

Spanish Insolvency Law Reform Extends to Composition Agreements

A second round of material reforms should encourage the viability of distressed companies in Spain.

Royal Decree Law 11/2014 (the New Reform) is another clear effort to decrease the number of insolvent companies which end up in value-destructive liquidation in Spain. In order to achieve this, the New Reform has extended the main principles of pre-insolvency refinancing agreements — which were introduced by the March 2014 reform of the Spanish Insolvency Law (the [March Reform](#)¹) — to composition agreements and has set forth certain rules regarding the sale of production units and company liquidation.

In this Client Alert, we discuss the following key implications:

- **Composition agreement provisions:** Among other amendments, the scope of the composition agreement provisions has been broadened and cram-down possibilities have been built in.
- **Production unit sales and liquidation:** The New Reform has included specific rules.
- **Other related provisions:** Among other amendments, the New Reform includes new insolvency 'guilty' classification rules and a second opportunity for composition agreements.

Composition agreements provisions

Extension of the terms of a composition agreement

Composition agreements can now be more flexible because the New Reform allows for more varied alternatives. Hopefully these four new alternatives described below will help reduce the increasing number of insolvent companies which end up in liquidation:

- Limitations:** The New Reform has removed the previous general restrictions on stays and haircuts. Now a 10-year limit applies to stays, as opposed to the previous five-year general limit to stays, (which will not apply if the composition agreement is unanimously approved); and haircuts are uncapped.
- Alternative proposal:** The New Reform allows for the composition agreement to include alternative proposals including the conversion of debt into shares, convertible bonds, subordinated loans, participating loans, loans with capitalized interest or any other financial instrument with ranking, maturity or other characteristics different from those of the original facility. However, these alternative proposals may not be imposed on public creditors (*i.e.* public authorities).

- (iii) **Assignment of assets in lieu of payment:** This alternative is available to the extent that (a) said assets are not necessary for the business or professional activity of the insolvent debtor; and (b) their [value](#)² (please see B (ii) below) is equal to or less than the amount of the relevant claim (any excess should be paid back to the insolvent estate). Again, this measure may not be imposed on public creditors.
- (iv) **Direct sale:** The composition agreement may include proposals regarding the direct sale of the insolvent debtor's whole business or of particular production units. Please see section "Production unit sales and liquidation" below for the relevant applicable rules.

Notably, many of the above alternatives may not be imposed on public creditors. Depending on the insolvent debtor's kind of company, and depending on the nature of its liabilities (e.g. if public creditors hold the majority of credit rights), including so many exceptions for public creditors could mean, in practice, that the above described terms have little or no effect.

Privileged creditors

Specially and generally privileged creditors have now been divided into four creditor classes. In addition, given that specially privileged creditors' claims are only privileged up to the value of the security interest, certain provisions have been included in order to ascertain how to calculate such value:

- (i) **Classes of privileged creditors:** Specially privileged creditors (*i.e.* secured creditors) and generally privileged creditors have each been classified into the following four categories:
- Labor creditors (*i.e.* employees)
 - Public creditors (*i.e.* public authorities)
 - Financial creditors
 - All other creditors (mainly, trade creditors)
- Significantly, when dealing with majorities, the New Reform (in contrast to the UK Scheme of Arrangement) does not refer to the number of creditors within any particular class, but rather only considers the percentage of total liabilities or value of the security (please see 'Voting rights and majorities' below) within a class of creditors.
- (ii) **Value of security interests:** The value of the specially privileged creditors' security interest is calculated using the same formula which is used in [pre-insolvency refinancing agreements](#)³ pursuant to the March Reform; the following rules apply to the calculation of the "reasonable value" of security:
- Publicly traded securities: The reasonable value shall be the weighted average price during the quarter immediately preceding the declaration of insolvency.
 - Real estate property: The reasonable value shall be determined in an appraisal report issued by a recognized appraisal expert (*sociedad de tasación*).
 - Other type of assets: The reasonable value shall be determined by means of an independent expert's appraisal report.

