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New legal framework for Spanish restructurings: technical analysis of the amendments introduced by Royal Decree Act 4/2014

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Introduction

The present publication sets out to explain the main amendments which Royal Decree Act 4/2014 ("RDA4/2014") has introduced in Spanish pre-insolvency debt restructurings and, in particular, tries to provide some guidance on a number of issues which remain unclear after its enactment.

RDA4/2014 constitutes an amendment of the Spanish Insolvency Act but its most relevant provisions affect how pre-insolvency debt restructurings can be effected, increasing the number of schemes available for binding dissenting creditors, facilitating debt for equity swaps, enlarging the basket of measures that can be agreed in reorganization proceedings and creating new safe-harbour exemptions for protection against the avoidance or unwinding of pre-insolvency transactions (clawbacks). The importance of this piece of legislation cannot be overstressed, representing a major breakthrough in Spanish restructurings which should be understood in detail by all players in the market.

As any significant law amendment, RDA4/2014 has raised a significant number of questions regarding some of its provisions. In order to provide tentative answers to these questions we asked our academic counsel - comprising prominent university professors and policy makers - to produce the analysis and findings here contained. This booklet is thus a very detailed and technical document rather than a commercial description of the amendments. We acknowledge that reading some of the included memorandums may be difficult, but we believe they will provide significant value to those in need of proper direction through the murky waters of RDA4/2014.

This document does not intend to be comprehensive and should not be relied on as legal advice. Specific advice should be sought before taking any legal action.

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March 2014

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 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 different 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.

April 2014

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 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).

[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.

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 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

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

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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Insolvency Reform of RD Act 4/2014 concerning the liability on insolvency for a shortfall (Art. 172 Bis IA)

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Art. 172 IA determines the pronouncements the at-fault classification ruling must contain, judicial pronouncements that constitute true civil penalties.[1]

Thus, after classifying the insolvency proceedings as at-fault, the people affected by the classification and the accomplices, on whom the orders will fall, have to be determined. Then, arts. 172 and 172 bis IA establish that the judgment must order:

— the disqualification from managing other people's property,

— the loss of creditor rights,

— the return of property,

— damages,

— redress, in full or in part, of the shortfall (liability on insolvency).

What is the difference between the damages under art. 172(2)(3) IA and the liability on insolvency under 172 bis IA?

1. A minority view was that of the *Audiencia Provincial* of Barcelona no.15, which argued that the liability on insolvency under art.172 bis IA is a liability for intent and negligence which indeed shared the same compensatory nature of the liability under art. 172(2)(3) IA. In both cases the director who has knowingly or recklessly brought about or aggravated the insolvency will be found liable, and the extent of the compensation will be calculated in accordance with his degree of involvement or role (i.e., causality) in such insolvency.

2. To differentiate them and avoid the nonsensicality of the legislature doubly criminalising the same liability, the Court, resorting to a restrictive interpretation of the adverbial phrase "*as well as to compensate for any damage or loss caused*" under art. 172(2)(3) IA, in fine argued that this liability was linked to the case previously described in the precept: the order to return the property or rights wrongfully received out of the debtor's assets or pool of assets[2]. Consequently,

[1] *Explanatory Note VIII to the IA states that "The effects of the classification are limited to the civil sphere, neither spreading to the sentence nor constituting a criminal matter for preliminary ruling in order to prosecute conduct that could constitute a an offence. The law clearly keeps unlawful civil and criminal acts apart in this matter"*. In the same direction, art. 163 IA.

[2] Judgment of the AP of BCN no. 15 of 29 November 2007: "*The damages to be ordered from those found affected by the classification and/or accomplices is linked to the referred restitutionary order such as, for example, the devaluation on account of the use made and time elapsed in respect of the property or rights to be recovered or the impossibility of verifying said return inasmuch as the property has perished, gone to bona fide third parties or benefits from irreclaimability or registry protection*"

another class of acts other than improperly obtaining property and causing damage and loss should be claimed through the channel of liability on insolvency under art. 172 bis IA.

3. The response of most other *Audiencias Provinciales* (AP of Madrid, Huesca, Leon, Pontevedra, Cordoba, Guipuzcoa, Caceres, Murcia, Granada, Balearic Islands...) differed, such courts considering that the liability on insolvency under art. 172 bis IA was a kind of objective liability - penalty, devoid of any inculpatory element in the production of the insolvency. Following this reasoning, if the conditions of art. 172 bis IA were met (opening of the liquidation stage, at-fault classification and existence of a shortfall), the director's conduct was sanctioned and ordered to meet all or part of the shortfall[3].

   With this reasoning, the phrase "*as well as to compensate for any damage or loss caused*" of art. 172(2)(3) IA was given a broad and independent interpretation, without linking such to the prior order to return property wrongfully obtained. Such liability would always lie provided the causal relationship between any case of damage or loss and the conduct of the person affected by the at-fault classification or accomplice was proven.

4. In short, the difference between the two lines of reasoning rested on whether or not the court should order redress of the shortfall on insolvency.

5. At this point, the reform of Act 38/11 did not dispel doubts regarding the legal nature of the liability on insolvency and it was the Supreme Court (SC) which ended up shaping the case law on this matter[4], doctrine that RDL 4/2014 has challenged with the new wording of art. 172 bis IA.

The heretofore peaceful case law of the SC concerning liability on insolvency

6. The SC[5] has stated that:

   (i) By exclusion, the liability on insolvency for the shortfall under art. 172 bis IA is not conceptualised as a penalty.

   Therefore, the SC attributes to this source of liability a compensatory or reparatory nature with respect to "*the damage indirectly caused to the creditors (...) to an extent equivalent to the amount of the claims they do not receive in the liquidation of the pool of assets*"[6]. In short, this liability has a "role in protecting the interests of the company's creditors", not a sanctioning or punitive role.

   (ii) By exclusion, nor is it compensation for the damage resulting from knowingly or recklessly bringing about or aggravating the insolvency. This kind of liability must be claimed under article 172(2)(3) IA, providing evidence of the classic action/omission, damage (identified with the damage or loss from "bringing about or aggravating" the insolvency) and causation.

