ALLEN & OVERY

September 2014

New amendment to the Spanish Insolvency Law

Royal Decree-Law 11/2014

Contents

Summary

On 5 September 2014, the Spanish Government approved the Royal Decree-Law 11/2014, of 5 September, on urgent insolvency measures, amending various provisions of Law 22/2003, of 9 July, on Insolvency. The law was published in the Official Gazette on 6 September and entered into effect the day afterwards, 7 September 2014. Further amendments to the law are expected to be passed by the Spanish parliament in a few weeks time.

The aim of the recent Royal Decree-Law is to broaden the ability of corporate debtors to enter into compositions with their creditors, to enable them to survive as going concerns, notwithstanding that the debtors have been declared insolvent and have entered into formal insolvency proceedings. At present, a large number of companies that enter into insolvency proceedings still end up being liquidated rather than being rescued or restructured, despite other amendments made to the Insolvency Law since 2009.

Accordingly, certain cram-down procedures enabling financially distressed debtors to refinance or restructure their debts that were previously available only at the pre insolvency stage (the so-called *homologación* or Spanish scheme of arrangement) are now available within insolvency proceedings, providing debtors with another potential exit route from judicially declared insolvency through a composition agreement implemented pursuant to a *homologación*.

The new regulation of special privileged (secured) claims within insolvency proceedings

Among other amendments to the Insolvency Law, the entire value of the claim of a secured creditor will no longer automatically be treated as a specially privileged (secured) claim. Under the prior law, although there may have been a complete mismatch between the value of the relevant secured assets and the value of the creditor's claim, the mere fact that a creditor held a security interest, although the secured asset may have been of little value, transformed the full amount of the debt into a secured claim.

With the new reform, special privileges will only apply to a proportion of the secured creditor's debt claim equal to 90% of the fair value ascribed to the relevant charged assets or rights, once any higher ranking charges have been accounted for.

The method for calculating the fair value of the secured asset will differ according to the nature of the asset. Thus, (i) intangible assets such as shares or debt securities listed on regulated markets or other money market instruments shall be valued according to their market value; (ii) real

estate shall be valued according to a valuation methodology approved by a company authorised for these purposes by the Bank of Spain; and (iii) other types of assets shall be valued according to the methodologies set out in reports prepared by independent experts. Depending on the quantity of secured assets that an insolvent debtor owns, the requirement to carry out these valuations could delay or complicate the preparation of the insolvency report regarding the debtor that insolvency administrators are obliged to prepare within the first few weeks of their appointment.

When one security is jointly granted over the same asset in favour of two or more creditors, the security value that will be assigned to each creditor's claim shall be such proportion of the total security value ascribed to the relevant secured asset as that which each creditor is entitled to receive from the proceeds of realisation of the secured asset after taking into account the contractual terms of the relevant security interests.

Finally, the amendment makes clear that these legal provisions governing the valuation of security interests are applicable to insolvency proceedings and no amendment is made to the rules regarding the registration of security interests in the relevant public register or the provisions which govern the enforcement of security interests outside of insolvency proceedings.

These amendments are applicable to all insolvency proceedings opened after the law comes into effect and to those insolvency proceedings that had already been opened at the date the law became effective if, at that date, the relevant insolvency administrator had not presented its provisional insolvency report to creditors (such affected proceedings are referred to as **Relevant Insolvency Proceedings** in this bulletin). The amendments do not apply to other insolvency proceedings that were opened before the law came into effect.

The new classes of privileged creditors

Under the new reforms, the list of a debtor's creditors prepared by the insolvency administrator must divide privileged creditors (both general and special) into four different classes:

(a) Labour creditors (e.g. employees).

(b) Public creditors.

(c) Secured financial creditors; this class includes all secured creditors holding any financial indebtedness of the debtor regardless of whether the creditor is regulated by or subject to the supervision of a financial authority.

(d) All other privileged creditors.

Specially privileged creditors are creditors holding security interests (although see above regarding how secured claims will now be valued). Generally privileged comprise mainly tax authority claims, social security, and some labour credits. The division of privileged creditors into these separate classes will be most relevant in the composition phase of the insolvency proceedings since the majority of the members of each class will now be able to agree the terms of a proposed composition in a manner that is binding on any dissenting or abstaining members of the relevant class in accordance with new cram-down provisions as described below. This amendment will also apply only to Relevant Insolvency Proceedings.

