GARRIGUES

NEWSLETTER
RESTRUCTURING
& INSOLVENCY

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WHAT IS THE CURRENT SITUATION OF NPLs IN THE EUROPEAN UNION?
FIRST PROGRESS REPORT OF THE EUROPEAN COMMISSION

SUMMARY

CURRENT NEWS

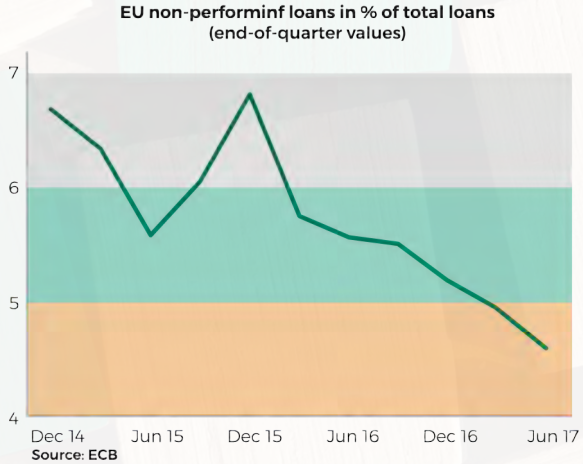
FIRST PROGRESS REPORT ON THE REDUCTION OF NPLs IN THE EUROPEAN UNION

On January 18, 2018, the European Commission published a number of documents on the reduction of non-performing loans ('NPLs'): a memo, a factsheet and the Staff working document and Communication, the **English** versions of which are available on the website of the European Commission.

This is the First Progress Report on the reduction of NPLs in European Union. It explains that the ratios of NPLs have fallen in almost all Member States (an average reduction of 4.6% according to data from the second half of 2017), although the situation varies considerably between them (NPLs currently represent between 0.7% and 46.9% of the balance sheets of Member States' banks).

	Non-performing loans in % of total loans in selected countries		
	Q2 2016	Q2 2017	% change
Cyprus	37.6	33.4	-11.0%
Spain	5.9	5.3	-11.0%
Greece	47.2	46.9	-0.6%
Ireland	14.6	11.6	-20.6%
Italy	16.2	12.2	-24.6%
Portugal	17.6	15.5	-12.0%
Slovenia	16.3	11.4	-30.4%

Source: ECB



In the case of **Spain**, the report finds that the downward trend in the volume of NPLs continues, although the decline would have been higher if the Bank of Spain had not toughened the credit risk classification criteria in its most recent circulars on bank provisioning. NPL ratios for the Spanish construction and real estate sectors stand at 25.2% and 20.8% respectively, although

the report refers to the efforts made by Spanish institutions to reduce their foreclosure portfolios through asset disposals in proportions which, according to the latest data, exceed new foreclosures. The European Commission's view is that Spain will continue to reduce its NPLs ratio at a brisk pace due to the disposals announced by Banco Santander and BBVA, with a combined value of over €43 billion, as well as the significant number of smaller operations that have already been finalized or are ongoing.

Overall, the statistics show that risk reduction has taken hold and that the European Union is on the right track in implementing the Action Plan to reduce the risks posed by NPLs. These risks are, essentially, (i) the high levels of bank provisioning which, in the most extreme cases, may endanger the viability of the banks themselves, and (ii) the large-scale earmarking by banks of human and financial resources to manage NPLs, which has an impact on their ability to pursue their main business activity (providing credit to small and medium-sized enterprises), damaging growth and job creation.

The most noteworthy aspect of the First Progress Report is the package of five (5) measures it presents to tackle the NPLs problem, which includes three legislative initiatives. The measures will be published in spring 2018 and relate to the following:

1. **Asset Management Companies ('AMCs'):** a plan will be published on how to build on the lessons learned in order to set up these companies (known as), examples of which include NAMA (Ireland, 2009), SAREB (Spain, 2012) and BAMC (Slovenia, 2013).

2. **Elimination of hurdles to the servicing and transfer of NPLs:** measures will be taken to further develop secondary markets for NPLs and to increase activity on those markets, removing current restrictions on the management of loans by third parties (loan servicing) and the transfer of loans.

3. **Accelerated Extrajudicial Collateral Enforcement ('AECE'):** measures will be proposed to increase the value of NPLs recovered through accelerated extrajudicial collateral enforcement, which will only be possible if the parties so agree and the other party is a company or entrepreneur.