   (iii) The liability on insolvency for the shortfall under art. 172 bis is a liability for another person's debt. Strictly speaking, the debt is of the insolvent legal person and the person affected by the

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[3] In the same way as with the liability of the directors under the Spanish Companies Act (CA), this reasoning meant allowing certain nuances to adjust or even release from the liability on insolvency. Hence, an automatic imputation was not always imposed, requiring instead subjective imputation, a review of personal involvement to support the penalty and the proportion of liability.

[4] SC Judgments of 23 February, 12 September, 6 October, 17 November 2011, 21 March, 26 April, 21 May, 20 June, 16 and 19 July 2012, 28 February 2013.

[5] SC Judgment of 16 July 2012.

[6] SC Judgment of 6 October 2011.

at-fault classification is required to take it on[7] in the event of opening of the liquidation stage[8] and non-satisfaction, in whole or in part, of the creditors' claims[9].

7. If these requirements are met, the Judge "*may*" order redress, in full or in part, of the shortfall.

   This "*may*" raised the question of which is the imputation criterion, which is not at all clear in the legal text and which the SC resolved by attributing to the Judge a wide discretionary freedom in the making of orders and determination of the quantum[10].

8. Because of the obligation to reason judgments (art. 120(3) of the Spanish Constitution), the SC required, in its exercise of discretionary powers, an "*added justification*" to make an order to meet the shortfall. That is, the reasons behind the determination should be clarified.

   The SC defined this "*added justification*" cryptically stating that "*the Judge must assess, in accordance with regulatory criteria and in order to substantiate the necessary reproval, the different objective and subjective elements of the conduct of each of the directors in relation to the acts that, attributed to the governing body with which they are identified or of which they form part, had determined the at-fault classification of the insolvency proceedings*"[11].

   In short, according to the case law of the SC, art. 172 bis IA did not require causation between the (wilful, negligent or without fault) conduct and the creation or aggravation of the insolvency of the company subject to insolvency proceedings[12].

9. The above doctrine is being applied and developed by the courts of law.

   For example , the AP no. 15 of Barcelona, with the strength of the convert, essentially states that the liability's reparatory role does not refer to direct damage but to something different, the "*damage that was indirectly caused to the creditors*"(...); "*one might say that this amounts to not requiring evidence, not even the existence of causation between the quantum of the penalty and the fact determining the declaration of at-fault insolvency proceedings*." Said court recognises that it is the judge who in each case specifies the sum and at the same time indicates the criterion of imputation he must serve himself of: as art. 172 bis IA is a rule of distribution or allocation of risks – just as corporate liability for company debts under art. 367 CA - "*There is objective imputation between the behaviour determining the at-fault classification and non-payment of company debts*". However, the

[7] The affected persons may be "*all or some of the directors, liquidators, de jure or de facto, or general attorneys-in-fact of the legal person subject to insolvency proceedings*" and now also, by virtue of the reform of RDL 4/2014, "*shareholders who have rejected without good cause the capitalisation of claims or issuance of securities or convertible instruments, thereby frustrating the attainment of a refinancing agreement under article 71 bis (1) or the fourth additional provision*".

[8] There will be no liability for the defaulting insolvent company if the at-fault classification is made within insolvency proceedings concluded by a composition with creditors, even if such is extremely burdensome (art. 167(1) IA).

[9] Be they creditors in insolvency proceedings or against the pool of assets.

[10] SC Judgment of 16 July 2012: "*The nature of the liability for another's debt is not obscured by the broad discretion that the rule attributes to the Judge in respect of making an order and determining the quantitative reach of such order – something unthinkable given the damage and loss all the accused must be held accountable for – which, however, raises the question as to what are the factors the Adjudicator should take into consideration (...)* ".

[11] SC Judgment of 28 February 2013 and those it refers to.

[12] In numerous judgments, the SC denies the plea of respondents ordered to meet the shortfall on insolvency that the *Audiencia* (which applied the sanctioning reasoning) should have justified or reasoned the causation between the behaviour of the director and the creation or aggravation of the insolvency. The Judgment of the SC of 19 July 2012 states in a case where it applied a presumption of art. 164(2) IA (accounting irregularities) that: "*We have stated in the above situations that, given the relationship between the provision of article 172(3) and those serving as precedent, conditioning the order against the director on the concurrence of a requirement that is not needed for the class of offence leading to the at-fault classification of the insolvency proceedings does not conform either to the necessary respect to judicial discretion the aforementioned provision recognises or to the systematic canon or hermeneutical integrity imposed by the mutual illumination of the concerned provisions*."

court recognises that facts may be ascertained that make it possible to exclude or reduce said objective imputation. Therefore, the judgment determining the quantum must take into account all the facts and circumstances relevant in each case to impute the aggravation of the insolvency and not just, in causation terms, the behaviour in relation to the at-fault creation/aggravation of the insolvency. The court specifies that "*it involves judging to what extent the shortfall is attributable to the directors, for which all the facts associated to the at-fault insolvency proceedings declaration must be taken into account, both jointly and individually*"[13].

Elsewhere (Oviedo), a distinction is drawn between the criminalised acts according to their abstract, not specific, gravity. For example, keeping a double set of books, serious inaccuracy or misrepresentation in the documentary evidence submitted in the insolvency proceedings, asset stripping, acts which delay, hinder or impede the levying of an execution against property, fraudulent trading or sham transaction, the penalty should be set between 75% and 100% of the shortfall. In a second group of conduct, such as a material breach of the book-keeping obligation, relevant accounting irregularity, opening of the liquidation stage due to a breach of the composition with creditors or breach of duties related to the annual accounts, the redress ordered would be between 30% and 75%. Finally, the penalty would not exceed 30% of the shortfall, in cases of breach of duty to petition for the opening of insolvency proceedings, breach of duty to cooperate and inform and non-attendance at the meeting of creditors.