People closely linked with the debtor

A minor amendment to Article 93 of the Insolvency Law has been introduced. Persons who are specially related (as that term is defined in the Insolvency Law) to an individual who is a shareholder in the insolvent debtor (such persons being principally individuals who are husbands, wives or parents of, or other companies owned or controlled by, the shareholder and companies in the same group of companies as a company owned/controlled by the shareholder) will also be considered to be people closely linked to such insolvent debtor. Certain debt claims held by a closely linked person against the insolvent debtor risk being equitably subordinated to other debt claims.

The reason for the amendment is to prevent certain fraudulent practices that had been prevalent in the market using the concept of the separate legal personality of corporations.

This amendment applies only to Relevant Insolvency Proceedings.

New regulation of the composition agreement

The main reform regarding composition agreements is the broadening of what may be proposed by way of composition and greater flexibility as regards cramming down dissenting creditors under certain circumstances.

With respect to the commercial terms that may be proposed in a composition agreement, the limitations regarding the maximum debt write off (50% of the value of creditors' claims) and the maximum deferral (five years) that a composition could impose have been lifted; although for a composition agreement to exceed these maximum caps, an enhanced majority of creditors, 65% by value, will have to approve the composition.

Alternatively, compositions may now propose the conversion of debt claims into shares, quota shares, convertible bonds and subordinated loans or into profit participating loans (which rank as equity under Spanish law), or the conversion of debt into any other financial instrument with a different ranking, term or characteristic from the original debt, and the capitalisation of loan interest.

Whenever debt claims are converted into shares/quota shares, it is expressly stated that any share capital increase of the debtor required to enable the capitalisation of the relevant loans to proceed must be approved by the same majority of shareholders as that which must approve the increase under corporate law applicable to the type of company in question.

In addition, debt for asset swaps may be included in the composition agreement, provided that (1) the assets or rights assigned to a creditor are not required by the debtor for it to continue its business activities and (2) the fair value of the assets is equal to or lower than the amount of debt which is cancelled. However, public creditors can never be forced to accept debt for asset swaps.

For a composition proposal to be approved, the following majorities must vote in favour of it:

A) *Standard procedure*: the previous regime is maintained. In other words, if creditors representing at least 50% by value of all the debtor's ordinary unsecured liabilities (and not just 50% of those who actually vote on the composition) vote in favour of the composition agreement, ordinary claims can be subject to write-offs and deferrals but no more than 50% of any claim can be written off; and deferrals cannot exceed five years. Alternatively, in the case of creditors other than those that are public or labour related, debt claims can be converted into profit participating loans and their repayment deferred for up to five years.

   However, as an exception, when the proposed composition provides for (i) the complete payment of ordinary unsecured claims within three years or (ii) the immediate payment of any ordinary claims that are presently due and which are not subject to a write off of 20% or more, the composition shall be validly approved if, of those creditors who vote on the composition, a greater number of ordinary creditors in value vote in favour of it rather than against it, as was the case before.

B) *Enhanced majority procedure*: under the new law, where the composition proposal is approved by a new enhanced majority of 65% by value of all the ordinary unsecured creditors, the composition can impose debt deferrals of more than five (and up to 10) years and debt write offs greater than 50% of creditors' claims. Moreover, save as regards creditors that are public or labour related, the composition can convert debt into profit participating loans with maturities deferred for up to ten years, and provide for the other measures foreseen in Article 100 of the Insolvency Law (basically alternative proposals and debt for asset swaps).

Separately, as aforementioned, new provisions affecting privileged creditors have been put in place. Secured creditors are still free to decide whether or not to vote on a composition agreement, but there now exists the possibility that the composition agreement may also become binding on dissenting [or abstaining] secured creditors if secured creditors holding 60% by value of the claims that are admitted as secured claims under the new valuation rules described in paragraph 2 above (for the issues described in paragraph A) above) or 75% by value of the admitted secured claims (for the issues described in paragraph B) above) vote in favour of the composition agreement. Similarly, compositions can become binding on other classes of privileged creditors (labour, public and other privileged creditors) if the applicable majority of the creditors comprised in the relevant class (65% or 75% by value depending on the terms of the proposed composition) vote in favour of it.

This amendment is only applicable to Relevant Insolvency Proceedings.

VOTING RIGHTS WITH RESPECT TO COMPOSITION AGREEMENTS

Furthermore, additional measures have been introduced to eliminate some of the factors that acted as disincentives to secondary market participants acquiring the debt of companies facing financial difficulties.

