

Legal Issues to be considered by Purchasers of Distressed Debt in Spain

Banking and Capital Markets Department

1. Introduction

- 1.1. The current economic conditions have enhanced the interest of a high number of investors in opportunities within the distressed debt market. The distressed debt market has significantly increased in the US and Europe, but creditors in Spain are still reluctant to sell their credits at a discount. In general, banks and financial entities have a preference for reaching restructuring agreements with their Debtors.
- 1.2. In Spain the sale and transfer of credits is generally governed by Articles 1526 to 1537 of the Civil Code (the "**Code**"), but it is important to bear in mind other statutory provisions which may provide with formal requirements and/or limitations which may be applicable to a transfer. The Insolvency Act (the "**Act**") also plays a key role as it provides with certain particularities for transactions carried out once the Debtor has entered into an insolvency procedure and determines the restructuring procedure within an insolvent company. Also the ranking of the purchased credit (and whether the ranking of the seller is maintained after the transfer) in a potential insolvency of the debtor is fundamental when acquiring distressed debt.
- 1.3. Unlike in other jurisdictions (eg. England & Wales), Spanish Laws do not make any differences between legal and equitable interests, thus the purchase of debt in Spain will generally imply transfer of ownership of the credit.
- 1.4. As per the above, it is recommendable for any foreign investors to seek advice of Spanish local counsel when: (i) the debtor is a Spanish company or the credit is guaranteed by a Spanish company, (ii) the credit or debt is subject to Spanish Law; or (iii) the credit is secured with Spanish assets or Spanish security.
- 1.5. For the purposes of this paper: (i) the investor acquiring or targeting the distressed debt will be indistinctly referred to as "**Purchaser**", "**Buyer**" or "**Transferee**"; (ii) the owner of the credit selling it to the investor, indistinctly as "**Seller**", or "**Transferor**" and (iii) the debtor of the assigned debt will be defined as the "**Debtor**". Also, the credit right of the Seller against the Debtor will be defined as the "**Debt**" or the "**Credit**".
- 1.6. This document only refers to Spanish Law. This document does not intend to be comprehensive. Legal advice should be obtained on a case by case basis.

2. Legal Issues

- 2.1. *Restrictions and need of consent:* the general rule under Spanish Law in respect of transfers of credits is that a credit may be freely transferred without the need to obtain the consent of the Debtor, and they can be executed against the Debtor's

will. However, contractual arrangements reached between Seller and Debtor may limit the transfer of the debt or subject it to certain conditions. In particular, it is fairly common that syndicated loans provide for certain conditions to transfer, such as the same being for a minimum amount or on particular dates (such as at the end of interest periods so that break costs are eliminated or mitigated). Also, many contractual arrangements limit the right of a Seller to transfer to a Purchaser if the latter is not a bank or a financial institution or if any withholding or increased cost on the side of the Debtor arise (generally covered by the respective gross-up provision). This must be specially taken into account by funds and other non-bank investors.

- 2.2. *Transferring the Credit or the Participation:* special care needs to be taken when purchasing a position in a facility where amounts are still to be disbursed. Need to clearly identify that it is the Credit which is being purchased, but not the whole participation in the loan (which would imply an obligation to disburse available funds, if applicable). This possibility may be limited contractually and must be carefully reviewed.
- 2.3. *Notice to the Debtor:* as a general rule notice to the debtor is not required for effectiveness of the transfer. However, a Debtor who pays the Seller before having been notified about the transfer would be released from its obligations. Once the Debtor has been notified, the transfer will be fully effective and no payment made by the Debtor to the Seller will have extinctive effects on the Debtor. There are special rules upon situations of multiple Debtors, whereby: (i) if joint Debtors, each Debtor shall be notified; and (ii) if joint and several Debtors, any of them to be notified, indistinctly. Also, the agreement reflecting the Credit may (and generally will) establish the obligation of giving notice to the Debtor.
- 2.4. *Transferring the Debt and its security:* the general rule is that upon transfer of a Credit the same will remain in existence between the Purchaser and the Debtor with all its ancillary rights and securities, if any. However, upon certain circumstances certain formalities need to be complied with in order to maintain enforceable security by the Purchaser. Special care needs to be taken when the Credit is secured by registered security (this is, any security which requires registration for its effectiveness).
- 2.5. *Formalities:* Spanish Law does not impose on Buyer and Seller any formal requirements, thus transfers may be executed either in a private or in a public document. However, transferring a Credit through a public document is always recommendable in order to be able to evidence the ownership of the Credit vis-à-vis third parties and the date on which such ownership was transferred. Also, a Spanish Public Document will generally be required in scenarios where the Credit is secured by registered security and the Purchaser wishes its position to be registered within the applicable Spanish registries. A reasonable recommendation (although to be analysed on a case by case basis) should be that if the Credit is documented as a public document the acquisition of the same should also be made as a public document. It is advisable for any Buyer of a Spanish secured Credit to register its acquisition by following any statutory formalities whenever the original Credit or its security is registered. Otherwise the entries in the relevant registry will not be accurate thus being the Buyer at the risk of not being able to enforce the security for not appearing as the registered beneficiary of the security.
- 2.6. *Recourse to the Seller:* as long as the credit is not sold as doubtful credit and unless otherwise stated, upon a transfer of a credit right the liabilities of the Seller are very limited and restricted to: (i) the existence of the credit; and (ii) the legitimacy of the credit. The Seller shall not be liable for the solvency of the Debtor, unless otherwise agreed with the Buyer or the insolvency of the Debtor was pre-existent and publicly known, therefore being any distressed debt acquisitions susceptible of being affected by this provision. The responsibility of the Seller regarding the existence and