10. With this doctrine consisting in not limiting judicial discretion in ordering the redress of the shortfall to causation between the conduct of the person found guilty and the creation or aggravation of insolvency has caused considerable legal uncertainty and concern for litigants, who do not know for sure what to expect in order to avoid such costly and serious liability.

The reform in this area operated by RD Act 4/2014

11. Now, amongst the profound reforms made to the Insolvency Act with the enactment of RD Act 4/2014, there is one that merits special attention because of the enormous practical importance it will have for the liability of persons affected by the at-fault classification of liquidating insolvency proceedings and with an outcome where the creditors' claims have not been fully satisfied (shortfall on insolvency).

    Leaving aside the novelty that those "*who have rejected without good cause the capitalisation of claims or issuance of securities or convertible instruments, thereby frustrating the attainment of a refinancing agreement under article 71 bis (1) or the fourth additional provision*" (art. 165(4), art. 172 bis and art. 172(2)(1) IA) will be persons affected by the at-fault declaration, RD Act 4/2014 has given a new wording to art. 172 bis (1) that has introduced a parameter to determine the liability for a shortfall on insolvency. Now the penalty ordering full or partial redress of the shortfall must be *"to the extent that the conduct that determined the at-fault classification created or aggravated the insolvency".*

    With this guideline, in order to avoid legal uncertainty , the legislator reacts against the SC's case law on this matter and rejects judicial discretion where ordering or not redress, prescribing that the judgment of liability must proceed in accordance with the terms expressed by the dissenting judge in the SC Judgment of 21 May 2012: "the criterion for imputation of liability would be determined by the influence that the conduct of the administrator or liquidator, deserving of the at-fault classification of the insolvency proceedings, has had in bringing about or aggravating the insolvency. Depending on the greater or lesser extent he has contributed to this creation or aggravation of the insolvency, such should be the extent to which he should be held accountable, which ordinarily will be reflected in the order to pay a percentage of the shortfall on insolvency: if fully responsible for bringing about the insolvency, he shall be liable to pay all the shortfall on insolvency; if responsible for having contributed to the creation or aggravation of the insolvency, such influence should be estimated."

[13] Judgment of the AP of BCN no. 15 of 23 April 2012.

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Obstruction of refinancing agreements and at-fault classification of insolvency proceedings

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I. Approach

The overhaul of companies in crisis sometimes requires the adoption of measures that affect the financial and legal position of a shareholder, thereby warranting the adoption of resolutions by the general meeting. Debt-equity swaps or the issue of convertible securities and bonds are paradigms of the aforementioned, as they invariably involve an actual or potential dilution for shareholders who do not exercise their pre-emption rights, but there are many other conceivable situations (e.g., amendments to the company's objects, divisions to clear the books, subsidiarisations traceable to management powers integral to general meetings, etc.).

In the context of insolvency proceedings, Spanish law does not allow the adoption of measures that affect the insolvent's governing body and capital structure, however necessary these measures may be to achieve corporate reorganisation (e.g., compulsory appointment or termination of appointment of company directors, expulsion of shareholders, court-ordered debt capitalisation, etc.). This is due to the nature of the rules that shape such law, which only fall on the company's assets and liabilities and only affect the holder of the same as far as necessary to achieve their goal.

The inadequacy of the legal framework makes it necessary to find solutions such as those contained in *Royal Decree Act 4/2014, of 7 March, on company debt refinancing and restructuring* with regard to the at-fault classification of the insolvency proceedings on account of obstruction of refinancing agreements. Imposing on shareholders the duty to collaborate with the overhaul is not easy and so the legislature has opted for a preventive - not punitive - rule: those shareholders who, without good reason, reject a debt-equity swap or issue of convertible securities or bonds and thereby defeat a refinancing agreement, shall be regarded as persons affected by the classification and, among other consequences, held liable for the shortfall on insolvency.

Below we will discuss some of the conditions of this new at-fault classification of the insolvency proceedings and we will make a first attempt at offering some criteria that, in our view, may serve as guidance for its implementation.

II. Elements of the case

2.1. Refusal without good reason

The new rebuttable presumption of article 165(4) makes it possible to classify insolvency proceedings as at-fault where the debtor or, if applicable, their legal representatives, directors or liquidators:

"4.Have refused, *without good reason*, the capitalisation of debt or the issuance of convertible securities or bonds, thereby defeating a refinancing agreement under article 71 bis (1) or the

fourth additional provision. For these purposes, *it is presumed that the capitalisation responds to a good reason when so declared* by a report issued, prior to the refusal of the debtor, by an independent expert appointed in conformity with the provisions of article 71 bis (4). If there is more than one report, the majority of the issued reports must agree on this assessment.

In any case, for the refusal to establish fault in the insolvency proceedings, the proposed agreement must *recognise, in favour of the debtor's shareholders and as a result of the proposed capitalisation or issue, a pre-emption right* on the shares, securities or convertible instruments subscribed to by the creditors in the event of subsequent disposal of the same.

However, the proposed agreement may exclude the pre-emption right on transfers carried out by the creditor to a company belonging to the same group or any undertaking whose purpose is the ownership and management of interests in the capital of other undertakings. In any case, disposal shall mean that made in favour of a third party by the creditor or by the companies or undertakings referred to in the preceding line."

Article 172, which regulates the content of the classification ruling and provides the legal consequences, states that the ruling may regard as persons affected by the classification managers and:

"(…)the shareholders who have refused, without good reason, the capitalisation of debt or the issuance of convertible securities or instruments according to the terms of article 165(4), depending on the degree to which they contributed to obtaining the majority required for rejection of the agreement".

It should be noted that the reference to *the degree to which they contributed to obtaining the majority required for rejection of the agreement* is in order to decide on the attribution of the "person affected by the classification" characterisation and not to "adjust" the associated legal consequences.

The last line of this precept adds a rule with reference to directors:

"The presumption under article 165(4) shall not apply to directors who have recommended the recapitalization with good reason, even if such was subsequently rejected by the shareholders".

