Amendment of the Spanish Insolvency Regulations and their Implication in Spanish Restructuring/Distressed Deals

Banking and Capital Markets Department

1. Introduction

In the light of the current economic climate, some of the restrictive provisions of the Insolvency Act and the fears of rescission of transactions carried out in relation to companies in distress have resulted in a high number of the petitions of insolvency to end up in liquidation of the debtor. Also, the existing Insolvency Act (the "Insolvency Act") has somewhat acted as a deterrent to a Spanish distressed market and certain of its provisions have proven to be too strict to facilitate proper restructurings. This has forced market participants to find imaginative solutions, which in some cases include the use of foreign laws to carry out a restructuring plan.

With the aim of preserving the business activities of companies in distress, to induce capital investment in distressed companies and to facilitate pre-insolvency restructurings, a substantial reform of the Insolvency Act has been approved on 4 October, 2011 (the "Reform"). The Reform introduces concepts which have been unknown to the Spanish market such as pre-insolvency cram-down mechanisms or dip financings and allows for certain purchasers of debt of insolvent companies to keep their right to vote in a composition of creditors. We have tried to list those issues within the Reform which we think directly affect restructuring/distressed deals, rather than citing all proposals made within the Reform.

2. Refinancing Agreements and Dip Financing (Fresh Money)

One of the biggest fears of investors in distressed companies is the two-year hardening period established by the Insolvency Act (the "Hardening Period"). Section 71 of the Insolvency act establishes that any acts carried out by the insolvent company within the two year period preceding the date of declaration of insolvency may be set aside, subject to evidence being provided by the challenger that the particular act is prejudicial to the insolvent company's estate. Further to that, this same section provides that certain specific acts of the debtor, carried out during the hardening period, are deemed to be prejudicial to the debtor's estate, hence the burden of proof[1] being shifted to the parties to the contract or arrangement at stake[2].

For a debtor to be refinanced/restructured in an agreement with its creditors, mitigating the risks of rescission brought up by the Hardening Period, any agreements reached (the "Refinancing Agreements") by the debtor's creditors and the debtor in a pre-insolvency stage have to comply with the following requirements:

1 That no prejudice is caused to the debtor by this particular arrangement.

2 This shift of the burden of proof only takes place where the presumption is *iuris tantum* (rebuttable) as some of these presumptions are *iuris et de iure* and no evidence to the contrary is allowed hence claw back being automatically applied.

a) The purposes of the Refinancing Agreement shall be: (i) to substantially increase the funds available to the debtor; and/or (ii) to extend or amend the terms of the debt that is to be re-negotiated by means of the Refinancing Agreement;

b) The Refinancing Agreement shall be a part of a short and mid term viability plan of the debtor;

c) It shall be approved by creditors representing, at least, 3/5 of the liabilities of the debtor;

d) It should be executed before a Spanish Public Notary and recorded in a public deed; and

e) An independent expert appointed by the Companies Registry should issue a report assessing: (i) sufficiency of the information provided by the parties (in particular, by the debtor); (ii) reasonability of the Refinancing Agreement and that the viability plan is sensible and feasible; and (iii) the security package of the Refinancing Agreement being proportional to the usual market practice.

The Reform tops-up the seniority of new money put in within a Refinancing Agreement by widening the categories of Credits Against the Estate and Privileged Credits. In this regard, new wording of Section 84.2.11º of the Insolvency Act provides that the insolvency ranking of any additional funds made available to the debtor in a Refinancing Agreement (*"Fresh Money"*) shall be enhanced by giving them the treatment of Privileged, in respect of 50% of its amount and Pre-deductible, in respect of the remaining 50%.

This provision will entail more certainty and an incentive to any lending institutions and investors willing to carry out rescue financings. Note that the Refinancing Agreement will not necessarily require now 100% consent of the creditors (See 2 below), thus this solution is especially interesting when there would otherwise be no consent for an intercreditors agreement to be put in place recognizing seniority to the new money.

