Spain: Hurdles when Acquiring or Managing NPLs or REOs Portfolios

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There was a particularly vibrant start to 2016 in Spain: the first general elections had just been held, from which the nation's government was to emerge, the entire country had been left waiting for an agreement that would enable the formation of that government, and the Abengoa group, which on the afternoon of 25 November 2015 had filed with a Seville court what is known as a pre-insolvency notice, was fervently trying to hammer out a deal with its creditors (mutual funds, in many cases) that would lift the shadow of insolvency. Twelve months on, and after holding another general election, Spain finally has a government and Abengoa got its restructuring validated by court; however, a number of uncertainties still hover over this powerfully controversial, unique debt-restructuring process.

It may be said, however, that the political and economic upheavals of 2016 have not particularly affected the distressed market, which, especially from the second quarter onwards, has seen the same or an increased amount of activity compared with previous years.

Abengoa has undeniably been the star of media headlines many times. In March, the company achieved completion of a financing pre-agreement with a number of creditors, including many of the usual suspects in these types of transactions, such as Elliot, KKR, Oak Hill, Värde Partners and Eton Park (some of which later offloaded their position in the company, with not inconsiderable gains in a few cases). The first agreement reached by Abengoa was, in actual fact, a straightforward standstill for seven months, which was court-validated on 6 April 2016 in a highly controversial decision, challenged by various entities. Some of the challenges were upheld in a pioneer ruling in which the court confirmed that Abengoa's restructuring, in the way it was originally conceived, indeed entailed a disproportionate sacrifice for some dissenting creditors. On 11 August, the company announced a second agreement with its main financial creditors, providing, among other items, for the contribution of €655 million by 10 institutional investors, which will come to control 50 per cent of the company's capital stock, and the potential conversion into equity of 70 per cent of the existing debt, in exchange for a 40 per cent stake in its capital, by the banks and bondholders, together with other trade-offs for creditors. This agreement was also submitted for court validation and Moody's has shown skepticism on the feasibility of the few details of the viability plan disclosed by the debtor, so Abengoa will likely be making headlines in 2017.

This is not the only loan-to-own deal we have seen in the distressed market. Some have had equal media attention (Isolux) and others (the vast majority) have been less well known, often involving companies that were overleveraged at the start of the downturn, never managing to bring it down (other than by delivering possession of properties to the creditors or through sale of non-core assets), and in need of financing to keep their businesses afloat. The main participants in these transactions have been institutional investors and they have primarily consisted of a combination of contributions of funds to the debtor, acquisition by the investor, at a heavily discounted price, of a portion of the company's debt for it later to be converted into equity or subordinated, and a renegotiation of the terms and conditions of the sustainable debt. While some of these investments have been so successful that investors started the divestment process a year after taking over the company, these investments are normally experiencing longer maturity processes.

There were definitely fewer acquisitions of insolvent companies in 2016, which could be explained by an exponential reduction in the number of insolvency proceedings, and above all, by the latest amendments to the law, which incomprehensibly penalise investors by burdening them with a 'backpack' of the wage and social security debts of the acquired company. Whereas there was little variation from previous years in the number of direct lending transactions and very few corporate debt purchases, because the latest amendments to the law, while extremely useful for enabling restructurings of financial debt, are preventing the flow of corporate debt towards the secondary market at the same pace as before.

All in all, portfolio sales were again the stars of the distress market. The popularity of unsecured debt sales has declined (most banks have already cleaned their balance sheets of this type of debt) and the sale of collateralised debts (primarily in respect of mortgages) and of REOs were top of the podium. These divestments continue to be made in competitive processes (led by Alantra or the Big Four), which have had much fewer takers than in 2015 and are not always reaching completion for various reasons (seller and buyer not agreeing on a price, the portfolio being of an unwieldy size and acting as a barrier to entry, unrealistic time frames set by the seller to transfer the portfolio, etc).

That said, because the transactions have been larger than they were in 2015, the end-of-year sales figure was in the region of €19.5 billion if all processes under way or about to commence are completed. Banks were the participants in most of these divestments, but there have also been sales of stakes by investors with more opportunistic profiles, which are gradually being replaced by more patient capital with lower return expectations.

Taking all these factors into account, in this article we will take a look at some of the obstacles that have been facing investors over recent years in acquisitions or management of loans and REO properties, and in foreclosures of the mortgages they acquire. At the end of the article, we give our opinion on the foreseeable future of the market for loan and REO property sales, which we can say, as a foretaste, is positive.

