Some Legal Issues On Spanish Pre-Insolvency Debt Restructurings

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1. Introduction

Given the prolonged distressed situation of the Spanish credit market, corporates and creditors are finding it increasingly necessary to proceed to debt restructurings. Such debt restructurings may be limited to amend and to extend situations or have a broader effect, including haircuts, equitization and/or equivalent measures. In the recent years we have seen different restructuring trends mainly due to: **(i)** the Insolvency Laws having been amended to open alternative routes (not as useful as intended); **(ii)** the use of foreign jurisdictions to procure non-consensual restructurings and **(iii)** the evolution of Spanish restructuring market practice as well as market participants becoming more knowledgeable on structures which have been already known in other jurisdictions for some time.

This note aims to briefly identify the most analysed restructuring alternatives in Spain and spots some of the main legal issues and tools surrounding the same. For the purposes of this note the term "**Insolvency Act**" or "**SIA**" shall refer to Law 22/2003 as amended from time to time; whereas the term "**Consensual Restructuring**" shall refer to a debt restructuring on which 100% of the creditors are consenting; likewise, the term "**Non-Consensual Restructuring**" shall refer to a debt restructuring were not 100% of the creditors are consenting.

This document does not pretend to be comprehensive and should not be relied upon. Specific legal advice should be at all times requested for each particular situation.

2. Some Issues on Spanish Restructuring

Consensual Restructuring as a pattern

It can be asserted that most of the Spanish debt restructurings (certainly in number, and less clearly in terms of volume) have been performed by means of Consensual Restructurings. Therefore, a particular debtor will be facing maturities, liquidity tensions and/or other distressed situations and financial creditors will unanimously agree to provide refinancing or restructuring options. This has been the general pattern in the past, although it will not necessarily be the pattern in the future.

As a general principle –and subject to different provisions being agreed upon the finance documents– financial debt restructuring will require consent of 100% of the creditors whose debt is to be amended. If the respective finance documentation provides otherwise –like majority decisions under syndicated agreements– such different agreements should be respected, although it is market practice in Spain that haircuts, extensions, amendment of interest rates and generally all "money terms" under bank documents require unanimous consent to be amended. This is not always the case for some delicate issues such as amending pre-payment provisions or changing applicable law, where particular attention should be given.

Filing for insolvency by the Debtor if a deal is not agreed

According to Section 5 of the Insolvency Act a debtor must file for insolvency within the two (2) months following the date on which

it knows –or should have been aware– of his state of insolvency. By "state of insolvency" the SIA refers to a cash flow test measured on the inability to pay its debts when due. This "obligation to file" is critical on each pre-insolvency restructuring process as it will determine an end-game date, save for the pre-insolvency period described below. Director's liabilities if filing is not made serves as a good incentive for the filing and a creditor should expect the company to do so within the said period. Creditor's filing for insolvency is technically possible although difficult in practice due to the tests that need to be evidenced and the chances that, upon such risk, the debtor prefers to file itself.

The Pre-Insolvency Period (Section 5 bis of the SIA)

Section 5 bis of the SIA allows the debtor to postpone the declaration of voluntary insolvency if it has commenced negotiations in order to reach a refinancing agreement or adhesions to an early composition of creditors. In this case the debtor shall communicate such negotiations at any time before the ending of the two (2) month period and will benefit from additional four (4) months to reach an agreement with its creditors (three (3) to reach an agreement and one (1) more to document it) (the "**Pre-Insolvency Period**").

During the Pre-Insolvency Period the main effects are that the company is protected from being filed for insolvency by its creditors and that directors are not obliged to file for insolvency within the statutory two (2) month period. However, Section 5 bis does not include any temporal stay to individual enforcements or foreclosures by creditors during the Pre-Insolvency Period. If during the Pre-Insolvency Period the borrower reaches an agreement with its creditors by virtue of which it is no longer insolvent, then it will not have to file for insolvency after the said period. However, it will most likely do so if the agreement is not reached. It should be also be noted that nothing prevents the debtor from filing for insolvency at any time within the Pre-Insolvency Period if it so considers.

Clawback and the concept of Refinancing Agreements

In order to protect the assets of the insolvent debtor as well as to maintain the principle of equality amongst creditors (*par condition creditorum*), 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's estate. Upon declaration of insolvency, those actions which are deemed to be detrimental to the estate of the insolvent debtor and which have been carried out during the 2 year period preceding such date, may be rescinded even in the absence of fraudulent intention.