Until this amendment came into force, one of the greatest limitations faced by any purchaser of debt claims against a debtor that had been declared insolvent before the debt acquisition was that it could not vote on any composition proposed within the insolvency proceedings, unless its acquisition had arisen by way of operation of law through a merger of legal entities (universal succession - *sucesión universal*) or through an enforcement proceeding (*realización forzosa*), or if the acquirer was an entity subject to supervision by a financial regulator. As explained in the Royal Decree-Law, the aforementioned prohibition was established to prevent fraudulent purchases of claims. However, the intention of the government is now "*to promote the existence of a market for such credits, enabling holders of claims to obtain better market liquidity for the disposal of claims in situations where the debtor has been declared insolvent*". Therefore, under the new law, only people closely linked to the debtor who purchase claims after an insolvency

declaration has been made will be prevented from voting on a proposed composition.

This amendment is only applicable to Relevant Insolvency Proceedings.

In addition, for the purposes of calculating the votes in favour of a composition agreement, the rule relating to syndicated facility agreements that had already been introduced with regard to pre-insolvency compositions (*homologaciones*) has been extended to composition agreements made within insolvency proceedings: if a composition is approved by 75% by value of the creditors under a syndicated facility agreement, all the creditors in the syndicated facility agreement will be deemed to have voted in favour of it.

This amendment is also only applicable to Relevant Insolvency Proceedings.

NEW REGULATION REGARDING COMPOSITIONS WITH CREDITORS: APPLICABILITY TO COMPOSITIONS WITH CREDITORS ALREADY APPROVED

The remaining important changes are introduced in the transitory provisions (*disposiciones transitorias*) of the Royal Decree-Law. The law confirms that the terms of compositions with creditors approved before this amendment came into force must be completely fulfilled by the debtor on the terms approved by the creditors.

However, if a composition with creditors is breached in the next two years (that is, before 7 September 2016), the debtor, or creditors holding at least 30% of the total debt outstanding at the moment of the breach, may request an amendment of the terms of the composition in accordance with the new rules and majorities established in the amended Insolvency Law.

Any amendment of the composition would require the court being satisfied, on the basis of the evidence presented to it, that the debtor will be able to comply with the new terms and remain a viable entity. In addition, to be approved, the following majorities of the creditors must vote in favour of the amendment:

(a) In the case of ordinary creditors:

  (1) 60% by value to approve terms which do not require an enhanced majority under the new law.

  (2) 75% by value to approve terms which require an enhanced majority under the new law.

(b) In the case of privileged creditors:

  (1) 65% by value of the creditors comprised in the relevant newly designated class of privileged creditors to approve terms which do not require an enhanced majority under the new law.

  (2) 80% by value of the creditors comprised in the relevant class of privileged creditors to approve terms which require an enhanced majority under the new law.

The above rules are not applicable to public creditors (*acreedores públicos*), who are not taken into account for voting and quorum purposes.

Therefore, the new law aims to provide a further and final restructuring opportunity for those companies that have already agreed a composition with their creditors but breach the terms of that composition in the next two years.

Developments with regard to the liquidation of insolvent debtors

DISPOSAL OF PRODUCTIVE UNITS

A number of additional rules have been introduced in relation to the disposal of a debtor's business units or divisions within the liquidation phase. Where there are current contracts between the debtor and third parties (eg. suppliers, customers, gas, electricity etc) which contracts need to remain in place to ensure the continued viability of the business unit, if a third party buyer acquires the business unit, those contracts will be deemed to be novated from the debtor to the third party even if the contract counterparty does not expressly consent to that transfer, provided it has not requested termination of the contract as part of the liquidation process.

In addition, licences or administrative authorizations which are necessary to enable the continued viability of a business unit transferred to a purchaser will also be deemed to be assigned to the relevant purchaser (without it having to apply for a new licence), provided that the purchaser continues the relevant business activity at the same premises.

Moreover, except in the case of public creditors (*acreedores públicos*), liquidation plans may now provide for certain creditors' claims to be satisfied by way of the transfer to them of certain goods or rights (*cesión en pago o para pago*), unless those goods or rights are secured in favour of another creditor when special rules under section 4 of Article 155 of the Insolvency Law will apply to protect the secured creditor's interest in those goods or rights. This amendment is applicable to all insolvency proceedings opened after the new law comes into effect and to those insolvency proceedings that had already been opened at the date the law became effective if, at that date, the liquidation phase of the proceedings had not been opened (such affected proceedings are referred to as **Relevant Pre-liquidation Proceedings** in this bulletin). The amendments do not apply to other insolvency proceedings that were opened before the law came into effect and in which the liquidation phase has already started.