The new art. 172 bis IA provides the legal consequence regarding the redress of the shortfall on insolvency, which operates without prejudice to the other consequences inherent in the classification (disqualification, damages, etc.):

"When the classification phase has been established or reopened as a result of the opening of the liquidation stage, the court may order all or any of the directors, liquidators, de jure or de facto, or general attorneys-in-fact of the legal person subject to insolvency proceedings, *as well as the shareholders who have refused, without good reason, the capitalisation of debt or the issuance of convertible securities or instruments according to the terms of article 165(4*), who have been held persons affected by the classification and liable to meet all or part of the shortfall, *to the extent that the conduct that determined the at-fault classification created or aggravated the insolvency*".

The wording of these rules and their integration into the regulatory system of the classification will generate problems in respect of their practical application, which was inevitable considering the hastiness of this legislative intervention.

In general, it can be said that the basic case of the presumption consists in defeating a refinancing agreement by refusing without good reason the capitalisation of debt or the issue of convertible

securities or instruments (art. 165(4) IA), but from there some doubts arise as to the elements that comprise the unlawful conduct.

First one must assess whether the rule presupposes the holding of a general meeting and presentation of a proposed agreement rejected with the casting of votes against or whether the rule may also apply when the general meeting has been prevented from taking place due to absence of quorum, as defined under the law or the articles of association. The answer to the latter should be in the affirmative because the obtainment of the required majority is the result of a process comprising the holding of the general meeting and, if such is prevented, so will the obtainment of the majority. The basis of this case of at-fault classification is hindrance and, therefore, it is our understanding that all possible events should be included. It would make no sense to treat differently that which is the same.

Good reason (to which, where appropriate, the experts reporting on the content of the agreements must satisfy themselves) presupposes the *appropriateness* of the measure in respect of the attainment of the ends pursued by the refinancing. On the basis of the wording of the rule one can deduce that refusal to recapitalise must have defeated the refinancing, so the condition must be not only appropriate, but also essential. Certain *proportionality* must also be found between the sacrifice imposed on the shareholder and the situation which would arise in case of rejection (e.g. loss of value of the shareholder's position in a liquidation context). Even if pre-emption rights are recognised, disproportionate sacrifices may not be imposed on the holders of capital from a qualitative (type of measure) or quantitative (extent of dilution) point of view. In principle, when shareholders lack real pecuniary interest in the transaction because the company has insufficient assets, no refusal may be deemed reasonable.

The reasonableness of the proposal must be demonstrated by whoever intends to avail himself of this presumption in the classification phase of the subsequent insolvency proceedings (if opened). The statements specifically provided in the reports of independent experts shift the burden of proving whether the adoption of these agreements (debt capitalisation, issue of securities, finance instruments) was appropriate and necessary to achieve the purposes of refinancing and whether such adoption causes a disproportionate sacrifice.

2.2. The rebuttable nature of the presumption

The scientific doctrine and case law widely consider that the rebuttable presumptions of at-fault insolvency proceedings (art. 165 IA) serve to prove the subjective element of the general clause (intent or gross negligence), but that the at-fault classification also requires proving the presence of an objective element (creation or aggravation of the insolvency) that is associated with the idea of causation of financial damage to the debtor (art. 164(1) IA).

According to this view, the unjustified refusal to recapitalise only proves the subjective element of the at-fault classification (intent or gross negligence) and those who seek to avail themselves of it must prove that such refusal caused financial damage that brought about or aggravated the insolvency (the objective element). Proof of financial damage caused by the refusal of the refinancing agreement, with all that that implies, is thus required.

This understanding of the scope of rebuttable presumptions raises serious questions because in many cases it will be impossible to prove the connection of the conduct comprising the same with the creation of financial damage, and surely another understanding of this rule, more consistent with the method of regulation (e.g., the thoughtful reflections of the Judgment of the *Audiencia Provincial* of Barcelona, of 21 February 2008), is possible.

In our opinion, proof of conduct comprising the presumptions of 165 IA is prima facie evidence of disorderly management and causation (objective imputation connection) between the insolvency and such management which is what is required to classify the insolvency proceedings as

at-fault. Proof of damage is only relevant at a later time, to assign the consequences associated with the classification (damages, liability for the shortfall, disqualification, etc.).

Thus, the insolvency of the legal person that refused to approve an agreement to refinance with debt capitalisation (adequate and without disproportionate sacrifice) that would have averted insolvency (creation) or corrected the direction in a context of proximity to insolvency (aggravation) will be held, prima facie, attributable to careless conduct in relation to the sphere of company creditors. This will exclude no-fault insolvency proceedings, declaring them at-fault.

Rebuttal evidence is possible. Refinancing is not always the only way to deal with the business crisis and there will be other diligent options from the point of view of creditor protection (e.g., in the face of imminent insolvency, it was resolved to instigate a petition for insolvency proceedings with immediate opening of liquidation). If there was no alternative, the mere refusal of refinancing will determine an at-fault classification in accordance with the terms above and with all its consequences.

2.3. The imputation to shareholders as persons affected

Reading all these legal provisions makes it clear that the reform, as a whole, is intended to punish the owners of capital who hinder the refinancing of a company in crisis which, in turn, requires the capitalisation of debt or the issue of convertible securities or instruments, and not to create a new case of classification and liability of directors.

The last line of article 172 tries to recall this. When the legislator warns that "The presumption under article 165(4) shall not apply to directors who have recommended the recapitalization with good reason, even if such was subsequently rejected by the shareholders" does not mean the opposite, that is, that directors who do not recommend the adoption of the measure will be considered affected by the classification by applying this new at-fault classification of insolvency proceedings.

Directors who do not recommend the adoption of overhaul measures already infringe general duties to protect the sphere of company creditors that fit in the standard clause of at-fault insolvency proceedings (art. 164(1) IA. In the legal model, the collaboration of the managers negotiating the refinancing agreement and the preparation of a proposed recapitalization agreement or issue of convertible securities or instruments is taken for granted.

