be allowed in the specific incidental issue of enforcement.

18. But why must they necessarily be shares in a company that is exclusively involved in the holding of an asset? Regarding the insolvent shareholder, its investor activity in the capital of a company is or is not a *business* activity, regardless of whether the activity of the target company is or is not a business activity. Moreover, it may be that the holding of such shares is a thing *necessary* for continuity of the insolvent shareholder's business, regardless of any indirect connection to the underlying asset. Besides, if the holding of shares in a company of this kind is not a business activity, then neither will it be the holding of the immoveable, so that, if the company holding the immovable is the subject of insolvency proceedings, the asset in question may be pursued in enforcement proceedings, because it will be an *unnecessary* asset for the activity of this company. This shareholder may carry out other business, and holding the shares of the company holding an asset may be *necessary* for continuity. And yet, the

[2] Was the author of the relevant passage of the Explanatory Notes in his right mind?: (...) enforcements are really an impediment to business continuity when the separation of the right of disposition cannot be made without prejudice to the powers of use and enjoyment by the company. By way of example, article 56 introduces a case in which this dissociation can be done relatively easily without prejudice to the continuation of the activity: the stay of enforcements against shares of companies involved in the holding of an asset and liability necessary for its financing are excluded. This is to facilitate the financing of assets through structures and agreements that allow for a possible realisation with preservation of the property by the debtor with sufficient title, even if merely obligational, to continue exploiting it.

rule applies and enforcement proceeds. There are more things that make little sense: why should it be a company *exclusively holding an* asset? Can it not be several assets? Why can the pledge the creditor of the insolvent company has over its shares in the operating subsidiary not be enforced? Why is it "right" that a company holding an asset can be sold, but wrong to split an operating subsidiary with value?

The exception of unenforceability

19. What is the meaning of the very obscure final formula, establishing an exception to enforceability over these shares? In order to not speculate too much, let us stick to the literal sequence. Enforcement is stayed if it produces a *change of control* in the company holding the asset and such change of control is considered grounds for termination of contract(s) with third parties through whom the *insolvent debtor* had a right allowing the exploit the asset held by the holding company.

20. The result is whimsical, arbitrary. I am sure that there are plenty of equivalent or similar circumstances imaginable, and yet not covered. Note, for example, these: a group company (not insolvent) gives security over its immovables, where the company sits exploited by another group company, which enters insolvency proceedings, and then the mortgage is foreclosed, evicting the insolvent company; the insolvent company operates an immovable through a lease with the owner, the freehold of which is executed by a first-priority mortgagee due to default by the owner of the loan repayment; the insolvent company is a shareholder of the lessee company, which in turn subleased from the former, without being such company a company holding a *single* asset; etc.

The extension of effects of the homologated agreement to secured creditors

Exposure limit

21. The reform enables a refinancing agreement homologated under the 4th additional provision to extend to secured creditors who have not supported the agreement. I am going to sieve through remaining issues raised by the 4th additional provision so as to select only what is specific to real security. For reasons of space, I will leave out the comment on the speculation made by the RD Act in relation to the "value of security".

Syndicate claims

22. The insolvency reform has determined that syndicate creditors (holders of real security, in our case) are deemed to accept the agreement when supported by 75% of the syndicate, unless the loan agreement or other ancillary agreement provides a lower percentage. A refinancing agreement thus "consented" no longer requires to be "extended" to dissenting creditors if it reaches, in addition, the majority required for homologation (see below). And its content is unlimited, not just forgiveness of debt, payment deferral and other effects susceptible to imposition via "extension" to dissenting creditors. Syndicate members are bound in all respects and cannot plead the reinforced majority discussed further below.

23. The structure of the joint holding over the claims (joint and severable, divisible, joint) does not matter. *Nor does it matter* that the loan agreement recognises the legitimacy of each creditor to pursue fulfilment of its own claims or that it could do so even by the individual exercise of its real security. The difficulties of a dissenting syndicate lender do not end here. As the whole syndicate is deemed to have consented, the dissenting creditor within the syndicate runs the risks of losing also the recourse against third party guarantors, according to the obscure referral of para. 9 *in fine*: *regarding financial creditors who have signed the refinancing agreement, the maintenance of their rights against the other obligors, bondsmen or sureties, will depend on what was agreed upon in the respective legal relationship*. I raise the question of whether this broad interpretation is relevant, because in that case it would be a "disproportionate sacrifice" within the meaning of para. 7 of the 4th additional provision[3].

[3] Although the dissenting lenders consenting means when it does 75% of the union obviously have not "wanted" consent, so it is clear that they have the standing to challenge the agreement by the existence of a "disproportionate sacrifice."

24. The "extension" of the syndicate's majority vote will occur only if the syndicate manages to add up (alone or with other creditors) the appropriate majority to achieve homologation. 51% of total financial liabilities suffices, but a wider majority (60% to 80%, depending on the case) is not necessary to "extend" the agreement's content, whichever it be, to the dissenting (syndicate) lender.

25. Outside the homologated agreements of the 4th additional provision, 75% of the syndicate cannot bind dissenting creditors. This does not mean that dissenting creditors within a syndicate cannot be bound against their will outside the 4th additional provision. They can be, like any other creditor, if the composition with creditors or administered out-of-court settlement obtains the appropriate majorities to bind dissenting creditors. In principle, syndicate creditors are like any class of creditor, and do not constitute a class within unsecured liabilities.