Calculating the reasonable value of security interests over assets other than publicly traded securities or real estate property can be troublesome, given that a reliable and developed market precedent may not be available — such as a pledge over contingent or unquantified future credit rights arising from purchase agreements or hedging agreements. This issue is particularly relevant in multijurisdictional cross-border deals and/or if such underlying agreements are subject to foreign law, since this adds even more uncertainty.

Further to the above, we would have expected the reforms to have included rules allowing for the valuation to be updated throughout the insolvency proceedings, since the value of the collateral is likely to vary during that time.

In addition, significant questions remain around the issue of whether the resulting appraisal of the security interest could be challenged and, if so, by whom, how and when. Arguably, given that creditors may challenge the list of creditors and the inventory, they should also be able to challenge the value of security interests. However, this matter remains unfortunately unclear.

Voting rights and majorities

The New Reform includes certain voting rules and majorities which inter alia update, most notably, the cram-down regime:

- (i) **Post-insolvency acquisitions:** Creditors (whether subject to supervision or not) who have acquired their credit rights after the initiation of insolvency proceedings are now entitled to vote regarding the composition agreements, unless the creditors are specially related⁴ to the insolvent debtor.

Particularly worthwhile, the concept of a company's "shareholders" — for the purposes of specially related persons — includes both direct and **indirect** shareholders. This significantly broadens the concept of "specially related person" and may materially affect lenders involved in insolvency proceedings in Spain.

- (ii) **Syndicated facilities:** The 75 percent majority rule included in the [March Reform](#)⁵ has now been extended to composition agreements.
- (iii) **Majorities generally:** The New Reform has included three majority log-steps which debtors must reach in order to approve a composition agreement depending on its proposed content:

	Majority required	Stay	Haircut	Alternative arrangements
(1) "Super Soft Composition agreements"	Simple majority of those participating in the vote	Up to 3 years	None	None
		None	Less than 20%	
(2) "Soft Composition agreements"	At least 50% of ordinary claims	Up to 5 years	Up to 50%	Conversion of debt into participating loans for up to 5 years. This is not applicable to labor or public creditors
(3) "Hard Composition agreements"	At least 65% of ordinary claims	More than 5 and up to 10 years (unless there is unanimous consent)	Over 50%	Conversion of debt into participating loans for up to 5 years or other measures (please see A(ii) above). This is not applicable to labor or public creditors

(iv) **Extension of composition agreements to privileged creditors:** The effects of composition agreements may be extended to privileged creditors provided the following majorities are reached within each creditor class (please see below):

- 60 percent for arrangements under (iii)(1) “Super Soft Composition agreements” and (iii)(2) “Soft Composition agreements” above
- 75 percent for arrangements under (iii)(3) “Hard Composition agreements” above

Creditors should bear in mind that in this case, majorities are calculated over total value of security granted within each class. Therefore, a case could arise whereby a mezzanine lender with a subordinated security interest could be motivated to waive its security in order to avoid the compromise of its voting power in the composition agreement.

Failure to effect composition agreements

In the event that a composition agreement is not effected and the insolvency court declares by means of a court ruling that the parties have not complied with the agreement, any specially privileged creditors who were bound by such composition agreement may initiate separate enforcement proceedings or continue any enforcement proceedings which had been suspended, even if the liquidation phase has not begun.

Production unit sales and liquidation

As we stressed in our Clients Alerts dated [18 March 2014](#) and [30 July 2014](#), we were expecting from the lawmakers a proper uniform and detailed regulation in the Spanish Insolvency Law applicable to the whole Spanish regime as opposed to merely in Catalonia. The New Reform has, indeed, set forth clear rules, although it has also raised a few questions:

Production unit sales

- (i) **Transfer of assets:** The New Reform sets forth that the assignee shall automatically — *i.e.*, without the counterparty’s consent — acquire the rights and obligations arising from:
- Agreements which are used in the insolvent debtors’ business, provided that the relevant counterparty has not requested their termination
 - Administrative or governmental licenses or authorizations which are necessary for the insolvent debtor’s business and which are included in the production unit, provided that the assignee continues the insolvent debtor’s activity in the same premises

Most notably, the assignee may choose which agreements, licenses and authorizations it wishes to take on and which to leave behind.

