Spanish Loan-to-Own: Capital Increases in Exchange of Debt

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The main purpose of this note is to briefly explain some of the different procedures by virtue of which a creditor can become a shareholder (controlling or not) of a Spanish company. Leaving aside some more complex strategies, the conversion of debt into equity will generally be effected through a capital increase or through the enforcement of security over the respective shares. Loan to own through enforcement of security is not included in this analysis and will be discussed in a different paper. Obviously creditors will generally not agree to become equity holders as a stand-alone deal (since they would be subordinating their claims) but this is generally a useful tool when used in combination with a further debt restructuring (i.e. some creditors agree to equityse subject to some others agreeing to an amendment of their debt terms).

According to Section 295 of the Spanish Companies Act ("SCA"), the share capital of a company can be increased by issuing new shares or by increasing the par value of the existing ones. In both cases the capital can be increased through monetary or in kind contributions, including the set-off of credits that any creditor may hold against the company. Up until recent times the conversion of debt into equity was made through a capital increase through set-off (i.e. the debt was extinguished by set-off against a certain number of shares in the debtor). For the reasons explained below this process has proven technically difficult in various Spanish restructurings, particularly when –within a syndicated financing– some members wish to equityse and some do not and individual acceleration is not allowed under the terms of the finance documents. The other option that has been used (not without some serious scholarly discussion) has been to increase the capital through contribution in kind, where the asset contributed is the debt against the company itself. In this case the debt is extinguished automatically by confusion (since debtor and creditor would become the same person) but it is not a set-off that is taking place, but rather an actual transfer of the debt of all or part of the creditors to the debtor-company. Below we are including some brief analysis on these and thereafter some of the practical differences between one approach and the other.

1. Capital increase through set-off

The conversion of debt into equity through set-off implies a capital increase with an equal value to the cancellation of a credit that the holder bears against the company. Since the capital increase is envisaged to be made through set-off, the following requirements shall be met under Spanish laws:

(i) in the case of Limited Liability Companies (S.L.s), all credits which are being equitysed must be due and payable; and

(ii) in the case of Joint-Stock Companies (S.A.s), at least 25% of the credits must be due and payable, and the due date of the remaining must not exceed 5 years.

In addition to the above when the General Shareholders Meeting is called a report from the Board of Directors shall be made available to the shareholders. The report shall include the main characteristics of the credits to be set-off, identity of the creditors, number of shares to be created and other fundamental information. In

addition in the case of an S.A., the company's auditor shall certify that, upon review and examination of the Company's accounting, the details regarding the credits provided by the Board are accurate and complete.

The majorities and quorums are those generally applicable for modifications of corporate By-laws. In the case of an S.L., a majority vote in favor by more than 50% of the share capital with voting rights is required. In the case of an S.A., more than 50% of the share capital with voting rights must be present at first call, in which case the resolution may be adopted by a simple majority. At second call, the quorum goes down to 25%; however, when less than 50% of the share capital is present, the vote in favor by at least 2/3 of the share capital either present or represented at the meeting is required.

There are no preemption rights for the existing shareholders in this type of capital increase

2. Capital increase through contribution-in-kind

A contribution in kind is a non-cash input which is received by a company in exchange of shares. This is fundamentally different to a set-off since it is an asset (in this case the credit) which is transferred to the company in exchange of shares, the shares not being in consideration for the actual set-off but in consideration for the transfer of the asset.

The application of the capital increase through contribution in kind when the asset is a credit right held against the company has been the subject of strong discussions (since in some way it leads to a result equivalent to the set-off but by applying different requirements).

In our opinion, the option of contributing a credit as an in-kind contribution should be deemed as possible under Spanish corporate laws. There are some recent precedents where the contribution in kind of a credit held against the company has been also accepted by Spanish Mercantile Registries and, consequently, duly registered and completed.