The reference to *the degree to which they contributed to obtaining the majority required for rejection of the agreement* gives rise, however, to implementation problems.

As a general rule, the attribution of the characterisation of person affected by the classification is done somewhat automatically, because when it comes to directors it is only necessary to prove the position of director at the time of the events leading to the at-fault classification of the insolvency proceedings, and it is the person affected who must prove that the breaches giving rise to said classification are not attributable to him by reason of intent or gross negligence.

(T)he degree to which they contributed to obtaining the majority required for rejection of the agreement must serve the courts to handle this rule with some discretion according to the circumstances of each case.

With respect to closely-held companies it is difficult to know how the rule applies because all votes count and the hindering shareholder is easily identifiable. The nuance may have been intended for listed companies where it will be possible to distinguish between shareholders who actively hinder by requesting proxies to prevent the Board of Directors' and shareholders' proposal from going through and those investors who have confined themselves to granting their representation or who simply have not attended the general meeting to which they never attend. Clearly, the latter shareholders have contributed to preventing obtainment of the required majority, but it seems that the penalty should be reserved for those who actively defeated the proposal.

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"Value of real security" and "disproportionate sacrifice" in refinancing agreements under RD Act 4/2014

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In homologated refinancing agreements

1. According to paragraph 2 of the 4th additional provision, for the purpose of this provision the "value of real security" held by each creditor will be that obtained by subtracting the outstanding debts payable in priority with the property over which such security has been granted from nine-tenths of said property's fair value. Notwithstanding the foregoing, the value of the security can never be less than zero or greater than the value of the claim held by the appropriate creditor.

Scope

2. In principle, this regulation of the "value of real security" does not have effects outside the homologation (court approval) procedure under the 4th additional provision or, indirectly, the provisions of art. 71 bis (2)(c) of the Spanish Insolvency Act (IA). It shall not apply in the ordinary proof of claims on insolvency or, more importantly, in the determination of the security enforcement or sale price for the purpose of arts. 149 and 155 IA when the disposal of the secured asset is performed without auction or as part and parcel of a bulk transfer.

Importance of the "value of security"

3. Suppose the security in question is a highest-ranking claim and there are no charges payable in priority. In this case, the security cannot be greater in value than nine-tenths of the fair value of the asset over which the security rests. This means that the "secured" part of the claim exceeding this deducted value is deemed *in any case* (but only "for the purpose of this provision") as unsecured, *even if* the creditor could in fact settle the claim entirely by enforcing the secured property. This is the first ceiling of the value of an in rem security.

   The second ceiling would be the amount of the secured claim, so that the value of security may never exceed the total amount of the secured claim, otherwise obvious as in insolvency proceedings a creditor cannot use the surplus from an enforcement to the satisfaction of other claims unsecured by the security in question. Consequently, the claim surplus not covered by the statutory value of the security shall have the consideration of unsecured liabilities for the purpose of majorities regulated under the 4th additional provision.

Deduction of charges payable in priority

4. "(O)utstanding debts payable in priority with the property" are deducted from the property's fair value. Therefore, *real security payable in priority* and *first-priority legal mortgages* are deducted whilst mere *preferential* claims ("liens") are not, even if *outside insolvency proceedings the latter would have ranked senior* to the fixed charge created by a security interest; such is the case of wage claims enjoying super-priority.

However, will the debts *enjoying an execution against property right of payment prior* to the real security in question – and which according to extra-insolvency ranking rules were senior to said security – be deducted? Indeed, they must be deducted, even when involving a charge or quasi-security that would lose priority on insolvency, as occurs with execution caveat entries. This is so because, by definition, as long as the homologated agreement is subject to fulfilment, the debtor is not insolvent.

It is true that paragraph 10 of the 4th additional provision states that *to comply with the homologated refinancing agreement, the judge may order the cancellation of executions against property ordered in proceedings for the recovery of debts affected by the refinancing agreement*. "May cancel them", but may also not. In any case, this action would come after the homologation, not before, so it could hardly take effect in the security valuation stage. And finally, the vague term "cancellation of executions against property" can only mean a *stay of executions*, but not release of any caveat entry made. It would be arbitrary to propose this effect for the homologation, when not even the opening of insolvency proceedings has it.

5. Inevitably, *future* debts for which the debtor has advanced real security are not deducted either, not even in the *maximum amount of liability* agreed for this security against future liabilities.

6. Note the *amount of incentives* the secured creditor has to instigate as soon as possible the opening of insolvency proceedings and avoid being trapped in a situation covered by the 4th additional provision.

7. Are securities *pari passu in right of payment* agreed - over the same divisible asset – in the case of syndicated loans or other situations equivalent to a syndicated loan "securities payable in priority"? We know that for the purpose of enforcement of securities of *equal* rank the remaining co-extensive securities are regarded in the Spanish Mortgage Act as *senior* to the enforced security, but only insofar as the latter is enforced. Strictly speaking, in the joint real security stage there is no charge payable in priority or subsequent, since this condition is determined solely by reference to which creditor exercises, or exercises first, its right of enforcement.

   In my opinion, pari passu securities are not discounted for the purpose of calculating the value of security. But neither is it sensible to notionally multiply the value of an asset by as many securities as there are of equal rank. For example, if an asset with a value of 10 is charged with 5 securities of equal rank in favour of as many creditors, each of which is a creditor in respect of an amount of 4, the value of security for each creditor cannot be 10 or 4, but 2, since it is clear that the five creditors cannot be fully secured in this case. Consequently, we must proceed in the manner provided in paragraph 2 *in fine* when security is undivided.

8. Instead, real security will be deducted when it favours senior creditors in structured financing where a particular class of creditors has been subordinated by agreement. However, in this kind of structured finance another factor, more important than that expressed above, must be considered. It comes as no surprise if a Creditors' Agreement agrees that the holders of senior debt may hold, agree, negotiate and compromise in respect of the entire security, with effects against subordinated creditors. In this case there will not be a deduction as such, but a binding of these under-secured creditors by the vote of the senior creditors.

