Main amendments to Spanish Pre-Insolvency debt restructurings introduced by Royal Decree Act 4/2014

1. Introduction

This paper sets out to present a concise description of the amendments to the rules governing Spanish pre-insolvency arrangements pursuant to new Royal Decree Act (Order in Council) 4/2014, of 7 March, *adopting urgent measures in relation to refinancing and restructuring of corporate debt* ("**RDA 4/2014**"), in force as from 9 March 2014. This new text has introduced a series of important changes, most of them via amendments to the Spanish Insolvency Act ("**SIA**"), aimed at easing and expediting pre-insolvency debt refinancing and restructuring processes in Spain. Ultimately, the amendments seek to provide a more appropriate legal framework where insolvent but viable companies may survive and avoid liquidation. This memorandum does not intend to be comprehensive, addressing but some of the issues affecting the debt restructuring regime after the approval of RDA 4/2014. Proper legal advice should be sought before taking any action.

2. Main amendments

The main amendments introduced by RDA 4/2014 can be summarised as follows:

a) *New effects of filing for pre-insolvency*

Traditionally, the main effect of filing for pre-insolvency under art. 5.bis SIA (for the purpose of entering into negotiations to refinance a debt or reach an early composition of creditors) has been the protection of the debtor from being filed for insolvency within a period of 3+1 months as well as suspending the obligation of such debtor to file for insolvency.

Under the new regulations, the mere notification by the debtor of the initiation of negotiations under this mechanism of article 5.bis SIA (Pre-insolvency) may also stay (i) any judicial enforcements over assets which are necessary for the continuity of the debtor's activity, (ii) any enforcement of security rights encumbering assets necessary for business continuity, and (iii) any enforcement of financial claims provided that creditors representing at least 51% of such financial debt have expressly supported the commencement of negotiations under article 5.bis.

b) *Stay of security enforcement under insolvency*

Art. 56 SIA now states that the enforcement of security may be subject to a 1-year stay in the event that the debtor is declared insolvent, provided that the secured assets are considered *necessary* for the continuity of the debtor's business or professional activities (whereas the previous wording referred to assets which were considered just *attached* to the debtor's business or professional activities).

In addition, RDA 4/2014 attempts to indentify certain assets which shall not be considered as "necessary for the continuity of the business" for this purpose (and, thus, where enforcement cannot be stayed by the opening of insolvency proceedings): *shares of companies whose exclusive corporate purpose is the holding of one asset and the liabilities (pasivo) necessary to finance the same (provided that enforcement does not entail an event of default or a material amendment to the contractual relationships held by this 2nd company which allow the debtor to maintain the exploitation of the asset).*

c) *Amendments on clawback issues: Refinancing Agreements and new non-rescindable acts*

In order to encourage creditors to participate in restructuring agreements, a new art. 71.bis has been incorporated to the SIA which encompasses the two kinds of acts/agreements which operate as a safe harbour from clawback risk (understood as risk of rescission of certain acts which may be detrimental to the insolvency asset pool within the 2-year period preceding the opening of insolvency proceedings):

(i) Traditional Refinancing Agreements: as previously established, any transactions fulfilling the conditions under art. 71.bis.1 SIA to be considered a *Refinancing Agreement* cannot be rescinded (except when instigated or challenged by the insolvency administrator). Prior to approval of RDA 4/2014, a refinancing agreement had to meet the following conditions: (1) it should aim at substantially increasing the funds available to the debtor and/or at amending the terms of the debt that is to be re-negotiated by means of the same; (2) it should be part of a short and mid term viability plan of the debtor; (3) it should be approved by creditors representing at least 3/5 of the total liabilities of the debtor; (4) an independent expert appointed by the Spanish Register of Companies should issue a report assessing different aspects of the agreement; and (5) it should be recorded into a public instrument.

