GARRIGUES
Commentary

Restructuring and Insolvency Work

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Royal Decree Law 4/2014 adopting urgent measures on business debt refinancing and restructuring

On Saturday, March 8, the Official State Gazette published Royal Decree-Law 4/2014 adopting urgent measures on business debt refinancing and restructuring.

The main purpose of this new legislation is to broaden and make the provisions on refinancing agreements more efficient to help lighten the financial burden of, and deleverage, potentially viable businesses from an operating standpoint, with maximum respect for the lawful expectations of the creditors who are encouraged to take an active part in these **financial turnaround processes**. Before we enter into a more in-depth analysis, below is a list of the key components of the reform:

- Article 5 *bis* of the Spanish Insolvency Law ("LC" - *Ley Concursal*) has been amended to allow the filing of the notice of the start of negotiations to reach certain agreements to interrupt, for the time period envisaged to bring the negotiations into effect, any court enforcements against assets that prove to be necessary for the continuity of the debtor's economic activities; any enforcements against other assets, except for those originating from public law claims, may also be interrupted where at least 51% of the creditors holding financial claims against the debtor have expressly supported the start of the negotiations.

- Safe harbor protection against a future insolvency proceeding on the company for any separate bilateral or multilateral refinancing agreements improving the debtor's financial position and solvency that might have had been reached between the company and one or more of its creditors.

- An inducement has been given to the provision of fresh money to the debtor in the context of refinancing agreements executed until March 2016, by determining that the whole amount of any such fresh money will be treated as post-insolvency order claims in a potential later insolvency proceeding, even if that fresh money is provided by persons having a special relationship with the debtor (insider creditors); this is only a temporary measure in force for two years after the fresh money is provided.

- The new provisions on the court approval procedure for refinancing agreements have broadened significantly the parties to which they may be applied and the allowed terms in the refinancing agreements that can be approved by the commercial court judge. Their effects can now be made to apply to creditors that have not adhered, or have expressed their objection, to those agreements. The terms that can be made to apply vary according to the majorities obtained for them, ranging from a simple deferral shorter than five years to deferrals of up to ten years, releases, debt for equity clauses, etc.

  Additionally, those effects can also be made to apply to creditors holding collateral in relation to the portion of their claims that the value of the collateral provided does not cover (in cases of collateral shortfalls) and, where determined by majorities of this class of creditors set by reference to the value of such collateral, those effects can also be made to apply to the other claims covered by the collateral, although these majorities are quite highly qualified.

This royal decree-law entered into force the day after its publication in the Official State Gazette.

The most important new legislation is summarized below:

1. Amendment of article 5 bis LC

The primary aim of the reform is to satisfy a demand by players in the field of refinancing transactions for a certain amount of stability to be provided for the negotiations between the debtor and its creditors which are often upset by a sudden enforcement against certain assets provided as collateral which, apart from anything else, could bring forward the debtor's technical insolvency.

That stability, often a condition for the workability of the negotiations, which could hitherto only be achieved by signing stand-still agreements, is underpinned by the new rule putting a temporary halt, from the filing of the notice that negotiations have started for up to 4 months, to any court enforcements against the debtor's assets that may prove to be necessary for the continuity of its activities.

If 51% of the financial claims have undertaken not to start or continue with individual enforcements against the debtor while they are negotiating, that undertaking will be binding on all the creditors holding financial claims, which, although it will not prevent the secured creditors from bringing only action in rem, it will indeed determine that the procedure may be halted after it has started.

The notice given to the court of the start of negotiations must be publicized on the Public Insolvency Register, unless the debtor requests secrecy for the proceeding.

Once the notice under article 5 *bis* LC has been given, no other notice can be submitted by the same debtor within a year.

2. New refinancing agreements (art. 71 bis LC)

New wording has been added to article 71 *bis* LC on the characteristics of certain refinancing agreements, establishing the conditions that must be fulfilled to make them not subject to clawback in the event of a future insolvency proceeding on the debtor. The new legislation only confers authority on the insolvency manager to bring action to challenge or claw back these refinancing agreements, which may only be done on the basis of a breach of the conditions provided in this article.

2.1 Refinancing agreements adopted by 3/5 of the unsecured creditors and made in response to a viability plan

There is still a "protective shield" in the event of a future insolvency proceeding on the debtor for refinancing agreements on any type of unsecured or subordinated claims and made in response to a viability plan that will allow the debtor's activities to continue in the short and medium term.