"Value of security" and classes of creditors

9. The legal procedure for calculating the value of real security introduces an equation giving the common economic value of any class of real security, be it a real estate mortgage loan, a pledge of inventory or security over future claims which are virtually devoid of pledge value.

   If each of these securities were to be managed as a whole within the refinancing agreement, the secured creditors would need to be divided in as many classes as creditors (or syndicate of creditors) as security rights are, since the existence of two securities with equivalent consistency is almost inconceivable.

Consequently, a class with the majority of 65% or 80% to which paragraph 4 refers could not be formed, and each would vote and form a majority in respect of itself as a class. However, the reduction of security to a quantitative amount covered by the priority in payment makes it possible, within the value of the security (which will be higher in respect of the mortgagee and almost nil in respect of a pledgee over future claims), for all secured creditors to be treated equivalently[1].

Calculation of the value of illiquid security

10. Suppose now that there is no market or objective procedure for determining the "fair value" of the property. In this case, sub-paragraph c) of paragraph 2 of the 4th additional provision states that, unless the exception provided therein applies, fair value shall be that determined by an independent expert - appointed by the Register of Companies under the terms of art. 71 bis (4) IA - in accordance with the generally accepted principles and standards of valuation for such property.

    This implies that an independent expert 's report (and not only the auditor's report) will be required where there are liabilities payable in priority by reason of real security (other than real estate: in such case an official appraisal would have to be provided). Excepted of this provision are security rights on financial instruments negotiated in regulated markets.

The burden of proving the value of security

11. It is unclear on who bears the initiative or the burden of providing this expert report. The instigators of the agreement? The debtor? This seems logical and almost necessary in view of the wording of paragraph 5 (*The application must be made by the debtor and is to be accompanied by the adopted refinancing agreement, the auditor's certification on the sufficiency of the majorities required to adopt the agreements with the effects provided for each case, the reports issued (if any) by independent experts appointed in accordance with article 71 bis (4)*). But the debtor may not know *bona fide* what securities are enjoyed by certain financial creditors. Will valuation be required from the auditor issuing the "sufficiency" of financial liabilities report? Probably not. If not appointed by the Registrar as an "independent expert", is this auditor in the same situation of not been able, even if knowing it, to determine the value of security? Chances are that the burden *ultimately* lies - as with ordinary proof of claims on insolvency - on those who intend to *not be included in the class of unsecured creditors*. And they will have to do so in the time limbo existing between the publication of the order giving permission to proceed and the homologation decision made by the "fast track procedure" to which paragraph 6 refers.

In ordinary non-homologated agreements without a qualified majority

Conditions of non-rescission (no unwinding)

12. An essential requirement for a refinancing agreement - not qualified by art. 71 bis (1) and not homologated by the 4th additional provision- to enjoy the resistance on insolvency to which art. 72(2) refers, is that *the value of resulting security in favour of the involved creditors does not exceed nine-tenths of the value of the outstanding debt in favour of the same, or the security to outstanding debt ratio prior to the agreement*. The value of security is as defined in paragraph 2 of the 4th additional provision.

The "waiver" of real security

13. At least one-tenth of each claim resulting from the agreement must be *under-secured* and the total claims as a whole must not increase their secured part vis à vis the secured-unsecured ratio

[1] That the rate of depreciation of a given real security may be much higher than that of other real security is problematic, nonetheless. Movable security loses value quickly; a mortgage security may not lose value. This would make it necessary to continuously recalculate the value of securities in order to determine if just before court approval the required qualified majority proportions are maintained.

pre-existing the agreement. Consequently, if the claims prior the agreement were fully secured or over-secured, involved creditors must waive security rights or inject new unsecured claims and, in general, the involved creditors cannot improve their position in respect of a hypothetical liquidating dividend on the debtor's insolvency. But they may also *waive* the priority rank of their claim above this ceiling, though in fact it may be that the claim would be satisfied in full with the value of the security if enforced. Note that the fresh money that may have been granted with the agreement can be secured, but cross-collateralization of old claims is not allowed.

The "disproportionate sacrifice"

14. In the original version of the 4th additional provision, the judge would homologate the agreement if it did not impose a "disproportionate sacrifice" on dissenting creditors. In the text resulting from the reform of 2014, the judge will not make this assessment prior to homologating the agreement. The disproportionate sacrifice will only be taken into account if a (dissenting) creditor challenges the agreement already homologated. It is the only substantive reason that can be alleged in a challenge.

When is there a disproportionate sacrifice?

15. Whether or not a sacrifice is disproportionate must be determined on the basis of the criteria contained in recommendation 22 c) of the EU Commission Recommendation of 12 March 2014, according to which "the restructuring plan does not reduce the rights of dissenting creditors below what they would reasonably be expected to receive in the absence of the restructuring, if the debtor's business was liquidated or sold as a going concern, as the case may be". In other words, a sacrifice is disproportionate when the refinancing agreement forces dissenting creditors to bear a liquidating dividend lower than they would have received upon a direct sale of insolvency assets. No creditor is obliged to sacrifice himself beyond his hypothetical liquidating dividend to sustain an insolvent company as a going concern.

16. The above standard only makes practical sense for secured creditors to which the refinancing agreement is "extended" against their will and for dissenting (secured) creditors of the syndicate to which the agreement reached by 75% of the creditor syndicate is "imposed", pursuant to the aforementioned paragraph 2 of the precept. A creditor whose claim is *fully* secured would not be subject, prima facie, to accept against his will the extension of *any* effects of the refinancing agreement described in paragraph 4 of the 4th additional provision, *since any of the effects places him in a situation worse* than that he would find himself in if he had enforced his security in accordance with the terms of art. 56 IA.