4. **Statutory measures to prevent NPLs ('backstops'):** the creation, by law and on newly originated loans, of minimum levels of provisions and deductions from own funds that eliminate the risk of under-provisioning in the event that a loan later becomes non-performing.

5. **Promotion of transparency on the NPL market:** measures to improve the accessibility, availability and comparability of existing data on NPLs and potential support for the development of the NPL platforms or registers being developed by market participants.

2 New legislation

1 BANK OF SPAIN CIRCULAR 4/2017 OF NOVEMBER 27, 2017, ADDRESSED TO CREDIT INSTITUTIONS CONCERNING PUBLIC AND CONFIDENTIAL FINANCIAL REPORTING RULES AND FINANCIAL STATEMENT FORMATS (Official State Gazette of December 6, 2017)

On December 6, 2017, the Bank of Spain's new circular directed at credit institutions, Circular 4/2017 ('**Circular 4/2017**'), which lays down the rules on public and confidential financial reporting and contains financial statement formats, was published in the Official State Gazette.

Circular 4/2017 entered into force on January 1, 2018, and repeals Circular 4/2004, which had been the benchmark in the field of bank impairment allowances and the subject of several amendments, the last by means of Circular 4/2016. The changes ushered in by the new circular are in line with the content of the European Central Bank Guide of March 2017 on NPLs.

Annex 9 to Circular 4/2017, which concerns the analysis and coverage of credit risk, lays down rules to determine (i) the credit risk to which financial institutions are exposed, with various classifications or categories; (ii) the needs in terms of coverage or bank allowance for impairment; and (iii) the criteria for classifying foreclosed real estate. Circular 4/2017 retains most of the amendments made by Circular 4/2016, which were aimed at strengthening the management of credit risk, the correct classification of transactions, the robustness of coverage estimations, the proper treatment of collateral for accounting purposes and the correct valuation of foreclosed assets.

As regards refinancing operations and insolvency proceedings, the most important rules for classifying financial debt are:

- **Rule 100: Refinancing operations, whether refinanced or restructured:** the highest credit ranking that can be assigned to such operations initially is 'normal risk on the watch-list', unless a number of very stringent requirements are met, in which case they will be reclassified as 'normal risk'. However, if the restructuring includes certain clauses (grace period of 2 years) or is based on an inadequate viability plan, it will always be classified as 'non-performing' (criterion 116).

- **Rule 110: Classification of the risks of insolvent debtors that have approved a creditors' arrangement:** these will be classified as 'non-performing' with the possibility of moving up to 'normal risk on the watch-list' if certain requirements are met (payment of 25% of the pre-insolvency claims of the entity, minus any write off, or the lapse of two years from registration of the judgment approving the creditors' arrangement provided that there are no doubts concerning performance of the arrangement; that is the position unless there is an agreement to apply interest rates falling well below market rates).

  The risks attached to credit granted after the approval of a creditors' arrangement will not be classified as non-performing, either, if the arrangement is being performed and there is no reason to doubt the recovery of claims.

- **Rule 112: Classification of all positions as 'non-performing' on account of drag-along:** the amounts of all operations with the same borrower will be treated as 'non-performing' where the amounts overdue by more than 90 days represent more than 20% of the amounts outstanding for recovery, even if the remainder has not fallen due. This drag-along will also occur if the percentage of risk due is less than 20% but, following an individualized study, the view is taken that there are reasonable doubts as to the likelihood of full repayment (principal and interest).

2 DIRECTIVE (EU) 2017/2399 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 12 DECEMBER 2017 AMENDING DIRECTIVE 2014/59/EU AS REGARDS THE RANKING OF UNSECURED DEBT INSTRUMENTS IN INSOLVENCY HIERARCHY (Official Journal of the European Union, December 27, 2017)

The financial crisis has demonstrated that there is a lack of appropriate tools to deal effectively with the solvency problems of credit institutions whose viability is compromised.

New Directive 2017/2399 requires Member States to create a new class of 'non-preferred' senior bank debt. If a financial institution were to experience solvency problems, this type of debt would have preference over own funds instruments and other subordinated liabilities, but not over other senior liabilities. Financial institutions will, of course, continue to have the power to issue both traditional senior debt and this new 'non-preferred' senior debt, but when they opt for the latter, the documentation related to the issuance must expressly state that such debt will be treated as 'non-preferred' or subordinated in the event of the financial institution's insolvency.