Right of redemption

The Spanish Civil Code (Article 1535) entitles a debtor to unwind the sale of a 'litigious' loan by paying to the buyer the price paid for it, plus any costs they may have incurred and the interest on the purchase price. A debtor may use their right to redeem the loan within nine days following the date when the buyer claims payment from them.

It is increasingly being found on claiming payment that debtors are seeking to redeem the loans bought by investors. It is not uncommon, however, for these attempts by debtors to free themselves of debts by

paying investors the price they paid for the loans not to achieve their goal, either because the debtor lets the nine-day time limit expire, or because the loan is not litigious by any means (the definition of 'litigious' loan is stricter than the definition of 'defaulted' loan), or because it is found that the loan was transferred in a transaction to sell a portfolio at an overall price without itemising the price paid for each individual loan it comprises, which is common practice in granular portfolios of unsecured debt (not in the case of mortgage portfolios, in which a portion of the price will usually be specifically apportioned to each loan).

This has not prevented credence being added to the idea (with which we openly disagree) that 'litigious' loan and 'defaulted' loan should be treated the same and, therefore, debtors should be allowed to redeem any loans that have been sold. This insane confusion, which, moreover, is powerfully disruptive to the mature and buoyant Spanish loans market, has been stoked by a number of references for a preliminary ruling recently made to the Court of Justice of the European Union (CJEU) seeking for the CJEU to conclude that the Spanish legislation on debt transfers is contrary to Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts (Directive 93/13/EEC). While at the same time, in some autonomous communities there has been an (albeit timid) resurgence of antiquated and outmoded tools (such as Law 511 in Navarre), which could increase the debtors' chances of redeeming the sold loan. When the issue is not archaic legislation, some autonomous communities have been introducing new mechanisms to allow debtors to redeem mortgage loans secured with their principal residence that might have been transferred for monetary consideration (Law 24/2015 of 29 July 2015, in Catalonia).

Need for the investor to be registered

On a few occasions, an investor has not been allowed to register the mortgage securing the sold loan in its name, by reason of the investor not being able to evidence satisfaction of the requirements in Law 2/2009, of 31 March 2009, on contracts with consumers for mortgage loans or credit facilities and intermediation services for the conclusion of loan or credit facility agreements (Law 2/2009). These requirements are: (i) the investor being entered on the Public Register of Companies for the autonomous community where its registered office is located (or, if none exists, on the Central Government Register at the National Consumer Affairs Institute); and (ii) having insurance cover for civil liability or a bank guarantee covering any potential liability that the investor assumes with respect to the debtor. We believe that this view, supported by the heterodox decision of 13 July 2015 by the Directorate-General for Registries and the Notarial Profession (DGRN), is fundamentally misguided when applied to the acquisition of credit facilities or loans that have been drawn down in full (which is frequently the case in credit portfolio sale transactions), where the investor is no longer required to make funds available to the debtor. As we have said, we do not share this view and probably neither do hundreds of notaries acting in the sales of mortgage loan portfolios or a large majority of the property registrars, because we have not identified a widespread problem in entering the transfers of mortgage loans or credit facilities. The DGRN's view nevertheless requires us to follow this matter closely.

Notarial claim for debts

Law 15/2015, of 2 July 2015, established the option to claim uncontested monetary debts through a notary, which provides investors buying credit portfolios with a faster procedure for claiming payment from the debtor and, if the debtor defaults, with a nonjudicial enforceable instrument in a very short space of time.

The only debts that can be claimed through a notary are civil or commercial monetary debts, regardless of their amount and their origin, that: (i) are liquid, determined, due and payable; (ii) are indubitably evidenced in documentary form; (iii) may be itemised into principal, remunerative interest and late-payment interest; and (iv) do not fall within any excluded categories, which include any under a contract between a trader or professional and a consumer or user (these types of debt must be claimed in court).

Briefly, the proceeding consists of a notarial demand for payment on the debtor, which may be successful or otherwise. If the notification is served, the debtor has 20 days in which to satisfy the debt, and if they fail to do so or fail to provide reasons for objecting to payment, the notary will provide the creditor with a valid instrument for commencing enforcement. If the notification is not served, because the debtor cannot be located or its delivery cannot take place, the notary's participation will be deemed completed and the creditor may exercise its rights in court.