To benefit from the "protective shield" it is laid down that the agreement must be signed by at least 3/5 of the claims against the debtor, a majority that must be certified by the financial auditor, and that it must be perfected in a public instrument.

Although the requirement for a favorable report by an independent expert has apparently been eliminated, the article retains the provisions on the appointment of that expert and the scope of the report, since because it is still a requirement for those agreements to be in response to a viability plan that will allow the debtor's activities to continue, on occasions it will be prudent to have this report, as preferred advance proof of the fulfillment of this requirement making them not subject to clawback.

2.2 Separate agreements not subject to clawback because they clearly improve the debtor's financial position ("safe harbor")

Alongside the refinancing agreements not subject to clawback largely as a result of the majority of claims supporting them, the reform has added an option for the debtor to arrive at separate agreements with one or more creditors not representing the above majority, and these agreements will not be subject to clawback if they fulfill strict requirements aimed at ensuring that the achievement of those separate agreements not only does not cause detriment to the assets available to creditors, but also clearly improves the debtor's financial position.

Those agreements must thus (i) increase the debtor's equity, (ii) not reduce the debtor's current assets; (iii) the proportion of collateral to debt under the transaction must not be higher than 90%, or to that existing before the agreement; (iv) the interest rates must not be put up by more than a third; and (v) the agreement must be perfected in a public instrument expressly recording the economic reasons behind the agreement and the fulfillment of the foregoing conditions.

3. Refinancing agreements able to be approved by the courts (Additional provision four LC)

The parties to which the refinancing agreements may apply and the terms that a majority of creditors may impose on other nonparticipating or dissenting creditors have both been broadened. All types of financial claims may qualify, even those held by parties not subject to financial supervision, the only ones falling outside these provisions are creditors holding claims from commercial transactions and creditors holding public law claims. The terms that can be made to apply to those qualifying claims are not just deferrals, but also other measures such as releases, debt for equity clauses, transfers of assets in or for payment, all of the above depending on the majorities that sign up to them, the strength of the security protecting them, or the restricted class of creditors voting for them. In very simplified terms:

- The refinancing agreements that may be approved by the court are those that have been signed by 51% of the financial claims, but that majority does not allow its effects to be made to apply to the nonparticipating or dissenting creditors, and therefore that approval will only make the agreement absolutely free from clawback on the terms of point 13 of additional provision of four, although not immune from the types of challenging action mentioned in that point;

- If the achieved majority is at least 60% of the financial claims, the deferral of any amount owed for a term not longer than 5 years or the conversion of debt into participating loans for a term of the same length can be made to apply as a result of achieving court approval. The creditors those terms can be made to apply to are both the holders of unsecured financial claims and the holders of secured claims in relation to the portion of the claim not covered by the fair value of the collateral.

- If the majority reaches 75% other measures can be made to apply to those same unsecured creditors or secured creditors in relation to the unsecured portion of their claims, such as deferrals for between five and ten years, releases, debt for equity clauses (with the option for an equivalent release), conversions of debt into participating loans or other financial instruments for up to 10 years and the transfer of assets in or for payment.

- The effects of court approval may be made to apply to the portion of the claims of secured creditors that are covered by the fair value of the collateral only if those effects have been supported, restrictedly, within that class of creditors, by (a) those holding 65% of the aggregate value of the collateral provided, for deferrals or conversions into participating loans for a term shorter than 5 years, or (b) those holding 80% for the other measures.

Syndicated loans

In the case of syndicated loans, it will be considered that the lender creditors sign the refinancing agreement where 75% of the claims the loan represents vote for it, unless a smaller majority is provided in the syndicated loan agreement, in which case that majority will be sufficient.

Secured creditors

As we have mentioned, secured creditors can be treated as unsecured creditors in relation to the portion of their claims not covered by the collateral provided to them. This makes it necessary to determine the value of the collateral, for which a valuation method is provided.

This method consists of determining the fair value of the asset (by reference to its listed value, if it has one, or its appraised value or the value set in an independent expert's report) and subtracting from ninety percent of that value the amount of the outstanding debt for which the asset has been provided as preferred collateral.