In the case of Spain, the rules laid down in new Directive 2017/2399 have already led to the amendment of the Insolvency Law, as explained in our **newsletter** of July 2017.

Lastly, the Directive introduces a number of safeguards as regards the ranking of claims resulting from debt instruments issued previously. To that end:

- Member States must ensure that the ranking of debt instruments issued previously is governed by the national laws in force as of December 31, 2016;

- To the extent that certain national laws in force as of December 31, 2016, already address the possibility of financial institutions issuing subordinated debt (such as Spanish law, see Royal Decree-Law 11/2017, of June 23, 2017, on urgent measures in financial matters), the claims resulting from such issues must have the same ranking in insolvency proceedings as the new 'non-preferred' senior debt instruments.

Member States are required to bring into force the laws, regulations, and administrative provisions necessary to comply with Directive 2017/2399 as from December 29, 2018.

3 ROYAL DECREE 1071/2017 OF DECEMBER 29, 2017, AMENDING THE GENERAL COLLECTION REGULATIONS, APPROVED BY ROYAL DECREE 939/2005 OF JULY 29, 2005 (Official State Gazette, December 30, 2017)

This Royal Decree, which amends a number of components of the General Collection Regulations ('**the Regulations**'), was published in the Official State Gazette on December 30, 2017. The Regulations apply to both the central government and other tax authorities.

The insolvency-related amendments to the Regulations include the following:

- **Deferred or split-payment of the tax debts of debtors in insolvency with an approved creditors' arrangement:** in the petition, it will be necessary to state that the tax debts affected are not post-insolvency claims and a statement to that effect will have to be produced together with supporting documentation.

- **Collateral for the deferral or split-payment of tax debts:** in the case of debts at the enforcement stage, the collateral provided must cover the deferred amount, including any surcharge and late-payment interest resulting from the deferral, plus 5% of the sum of both items.

These amendments will enter into force on January 1, 2018.

4 SECOND CHANCE: NON-LEGISLATIVE MOTION BY THE PARLIAMENTARY GROUPS OF THE CIUDADANOS AND SOCIALIST PARTIES

On November 16, 2017 a Compromise Text was published after being approved by the Lower House of the Spanish Parliament in connection with two non-legislative motions to ensure that insolvent families and debtors are given a real 'second chance'.

The Compromise Text calls on the Government to present, within 6 months, amendments to the Insolvency Law to strengthen the 'second chance' or 'fresh start' mechanism for distressed debtors. The following matters are to be addressed in the amendments to the Insolvency Law:

i. Review of the requirements enabling a debtor to access the 'second chance' mechanism (technically known as debt relief).

ii. To allow debts owed to the tax and social security authorities to be negotiated and relieved.

iii. To eliminate the 5-year period during which the relieved debts may be reclaimed by creditors if the debtor secures new sources of income.

iv. To establish a period not exceeding 3 years after which the debt relief becomes definitive.

v. To make the statutory majorities for the approval of a non-judicial payment agreement the same as the statutory majorities for the approval of a creditors' arrangement.

vi. To allow the courts to decide to order debt relief in respect of an individual without the individual having to apply for that relief.

The Compromise Text also proposes changes to the Civil Procedure Law, such as the following:

i. To add flexibility to the requirements enabling the most vulnerable debtors to discharge their debts by handing over their principal residence in payment, by allowing them to remain in their homes for 3 years whilst paying a sustainable rent.

ii. To carry out a fresh appraisal of the dwelling within the foreclosure process, the amount of which may not be less than the value of the dwelling as agreed upon by the parties when the loan was granted; and

iii. To declare certain financial assistance and benefits received by the debtor to be immune from attachment.