Debtors at risk of social exclusion

Although there were fewer mortgage foreclosures in 2015 than in 2014, for a portion of the public opinion they continue to be above an acceptable level. Royal Decree-Law 6/2012, of 9 March 2012, on urgent protection measures for low-income mortgage debtors, approved what is known as the Code of Best Practices for the viable restructuring of debts secured by mortgages on principal residences (CBP), which laid down for debtors on the threshold of social exclusion and satisfying the requirements provided in that royal decree-law a 'mandatory' restructuring (for those creditors who had voluntarily signed up to the CBP) of their mortgage debts and, if such a restructuring were not possible, the delivery of possession of their principal residence in payment, with the option for any debtors who so requested when applying for the delivery in payment, to remain in the residence for two years under a lease, by paying an annual rent equal to 3 per cent of the total amount of the debt when the delivery took place.

In practice, this initiative has not had the outcome sought by those who supported it. According to the latest report published by the CBP Compliance Monitoring Commission, 63,752 debt restructuring applications have been recorded since its approval, of which more than half have been rejected because of their failure to satisfy the legal requirements (especially the requirement for an absence of other assets in the debtor's family unit); and, out of the 31,000 restructurings undertaken, some 25,000 ended in restructuring (involving a debt recomposition on only six occasions) and some 6,000 ended in delivery of possession in payment.

Faced with these outcomes, the Catalan autonomous community issued Law 24/2015, which provides two resolution mechanisms for over-indebtedness scenarios related to the principal residence, one out of court and the other in court. The scope and benefits of these mechanisms are still unknown because there have been no implementing regulations for Law 24/2015. What this law does provide are mechanisms to avoid evictions that could cause people at risk of residential exclusion to be without a home. These include social rented housing, income support and the provision of alternative accommodation. In fact, 'large residential property owners', and legal entities who since 30 April 2008 have acquired residential properties hailing from mortgage foreclosures, have been placed under obligation to provide a social rented housing proposal (for at least three years) before commencing a mortgage foreclosure or eviction proceeding by reason of default on the rent by persons at risk of residential exclusion. Furthermore, Law 24/2015 introduced the mandatory assignment of empty homes owned by legal entities, for a period of three years, to include them in a fund of rental properties for social policies.

A few incidents in mortgage foreclosures

The buyers of mortgage portfolios have three alternative means of foreclosure if debtors default: the ordinary monetary foreclosure proceeding, out-of-court foreclosure (notarial proceeding) and the special foreclosure proceeding on mortgaged assets provided in articles 681 et seq of the Civil Procedure Law (LEC). This last proceeding is the one preferred by servicers in almost all cases in which it is decided to foreclose on the loan, which is usually secured by a mortgaged asset.

Up until 2013, the chances of a debtor objecting to the foreclosure were extraordinarily low, but since the reform made by Law 1/2013 of 14 May 2013 on measures to strengthen the protection of mortgage debtors, debt restructuring and social rented housing, they have increased significantly, in that one of the grounds for objection provided in article 695 LEC is 'the unfairness of a contractual term which constitutes the ground for the foreclosure or which had determined the payable amount'.

It is an understandable reaction for a debtor not in agreement with the foreclosure on the mortgage to plead the existence of unfair terms in the loan agreement, the most common cases being terms enabling early maturity and foreclosure on the occurrence of a single defaulted payment, the 'floor' or collar terms and the late-payment interest terms.

In relation to the first of these, the truth is that creditors usually wait until the debtor has defaulted on at least three monthly payments before commencing the proceeding, and so once the timing requirement has been satisfied, the spotlight is placed only on the actions of the bank in the period running up to the claim, clearing the way to the foreclosure with no further setbacks.

On the subject of interest rate floor or collar terms, in its famous judgment of 9 May 2013 (reiterated in judgments of 24 May and 25 May 2015), the Spanish Supreme Court adopted the principle that generally they may be rendered null and void, although debtors are not entitled to a refund of all the interest they had been required to pay by the term, only the interest they had paid on or after the publication date of the judgment of 9 May 2013.

Some Spanish courts filed a request for a preliminary ruling to the CJEU over whether this limit on retroactive invalidity to 8 May 2013 was compatible with Directive 93/13/CEE. In his conclusions issued on 13 July 2006, coming as a great relief to Spanish banks by confirming the Spanish Supreme Court's decision, Advocate General Paolo Mengozzi suggested that the court should hold that the temporal limit on the effects of invalidity is compatible with EU law, but on 21 December 2016, the CJEU overruled that. It is estimated that a sum in the region of €7.6 billion would have to be refunded, therefore, the Spanish government has swiftly suggested that Spanish banks enter into a voluntary scheme with borrowers affected by such interest rate floor in order to reimburse or otherwise compensate them.