legitimacy of the credit, unless otherwise agreed with the Buyer shall be limited to: (i) the purchase price; (ii) the expenses incurred in respect of the sale and purchase agreement; and (iii) any other legitimate payment made by reason of the sale of the credit (Articles 1529 and 1518 of the Code).

2.7. *Credits in Litigation*: special care must be put on transfer of the so-called "Credits in Litigation" ("*créditos litigiosos*"). A credit shall be considered in litigation from the day the plaintiff submits to the Court its response to a formal claim, the object of which is the existence of the Credit. Those Credits in Litigation will be considered as such until a final court order ("*sentencia judicial firme*") has been issued in respect of the claim. The main peculiarity of Credits in Litigation is the right that Article 1535 of the Code vests on the Debtor so that he can cancel the credit, provided that: (i) the transfer of the credit shall have been made to a third party other than the parties in litigation; and (ii) the right to cancel is exercised by the Debtor within nine (9) days from the date of claim of payment by the purchaser of the credit. To cancel the credit, the Debtor shall pay the purchaser: (i) the purchase price; (ii) any litigation costs incurred by the purchaser; and (iii) any interests on the price paid by the purchaser accrued from the day on which the same was satisfied to the Seller. Once all the above amounts are satisfied by the Debtor, the credit will be extinguished, thus being the judicial claim finished.

2.8. *Stamp Duty for transferring the credit*: as a general rule the transfer of a Credit from a Seller to a Purchaser does not imply stamp duty. However, the granting of public deeds the object of which is any act that is subject to registration in any of the Spanish public registries will trigger the obligation to pay Stamp Duty Tax. Thus upon execution of a public deed of assignment of a credit secured with a registered security or with a security that may be registered, Stamp Duty Tax will be due. Special care needs to be taken on mortgaged backed loans.

2.9. *Purchase of Credits against an Insolvent Company after commencement of insolvency proceedings*: Section 122 of the Act (hereinafter, "**S. 122**") is paramount. S. 122 establishes that subordinated creditors or those who have acquired their claim by *inter vivos* acts after the insolvency proceedings have commenced shall not be entitled to vote at the creditors' meeting, except if the acquisition took place by: (a) universal title, *eg.* upon acquisition being made as a consequence of a merger or split-up of the transferor; or (b) as a consequence of an enforcement, such as the foreclosure of a pledge over receivables, etc. S. 122 does not forbid the transfer of credits after the commencement of insolvency proceedings, thus being valid and binding not only for the assignor and the assignee but also against the Debtor, however it does limit the right of the Purchaser to vote (This provision was subsequently amended as described in the article "Amendment of the Spanish Insolvency regulations And Their Implication in Spanish Restructuring/Distressed Deals").