It should be noted however that the safe harbor or protection provided to those Refinancing Agreements complying with the aforementioned requirements only refers to the challenges of other creditors. The insolvency administrators are still entitled to challenge the arrangements contained in a Refinancing Agreement if, despite the preventions adopted, they understand that they were indeed prejudicial to the estate of the debtor.

3. Cramdown Mechanisms resulting from Refinancing Agreements

To date, there were no provision under Spanish Law to entitle a majority of creditors to carry out a restructuring of the debtor without the consent of the minority creditors in an out-of-court situation (i.e. where no insolvency proceedings have been commenced).

The above has lead to a situation were if 100% consensus was not obtained the company would file for insolvency as the only way to de-leverage, unless imaginative solutions were found such as foreclosing holdco security and applying release provisions under intercreditors agreements (when found, which is not the case in most Spanish Law financings) or foreign laws providing for lower consensus requirement were applied. To these effects the Reform introduces a new provision allowing for any Refinancing Agreements complying with the requirements set forth in Section 2 above being approved by the relevant Commercial Court (*"homologación judicial"*).

The only requirement for this court homologation is basically the Refinancing Agreement being approved by financial entities holding at least 75% of the "bank debt" of the debtor.

Once the Refinancing Agreement has been homologated, the stays in payments accepted by the financial entities adhering to it shall be extended to any absent or dissident unsecured financial entity, with the limit of 3 years.

The homologation resolution may also provide for the stay in individual enforcement proceedings for so long as the deferral of payments of unsecured and unsubordinated claims is in place in accordance with the Refinancing Agreement (subject to the 3 year maximum stay referred to above).

The relevant Commercial Courts shall ensure the reasonability of the new arrangements and make sure that the mechanism is not disproportionate on any absent and dissident creditors.

As per the above, it becomes obvious that the impact of the homologation on dissident creditors is subject to certain boundaries such as:

a) Secured lenders will not be affected by the stay in payments but may be affected by the stay in enforcement proceedings;

b) Lenders may not be obliged to condone the debt. Unsecured lenders may only be forced to extend and stay ("*espera*"); and

c) Lenders may not be obliged to capitalise the debt (debt-for-equity).

It seems obvious that the restrictions depited in (a) through (c) above make this mechanism less efficient for deleveraging a company in distress. However, it does open certain routes to avoid minority creditors blocking a restructuring and is a first step which will most likely be welcomed by market participants.

4. Incentives for creditors to request Compulsory Insolvency of a debtor

In the event of lack of agreement between creditors in a pre-insolvency stage, the Insolvency Act establishes that insolvency proceedings can be commenced at the request of (i) the debtor ("Voluntary Insolvency") or (ii) by the debtor's creditors ("Compulsory Insolvency").

With regards to Compulsory Insolvencies, the Reform provides that upon request of commencement of proceedings by a Creditor, the claims held by such (unsubordinated) Creditor shall be considered as generally privileged up to 50% of their amount.

This new provision enhances the likelihood of creditors filing debtors for insolvency and will most likely open an interesting investment angle for investors (among others, when the distressed debt is trading below 50 cents).

5. Voting rights and Purchasers

Maybe the biggest hold off for purchasers of distressed debt in Spain so far has been the lose of their potential voting rights in a creditors' Meeting when acquiring any debt of an insolvent debtor. Section 122.1.2.º of the Insolvency Act provided that any Purchasers who had acquired their claim by *inter vivos* acts after the commencement of an insolvency proceeding of the debtor were declared open had no voting rights in a Creditors' Meeting, except if the acquisition took place by universal title or as a consequence of an enforcement of security.

The Reform has introduced novelties so that any potential voting rights that would have been allocated to a Purchaser will remain vested on the Purchaser for as long as it is an entity subject to financial supervision. This wording seems to deliberately include financial entities as well as funds which are subject to supervisions and will open the scope of potential debt investments to situations where the company has already filed for insolvency.

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