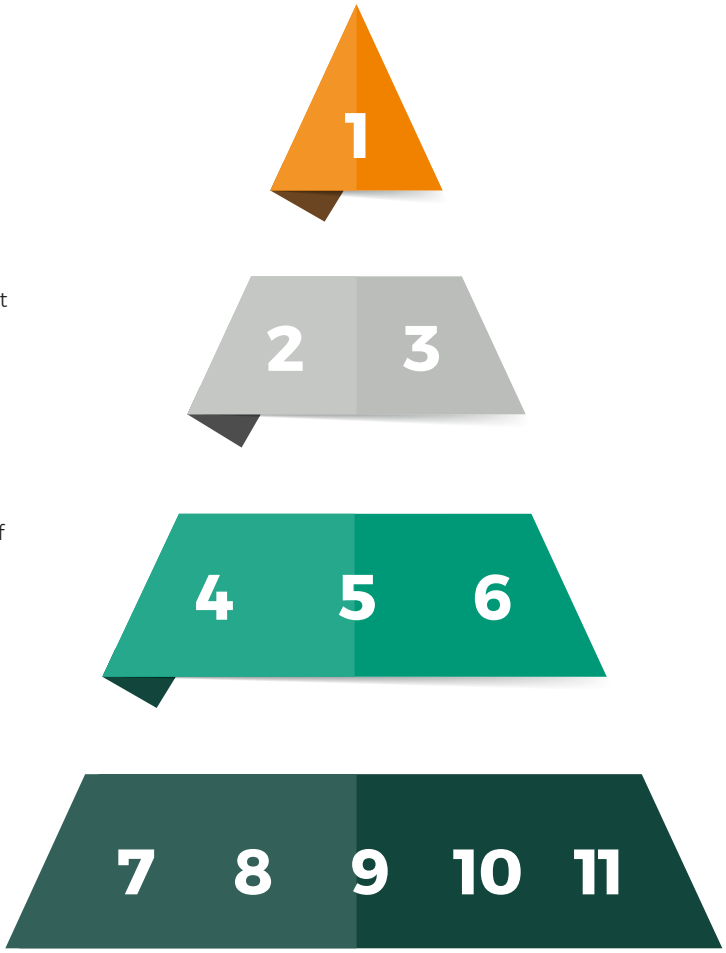
3 Notional pyramid

- Sale of a business unit and cancellation of registered charges

- Fault-based insolvency of a subsidiary and judgment against its parent company / director
- Registration of pre-agreed mortgage liens after the making of an insolvency order

- No transfer of undertakings following a collective layoff procedure within an insolvency proceeding
- Injunctive relief and contingent claims
- Prohibition on offsetting VAT claims

- Enforced collection of tax claims and insolvency proceedings
- Conclusion of an insolvency proceeding following a post-arrangement merger
- Court jurisdiction and transfer of undertakings
- Standing to appeal in clawback actions
- Sale of essential assets without approval by the shareholders' meeting



1 Refusal to cancel registered charges after the sale, together with the other assets and rights comprising the business unit, of a property subject to a secured claim: judgment rendered by the Supreme Court on November 21, 2017

According to the wording of section 149.2 of the Spanish Insolvency Act ("SIA)" prior to September 2014, it was an unavoidable requisite that the mortgage creditor had expressly accepted the cancellation of its secured claim when its mortgage encumbered an asset which formed part of the production unit and the amount to be received by the secured creditor, charged to the total price of the production unit, was less than the secured claim (section 155.4 SIA). The court order for cancellation of the mortgage lien must state that that requirement has been met in order to be registered. It is not sufficient to prove after the event that such acceptance was given. When the court order for cancellation of the mortgage lien states that that requirement has been met, the registrar is not entitled to carry out any additional analysis.

2 Finding that a parent company, in its capacity as director, is a person affected by a fault-based assessment of the insolvency of its subsidiary, and is partly liable for the shortfall in the insolvency proceeding: judgment rendered by the Supreme Court on December 20, 2017

The unlawfulness of the parent company's conduct was assessed on the basis of the prejudice caused to the subsidiary's creditors. Those creditors were adversely affected by the willful misconduct or gross negli-

gence of the parent company which, in its capacity as director of the subsidiary, sacrificed the subsidiary's solvency in favor of its own survival. The misconduct consisted in the failure of the subsidiary to require the parent company to pay a very substantial claim, which had a causal effect on the subsidiary's insolvency.

3 Validity of a mortgage provided by a debtor before the debtor's formal insolvency but registered afterwards: judgment rendered by the Supreme Court on November 7, 2017

Mortgage provided before the insolvency order but registered afterwards. The mortgage was provided at a time when the insolvent debtor held full powers of disposal and when there was no need to obtain mandatory authorization by a court to be able to encumber assets. Subsequent authorization by the court was not required for subsequent registration since the registration itself is not an act of disposition.