The main amendments introduced in this regard by RDA 4/2014 are, on the one hand, that obtaining a report issued by an independent expert is no longer a requirement for these agreements to be regarded as such (this has been replaced by the requirement of a certificate issued by the debtor's auditor stating that the majority required by the SIA for the approval of Refinancing Agreements has been obtained), and, on the other hand, that the ability of the insolvency administrator to instigate the rescission of a Refinancing Agreement has been restricted to only those events in which the requirements stated above have not been fulfilled (the previous wording led to a wider interpretation).

In addition to the above, RDA 4/2014 also incorporates the possibility of getting safe harbor protection for Refinancing Agreements that comply with the aforementioned requirements but have obtained the consent of 51% of the financial creditors (as opposed to 3/5 of the total liabilities of the debtor), if they have been homologated by the Court. In this case, it must be noted that the specific rule applicable to syndicated facilities (see section g) below) would apply for the purpose of the calculation of the 51% majority.

(ii) Those acts carried out before the opening of insolvency proceedings and not qualifying as a Refinancing Agreement but complying with all the following conditions:

i. they increase the previous assets-liabilities proportion;

ii. the resulting current assets are equal to or higher than current liabilities;

iii. the value of any resulting security does not exceed either (a) 9/10 of the value of the outstanding debt or (b) security-outstanding debt proportion prior to the agreement;

iv. the interest rate applicable to the remaining debt (or the debt resulting from the restructuring) does not exceed the rate applicable to the previous debt in more than 1/3; and

v. the relevant agreement is recorded into a public instrument (which complies with certain legal formalities).

Note that these acts under section (ii) do not require any specific majority for approval (unlike Refinancing Agreements), but the requirements that need to be met are much stricter than those applicable to Refinancing Agreements. Similarly, as provided for Refinancing Agreements, any acts/agreements under this section (ii) may only be rescinded at the request of the insolvency administrator, and based only on non-compliance with the formal requirements specified above.

d) *Increase of the portion of fresh money to be deemed a Claim Against the Asset Pool*

As a temporary measure (to be applicable only during the next 2 years), any credits representing income for the debtor (*fresh money*) obtained under a refinancing agreement pursuant to section (c) above or (g) below shall be deemed 100% (prior to RDA 4/2014, only 50%) claims against the asset pool in the event of subsequent insolvency –senior to ordinary creditors as regards the assets which are not securing other debt -. Note that this only applies for a period of 2 years and thus, after the said 2 years have elapsed, the regime applicable to such credits should be the one existing prior to RDA 4/2014. It must be noted that this temporary benefit also applies to *fresh money* contributed by the debtor or *insiders* ("specially related parties"), except in the case of capital increase transactions.

e) *No subordination in case of equitisation under a Refinancing Agreement*

According to art. 92.5 SIA creditors which are a "specially related party" to the debtor are subordinated (no change as regards those factors considered in determining if a party is "specially related", among others: (i) holding more than 10% (for unlisted companies) or 5% (for listed companies) of the capital of the debtor on the date on which the claim arises, (ii) forming part of the same group of companies, or (iii) holding a position of director (de facto or de jure) of the company in the preceding 2 years –assignees of any claim held by a specially related party also being presumed to be subordinated creditors-).

RDA 4/2014 has established an exception to the subordination described above: those creditors who have equitised (directly or indirectly) all or part of their claims in compliance with a Refinancing Agreement (pursuant to section (c) above or (g) below) shall not be deemed "specially related parties" for the mentioned purposes.

f) *Encouraging of equitisations*

RDA 4/2014 has also introduced some measures aimed at encouraging debt-for-equity swaps in order to complete satisfactory debt restructurings. These new measures can be summarised as follows:

(i) Eventual shareholders' liability in the classification of the insolvency as "at fault" (*concurso culpable*):