- (ii) **Payment obligations:** The assignee shall not be obliged to pay any liabilities which arose prior to the transfer unless it expressly agrees to do so, unless the assignee is specially related to the insolvent debtor.

By way of an exception, the assignee must pay labor and social security obligations (though we understand only in respect of the employees being transferred) — thus contradicting the views of the [Mercantile Courts of Catalonia](#)⁶ which were issued earlier this year. In respect of labor obligations, the insolvency court may decide that the Wages Guarantee Fund (*Fondo de Garantía Salarial*) shall pay part of those labor liabilities (as set forth in the applicable regulations).

This amendment reflects the most widely shared views among Spanish courts.

- (iii) **Appraisal of the business as well as of all of its production units:** This appraisal must now be included as an item in the insolvency receiver's report, which may delay the publication of the report. Probably — in case of large corporations — including such an appraisal is wishful thinking.

Liquidation

- (i) **Assignment of assets:** The liquidation plan may include the assignment of assets in lieu of payment. However, this may not apply to public creditors.
- (ii) **Alternative ways to transfer assets:** The insolvency court may authorize the direct sale of assets or their sale through a specialized entity, in the event that an auction is unsuccessful or that court consider such alternative means to be in the best interests of the insolvency proceedings. This rule applies to the extent that a liquidation plan is not approved or that it does not provide for such sale.
- (iii) **Transfer of encumbered assets:**
 - If the assets are transferred and the security is released, the privileged creditors are entitled to receive an amount equal to the consideration for the production unit multiplied by the result of dividing the value of the asset by the total value of the transferred production unit:

$$(\text{Production Unit Consideration}) \times (\text{Value of asset} / \text{Value of Production Unit})$$

If the resulting amount is less than the value of the security interest, the transfer will require the consent of privileged creditors representing at least 75 percent of specially privileged claims within the same class who are entitled to separate enforcement proceedings and who are affected by the sale.

- If the assets are transferred, the security remains in place and the assignee takes the place of the insolvent debtor. The relevant claim shall be excluded from the list of insolvency claims and the specially privileged creditor's consent will not be required in order to carry out the transfer.

Other related provisions

We summarize below the most noteworthy of the New Reform's few additional provisions:

- (i) **'Guilty' classification of the insolvency:** The guilty classification section shall not be triggered if the approved composition agreement includes, for any class of creditors (including the four new classes), a stay of less than three years or a haircut of less than 1/3 of liabilities.
- (ii) **Public works and services concession holders and public contractors:** Insolvency proceedings which have already been initiated regarding these kind of insolvent debtors may be conjoined, provided that the proposed composition agreement affects all the proceedings to be conjoined. Further, the Spanish public authorities may propose a composition agreement.

Although the Spanish legislator has not tackled the core problem which is — the validity of the pledge over the RPA (Spanish state financial liability) regulated in the controversial [article 90.1.6° of the Spanish Insolvency Law](#)⁷ — they have at least included the foregoing new rule.
- (iii) **Second opportunity, refinancing of the composition agreement:** For the case of composition agreements which were in place prior to the New Reform, but with which parties have not complied within two years following the New Reform, the insolvent debtor, as well as creditors representing at least 30 percent of total liabilities at that time, may propose to amend

the composition agreement and to include the measures and particularities set forth in the New Reform.

Certain special majorities are required in order to secure the court ruling from the insolvency court to approve such an amendment. Provided that both the creditors and the insolvency court approve the relevant amendments, its effects shall be extended to privileged and ordinary creditors who have not voted in favor of the amendment, as well as to subordinated creditors. Such amendments will not, however, apply to public creditors.