4 No transfer of undertakings where there is no continuity of the organized asset unit: judgment rendered by the Labor Chamber of Madrid High Court on July 24, 2017

A transfer of undertakings only exists where a third party acquires from the insolvent debtor a set of organized resources enabling the debtor to carry on an economic activity. There is no transfer of undertakings if the transfer post-dates the conduct and completion of a collective layoff procedure at the insolvent company, and furthermore, the subject-matter of the sale was the shares of a company that received only isolated human resources and assets from the insolvent company and did not include the intangible assets that were an essential component needed to carry on the business, resulting in the purchaser having to make a major investment in new tangible and intangible resources.

5 Injunctive relief granted in view of the possible confirmation of a contingent claim: decision rendered by Barcelona Provincial Appellate Court on October 27, 2017

The granting of injunctive relief to secure a contingent claim (Article 87.4 of the Insolvency Law) requires the appearance of a right and the existence of a risk caused by the danger of a final decision on the merits of the case being delayed. The appearance of a right is made out if the confirmation of the contingent claim is likely. As regards the second requirement, the risk of delay is inherent in the conduct of the insolvency proceeding. The available injunctive relief may not involve alterations to procedural requirements, such as cancelling the creditors' meeting. The Chamber confirmed, without requiring the creditor to post a bond, a number of economic injunctive remedies, such as requiring provisioning against the assets available to creditors and imposing a prohibition on the insolvent company preventing it from paying subordinated claims, and encumbering, or disposing of, certain assets.

6 Prohibition preventing the State Tax Agency from offsetting a VAT claim related to invoices corrected on account of an insolvency order against a VAT claim to be refunded from tax years following the insolvency order: judgment rendered by the Civil Chamber of the Supreme Court on January 11, 2018

The pre-insolvency claim held by the State Tax Agency deriving from the correction of invoices as a result of an insolvency order on the debtor may be offset against VAT claims to be refunded from tax years prior to the insolvency order which are actually held by the debtor, but not against tax claims which accrued after the insolvency order.

7 Ability to claim by way of enforced collection tax claims arising before the insolvency order but assessed after approval of the creditors' arrangement: judgment rendered by the National Appellate Court (Judicial Review Chamber) on September 18, 2017

Tax claims arising before the insolvency order but not recognized in that order - because they were not assessed until after the arrangement with creditors had been approved - fall outside the effects of the insolvency proceeding. Accordingly, the enforceability of the assessments issued in relation to those claims may not be suspended, with the result that the orders initiating enforced collection of them are valid.

8 Dismissal of an insolvency proceeding due to the merger of the insolvent debtor during the performance of the creditors' arrangement: decision rendered by Cantabria Commercial Court on December 7, 2017

The court ordered conclusion of the insolvency proceeding on account of the unforeseen loss of subject-matter due to the merger by absorption of the insolvent company by another company during the performance of the arrangement, in circumstances where the arrangement did not make any provision for that eventuality. The subject-matter of the insolvency proceeding disappeared because the insolvent company's obligations passed over to the absorbing company's assets and liabilities, and because, moreover, such universal succession entails the extinguishment of the absorbed insolvent company's legal personality.

9 Jurisdiction to assess the existence of a transfer of undertakings and subrogation to employment obligations following the sale of a business unit in an insolvency proceeding: judgment rendered by the Supreme Court (Labor Chamber) on July 5, 2017

The labor courts have jurisdiction to determine whether there has been a transfer of undertakings where the business unit of the insolvent debtor is acquired by a third party outside the insolvency proceeding who was not involved in the insolvency proceeding as either creditor or debtor.

10 Standing of creditors to lodge appeals in ancillary processes for clawback in the context of insolvency proceedings: judgment rendered by the Supreme Court (Chamber One) on December 1, 2017

Despite the limited *locus standi* that exists to bring asset clawback actions, the intervention of a third party in a clawback action grants that person the status of party for all purposes. A creditor, who assisted the insolvency receivers in an asset clawback action, was entitled to lodge the appeals available under the Insolvency Law to challenge decisions delivered in that process, separately from the insolvency receivers.

11 Liquidation of essential assets without seeking the approval of the shareholders' meeting: decision of the Directorate-General for Registers and the Notarial Profession of November 29, 2017

It is not necessary to obtain the approval of the shareholders' meeting for the sale of essential assets if that sale takes place in circumstances where the transferring company is in liquidation, since the new corporate purpose in the liquidation phase imposes that disposal of assets on the managing body, with the result that there are no grounds for the intervention of the shareholders' meeting.

