Contestability of refinancing agreements under insolvency proceedings after RD Act 4/2014

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This paper is essentially a commentary on the changes introduced by Royal Decree Act (Order in Council) 4/2014 in respect of applications for clawback (avoidance) orders against or within refinancing agreements.

I. Non-homologated qualified majority refinancing agreements

Arbitrary differences

1. As far as I can see, it makes no sense that a refinancing agreement homologated (court-sanctioned) under the 4th additional provision or an administered out-of-court -settlement under art. 236(2) of the Insolvency Act (IA) may contain a *discharge through delivery of property in lieu of payment*, whereas a non-homologated qualified majority refinancing agreement may not have any such content. No less absurd is that a composition of creditors under art. 100 IA (outdated after the 2014 reform) has to continue being an instrument to rescue a company as a going concern.

The importance of removing the independent expert

2. The reform does not appear to appreciably modify the existing legal situation. *The refinancing content* under the current art. 71 *bis* (1)(a) is consistent in its terms with former art. 71(6). Neither have the subjective element (all the liabilities) nor the required majority (three-fifths) been modified. The agreement still has to be formalised in a notarial instrument to which documents supporting its content and compliance with the above requirements must be attached. But the *disappearance of the independent expert* under the pre-reform arts. 71(6)(2) and 71 *bis* and his *replacement* by the *company auditor* substantially alter the landscape of refinancing and its resistance to insolvency proceedings[1].

3. The auditor has only to issue a certificate on the sufficiency of the liabilities required to enter the agreement. Consequently, there is no one now competent to issue a *technical opinion on the sufficiency of the information provided by the debtor, on the reasonableness and feasibility of the scheme under the conditions defined in* art. 71 *bis* (1) and *on the proportionality of the security*. Given that the participation of the notary does

[1] This figure does not always disappear. In fact, his report will be required in agreements homologated under the 4th additional provision to calculate the value of security over property other than publicly traded financial instruments and real estate.

not add any substantial guarantee in this respect, it is sufficient that the three-fifths majority agrees with the debtor any kind of refinancing agreement that fits the broad description contained in art. 71 *bis* (1)(a).

4. A notable consequence of this lack of restrictions in art. 71 *bis* (1) is *the confirmation* that it is not possible to classify the claims in question or expunge those that would be classified as subordinated. Not even the insolvency administrators may contest the agreement for this reason, in accordance with art. 72(2).

Rescission of limited scope

5. In the text before the current reform, despite that the agreements now under discussion "could not be rescinded", they were, however, rescindable, as was clearly evidenced by art. 72(2), while legal standing was merely granted to insolvency administrators. The new art. 72(2) keeps this restriction, but also introduces a new restriction. Rescissory actions (petitions for rescission) *can only be based on non-compliance with the requirements laid down in said article, lying with whoever files the petition the burden of proving such non-compliance*. Let us consider the possible extent of this additional restriction.

6. "(O)ther contest (actions)" are still possible. The persistence of these alternative remedies is now more problematic, because an area of "rescission" or "invalidity" for material reasons is consequently open, beyond the legislative policy decision restricting the scope of the typical rescission under insolvency proceedings.

7. It is not true that now a refinancing agreement may not be contested on *substantive* grounds. Substantive *requirements* are clearly among the requirements of art. 71 *bis* (1), namely that it is a refinancing agreement within the meaning of the rule and that it responds to a viability plan to rescue the company as a going concern. Consequently, the insolvency administrator may contest the agreement alleging that the material prerequisites imposed by the rule have not been met.

8. But such contest may not be *on the basis of presumptions taken from art. 71(3)*. It is clear that this is the meaning of the allocation of the burden of proof contained in the rule. Therefore, the three presumptions under art. 71(3) disappear here, in particular the presumption of prejudice as a result of the provision of security in rem as collateral for pre-existing obligations.

9. But neither may the agreement be contested *positively proving* the "prejudice" either to the asset pool or, what is more important given the changes undergone by art. 71 IA, in respect of the *par conditio creditorum*. In fact, once the material requirements of art. 71 *bis* (1)(a) are met (that it is a refinancing agreement and that it responds to a viability plan), nothing else may be considered.