Extension of effects

26. To secured financial liability creditors - only *for the portion of their claim that is covered by the actual value of the security*, because for the rest they are simple unsecured creditors - that have not signed the refinancing agreement or have expressed their disagreement with it (and were not already bound by a majority agreement of the syndicate of lenders), the general effects will extend (forgiveness of debt, deferral of payment, conversion into profit sharing loans, capitalisation) provided that one or more of said effects have been agreed, to the extent equally agreed, by the following majorities, calculated according to the value of accepting security in respect of the total value of security: 65%, in the case of 5-year deferrals and conversion into profit sharing loans, and 80% in the case of deferrals beyond 5 years, forgiveness of debt, debt-equity swaps, conversion into profit sharing claims or debenture different from the original and transfer of assets as full or partial payment of the debt.

27. Note the rule's lack of systematic rationality. By way of a homologated agreement, an effect could be extended to a secured creditor that could not be imposed through a true insolvency agreement under art. 100 IA.

Types and classes of creditors

28. It might be the case that the effects "extended" to dissenting unsecured creditors cannot extend to secured ones, which actually act as a class within the group of creditors. It is even possible that effects can be extended to secured creditors different to those applicable to other creditors. It is even likely that the relevant majorities have been attained within the secured class of creditors but not the majority required in the unsecured class! Take into account that approval of the effect by the class of unsecured creditors is not an absolute condition of the extension of effects to (accepting or dissenting) secured creditors. The computation of majorities of the secured class is calculated on the basis of a quorum exclusively formed by the class itself. The latter hypothesis seems unlikely (why would 65% of fully secured creditors accept a forgiveness of loan (haircut) but not so the majority of unsecured creditors?), but conceptually there is no denying that the rule does not state or imply that the agreement has to be *unitary* and accepted by *both classes* of creditors. But then, will dissenting secured creditors not be able to say that they have suffered a "disproportionate sacrifice"?

Stay of enforcements

29. According to para. 5 of the 4th additional provision, *the judge, having considered the application for homologation, shall give the same permission to proceed and order that singular enforcements be stayed pending homologation*. But is this so also in respect of real security where the debtor has been unable to certify concurrence of the specific majorities to bind such creditors? It is curious that this matter has always been in need of elucidation before the reform. In view of the practical application of 4th additional provision by commercial court judges, most likely these creditors will also have their powers restrained to enforce, especially since they have already been subjected to this stay from the moment the general stay of art. 5 bis (4) came into effect. Moreover, it is quite possible that the maximalist construction ends up prevailing: the enforcement of *all* real security shall be stayed, even of such that is not *necessary* for continued operation, because the 4th additional provision does not

apply the corresponding restriction contained in arts. 5 bis and 56 IA. As the percentage of creditors supporting the agreement is already on record in the court at the time of the application for homologation's permission to proceed, it is odd that the rule imposes an unconditional stay of all enforcements, even those instigated by creditors in respect of which it is a known fact that they will not be subject to the agreement. Who is protected in this way and why are the consequences of an agreement externalised to third parties to whom such an agreement is *res inter alios acta*?

Breach of the refinancing agreement and enforcement of real security

30. Para. 11 of the 4th additional provision addresses us with another good dose of obscurity and meaninglessness. In the part I now fix my attention on, the rule reads: *upon a court-recognised breach, creditors may seek the opening of insolvency proceedings or initiate singular enforcements. If real security is enforced, and unless termination has been provided for in the agreement in the event of breach (...)*.

31. What is "terminated"? The agreement or the security? It may refer to both terms. I think neither of the possibilities makes any sense. It seems common sense that in any case the breach of the agreement should be accompanied by the declaration of termination. But if so, it is unclear what "unless termination has been provided for in the agreement in the event of breach" refers to because such termination would never be averse to the possibility of resuming the enforcement of the security. Rather it would be the condition for this enforcement. But neither can the "termination" refer to the security, not only because security is not terminated, but also because terminating it precisely when the novation is breached and insolvency proceedings have opened makes no sense. I can only surmise that what the rule means is that enforcement of real security shall not apply if the agreement provides that the affected holders waive security under any contingency. This hypothesis may make sense if the affected creditors accept it (or if they are a dissenting minority in a syndicate), but it cannot be imposed by extension to dissenting creditors since a waiver of this kind is not a possible content of the "extension" of effects of the homologated agreement.

32. And yet an alternative explanation is not impossible. Namely, the security to be enforced would be that recognised in the agreement itself as new refinancing security. Creditors of the agreement could directly enforce the security rather than file a petition for insolvency proceedings, unless provided in the agreement that such security would be extinguished if the agreement was terminated by reason of the debtor's default. But this explanation would not clarify what would happen to the pre-existing security.

33. The above is serious. More serious is that somehow it is assumed that, unless accepted under the agreement, creditors can recover their *status quo* prior to the agreement. It could be the case if forgiveness of debt or payment deferral has been homologated, even a conversion to a profit sharing loan or payment in kind with a limited scope, but always on condition of contractual termination of the agreement. But you cannot retrieve real security that has been *lost* (necessarily lost, in whole or in part) when the claims have been capitalised, at least in respect of that part of the claims that has been absorbed by the recapitalisation.

34. The inscrutable final paragraphs of para. 11 of the 4th additional provision are not decisive in respect of the aspect that I now consider, assuming I understand correctly – which is doubtful - the intent and intelligence of the legislature. The fourth paragraph (sub-para. a) presupposes that the (forgiveness of debt, I think) agreement is terminated by breach. But the following sub-paras. b and c assume the opposite.