The SCA (in article 58) allows contributions of any goods or rights whose value may be assessed, and credits undoubtedly fall within this definition. Article 65 of the SCA expressly governs the contribution of credit rights to share capital, requiring that the contributor guarantee the legitimacy of the loan and the solvency of the debtor. The fact that the Law provides for a specific procedure for increasing capital through set-off does not in our opinion mean that a credit cannot be contributed to the debtor company in accordance with the general system for capital increases by way of in-kind contributions. Otherwise, the possibility of contributing a credit against the debtor company itself when it is not payable in the terms described above would be excluded and, in our opinion, such exclusion would have no legal grounds. It is quite another matter that in these cases the report from the Board of Director and the auditor's certificate mentioned above in point 1 will not be sufficient; rather, the procedures established by Law for in kind contributions must be followed in order to guarantee the value and existence of the contributed credit.

As regards such requirements here again there are some differences between the S.A.s and the S.L.s, the main one being that within the S.A.s the contribution shall be evaluated by an independent expert appointed by the Commercial Registry, such report including a description of the contribution (i.e. the debt) and its value. There are some exceptions to the need of a report, such as: (i) when the securities are listed on a secondary market; (ii) when the contribution consists of assets, other than those previously mentioned, whose fair value has been determined, within the previous six months to the effective date of the contribution, by the independent expert; (iii) when the capital increase is aimed to provide the shareholders with new shares of an acquired or split company and a report on the proposed merger or division has been prepared by an independent expert, or (iv) when the capital increase is aimed to give the new shares to shareholders of a company subject to a takeover bid.

The majority and quorums required in these cases are the same as for capital increases though set-off. And, just as with the latter, there are no preemption rights in the case of an in kind contribution.

3. Some differences between the two options

Using the set-off route or the contribution in kind route for a loan-to-own has various practical

consequences which need to be analyzed in detail. Apart from the different procedures noted above, there are other examples, some of which are described below:

(i) *Need to accelerate the debt:* if capital increase is done through set-off most or all of the debt needs to be due and payable (as described above). This, in the case of a corporate credit –for example- will generally require that the same be due or otherwise accelerate it (totally or partially). Partial acceleration of credit facilities in Spain is generally not included in Spanish financings and thus its highly likely not a possibility. If acceleration is required this opens other issues, among others what is the status of creditors owing a piece of the syndicate debt and which are not willing to equityse (they will be left with an accelerated claim against a company with a better balance-sheet which, needless to say, is generally not a comfortable position for the equitysing group). Note that it is not uncommon that finance documents do not allow for individual acceleration of a lender's participation and thus majority decisions will generally be needed (and such decisions will be binding on dissenting lenders). Conversion of debt into equity through contribution in kind does not require debt to be due and thus there is no need to accelerate the debt.

(ii) *Individual or collective decisions:* if the increase is to be made through set-off and once the debt is accelerated, what decision must be adopted by a syndicate to accept a set-off? Will this be a majority decision (which can be taken with the consent of the majority lenders, binding any hold-outs) or will it be a unanimity decision (for which purposes all lenders need to agree)? This would need to be analyzed on a case by case basis, however it is more than likely that unanimity is required to effect a set-off since this will have the effect of changing the "money terms" of the deal (it will imply receiving paper in exchange of cash). If capital increase is done through contribution in kind it is the credit right which is to be contributed, and therefore each lender as owner of such credit right will have the capacity of transferring it to the company in exchange of shares (absent contractual limitations). In an ordinary Spanish syndicated facility one would generally find some restrictions which would not enable for the assignment of the debt to the debtor itself and thus it is likely that contractual amendments would need to be implemented. However, the decision to amend the assignment provisions can be of those that only require a majority vote (to be analyzed on a case by case basis).

(iii) *Are newly issues shares captured by sharing provisions?:* particular care needs to be given to reviewing the sharing provisions under the respective credit agreement to see if they capture the set-off (which generally will do) and/or the proceeds for an assignment with consideration in shares (which generally will not).

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