10. Consequently, where real or personal security has been provided within a group of companies in the strict (art. 42 of the Code of Commerce) or broad (also groups according to coordination, groups based on persons, etc.) sense, such may no longer be challenged, as has been the usual practice, resorting to the argument that they involve security provided gratuitously or, in any case, without direct consideration, when the existence of a *collective group interest* has not been proven.

11. As set out above, the refinancing agreement may not be rescinded even if, as stated hypothetically, it has *failed*. However, this brings a problem to the fore. It is almost unthinkable that an agreement could have failed because it did not conform to any of the forms of "refinancing" included in the broad case of art. 71 *bis* (1)(a). There can hardly be a collective agreement facing insolvency of a debtor that is not consistent with one of the circumstances described by the rule. Accordingly, it could only have failed because the viability plan was unrealistic. The current art. 72 makes

clear that a petition for rescission can only be based on non-compliance with the required conditions, so it can effectively be based on the argument that *the viability plan did not make it possible ex ante to rescue the company as a going concern*, but not on the argument that the viability plan *failed ex post due to supervening reasons*. And when the insolvency administrators can contest, in accordance with the terms described above, they need not submit proof of prejudice to the interests of the insolvency proceedings, but of the plan's non-viability.

12. Note that under these conditions it is almost impossible for the counterparty of the rescission to be regarded as having acted in bad faith within the meaning of art. 73(3) IA, because knowledge of the state of insolvency is not a characteristic element of the new rescission.

II. Ordinary non-homologated refinancing agreements

The case

13. I refer to the agreements under art. 71 *bis* (2). I will not examine them in detail, which would exceed the scope of this paper, but instead devote my attention to the strength of these agreements against rescissions. The rescission of these agreements (and other invalidating means) is not subject to conditions more lax than those for qualified majority agreements, and art. 72(2) is applied in accordance with the terms described above.

14. But here the precise *requirements* to cement the resistance of agreements under insolvency proceedings are more intense. The prior assets to liabilities ratio must be increased [e.g.: payment in kind (*datio in solutum*) exceeding the value of the assets, debt-equity swap, forgiveness of debt, deferral exceeding 10% of the original payment period]; the resulting current assets must be greater than or equal to current liabilities [e.g.: forgiveness of short-term debt, sufficient conversion of short- to long-term debt, fresh money, capitalisation of current liabilities]; the value of resulting security held by the intervening creditors shall not exceed nine-tenths of the value of the outstanding debt due to the same or of the security to outstanding debt ratio prior to the agreement; the interest rate applicable to the subsisting debt or debt resulting from the refinancing agreement with the intervening creditor or creditors shall not be more than one-third greater than that applicable to prior debt; the agreement must have been formalised in a public instrument executed by all parties to the same, and *expressing the reasons that support, from an economic point of view*, the different acts and transactions made between the debtor and intervening creditors, with special reference to the requirements laid down in the above points. To verify satisfaction of the first two foregoing requirements, *all financial consequences*, including tax consequences, acceleration clauses or akin, derived from the acts that are carried out, even when such consequences are for non-intervening creditors, shall be taken into account.

No additional requirements

15. The *refinancing content* cannot be here of any sort whatsoever, unlike qualified majority agreements. It cannot consist either (unlike homologated agreements) in payment in kind or have as content expeditious assets liquidation (although it can partially: "either individually or jointly with other settlements that have been made in execution of the refinancing agreement"). Now, if the requirements of art. 71 *bis* (2) are met, the agreement cannot be contested on the grounds of prejudice to the asset pool or in respect of the *par conditio*, or because security has been provided gratuitously or for pre-existing obligations. It will suffice that the package of new security / new debt ratio does not exceed the old security / pre-agreement liabilities ratio.