4 Garrigues archives

1 PUBLICATIONS

- ***"Los marcos de reestructuración preventiva en la propuesta de Directiva de 22 de noviembre de 2016 (y II)"*** ("The preventive restructuring framework in the Directive proposal of November 22nd, 2016 (II)") [Thery Martí], Revista de Derecho Concursal y Paraconcursal nº 28, January 1, 2018, Wolters Kluwer.

- ***"Incumplimiento de convenio: adopción de acuerdos sociales y modificaciones estructurales"*** ("Breach of the creditors' arrangement: adoption of corporate resolutions and structural modifications") [Gutiérrez Gilsanz], AA. VV., *Estudios sobre órganos de las sociedades de capital*, coordinated by JUSTE, J., and ESPÍN, C., Aranzadi, Cizur Menor 2017, Vol. II, pp. 711-728:

- ***"Definición de varios términos jurídico-concursales"*** ("Definitions of a collection of terms related to insolvency law") [Gutiérrez Gilsanz], Diccionario panhispánico del español jurídico de la Real Academia Española y el Consejo General del Poder Judicial, Editorial Santillana, Madrid 2017.

- ***"Acciones de reintegración y concurso internacional: aspectos de ley aplicable"*** ("Clawback actions and international insolvency: notes on applicable law") [Heredia Cervantes], Revista de Derecho Concursal y Paraconcursal nº 28, January 1, 2018, Wolters Kluwer.

2 EVENTS

- ***"Traslado internacional de domicilio social y límites al legislador nacional. Reflexiones tras la Sentencia «Polbud» del Tribunal de Justicia de la Unión Europea"*** ("International relocation of a company's registered office. Some observations following the "Polbud" judgment delivered by the Court of Justice of the European Union"). Fundación para la Investigación para el Derecho y la Empresa (FIDE), November 22, 2017, Madrid.

  Law lecturer Ivan Heredia, counsel in the Restructuring and Insolvency Department, moderated this session which addressed the main issues dealt with in the recent judgment of the Court of Justice of the European Union delivered on October 25, 2017.

- ***"La residencia como punto de conexión en la aplicación del Derecho: especial referencia a las particularidades fiscales"*** ("Residence as a connecting factor in applying the law: special reference to the particular tax features"). Alcalá de Henares University, January 19, 2018, Madrid.

  Iván Heredia participated in the round table discussion on 'Civil abode, registered offices and nationality in the application of private law'. Iván's presentation focused on the phenomenon known as "international insolvency tourism".

- ***"Los acuerdos de refinanciación y reestructuración"*** ("Refinancing and restructuring agreements"), X Congreso Español de Derecho de la Insolvencia (CEDIN X) ("10th Spanish Insolvency Law Conference") *under the presidency of Mr. Ángel Rojo*, March 8-10, 2018, Valencia (Thomson Reuters – Aranzadi, AEDIN).

  Adrián Thery, partner in the Restructuring and Insolvency Department, will take part as speaker in

this edition which will address "Negotiations" in the first round table discussion on "Notification of the commencement of negotiations with creditors".

- **Transatlantic Restructuring & Insolvency Group ("TARIC"),** March 15, 2018, Dublin (Ireland)

  Garrigues partner Juan Verdugo will participate in this meeting of specialists in cross-border restructuring and insolvency. The meeting will address global and pan-European issues such as the crisis at Carillion in the United Kingdom, the insolvency of the Austrian airline Niki, and the conflict of venues between Germany and Austria, as well as the impact of the new rules on bank provisioning in the world market for NPLs, with particular focus on the Spanish market.

- ***"Main challenges and trends in insolvency proceedings, restructuring and second chance".*** event organized in the context of the Bulgarian Presidency of the EU Council, May 18, 2018, Varna (Bulgaria).

  Our partner Adrian Thery will take part as a speaker in Panel 1 ("*Preventive restructuring procedures – A balancing act*") addressing the topic of *"Improving the chances of a plan being adopted while protecting creditors in cross-class cram-down plans"*.

- ***"Breaking the chains",*** Insol Europe 2018 Annual Congress, October 4-7, 2018, Athens (Greece).

  Our partner Adrian Thery will take part as a speaker in a panel dedicated to the current situation of NPL's in the European Union.

MORE INFORMATION:
RESTRUCTURING AND INSOLVENCY DEPARTMENT

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