The above majority system is not only much harsher toward privileged creditors than the general cram-down regime, but the majority system also excludes public creditors, who seem unaffected by almost any unfavorable arrangements.

- (iv) **Sareb's⁸ voting rights:** Clearly, now even if Sareb is specially related to the insolvent debtor, Sareb's claims must be taken into account for the purposes of the majorities required to approve the so-called [Spanish Scheme of Arrangement⁹](#).
- (v) **Amendment of the Spanish Procedural Law:** The Spanish legislator has added one more possibility for debtors to challenge the enforcement of security interests, which could potentially affect the liquidity and pricing of the non-performing loans secured market.

Conclusion

In general, the amendments set forth in the New Reform are welcome. The Spanish legislator has extended the principles of pre-insolvency refinancing agreements to composition agreements, including features from other jurisdictions into the Spanish insolvency system (particularly, from the UK — such as the cram-down concept, the creditors classes, etc.). Indeed, this reform remedies the previous illogical situation which provided more restructuring tools in the pre-insolvency stage than in the *concurso* itself.

Further, as we advocated, clear rules on the sale of production units have been introduced, which market players likely will welcome as the most effective way to maximize the debtor's assets' proceeds of sale.

The beneficial treatment given to the claims of public creditors like public authorities is questionable.

We must now wait to see how Spanish insolvency courts will interpret and apply the New Reform to properly ascertain how it will fare in practice.

Separately, the March Reform, which was a royal decree law, is currently being enacted into law. We expect that, in addition to the measures included in the March Reform, the insolvency receivers' status will be changed, basically to regulate the criteria for their appointment.

Finally, the Spanish legislator should now strive to provide transparency and predictability — and ultimately comfort — to the market players by avoiding multiple reforms of the Spanish Insolvency Law. In this sense, market players should note that some of the New Reform's measures will have retroactive effect, which does not provide legal certainty and could make investors reluctant to play in the Spanish market.

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Endnotes

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- ¹ Please see our Client Alert dated 18 March 2014, available at <http://www.lw.com/thoughtLeadership/lw-spanish-insolvency-law-new-reform>.
 - ² Please see section 5 of our Client Alert dated 18 March 2014, available at <http://www.lw.com/thoughtLeadership/lw-spanish-insolvency-law-new-reform>.
 - ³ Please see section 5 of our Client Alert dated 18 March 2014, available at <http://www.lw.com/thoughtLeadership/lw-spanish-insolvency-law-new-reform>.
 - ⁴ Please note that the list of persons who are specially related to the insolvent debtor is longer after the Reform. Basically, for insolvent debtors who are legal persons, provided that any shareholder of the insolvent company is a natural person:
 - a) A number of their relatives
 - b) Any companies controlled by such shareholder or its relatives
 - c) The directors or *de facto* directors of, or companies within the same group as the companies controlled by such shareholder or its relatives
 - d) The companies where the shareholder's relatives serve as directors or *de facto* directorsshall be considered specially related to the insolvent debtor.
 - ⁵ Please see our Client Alert dated 18 March 2014, available at <http://www.lw.com/thoughtLeadership/lw-spanish-insolvency-law-new-reform>.
 - ⁶ Please see our Client Alert dated 30 July 2014, available at <http://www.lw.com/thoughtLeadership/LW-Spanish-mercantile-courts-production-units-sales>.
 - ⁷ Please see our Client Alert dated 30 July 2014, available at <http://www.lw.com/thoughtLeadership/LW-Spanish-mercantile-courts-production-units-sales>.
 - ⁸ Management Company for Assets Arising from the Banking Sector Reorganisation (*Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria* or "Sareb").
 - ⁹ Please see our Client Alert dated 17 December 2013, available at <http://www.lw.com/thoughtLeadership/LW-spanish-insolvency-act-amendment>.