DISPOSAL OF ASSETS SUBJECT TO SPECIAL PRIVILEGE (PRIVILEGIO ESPECIAL)

An exception to the application of Article 155.4 has been introduced in respect of goods and rights that have been charged by the debtor in favour of creditors to secure the payment of certain claims but where those goods or rights form part of premises or a business unit or division of the insolvent debtor and which has been transferred as a whole to third party. If that is the case, the following rules will apply:

(a) If the goods or rights are transferred to the purchaser free and clear of the relevant third party charges, the part of the price paid that corresponds to the secured goods or rights comprised within the relevant premises or business unit shall be paid to the third party secured creditor.

If the part of the purchase price that is payable to the secured creditor does not cover the "*fair value*" of the secured asset, it will be necessary to obtain the consent of creditors holding 75% by value of the claims of those secured creditors comprised within the relevant class of privileged creditors (i.e. labour creditors, public creditors, financial creditors or other creditors), which have the right to individually

enforce (*ejecutar separadamente*) over the goods or rights that are the subject of the transfer to the third party.

If the price to be received is equal to or greater than the value of the security, no consent of the affected secured creditors is required.

(b) If goods or rights are transferred subject to the relevant charges, and the purchaser is subrogated to the debtor's obligations to the secured creditor, the secured creditor's consent will not be necessary, and the relevant claims will be removed from the list of creditors of the debtor. The insolvency court must ensure though, that the purchaser has sufficient financial standing and intends to meet the obligations that are transferred to him.

This amendment is only applicable to Relevant Pre-liquidation Proceedings.

APPEALS PENDING AGAINST LIQUIDATION ACTS

The insolvency court, within the liquidation phase, upon its own decision or following a request from any of the parties within the proceedings, can put into escrow in the Court bank account funds in an amount of up to 10% of the total value of the insolvent estate (*masa activa*). This amount will be available to discharge any sums eventually ruled to be payable to creditors as a result of claims and appeals filed by those creditors against individual acts or steps taken in the liquidation phase.

This amount will be released for distribution to creditors when either the aforementioned appeals have been resolved or when the deadline for the filing of such appeals has expired.

This amendment is only applicable to Relevant Pre-liquidation Proceedings.

New regulation affecting debtors who are a party to public contracts and public services

Additionally, specific rules have been introduced with regard to the insolvency of companies benefiting from public contracts or providing public services. Although it is expressly established that the specific rules governing the public sector and the relevant public contracts still apply, it is also possible to consolidate the conduct of the insolvency proceedings for several of these companies in one single proceeding, even if the proceedings were opened at different times, if any proposed composition will potentially affect the creditors in all of the proceedings. Composition proposals in relation to these types of entity may be filed by public administrations, including public bodies, public entities and corporations related to or dependent on them.

These amendments are only applicable to debtors whose public contracts have not been terminated, irrespective of the date on which they were entered into with the relevant public authority, regardless of the phase which the insolvency proceedings are in.

Other matters

It is worth highlighting two areas that have been modified.

First, it is expressly established that pre-insolvency proceedings under Article 5 bis and *homologaciones* (the Spanish scheme or arrangement) shall be financial reorganisation measures for the purposes of the Royal Decree-Law 5/2005, of 11 March which implements the EC Financial Collateral Directive in Spain.

Hence, it is now clear that creditors can enforce their security over eligible financial collateral even in those cases in which the debtor is subject to the moratorium protection afforded by Article 5 bis proceedings.

Finally, to avoid restrictive interpretations, the amendment specifies that debt claims transferred to the Spanish bad bank (SAREB) are to be taken into account in calculating whether the creditor majority required to approve a *homologación* has in fact done so.

Key Contacts

We will be pleased to discuss with you any information or further clarification which may arise in connection with any of the matters included in this Bulletin.

Antonio Vázquez-Guillén
Partner
Litigation

Tel +34 91 782 9810
antonio.vazquezguillen@allenovery.com

Borja Fernández de Trocóniz
Partner, Madrid
Litigation

Tel +34 91 782 9916
borja.fernandezdetroconiz@allenovery.com

Ignacio Ruiz-Cámara
Partner
ICM-Banking

Tel +34 91 782 9943
ignacio.ruiz-camara@allenovery.com

Javier Castresana
Senior Associate, Madrid
Litigation

Tel +34 91 782 9814
javier.castresana@allenovery.com

Allen & Overy

Pedro de Valdivia 10, 28006 Madrid, Spain

Tel +34 91 782 98 00

Fax +34 91 782 98 99

www.allenovery.com