Rescission under the Spanish Insolvency Act

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This paper aims to briefly describe the scenarios where acts or actions might be rescinded (particularly in the context of refinancing or debt restructuring of Spanish companies) pursuant to the Spanish Insolvency Act ("**SIA**") and the consequences of rescission from a legal standpoint. Procedural questions related to the subject matter are not analyzed in this document.

What acts can be rescinded?

Section 71 of the SIA establishes the possibility of rescinding certain acts within the two (2) year period preceding the Declaration of Insolvency, on the grounds that those acts are prejudicial to the insolvent estate and regardless of whether or not those acts had been performed with the aim of deceiving the interests of the creditors. Upon Declaration of Insolvency, those actions which are deemed by the judge to be detrimental to the estate of the insolvent debtor and which have been carried out during the two (2) year period preceding such date, may be rescinded even in the absence of fraudulent intention. The underlying rationale for this mechanism of rescission is the protection of the assets of the insolvent debtor as well as the principle of equality amongst creditors (*par condition creditorum*).

a) In order to assess which acts or actions may be detrimental to the insolvent estate (and therefore which actions may be rescinded upon Declaration of Insolvency of the Spanish debtor); the SIA establishes two main presumptions:

   Thus, pursuant to section 71.2 of the SIA, ***the detrimental nature of the act is irrefutably assumed*** in cases of (i) disposal actions without consideration (except for liberalities); and (ii) other acts aimed at discharging obligations where the due date is subsequent to the date of the Declaration of Insolvency (in other words, advanced payments) except if such obligations were secured with *in rem* security.

   By way of example of one of the presumptions mentioned above, there are Commercial Court precedents that provide for the rescission of guarantees granted by subsidiary companies in favour of their parent companies "without a consideration" on the grounds of these being detrimental to the aggregate assets of the insolvent company (in this case, the subsidiary companies which granted the securities).

b) Furthermore, pursuant to section 71.2 of the SIA, ***detrimental nature of acts is presumed but can be rebutted*** in the event of (i) disposal actions carried out in favour of a party related to the insolvent debtor (i.e. shareholders of the debtor); (ii) creation of *in rem* guarantees to secure pre-existing liabilities or new liabilities assumed to substitute the former and (iii) payment in advance of obligations or liabilities guaranteed with *in rem* security, which had a due date subsequent to the Declaration of Insolvency.

In the event of acts or actions outside the scope of the presumptions mentioned above, the detriment shall be evidenced by the person bringing the action of rescission. The fact that an act or action is detrimental to the insolvent debtor's estate shall be examined by the courts on a case-by-case basis.

Careful consideration should be given to structural modifications of capital companies, such as mergers, spin offs, and assignments of assets and liabilities, among other transactions. Recent case law which cites Section 44.2 and 47.1 of Act 3/2009, on Structural Modifications *(Ley de Modificaciones Estructurales de las sociedades mercantiles or **LME**)* has consolidated the principle of immunity to rescission of structural adjustments based on (i) the company creditors' right to contest such transactions in the term and conditions provided for in the *LME* and (ii) the impunity of these structural adjustments once they have been duly registered with the Companies' Registry.

Who can bring an action of rescission?

The legal standing to bring an action of rescission corresponds to the insolvency administrators. Creditors shall have subsidiary legal standing and shall be entitled to bring such an action when they had applied in writing to exercise any action, by stating the specific acts/actions they aim to rescind or contest, when the insolvency administration did not do so within the two (2) months following the request by the creditors.

Effects of rescission

According to the SIA (section 73), the ruling admitting the rescission shall declare the contested act ineffective and shall condemn the parties involved in the rescinded act to the reciprocal restitution of the goods or services, plus interest and fruits, if any.

In the event that the rights and assets affected by the rescission can no longer be returned to the insolvent debtor (since they no longer belong to the defendant but to third parties or parties which, according to the ruling, had intervened in good faith, or which enjoyed non recoverability or registry protection), the defendant shall be liable for paying the value of the assets/rights at the time of their exit from the insolvent debtor's estate in addition to legal interest. If the ruling finds that the party which contracted with the insolvent debtor intervened in bad faith, the party shall be required to compensate for the damages caused to the insolvent debtor's estate.

Once there is a ruling in favour of rescission, the defendant creditor shall have a claim against the aggregate liabilities of the insolvent debtor, which shall be paid simultaneously to the reintegration of the assets and rights subject to the rescinded act, except if the court declares bad faith on the part of the defendant creditor, in which case the creditor's claim will be subordinated.

Exceptions

The SIA lists certain acts which shall not be rescindable, namely, (a) ordinary acts of the professional or business activity of the insolvent debtor performed under normal conditions, (b) acts comprehended within the scope of the special laws that regulate the payment and setoff and liquidation systems of securities and derivative instruments; and (c) security created in favour of claims under Public Law and in favour of the Salary Guarantee Fund (Fogasa) in the agreements foreseen in their specific regulations.

Refinancing Agreements

The rescission regime under the SIA explained above complicated the refinancing process of Spanish companies and the SIA was amended in 2009 and 2011[1] in order to somehow facilitate and incentivize the refinancing processes.

Further to these amendments, another exception to rescission under the SIA refers to certain refinancing agreements between the insolvent debtor and its creditors. Thus, refinancing agreements (hereinafter referred to as the "**Refinancing Agreements**" or "**RA**") whose purpose shall be to (i) substantially increase the funds available to the debtor; and/or (ii) expand the tenor or reorganize the terms of the debt that are to be re-negotiated (either by extending its maturity date or creating new obligations in substitution of the former), shall not be rescinded provided they meet the requirements set out in Section 71.6 of the SIA. This protection against rescission will not only cover the Refinancing Agreement itself but will extend to any arrangements and/or payments documented by any mean as well as to the security granted pursuant to such Refinancing Agreement.

[1] Real Decreto Ley 3/2009 and Ley 38/2011, dated October 10.

Briefly, the mandatory requirements of a Refinancing Agreement set out in Section 71.6 of the SIA are as follows:

a) The RA shall be part of the debtor's short and mid-term viability plan;

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

c) It shall be executed before a Spanish Public Notary and recorded in a public document;

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

If the above requirements are met, only the insolvency administrators (and not any other creditors) shall have the legal standing to bring an action for rescission against a Refinancing Agreement. Hence, even though documenting any preinsolvency arrangements among debtor and creditors as a Refinancing Agreement mitigates the risk of rescission, such risk cannot be fully discarded.

Other actions

Outside the scope of the SIA, the Spanish Civil Code contemplates the legal action aimed at the rescission of acts and actions made in fraud of creditors in instances when the creditors cannot collect what is due to them in any other way. In this case, the statute of limitation shall be of four (4) years. However, once the court has issued the Declaration of Insolvency, only the insolvency administrators, and in certain cases the creditors, shall have the legal standing to execute this action.

Conclusions

The insolvency administrators will carefully review any acts or actions performed during the two (2) year hardening period and examine the terms and conditions under which they were carried out. From the creditor's perspective, it is of paramount importance to check that any acts executed with borrowers are not assumable in the list of presumptions included in the SIA. Likewise, if at all possible, documenting any preinsolvency arrangements among a company and its creditors as a Refinancing Agreement under Section 71.6 of the SIA is highly recommended in order to prevent from the possibility of other creditors claiming the rescission of such agreement.

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