Some actions which one would ordinarily expect to see in a Consensual Restructuring, such as the granting of new security in exchange of an extension, the increase in the interest rate (or inclusion of PIK elements) and alike may not only fall within the risk of rescission but, in some circumstances, fall under certain presumptions of rescindibility (mostly based on voidable preference or undervalued transactions) which need to be analysed in detail.

In order to mitigate this risk the Insolvency Act was amended to include the concept of a refinancing agreement ("**Refinancing Agreement**"). A Refinancing Agreement is a transaction which complies with the following conditions: **(i)** the Refinancing Agreement shall be aimed at substantially increasing the funds available to the debtor; and/or to amending the terms of the debt that is to be re-negotiated by means of the Refinancing Agreement; **(ii)** the Refinancing Agreement shall be a part of a short and mid term viability plan of the debtor; **(iii)** the Refinancing Agreement shall be approved by creditors representing, at least, 3/5 of the total liabilities of the debtor; and **(iv)** an independent expert appointed by the Spanish Companies House (*Registro Mercantil*) should issue a report assessing on, among other issues, sufficiency of the information provided, reasonability of the Refinancing Agreement, proportionality of its security and feasibility of the viability plan.

From a formal standpoint the Refinancing Agreement shall be executed before a Spanish Notary Public and recorded in a public deed to which all documents evidencing the content of the Refinancing Agreement as well as the fulfilment of all the above-mentioned requirements shall have to be attached. If the above is complied with and the restructuring is included within a broader Refinancing Agreement, then the claw-back risk of the financing or its security is

severally mitigated (not eliminated, although there is substantial discussion as to the exact level of protection given by the Refinancing Agreement due to the argued inconsistency of two different provisions within the SIA).

Additionally, the Refinancing Agreement will have two additional effects: **(i)** section 84.2.11º of the SIA provides that any credits representing income for the debtor ("*fresh money*") obtained within a Refinancing Agreement shall be deemed 50% credit against the estate –i.e. super senior as regards non-charged assets- and 50% privileged –senior to ordinary claims and junior to pre-deductible claims, in both cases as regards non-charged assets–; and **(ii)** a Refinancing Agreement could be used to effect a certain "cram-down" through a Court Homologation, as described below.

Note that the rule that a Refinancing Agreement requires 3/5 of total liabilities of the debtor does not replace the need for the 100% consent of the debt which was described above. This is, 3/5 of total liabilities will be needed in order to qualify as a Refinancing Agreement and, in addition, the required majorities for obtaining consent will need to be in place or a Court Homologation –described below– be available and used.

Limited Non-Consensual Restructurings

As said above the tools available for pre-insolvency non-consensual restructurings in Spain are limited and thus its use has not been significant. Limited does not however mean inexistent and they need to be considered in each situation. Below is the description of some available options. This note intends to refer to pre-insolvency options and thus it does not cover the alternatives which the Spanish insolvency process (or *concurso*) brings, either by reaching an agreement within the insolvency process or reaching an anticipated composition before insolvency and imposing it while insolvent (thus shortening the respective timeframes).

Cram-down through Court Homologation

The 4th Additional Disposition of the SIA provides that any Refinancing Agreement that is compliant with the requirements set out above and is approved by financial entities holding al least 75% of the "bank debt" of the debtor can be approved by the relevant Commercial Court ("*homologación judicial"*) and, if approved, some of its provisions can be forced to the other 25% of unsecured financial entities. Although the wording of the provision is unclear, the intention seems to be that once the Refinancing Agreement has been homologated, the stays in payments accepted by the financial entities adhering to it are extended to any absent or dissident unsecured financial entity (secured credits not being forced to the stay).

The relevant Commercial Court shall ensure the reasonability of the Refinancing Agreement and make sure that the mechanism is not disproportionate with respect to any absent or dissident creditors. In particular, the judge shall ensure that the stay period agreed under the Refinancing Agreement and security granted to secure such agreement are not disproportionate for dissenting creditors.