Pursuant to art. 163 SIA, insolvency may be held *without fault* or *at fault* by the Court. While the "without fault" (*concurso fortuito*) classification is the general rule, the "at fault" (*concurso culpable*) consideration shall apply when the generation or aggravation of the state of insolvency has involved malicious intent or gross negligence by the debtor or its management. For these purposes, art.165 SIA lists a series of events in which the existence of malicious intent or gross negligence shall be construed: (1) when the debtor or its directors or liquidators have breached the obligation of filing for insolvency or the duty to collaborate with the Court or the insolvency administrator, (2) when the debtor has failed to comply with its corporate obligations regarding filing, auditing or approval of the annual accounts, and, (3) as incorporated by RDA 4/2014, when the debtor has refused, without good cause, to equitise claims or issue convertible instruments/securities, frustrating the consecution of a Refinancing Agreement reached according to section c) i) above or section g) below. For these purposes, the proposed Refinancing Agreement shall include a pre-emption right in favour of the shareholders in case of a future transfer of such shares or convertible instruments subscribed by the creditors.

In connection with the above, according to art. 172.bis.1 SIA, the following persons may be held liable for the insolvency or its aggravation: (1) the debtor, (2) its de jure or de facto directors or liquidators or attorneys-in-fact of the debtor, and, from now on, (3) the debtor's shareholders in the events described above, and depending on the level of contribution to the refusal to the debt for equity swap contained in the Refinancing Agreement (in view of the % of voting rights).

(ii) Majorities required on debt-for-equity swaps:

The majorities required in the debtor's general shareholders meetings to approve a debt-for-equity swap resolution under a Refinancing Agreement scenario have been reduced from reinforced majorities (as applicable to the other types of share capital increases) to ordinary (simple) majorities.

(iii) Amendments to the takeover bid requirements:

The Takeover Bid Royal Decree 2007 is amended. Thus, acquisitions or transactions made in the context of the conversion or equitisation of credits in companies facing serious financial difficulties are exempt from filing a takeover bid, to the extent that the transaction seeks to restore the financial situation of the company on a long term basis. The Spanish Securities and Market Authority (*CNMV*, its acronym in Spanish) has to issue an authorisation to confirm that that the relevant transaction is exempt from the takeover bid, except in the case of specific transactions directly resulting from a homologated Refinancing Agreement, provided such bid is supported by the opinion of an independent expert. Therefore, homologated refinancing agreements supported by an opinion of the independent expert do not need express authorization of the CNMV to be exempt from the takeover bid obligations.

g) *New regime of Court Homologations*

Court Homologation regulations under the 4th Additional Provision SIA have been substantially amended. The new regime can be summarised as follows:

Any Refinancing Agreement that is compliant with the requirements set out above (except for the 3/5 requirement which is substituted by the thresholds below, calculated excluding the financial debt held by specially related parties), can be sanctioned by the relevant Commercial Court (*Homologación Judicial*) and, if so, some of its provisions can be forced onto dissenting creditors.

The new regulations clarify also how the majority rules regarding voting in favour or against a court homologation shall be applied to syndicated facilities. In particular, they now state that a Refinancing Agreement shall be deemed approved by a syndicate of lenders when approved by creditors representing at least 75% of the debt under such facility (or a lower threshold if agreed on the facility). This provision should be deemed to apply in addition to the other wider majorities described below so that 100% of the syndicate should count for the majorities below if at least 75% agrees to it.

The RD clarifies the majorities required to homologate and extend the effects of Refinancing Agreements to unsecured and secured creditors as follows:

- The following effects can be extended through homologation to *unsecured financial debt creditors* and secured financial debt creditors for the amount exceeding the value of their security:

  (i) If the Refinancing Agreement has been entered into by creditors representing at least 60% of the financial debt:

i. stays (whatever their nature –principal, interests, other owed amounts– is) for a period no longer than 5 years; and

ii. conversion of debt into profit sharing loans, also for a period no longer than 5 years.

