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EXCEPTIONAL SOLUTIONS TO REDRESS THE FAILURE TO PAY SUPPLIERS BY LOCAL ENTITIES (ROYAL DECREE LAW 4/2012)

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Royal Decree Law 4/2012 of 24 February, which determines the information obligations and necessary proceedings to establish a funding mechanism for payment to providers of local entities (Official Gazette of 25 February) establishes an exceptional payment mechanism for the payment and cancellation of debts to suppliers of local entities and its funding.

This mechanism and its implementation through the "immediate adoption of urgent and extraordinary measures", is justified by the "pressing" (often desperate) situation in which there is a lack of liquidity with regard to these companies due to the payment delays by local entities, and the "low efficiency" (absolute ineffectiveness) of the provisions agreed in recent years for this purpose (modifications in the debt claim procedure established in the Public Sector Contracts Law for debt claimed to the Administration, indebtedness special operation and guarantee line from ICO).

The new funding system for local entities has been called a "brave measure for economic revival" to achieve the payment of debts with private third parties within the local public sector, but due to the urgency of its adoption, it has some significant gaps and

inconsistencies, that will have to be amended by implementing regulations and agreements passed by the Government's Executive Commission for Economic Affairs.

The mechanism is set up in five steps:

1. The debts are determined by requiring the local entities to forward a debt certificate to the Ministry of Finance and Public Administration.
2. The Government's Executive Commission for Economic Affairs establishes a funding system that will allow signing agreements with financial institutions for its implementation.
3. Creditors may then proceed to receive the amounts directly from the financial institutions.
4. To fund these obligations, the Municipalities may enter into debt transactions with financial institutions that will have a State guarantee and that will include the assignment to the State of the rights of the local entity as to their participation in State taxes. If the Municipalities want to apply this funding mechanism, the Ministry of Economy and Public Administration must

have approved an economic-administrative adjustment plan.

5. If the Municipalities do not reach an agreement on the debt operation or if they breach said payment obligations, the Ministry of Finance and Public Administration shall make the corresponding deductions in order to meet those obligations against the financial institutions over the participation of the local entities in the State taxes.

A. Scope of application

The new mechanism is only applicable to debts held by local entities, and excludes obligations undertaken by autonomous communities. The guarantee mechanisms for the debts owed by the autonomous public sector, especially its health administration (main example of the autonomous public debt) may affect their financial independence, thus specific consensus shall be adopted with the autonomous communities, leaving this issue to the Tax Policy Council.

Local entities are understood in a broad sense, as these include not only "territorial" local entities referred to in Article 3 of the Act Regulating the Basis of Local Government, but also its instrumental bodies, in the case of "agencies and entities dependent upon or belonging entirely to local entities" included in the Inventory of Local Public Sector Bodies¹. Public companies whose equity is only partially participated by the local entity are not included in this Inventory, therefore a significant number of invoices to suppliers fall outside this funding mechanism.

Within the local sector, understood as defined above, the outstanding obligations to

contractors (defined as "both the contractor and the assignee that has assumed its payment right") must meet the following requirements in order to apply this funding mechanism:

- a) Debts must be due and payable and received in the administrative registry of the local entity of the invoice or equivalent payment must have been submitted before 1 January 2012. This reinforces the exceptional nature of these measures.
- b) They must be works, services or supplies included in the scope of the consolidated text of the Public Sector Contracts Law passed by Royal Legislative Decree 3/2011 of 14 November (TRLCSP).

The reference made to "works, service or supply contracts" could be understood as referring to any type of contractual relationship between the Public State Sector to which the TRLCSP precepts apply, either wholly or as pertains to the awarding proceeding. The explanatory memorandum of the Royal Decree Law refers broadly to "contracts within the scope" of TRLCSP. However, a purely literal interpretation could also be made, according to which the scope of application would be limited only to those related contracts, which, among others, will exclude public works concession contracts and public services management agreements, the latter widely used at the local level.

B. Determination of outstanding debts

Local entities are obliged to send to the Ministry of Finance and Public Administration, before 15 March 2012, a certified list of all

¹ The Inventory of Local Public Sector Goods that was regulated by Royal Decree 1463/2007 has been prepared by the Ministry of Finance through the Directorate General for Financial Coordination with Local Entities and is published on the web: <https://serviciostelematicos.sgcal.minhap.gob.es/bdgel/asp/consultaInventario.aspx>

outstanding payment obligations that meet all the mentioned requirements, identifying the creditor, the amount of the debt and the registry entry date, as well as the pertinent details if it has been claimed in court before 1 January 2012.

Contractors can consult if they have been included in, or omitted from, this list. If they are not included, they can request the local entity to issue an individual certificate that must be issued by the controller within 15 days from the request; if an answer is not given within this term, the right can be recognized.

The Royal Decree-Law does not mention its position regarding the excluded or rejected certificates; this can lead to a discrepancy between the contractor and the auditor regarding the debt, its amount or the inclusion in this system, and no mechanism has been included in order to resolve discrepancies.

On the other hand, this measure implies a huge burden on the controllers and can have very negative consequences for the local treasury. Also questionable, moreover, are the competence of controllers and their ability to take responsibility on issuing debt certificates affecting agencies and entities with legal personality from the Municipality.

Therefore, the Royal Decree-Law takes great care to specify that "the issuance of both certified relations and individual certificates will imply the accounting of any outstanding obligations, if any, without this implying responsibility of the controller under the terms of Article 188 of Royal Legislative Decree 2/2004 of 5 March, approving the consolidated text of the Law Regulating Local Tax", thereby punishing only the breach of the obligations of issuing certifications and communications.