The said Additional Disposition includes a three (3) year limitation which has lead to confusion by market participants, being doubtful whether such three (3) year limit applies as a maximum duration of the deferral of payments capable of being imposed on dissident creditors or as the maximum duration of a restriction to individual enforcements (which could eventually even affect to secured creditors as argued by some scholars) which the provision includes. There are some Court Precedents stating that the three (3) year period established by the 4th Additional Disposition does not operate as a limitation of the maximum duration of the deferral of payments capable of being imposed on dissident creditors, thus if this interpretation is maintained longer periods could be imposed (Ruling of the Commercial Court of Barcelona number 6, dated June 5, 2012 / Ruling of the Commercial Court of Seville, dated May 21, 2012). Whether this interpretation will finally prevail is still unclear. Also, how the three (3) year limitation on enforcement is to be interpreted is still unclear, particularly as regards who can be prevented from enforcing (secured and/or unsecured) and how this provisions should be read in combination with the stay to the unsecured.

There are also discussions as to whether the Refinancing Agreement to be homologated will require both the 3/5 of total debt approval requirement which is inserted in the definition of "Refinancing Agreement" and the 75% requirement

mentioned above or if, on the contrary, only the latter is required. On this topic the Commercial Court number 6 of Barcelona dated June 5, 2012 confirmed that the homologation of a Refinancing Agreement only requires the approval of financial entities holding at least 75% of the "bank debt" of the debtor (and not 3/5 of the liabilities, as it is established in Section 71.6), since the homologation ruling should only affect financial creditors. Again whether this interpretation will prevail is still unclear.

What so far seems to be clear is that the limitations of this Court Homologation are significant: **(i)** secured creditors should not be forced to a stay through a Court Homologation (note that the law seems to refer to the impossibility of forcing secured creditors rather than forcing creditors as regards the value of their security); **(ii)** non-consenting creditors may not be forced to a haircut through a Court Homologation and **(iii)** creditors may not, through this process, be obliged to equitise their debt (debt-for-equity swap). These limitations have made the Court Homologation less useful in practice.

Non-consensual restructuring through the use of contractual provisions

In addition to using a legal process, many market participants have considered (and executed) Non-Consensual Restructurings by applying structures and contractual provisions which were inserted in their respective documents when the deal was initially agreed or in a previous restructuring. Generally this will involve: **(i)** a somewhat controlled enforcement of the pledge of shares of the debtor (or its holdco) which generally will require a majority vote, **(ii)** payment of the enforcement price through debt (or sustainable notes) rather than in cash, **(iii)** delivery of such notes to consenting and dissenting lenders of the syndicate (so including the lenders that did not vote in favour of the enforcement) through the respective waterfall and **(iv)** application of release provisions in the intercreditor agreement to release the remaining debt (which generally can only be applied upon an enforcement of security taking place).

There are various reasons why these type of structures are rarely used in Spain, mostly being: **(i)** this system generally requires that a pledge over the shares of the borrower or its holding company be in place, which is not always the case, **(ii)** in order to proceed in this way the enforcement of the shares will generally need to be made by appropriation (rather than by public auction, which is the Spanish primary system for enforcement) and this will ordinarily imply using jurisdictions such as Luxembourg, which may not be in place at the time, **(iii)** within the enforcement process payment will need to be made in new debt (sustainable notes) rather than in cash, such method of payment creating a number of issues in a Spanish enforcement and thus reverting generally again to foreign jurisdictions, and **(iv)** the vast majority of the intercreditor agreements drafted under Spanish law not including release provisions which would allow the Agent to release the remaining debt (and even more, most of the Spanish capital structures below a certain threshold not having significant intercreditor agreements in place).

Due to the above limitations this process seems to be particularly useful in structures where Luxco entities (or equivalents) are located on top of the operative company, the pledge agreements can be enforced in jurisdictions that allow for non-cash appropriation and mostly where the finance documents are UK law or, if Spanish law, LMA based. These characteristics will mostly be found in post-LBO structures and in some other deals which, being above a certain value, have already been restructured.

The use of a UK Scheme of Arrangement

It is not the purpose of this note to discuss and argue on the validity and enforceability of a UK Scheme of Arrangement on the debt of a company with its Center of Main Interest (or COMI) in Spain but it should be indicated that UK Scheme of Arrangements to effect a non-consensual restructuring of a Spanish company have been used in the past and should be analyzed for particular situations.

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