16. Ordinary financing agreements do not require any condition in addition to those set out above. They do not even require a plurality of creditors. A singular

agreement to refinance existing liabilities may be an agreement under art. 71 *bis* (2). This is important, because it actually means that RD Act 4/2014 has changed for the refinancing of "singular" bank debt the rescission standards of art. 71 IA. If the requirements set out regarding assets, current liabilities, interest rates and security are met, other considerations usually made today become superfluous. Again, the requirement of pre-existing debt, the group structure and whether the security was provided for company or insider debt buy-back becomes superfluous; even whether the "refinancing" was provided under terms required by a reasonable viability plan, or whether the refinancing increased or not the real possibility of recovery of the insolvent company, becomes superfluous. Whether refinancing has essentially consisted of a granting of new credit whose primary objective has been the repayment of unattended old liabilities is also superfluous.

III. Homologated financing agreements

The case

17. Under the 4th additional provision, it is possible to obtain court sanction for the refinancing agreement that, having been subscribed by creditors representing at least 51% of the financial liabilities, meets at the time of its adoption the requirements provided in sub-para. a) [refinancing content in the broad sense: *significant expansion of available credit or modification or termination of its obligations , either through extension of its maturity or the establishment of other obligations acquired in substitution of those , provided that they respond to a viability plan that rescues the company as a going concern in the short and medium term*] and paras. 2 and 3 of sub-para. b) of article 71 *bis* (1) [auditor certification and public instrument execution] . The resolutions adopted by the described majority may not be the subject of art. 71's rescission under insolvency proceedings, although it may be contested with remaining actions (4th additional provision, para. 13).

Subordinated liabilities

18. The 4th additional provision, para. 1, sub-para. II, provides that for the purposes of calculating majorities, financial liabilities held by creditors regarded as specially related persons shall not be taken into account[2]. But this control cannot be carried out, as there is no process where a minimally adversarial classification of claims is feasible. The auditor certification cannot contain this classification, and in the homologation process the judge will not have at hand the elements for such classification, nor probably the competence to condition the homologation to a classification of claims, without prejudice to the possibility of contesting the homologation under para. 7.

No additional conditions are required

19. Homologation does not require any specific quality or condition of the agreement other than the indicated financial liabilities majority. Moreover, however surprising it may be, the judge cannot refuse homologation arguing on the merits or optimisation of the agreement or the prejudice the agreement could cause to non-consenting creditors.

20. It is true that the judge must ascertain that the viability plan is real, as such is a requirement of art. 71 *bis* (1)(a). But in the absence of an independent expert's certificate, the judge cannot make this determination, nor does the incidental homologation allow for an adversarial discussion on this important and complicated issue. In other words, this matter will not be subject to control.

21. The homologation will go forward regardless of the material content of the agreed refinancing. It may involve forgiveness (of any sum?), a deferral

[2] Shall not count in the liabilities of reference or, in addition, shall not count as votes in favour for the 51% calculation?

of payment, a conversion into a participating (profit-sharing) loan, debt capitalisation, part or full payment in kind. If the agreement does not reach the majorities provided for extension to dissenting creditors (from 60% to 80%, depending on the case), the agreement must be homologated, although then it shall not extend to dissenting creditors. Note then that it is not true that the approvable refinancing agreement must meet the material conditions of art. 71 *bis* (1)(a), because the present provision makes it clear that such agreement may involve a pure settlement with delivery of assets as payment. And if the agreement can be a settlement, the need to submit and show evidence of a viability plan also disappears.

Dissenting creditors and contest

22. If conditions do not exist to cause an extension of the agreement to dissenting creditors, then there will not be a case of "disproportionate sacrifice" imposed on said dissenting creditors, who shall not have either the opportunity or the need to contest the court's approval. There will be no dissenting creditors, because the agreement will not be extended; therefore, no one will have unwillingly suffered any sacrifice. That is, the homologated (necessarily homologated) and not "extended" to dissenting creditors agreement *may not be contested by anyone*. The result is rather paradoxical if, for example, we imagine a "refinancing" agreement agreed by 51% of the financial liabilities, under which it is agreed that the debtor gives *only to these* certain assets as payment of claims.