Thus where an asset has been provided as collateral in various hierarchized cases, in the case taking priority over the others the collateral will have a value equivalent to 90% of the fair value of the asset unless the claim is for a lower amount, in which case the value of the collateral will be restricted to that lower amount; in the case ranking second the collateral will have a value equal to subtracting from 90% of the fair value of the asset the value of the collateral in the preceding case subject to the same limit; and so on and so forth. What might happen is there might not be any value left for the last charges in line and therefore the claims secured by those charges will be treated as unsecured claims for the purposes of having to apply the terms of the refinancing agreement.

The value of the collateral cannot under any circumstances be below zero or higher than the value of the claim of the creditor concerned. If more than one asset has been provided as collateral the aggregate value of the collateral will be calculated by applying the above rule to each of the assets. If the collateral is provided as an undivided interest to two or more creditors, the value of the collateral for each creditor will be the proportionate share under the rules governing undivided interests in property.

Once the value of the collateral has been calculated, various scenarios may arise:

- The portion of the claim over and above the value of the collateral (excess over the "break-up value") is considered not to be a genuinely secured claim, and therefore the effects of the refinancing agreement will be made to apply to that portion of the claim, as if it were an unsecured claim.

- The portion of the claim below the break-up value of the collateral, in principle stays immune from the refinancing agreement unless those holding a majority of the aggregate value of the provided collateral accept all or part of the agreement, in which case the accepted effects will be made to apply, with the scope that may be agreed, also to that portion of the secured claim; majorities of 65% will be needed to make apply deferrals not longer than five years or the conversion of debt into participating loans with a term of the same length, or of 80%, for the other allowable terms.

Lastly, the creditors holding secured financial claims that have been made to apply the effects of the refinancing agreement will not see the effectiveness of their collateral reduced in the event they have to enforce it. The new legislation specifies the rules to define the scope of the terms "surplus" or "remaining amount" in a court enforcement procedure whereby a surplus can only be construed to exist where the amount obtained from the enforcement is higher than the original debt or the outstanding amount of the debt if the agreement had not taken place, and in all other cases the creditor can keep the proceeds of the enforcement, even if they exceed the amount of the claim novated by the effects of the refinancing agreement that have been made to apply; if the proceeds of the enforcement are lower than the amount of the novated claim, the remaining amount of the claim will be the difference between these two figures, unless it has been stipulated in the refinancing agreement that in the event of a breach it will be terminated, an event in which, following the disappearance of the effects of novation due to the termination, the remaining amount of the claim will be the difference between the proceeds of the enforcement and the amount of the original debt or of the outstanding amount of the debt if the agreement had not taken place.

Halt to enforcements

The judge will put a halt to all separate enforcements when the request for approval is admitted for consideration and until a decision is rendered on that request.

The halt can no longer be kept in force after the refinancing agreement has been approved. Individual enforcements, therefore, can be started or continued from that time provided the terms of the refinancing agreement do not affect the financial claims sought to be paid in that enforcement procedure.

Cancellation of attachments

The judge can order the cancellation of attachments made in any enforcement procedures initiated to seek the payment of claims affected by the refinancing agreement.

4. Halt in the insolvency proceeding to the enforcement of collateral

After the insolvency order has been issued all enforcements of collateral will be halted where the assets provided as collateral are necessary for the debtor's professional or business activities to continue.

In particular, the assets necessary for activities to continue will not include the shares in companies used only to hold an asset or liability needed for finance, provided the enforcement in this case does not entail a ground for termination or amendment of the contractual relationships to which that company is subject which allow the debtor to keep operating the asset.

5. Fresh money injected under refinancing agreements

A temporary amendment (until March 2016) has been made to the legal rules on the classification in an insolvency proceeding of claims in respect of fresh money which has been provided in the context of one of the refinancing agreements set out in the LC signed after the entry into force of the royal decree law. Specifically, the new temporary legal rules are:

- In the event of a later insolvency proceeding the whole amount of any such claims (not including the interest that may accrue on them) will be treated as post-insolvency order claims.
- This same classification as post-insolvency order claims will apply if the fresh money is provided in the context of an arrangement under article 100.5 LC and even if those claims (for money provided in the context of an arrangement with creditors or a refinancing agreement) are held by the debtor itself or by persons having a special relationship with the debtor.
- After the end of two years from the date on which that money was provided the terms of these temporary rules will cease to take effect and the ordinary rules will come into play, whereby only 50% of the fresh money provided will be treated as post-insolvency order claims.