In relation to the late-payment interest on mortgages, in a recent judgment (3 June 2016) the Spanish Supreme Court applied the principle provided for personal loans in the judgment of 22 April 2015, determining that any term providing for late-payment interest that is two points higher than the remunerative interest covenanted by the parties may be held unfair. Moreover, the Supreme Court has clarified that the legal limit in article 114.3 of the Mortgage Law (three times the legal rate for money) cannot be used as a parameter for determining the absence of unfairness in a term, but rather must serve as a guideline for a pre-assessment of the term by a notary or by the registry, so that any clauses exceeding that limit will not be included in the agreement or entered at the registry, and has also specified that after the late-payment term has been held unfair, it will be held null and void and the creditor will only be entitled to collect any ordinary interest covenanted by the parties.

Rights of first refusal and redemption in REOs

On a closing note, we would like to mention the autonomous community legislation that must be kept in mind by anyone buying portfolios of mortgages or of REOs, especially if the underlying properties are located in the Basque Country or Catalonia. The reason for this is that both autonomous communities have recently approved laws that in essence confer rights of first refusal and redemption in relation to residences bought in mortgage foreclosure proceedings or through the conversion or payment of debt with mortgage collateral, where they are situated in certain areas with an evidenced demand. This is Law 3/2015 of 18 June 2015 on housing (Basque Country) and Decree-Law 1/2015, of 24 March (Catalonia).

Under these laws, both regional governments have a priority right to buy one of those residences at the same price and on the same terms of purchase as were offered or on which the transfer actually took place. Of course, this requires the vendors of these types of residences to give prior notice of their intention to transfer them as a means of enabling that right of first refusal; if the notice fails to be served or is defective, then the right of redemption of those regional governments will come into play.

It seems clear to us that from the investor's standpoint in REO portfolios this mandatory right of first refusal and redemption may have an adverse impact on the valuation of the portfolio, without forgetting that the failure to give notice or giving incomplete notice to those regional governments may trigger those mechanisms, which will cause investors to find themselves bereft of the property, while also being unable to recover the tax costs incurred in the first transfer of the properties.

Despite the risks and uncertainties that, as we have seen, surround sales of credit or REO portfolios (whereas, generally, investors can suitably value and factor them in by having a legal due diligence on the portfolio), the truth is that our expectations regarding the size and number of transactions are undoubtedly good for the coming years.

In fact, the new measures adopted by the Bank of Spain in its role as strict supervisor of Spanish financial institutions (in particular, Circular 4/2016, of 27 April 2016, containing new credit risk hedging rules coming in force since 1 October 2016) are going to compel banks to redouble their provisioning efforts, which will doubtless provide an incentive for more banks to offload not only defaulted loans but also, fundamentally, REOs, which are expected to be the most heavily penalised by the new hedging rules. Furthermore, although the number of mortgage foreclosures continues to decline (101,820 in 2015 as compared to 120,539 in 2014, according to the figures published by the Spanish Statistics Institute), banks are still acquiring a higher number of assets than they are transferring, so their inventories of REOs are not shrinking as rapidly as was predicted by the Bank of Spain, which expects these measures to speed up the cleaning of their balance sheets.

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Borja García-Alamán is a partner in the firm's restructuring and insolvency group. Based at Garrigues' head office in Madrid, he holds a bachelor's degree in law from CEU San Pablo University and a master's degree in corporate and business law from Centro de Estudios Garrigues. He has been a partner at the firm since 2008, where he has spent over 19 years practising in the area of out-of-court restructuring processes defined broadly (workouts, debt refinancing, distressed situations and acquisitions, operations and turnarounds), as well as in insolvency and pre-insolvency scenarios and related court proceedings. He specialises in providing advice on business distress situations to debtors (in situations of actual or imminent technical insolvency) as well as creditors (defending their claims or interests in a disputed contract in which the other party is or could be affected by insolvency).

His career has for years been singled out for praise in the most prestigious international directories, such as *Chambers Global*, *IFLR1000*, *The Legal 500* and *Best Lawyers*. He is a regular speaker on courses and conferences on insolvency law and, inter alia, he has taught that subject on the business law master's degree offered by Centro de Estudios Garrigues since 2009. Mr García-Alamán is a member of the Madrid Bar Association and a founding member of the Turnaround Management Association in Spain. He has acted as an expert contributor for the World Bank on 'Doing Business' since 2009.

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José María Gil-Robles is a partner in the mergers and acquisitions team, being one of the partners in charge of the private equity, hedge funds and distressed M&A groups.