17. There is a very sensible situation where this conflict is heightened. In any case, if a creditor (or syndicate) has a pledge over the total capital of the holding company or over all of the shares in the operating subsidiaries, any measure that does not deliver *as payment* the same shares, which eventually would be awarded (or transferred to a third party) in the event of enforcement of the security, entails for the creditor(s) a disproportionate sacrifice. Moreover, in such cases allowing the debtor to negotiate and present a different agreement constitutes a disbursement, as it could only result in a deduction of the expected value from the secured creditors to partially compensate others interested parties in the insolvency proceedings, who, in the assumption of enforcement, almost certainly have a liquidating dividend of zero value.

Once again, the statutory value of security

18. To determine the liquidating dividend of these *fully* secured creditors, the "value of real security" must be calculated in accordance with the terms explained above. The value of real security *may not exceed* nine-tenths of the fair value of the encumbered asset, and therefore the *fully* secured creditor will have to discount or waive one-tenth of the value of security in calculating its liquidating dividend. The loss of expected value of the asset as a result of the imposition of the stay under 4th additional provision or art. 56 IA, must also be deducted from this value. These two deductions determine the threshold of disproportionate sacrifice.

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

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

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.

[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.

And yet, the 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.

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Classification of claims under a refinancing agreement pursuant to Royal Decree Act 4/2014

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According to its Explanatory Notes, RD Act (Order in Council) 4/2014, of 7 March, adopting urgent measures on business debt refinancing and restructuring, aims to facilitate the financial repair and recovery of companies facing an economic crisis. To this end, a set of rules varying in scope and significance have been laid down, which I here discuss with regards to the treatment reserved to loans granted under refinancing agreements - as provided by the Spanish Insolvency Act (IA) - and their signatory creditors.

1. The superseded legal regime in respect of "fresh money".

Article 84(2)(11) IA, in its wording prior to entry into force of RD Act 4/2014, classified as claims against the asset pool, though limited to fifty percent of their value, claims arising from fresh money granted under a refinancing agreement as provided in the erstwhile art. 71(6) IA. Further, it was stated that this consideration did not apply when the fresh money had been provided by the debtor itself (how could it apply given that the insolvent company can hardly be a creditor – on insolvency or against the asset pool – in respect of itself?) or by specially related persons through share capital increases, loans or other acts with a similar purpose (the reference to capital increases is equally puzzling since claims do not arise for the person who becomes a shareholder or increases his stake in the company). In fact, claims in these cases were classified as subordinated by virtue of art. 92(5) IA.

The foregoing was completed with the provisions of art. 91(6) IA, under which claims deriving from fresh money granted under a refinancing agreement would be preferential in the amount not recognised as a claim against the asset pool (although not specified by the Act, even if meaning fresh money, loans granted by persons specially related to the debtor would be deemed to not enjoy such preference).

This regime was criticised by some, contending that it did not sufficiently encourage fresh money in the case of viable companies in distress. On the one hand, because attributing a (sixth-place) preference to 50 per cent of the value of the claim did not ordinarily entail a great advantage if insolvency proceedings were to be opened. And, on the other, because it meant maintaining the subordinated claim classification for claims of people specially related to the debtor (which are often the natural - and sometimes only – source of financial resources in times of economic hardship).

2. The legal regime provided for the next two years: the temporary reinforcement of favourable treatment to "new money"

The new regime intends to forestall the criticism mentioned in the preceding paragraph. And it does so with a technique that is certainly peculiar inasmuch as it alters only temporarily the described situation. Indeed, the second additional provision of RD Act 4/2014 states that, during the two years following its entry into force, the content of the aforementioned arts. 84(2)(11) and 91(6) IA shall not apply. Actually, the rule cannot be understood literally: these provisions will continue to apply during the next

two years for all loans involving fresh money granted in refinancing agreements concluded before 9 March 2014.

Anyway, during said two-year period, loans involving fresh money and granted under a refinancing agreement *signed after the entry into force of RD Act 4/2014*, on the terms of the new art. 71 bis or the new 4th additional provision IA, will be considered, *for the full amount*, claims against the asset pool. Note that even loans granted by the debtor itself (?) and by persons specially related to the insolvent company will be considered claims against the asset pool. The RD Act views as an exception to the latter rule the case where fresh money been made obtained through a share capital increase, which is hard to comprehend for the reason previously outlined.

The 2nd additional provision of RD Act 4/2014 also provides that the interest accruing from the aforementioned loans shall be subordinated (art. 92(3) IA). This rule represents a worsening with respect to the situation that would arise if it had not been made; in the absence of a special rule, interest of a claim against the asset pool would also be considered a claim against the asset pool. Thus, the so-called "fresh money preference" only affects the principal provided.

Finally, the same 2nd additional provision states - keeping for this two-year period the criterion followed in the current wording of art. 84(2)(11) IA - that in the event of liquidation, loans granted under a composition with creditors to finance the viability plan will also be considered claims against the asset pool.

Importantly, after a period of two years from the date of grant (which must be construed as from coming into existence), the loans we have been discussing will be claims against the asset pool in the terms of art. 84(2)(11) IA. A truly enigmatic rule, which seems to imply that, once two years have elapsed, 50 per cent of claims arising from unpaid fresh money will be included in the list of creditors as preferential claims and that those held by people specially related to the debtor will be classified as subordinated claims (thus producing a change in the consideration of claims on insolvency). The (possibly unacceptable) consequences of this rule makes it advisable to narrow its scope and regard it as referring to the event of the insolvency proceedings not having been effectively opened within two years from emergence of the claim (so that if a such a procedure had already begun at the time, the consideration of such claims would not be altered on insolvency). Nothing is said in the rule in respect of interest, which creates uncertainties regarding the treatment to be applied thereto.