Other contesting remedies

23. Paragraph 13 of the 4th additional provision contains a referral to art. 72(2). By virtue of such, although petitions for rescission are not allowed, even within the limited scope of the new art. 72(2), remaining contesting actions may be pursued (fraudulent conveyance [*actio pauliana*], nullity, annulment), which are not subject to any special condition of admissibility, although standing is reserved to the insolvency administrators. Rescissory fraud under art. 1111 of the Code of Commerce is not likely in a court-sanctioned agreement, but nullity due to simulation (sham transaction), fraud of law (*fraus legis*), harm to third party interests, etc. is quite possible. This non-rescissory contest does not need to follow the procedure under paragraph 7 of the 4th additional provision, and autonomous actions of nullity are possible; it seems obvious, since the specific contest under paragraph 7 only supports one substantive reason (disproportionate sacrifice), that it does not exhaust the spectrum of nullity claims based on civil (or insolvency!) law grounds.

Syndicated loan

24. An agreement within the syndicate granting a loan is an agreement (with the debtor) that can be contested by *dissenting syndicate creditors*, even if it has obtained a 75% majority of the claims, provided that, on account of not achieving a 51% majority throughout the financial liability, the agreement as such cannot be homologated. There can be no *singular* court approval of an agreement of the syndicate of lenders, not even, in the absence of the rest of the required conditions, in order to extend to the dissenting lenders the terms of the agreement reached by the qualified majority of the syndicate. Consequently, an agreement within a syndicated loan only extends to dissenting lenders where the agreement in question reaches at least 51% of the *total* financial liabilities and is homologated.

25. The 25% of the dissenting syndicated lenders will be regarded as adhered only in the type of agreement that is processed under the 4th additional provision. An agreement under art. 71 *bis* (1) or 71 *bis* (2) cannot extend to the dissenting 25% within the syndicate. Neither can an ordinary composition of creditors or an administered out-of-court settlement extents *per se* to the dissenting 25% creditors of the syndicate.

26. However, a refinancing agreement of any kind and majority can (partly) avert rescission if it meets the requirements of art. 71 *bis* (2), even if the agreement has not been or cannot be homologated. An agreement whose homologation has been successfully contested by any of the two reasons under paragraph 7 of the 4th additional provision can still survive as a refinancing agreement under art. 71 *bis*, if the conditions required in each case are met.

IV. Contest of administered out-of-court -settlements

Limited scope

27. Regardless of the majority of liabilities obtained in the approval of the settlement, such shall not extend to secured creditors (art. 234(4)). And only the corresponding forgiveness of debt and/or deferral of payment or payment in kind (art. 236) may be imposed by extension on unsecured liabilities.

Control through mediator

28. Unlike the "blind" agreements under art. 71 *bis* and the 4th additional provision, where there is no competent person to classify and filter the content of the agreements, the insolvency mediator charged with conducting the extrajudicial settlement process does have, in part, competence of this kind (art. 234(1)), although in fact and in law he lacks the material means and functional competence to classify competing claims.

Possibility of rescission

29. It is unclear whether these agreements may be the subject of rescission in the event of consecutive insolvency proceedings. According to art. 242(2)(3), *the two-year time limit for determination of rescindable acts shall be counted from the date of the debtor's petition to the registrar of companies or notary public*. It seems that only acts and contracts that predate the petition for appointment of an insolvency mediator can be contested through a petition for rescission. This being so, both the out-of-court settlement and the acts executing the same would be automatically excluded from any rescission. This interpretation was not certain before the promulgation of Royal Decree Act 4/2014, but is now confirmed, since it makes no sense that an agreement of this type can be rescinded, but not so a bilateral refinancing agreement under art. 71 *bis* (2).

30. However, this proposal does not restore complete logic to the system. Recall that a homologated refinancing agreement may be contested for reasons other than those under art. 71 (4th additional provision, para. 13). An out-of-court settlement cannot have better consideration, even if it has overcome the contest art . 239 IA refers to.

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