Within the distressed M&A group, he regularly advises hedge funds and other distressed players in the sale and purchase of credit portfolios (performing or non-performing, with or without collateral), corporate debt, shares in insolvent (or near insolvent) companies, regional or local authorities' debt to pharmaceutical or construction companies or financial investors (institutional or retail), as well as on the provision of hybrid financing to Spanish companies, debt refinancing and operational restructuring. Prior to joining Garrigues, he worked as a financial analyst and portfolio manager at Inversiones y Estudios Financieros, SA (SAFEI) (1987–1989), as well as an auditor of energy companies at Arthur Andersen (1989–1990). In 1990, he joined the firm as member of the financial tax department, and later on as member of the corporate/commercial department. Between 2007 and 2009 he was the partner in charge of the London office, but he is now based in Madrid. He has been singled out as a leading private equity and corporate M&A practitioner by international directories such as *Chambers*, *Who's Who Legal* and *Practical Law Company*.

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Garrigues was the first Spanish firm to set up a Restructuring and Insolvency department, inspired by the Anglo-Saxon model. Other Spanish firms followed in our wake. Our success lies in tailor-made advice to hedge funds, debt funds and other relevant players of distressed market looking for successful deals related to listed companies, industrial, audiovisual, steel and defence companies, to name a few. Long before Spanish legislation allowed debtors to refinance their debt in a stable legal environment, Garrigues acted in and successfully negotiated debt refinancing arrangements by using innovative tools. When the law incorporated these tools (2009), Garrigues utilised them to maximum effect. Even today we continue to promote these legal tools, such as the so-called Spanish Scheme of Arrangements, with novel and ambitious interpretations that are validated by the courts, giving rise to pioneer cases that set the trend (Petromiralles, 2014). Having an experienced Banking and Finance team and, at the same time, being able to call on the best experts in restructuring (including former judges) enables us not only to assemble multidisciplinary teams (other firms already do this) but also to employ restructuring techniques that are tried and tested and effective in any of the phases a company may be going through. When advising investors, other firms find it hard to manage complex and urgent NPLs or REO transactions. Garrigues achieves a smooth transition from legal due diligence processes to the SPA phase by involving its specialists in insolvency, real estate and financing from the very outset.

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Adrian Thery is a partner in the firm's restructuring and insolvency group. He advises debtor companies, credit institutions and distressed investors on out-of-court refinancings and restructurings, as well as on in-court insolvency proceedings, both domestic and cross-border. His in-depth knowledge of the different idiosyncrasies at stake enables him to anticipate the incentives, deterrents and strategies the different parties may look for in each case, as well as find the potential leverage that might ultimately lead to collaborative solutions. He has been singled out by *Chambers and Partners* in the 'Restructuring and insolvency' category (from 2011 to 2016), *Best Lawyers* in Spain in the 'Insolvency and reorganisation' category (from 2009 to 2016), *IFLR1000* in the 'restructuring and insolvency' category (2012 and 2016) and *Who's Who Legal* in the Insolvency & Restructuring category (2015). In December 2015, Adrian was appointed as a member of the Group of Experts established to assist the European Commission in the preparation of a potential legislative proposal containing minimum standards for a harmonised restructuring and insolvency law in the European Union. He has a degree in law (CEU San Pablo University), a master's degree in EU law (CEU San Pablo University) and a master's degree in business and finance (Centro de Estudios Garrigues).

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Juan Verdugo is a partner in the firm's restructuring and insolvency department. One way or another he is currently advising hedge funds, investors and banks on the buy-side and sell-side of the foremost NPLs and REOs deals marketed in Spain during 2015 and 2016 (Amazona, Commander, Castle, Wind, Formentera, Babieca, Baracoa), successfully closing a number of them. He has amassed a wealth of experience in refinancing distressed businesses, the acquisition of debt from banking syndicates, the purchase of distressed companies and assets and defending clients in asset clawback actions. Also worth noting is his experience in the area of cross-border insolvencies and in advising foreign investors on bids to acquire a controlling stake in distressed companies through loan-to-own tools. Since 2008, Mr Verdugo has regularly featured in the main international legal directories, which have stated that his clients regard him as 'a talented young lawyer who already displays exceptional judgment' (*Chambers Europe 2011*). More recently, clients have lauded his 'strong leadership skills and ability to handle complex deals', focusing on his ability to 'fight for the client and […] making a name for himself ' (*Chambers Global Guide 2013*). *Chambers Global Guide 2015* again endorsed Mr Verdugo, gathering positive feedback from clients who reveal that he is 'communicative, and has helped in a way that not many lawyers do. He really lays down the legal landscape for us to understand'. He also sits on the World Bank Panel of Experts for the annual reports on 'Closing a Business' and 'Getting Credit'.