6. Claims not subordinated in the case of debt for equity stipulated in refinancing agreements

In the event of a later insolvency proceeding, any creditors who exchanged all or part of their claims for equity to fulfill a refinancing agreement will not be treated as a "person having a special relationship with the debtor" and, therefore, not have their claims subordinated (in relation to the debt exchanged for equity).

7. De facto directors: new non eligibility scenario

In the event of a later insolvency proceeding, any creditor who has executed a refinancing agreement will not be treated as a de facto director in relation to the obligations the debtor may acquire under the viability plan *unless proven otherwise*.

8. Consequences, on assessment of the debtor's insolvency, of the refusal to exchange debt for equity

New amendments have been made to the rules on assessment of the debtor's insolvency to dissuade debtors from objecting to refinancing agreements including debt for equity measures.

8.1 New presumption of serious wilful misconduct or fault for assessment of the insolvency proceeding as fault-based

To avoid debtors objecting unreasonably to reaching agreements setting out debt for equity terms, a new presumption of serious wilful misconduct or fault by the debtor or the debtor's legal representatives, directors or liquidators, in generating or aggravating the debtor's technical insolvency, has been added where they object to a refinancing agreement and an insolvency order is later issued on the debtor (and, most importantly, this presumption can apply even to the shareholders or members if it was their negative vote at the company's shareholders' meeting that prevented the exchange of debt for equity; see section 8.2 below).

Serious willful misconduct or fault is thus presumed to exist, *unless proven otherwise*, where there has been a refusal without reasonable cause to exchange debt for equity or issue securities or convertible instruments, thereby standing in the way of achievement of any of the refinancing agreements under article 71 *bis*.1 LC (agreements by a 3/5 majority in response to a viability plan), or an approvable refinancing agreement, provided that the debt for equity clause acknowledges a preemptive acquisition right for the debtor's shareholders in cases of subsequent disposals of subscribed capital that are not made to companies in the same group as the creditor or to companies having as their corporate purpose the holding and management of shares in the capital of other entities.

The new legislation sets out a presumption that the debtor's objection is not reasonable where a report or reports by an independent expert issued before the debtor's refusal declares that this is so.

8.2 Determination of new parties that could be affected by the assessment and their liability for the insolvency proceeding

The parties affected by the assessment, if the debtor is a legal entity, can now include any shareholders who refused without reasonable cause to exchange debt for equity or to issue securities or convertible instruments by reference to their degree of contribution to the formation of the necessary majority to reject the agreement.

These shareholders can even be ordered to cover all or part of the shortfall if the acts that determined the assessment of fault-based insolvency generated or aggravated the debtor's insolvency.

9. Tax incentives for refinancing agreements

The new royal decree-law also amends the Spanish Corporate Income Tax Law and the Spanish Transfer and Stamp Tax Law to add improvements to the tax treatment of refinancing agreements and, markedly, to debt for equity transactions.

Lastly, the royal decree-law mentions that the Bank of Spain will publish uniform tests to classify restructured transactions under a refinancing agreement as "normal risk" and takes the opportunity to usher in amendments to other pieces of legislation such as (i) Law 3/2009, of April 3, 2009 on structural modifications, in relation to EU cross border mergers; (ii) Law

3/2004, of December 29, 2004 establishing measures to combat late payment in commercial transactions, in relation to the ability to change late-payment interest on the part of public authorities; (iii) Royal Decree-Law 10/2008, of December 12, 2008, adopting financial measures to improve the liquidity of small and medium sized enterprises and other additional economic measures, in relation to the computation for accounting purposes of impairment losses.

More information:

Antonio Fernández
Partner in charge of Restructuring and Insolvency Work
antonio.fernandez.rodriguez@garrigues.com
T +34 91 514 52 00

Borja García-Alamán
Partner
borja.garcia-alaman@garrigues.com
T +34 91 514 52 00

Adrián Thery
Partner
adrian.thery@garrigues.com
T +34 91 514 52 00

Juan Verdugo
Partner
juan.verdugo@garrigues.com
T +34 91 514 52 00

Hermosilla, 3 - 28001 Madrid (Spain)
T +34 91 514 52 00 - **F** +34 91 399 24 08