Nor is the construction to be put upon the single transitory provision of RD Act 4/2014 clear with regard to the matter at hand. According to this provision, refinancing agreements negotiated under the former art. 71(6) IA at the time of entry into force of the new set of rules will be subject to the previous regime if the debtor has already requested the appointment of an independent expert. This, followed to the letter, could lead to the conclusion that the 2nd additional provision would not apply in these cases, but rather arts. 84(2)(11) and 91(6) IA, even if the refinancing agreement is finally signed after such entry into force. However, this interpretation must be rejected, construing instead that it is intended that the transitory provision only refer to the requirements refinancing agreements must meet (in particular, concerning the appointment of an independent expert). Hence, if the appointment of an independent expert had already been requested by the time RD Act 4/2014 came into force, the regime previously contained in the former arts. 71(6) and 71 bis IA would apply, unless the parties chose, within the refinancing agreement, to be subject to the regime of the current art. 71 bis (1) IA (the positive formulation of the latter qualification confirms the proposed interpretation on the scope of the single transitory provision).

3. The applicable legal regime after two years from the entry into force of RD Act 4/2014

After the two-year period provided in the 2nd additional provision, arts. 84(2)(11) and 91(6) IA – and, therefore, the regime outlined above under section 1 - will regain their validity. The aforementioned reform thus reveals itself to be merely circumstantial (not structural).

In any case, it should be noted that although the first of the two abovementioned provisions has been amended by RD Act 4/2014 (so that it now refers to art. 71 bis and the 4th additional provision IA), the same has not been done with the second, which still mentions art. 71(6) IA. This is of no consequence as it is clear that the referral to the new art. 71 bis and the new 4th additional provision should be deemed done once the said two-year period elapses.

4. The claims of creditors who have capitalised all or part of their claims

The RD Act 4/2014 reserves a specific treatment for creditors who have capitalised all or part of their claims under a refinancing agreement adopted pursuant to art. 71 bis or the 4th additional provision IA. *This new regime is applicable from the entry into force of the aforementioned RD Act and its validity is not subject to a time limit*.

The problem addressed is that raised by the possibility of creditors who have, under a refinancing agreement, capitalised their claims (through a share capital increase offsetting claims) being regarded as persons specially related to the debtor. Indeed, upon becoming shareholders, the rule of art. 93(2)(1) IA could be applied, which would discourage the granting of further financial facilities under said agreement (there would be no problem, however, with claims prior to the acquisition of the stake, since insofar as the holders thereof were not shareholders at the time of their coming into existence, subordination would not come into play).

Well, what has been done is to include a new paragraph under art. 92(5) IA, which reads as follows: "*Creditors who have directly or indirectly capitalised all or part of their claims under a refinancing agreement adopted pursuant to article 71 bis or the 4th additional provision, shall not be considered persons specially related to the insolvent company for the purpose of classification of claims held against the debtor as a result of refinancing granted in consequence of such agreement*."

Thus, the inconvenience previously discussed is resolved and the creditors that have capitalised their claims as a result of a refinancing agreement (only these creditors) are guaranteed that subsequent loans granted under the same agreement (only these claims) will not be subordinated later on account of being considered persons specially related to the insolvent company.

However, it is desirable to make some additional clarifications as to the scope of the new rule: (i) since one of the objectives of the reform is to facilitate debt-equity swaps as a method of financial repair, there should be no obstacle in the application of the rule even if the creditor who has capitalised his debt was prior to that already a shareholder with a relevant stake within the meaning of art. 93(2)(1) IA (although this, of course, will be relevant regarding the classification of non-capitalised claims existing prior to the refinancing agreement); (ii) the legal diction seems to cover others who could also be persons specially related to the insolvent company, such as group companies and (de facto or de iure) directors, liquidators or ordinary attorneys-in-fact. That is: not only are refinancing loans excluded from subordination where granted by creditors who. as a result of the capitalisation of claims, acquire the status of specially related persons, but also those of other persons who, having also proceeded to capitalise, could see their claims subordinated by other circumstances, regardless of whether they have acquired or not a significant stake through a debt-equity swap.

5. The (intended) conceptual delimitation of the de facto director

One of the "risks" that "refinancers" have had to endure was that of being classified as de facto (shadow) directors to the extent that refinancing agreements often include clauses that, in varying degrees, allow these creditors to "oversee" (or even "influence") the debtor's actions.

This de facto director classification actually has several consequences, one of which is its consideration as a person specially related to the debtor (insolvent company after), which entails the subordination of all claims held by said person.

Naturally, the possibility of this happening can sometimes discourage the participation of certain creditors in refinancing agreements. However, to reduce the described risk, a new sentence has been included in art. 93(2)(2) IA, according to which: "*Unless proven otherwise, creditors who have signed the refinancing agreement provided in article 71 bis or the 4th additional provision shall not be considered de facto directors in respect of the obligations assumed by the debtor in relation to the viability plan*".

From a technical point of view, the new rule is highly questionable since it seems to part (doubtlessly mistakenly) from the existence of a presumption that needs to be destroyed (when this is clearly not the case; one of the few clear points surrounding the de facto director is that the burden of proof lies with whoever alleges the existence of such person). Note that the rule states that if there is no evidence to the contrary, a creditor who has signed a refinancing agreement will not be considered a de facto director by reason of the existence of certain obligations assumed by the debtor under the business viability plan (as if, in the absence of evidence, such creditor could be considered a de facto director; and as if the other creditors who have not signed the agreement could be so considered under those conditions of lack of evidence). And, at the same time, it follows that when there is evidence that a person is a de facto director...such person will be effectively considered a de facto director! Therefore, the only thing that can be reasonably inferred from the new rule is that the mere assumption of certain liabilities by the debtor under a viability plan cannot be considered, by itself and without other considerations, as evidence of the presence of a de facto director. This, on the other hand, was already so before.

In this way, a substantially useless rule is included (the result would be the same in its absence) that raises, however, some problems. Among these, that it leaves the field open to logical fallacies (using the always dangerous art of interpreting *a contrario*) that lead to the conclusion that if there are refinancing agreements that do not meet the requirements of art. 71 bis or the 4th additional provision IA, the signatory creditors are to be presumed de facto directors. In any case, as the rule lacks any new regulatory content, asking oneself whether it is made only for the purpose of the classification of claims or also for the characterisation of the insolvency proceedings, is of no relevance.

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