(ii) If the Refinancing Agreement has been entered into by creditors representing at least 75% of the financial debt:

i. stays (for a period between 5 and 10 years);

ii. haircuts (or debt discharges);

iii. debt-for-equity swaps (dissenting creditors being able to choose between the shares or an equivalent haircut);

iv. conversion of debt into profit sharing loans (for a period between 5 and 10 years), convertible obligations, subordinated loans or any other financial instrument with ranking, maturity and conditions diffe- rent to those of the original debt; and

v. assignment of assets/rights to creditors in payment of debt.

- The same effects can be extended through homologation to *secured financial debt creditors* –for the amount up to the value of their security-, provided that the relevant Refinancing Agreement has been agreed with the following majorities (majorities to be calculated on the basis of the proportion of the value of the "accepting security" over the total value of the security):

(i) Creditors representing at least 65% on such proportion: as regards measures stated in section (i) above.

(ii) Creditors representing at least the 80% on such proportion: as regards measures stated in section (ii) above.

For the purposes of defining the value of the security (and thus the consideration of the secured vs unsecured part of the debt) the 4th Additional Provision of the SIA provides specific rules on how the value of the security should be determined. In particular, the value of the security will be the result of deducting, from the 9/10 of the *reasonable value* of the asset over which the security has been created, the amount of outstanding debts secured with priority security over the same asset. For these purposes, *reasonable value* of the asset shall be understood as follows:

(i) for securities listed in a regulated market: the balanced average price at which the securities have been negotiated within the last 3 months;

(ii) for real estate assets: the value stated in a report to be issued by an appraisal company duly registered with the Bank of Spain;

(iii) for other assets different to those in sections (i) and (ii) above: the value stated in a report to be issued by an independent expert.

In the event of enforcement of security after a failed homologated Refinancing Agreement, there are certain rules which allow the creditor to benefit from the value of their security up to the pre-homologation debt amount.

h) *Tax implications on debt restructuring*

For the purpose of avoiding that tax treatment issues may constitute an obstacle to debt refinancing transactions, RDA 4/2014 has also introduced some relevant amendments that create a more favourable tax regime for the refinancing process. The most remarkable amendments are the following:

(i) Debt equitisations:

Corporate Income Tax regulations establish a general rule by virtue of which, in the case of onerous and corporate transfers, elements shall be valuated (for tax purposes) according to market value. Notwithstanding this, RDA 4/2014 introduces an exception to such general valuation rule in the case of debt equitisations:

— *As regards the Debtor*: the relevant share capital increase shall be valuated, from a tax standpoint, at a value equivalent to the proper amount of the increase from a corporate perspective (this is, the amount of capital effectively increased), regardless of its market value. This measure shall avoid that the debtor recognises any taxable income in the event that distressed debt is equitised.

— *As regards the Creditor*: creditors shall include an amount equal to the difference between (1) the amount effectively increased (in the proportion corresponding to each creditor) and (2) the tax value of the capitalized debt, within their taxable base. For debt acquired at a discount, taxable income will arise. However, if the buyer of that debt is resident in the EU (except in Spain), such capital gain could be exempt from Spanish taxation.

(ii) The tax regime applicable to income derived from stays and haircuts under the SIA is also amended from a Corporate Income Tax standpoint such that they remain taxable, but taxation of the income generated in the taxable base is deferred pro-rata to the financial expenses latterly recognised:

i. any income under this scenario shall be allocated to the taxable base of the debtor to the extent that the financial expenses derived from such debt have to be latterly recognised (and up to the amount of such income);

ii. should such income be higher than the amount of the financial expenses derived from such debt pending to be recognised, the taxation of the income within the taxable base shall be apportioned proportionally to the financial expenses recognised during each of the tax periods in respect of the total financial expenses derived from the same debt and pending to be recognised.

(iii) Any public deeds containing stays or haircuts and easing the implementation of refinancing or repayment agreements shall be now exempted from the Transfer and Stamp Duty.

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