C. Debt financing system

The determination of the debt in the aforementioned terms aims to provide access to the funding mechanism that will operate pursuant to the Agreement of the Government's Executive Commission for Economic Affairs. The Royal Decree-Law establishes the main lines or criteria:

- Its temporary scope is limited to 2012 and can be articulated in successive temporary phases within this year.
- During each phase the following can be established: " a minimum discount to be offered by the contractor on the principal amount of the outstanding obligation so it can be paid to the contractor"; additionally, a maximum overall amount of funding can be set for each phase along with the establishment of specific amounts for small and medium enterprises.
- Likewise, criteria can be specified in order to prioritize the payment, including, i) any cancellation or discount that can be offered over the principal debt, ii) the existence of any legal proceeding for representation that has been initiated before 1 January 2012, and iii) the seniority of the debt.

These criteria are quite remarkable as they prioritize the payment of the debt taking into account its burdensome nature to the Public Administration. The debts claimed in court and those with greater seniority are those with the most associated costs (mainly interest) for the Administration and that preferably should be included in the implemented funding mechanism, given that waiving the interests and other expenses would enable a sizable cost saving to the Local Government. The criteria

for the discount offer is much more debatable, because although it could be defended on the grounds of cost savings, its legal justification is dubious as it poses a direct threat to the solvency of the public sector because it legally admits the possibility of cancellation of public debts, which could have important implications.

The payment to the debt contractor using this system “involves the discharge of the debt incurred by the local entity with the contractor by the principal, interest, court costs and any other expenses”.

Moreover, the document certifying the payment (provided by credit institutions to the local entities and to the contractor), “will determine the termination of the court proceedings, if any, by extrajudicial satisfaction in accordance with the provisions in Article 22.1 of the Act 1/2001 of 7 January on Civil Procedure”. This is not, however, the course of action that will have been followed for collection of debts, which will be the contentious-administrative. This provision can be explained due to the fact that the Law of Contentious-Administrative Jurisdiction includes the termination of the process by recognizing the plaintiff’s claims, but it only allows the recognition of the claim in its entirety. Again, this provision can lead to litigation.

D. The obligation of the Municipalities to develop an adjustment plan

One of the most positive aspects of the Royal Decree-Law is the obligation imposed upon local authorities who have not submitted payment of the recognized obligations that the controller prepares and that the committee approves an “adjustment plan” before 31 March 2012.

This adjustment plan will last during the amortization period prescribed for the

debt operation that will be explained in the next section; any general budgets approved must be consistent with the plan. In any case, the adjustment plan must meet the requirements approved by the Government Commission for Economic Affairs as well as, in all cases, the following: (i) collect enough revenues to finance its current expenses and amortization of indebtedness operations, (ii) any associated estimates of revenue streams should be consistent with the evolution of those actually obtained by the local entity from 2009 to 2011.

In addition, there are two essential requirements that go beyond what is required by the indebtedness amortization assumed by the Municipality, such as:

- “Adequate funding of public services provided at public prices or rates, and which should include sufficient information on the cost of these public services and its funding;
- Contain the description and the timetable for implementation of any structural reforms that will be implemented as well as the measures for reducing administrative burdens on citizens and companies to be adopted in the terms established by agreement of the Government Commission for Economic Affairs”

The adjustment plan may even “include a modification of the organization of the local corporation.”

The requirement for such a strict and wide-ranging adjustment plan to authorize the indebtedness operation serves as an important caution to prevent this system from failing as with previous instruments as well as to avoid this type of emergency situation in the future. At times like this we are reminded of the saying “every cloud has a silver lining”, although in this case,

perhaps it would be more appropriate to say that this is “like mustard after dinner”.

The adjustment plan shall be submitted by the local authority to the Ministry of Finance and Public Administration, who will evaluate it. If after 30 days the local entity does not receive this evaluation, the plan is deemed denied.

Once the plan is favourably evaluated (where applicable and following successive drafts of the same until it is deemed favourable), the operation will be deemed authorized.

E. Indebtedness operations of local entities

Local entities may finance payment obligations paid in the mechanism by agreeing on an operation of long-term indebtedness whose financial conditions will be set by Agreement of the Government Commission for Economic Affairs.

The article published by the Council of Ministers states that these indebtedness operations will have a guarantee from the State and, pursuant to the Royal Decree-Law may involve “the transmission to the State of the rights of the local entity as to their participation in State taxes in the necessary amount to meet the repayment of such payment obligations, without affecting the fulfillment of other obligations

arising from transactions of financial debt referred to in the adjustment plan”.

Although the Royal Decree-Law is obscure regarding the implementation of the indebtedness operation, we can infer, by following the principle of financial autonomy, that local authorities are empowered to decide whether or not they will formalize the indebtedness operation. In the case that they do not do so, we understand that the State will assume the payment to the financial institutions and recover such payment from local entities, considering that the ruling authorizes the State to implement, in this case, the debt compensation scheme provided in the Consolidated text of the Law Regulating local Tax (fourth Additional Provision), in such a manner that “if local entities do not conclude said indebtedness operation, or if they have concluded it and they do not comply with the payment obligations arising thereof, the competent body of the Ministry of Finance and Public Administration or the competent public body shall proceed with the corresponding deductions over the payment orders that are issued to meet their participation in the State taxes.

This compensation applies only to debts incurred by local entities within the framework of this funding mechanism, but its implementation may be extended, if necessary, to subsequent years.