2.10. *Purchaser's situation upon subsequent insolvency of the Debtor*: subject to certain exceptions generally the position of a Purchaser in a subsequent insolvency proceeding of the Debtor will be such as the position held by the Seller. In this respect, Section 89 of the Act establishes the following ranking of credits: (i) privileged, (ii) ordinary and (iii) subordinated. Subordinated credits ("**SCs**") are those that rank subordinated to ordinary and privileged credits and are listed in Section 92 of the Act. Among the list of SCs the following are of special importance: credits that the parties wish to consider as subordinated, credits due to interest (including default interest but excluding those secured by a *right in rem* up to the value of the asset) and those credits owned by parties specially related to the insolvent. Section 93 of the Act lists who may be considered "specially related to the Debtor". In respect of corporations, the following shall be considered as "specially related to the debtor": (i) any shareholders of the Company who, at the moment of the

debt arising, are holders of at least 5 % of the share capital (listed companies) or 10 % of the share capital (non-listed companies); (ii) the directors, *de jure* or *de facto*, the liquidators, if any appointed, of the Company, and the proxies with general powers of the company, as well as those who have acted as such during the two years preceding the declaration opening the insolvency proceedings; and (iii) any affiliates of the Company and their shareholders as long as they fulfil the conditions in (i) above. Section 93 of the Act also establishes that unless proved otherwise the purchasers of credits from persons “specially related to the Debtor” will be “specially related to the Debtor”, and thus subordinated, to the extent the purchase took place in the two years preceding the insolvency.

Therefore, in general terms, a Purchaser needs to ensure that the credit which is purchasing: (i) was not subordinated when due to the Seller and (ii) will not become subordinated once purchased by the Purchaser.

- 2.11. *Restrictions of the Act for creditors to request the commencement of insolvency proceedings against the Debtor.* Either the debtor, through its governing or winding-up body, as the case may be (“**Voluntary Insolvency**”) or any of its creditors (“**Compulsory Insolvency**”) are entitled to request the commencement of proceedings. In any event, a plurality of creditors must hold credit rights towards the debtor. Otherwise a singular judicial procedure would suffice to deal with an insolvency of the Debtor. In general, a debtor must petition for a declaration opening the insolvency proceedings within the (2) two months following the date on which it knows, or should know, its situation of insolvency. In the same manner, creditors shall be entitled to request the commencement of proceedings against the Debtor as soon as they are aware of the occurrence of any of the presumptions set out in the Act in respect of the effective insolvency of the Debtor, and after having claimed the debt and not being paid (plus certain requirements being met). This notwithstanding not all creditors will

be entitled to request commencement of proceedings against the debtor. Section 3.2 of The Act provides that any creditors who have acquired claims by *inter-vivos* acts (eg. via acquisition of debt) and by a singular title, after maturity thereof (e.g. non-performing loans, distressed debt, etc.) within the six months prior submission the application of commencement, shall not be entitled to request commencement of proceedings. This shall be borne in mind if the object of the acquisition of the Credit is to obtain leverage with the possibility of requesting the commencement of insolvency proceedings against the Debtor.

- 2.12. *Risks of rescission:* an additional risk may be imposed on the Purchaser when acquiring debt from a Spanish Seller in financial distress. If eventually the Seller filed for insolvency, Section 71 of the Act allows for the possibility to rescind certain acts carried out by it during the two (2) year period preceding the declaration of insolvency, on the grounds that those acts are prejudicial to the insolvent estate and regardless of whether those acts had been performed with the aim of deceiving the interests of the creditors or not. Upon an insolvency proceeding being commenced, those actions which are judged detrimental to the estate of the insolvent party and which have been carried out during the two (2) years preceding such date, may be rescinded even in the absence of fraudulent intention.

3. Tax Issues

- 3.1. *EU Residents:* if the Purchaser is a tax resident of a European Union Member State, the interests received by it under the Credit will be exempt from taxation in Spain, provided that the tax residence is duly justified with a certificate of tax residence issued by the Tax Authorities of the correspondent State.
- 3.2. *Non EU Residents:* if the Purchaser is a tax resident of a foreign State not being member of the European Union, the interests will be subject to taxation in Spain at a fix tax rate (currently 19 %),

except if a Double Taxation Treaty applies and establishes a lower tax rate, provided that the application of the Treaty is duly proved with a tax certificate issued by the Tax Authorities of the correspondent State that makes reference to the Treaty.

- 3.3. *Spanish Tax Residents. Withholdings:* If the Purchaser is a Spanish tax resident, the interests will be subject to withholding tax, on account of Corporate Income Tax, at a fixed rate of 19 %, except if the Purchaser is a finance entity duly registered with the Bank of Spain.
- 3.4. *Price finally received. Interests:* On the other hand, it should be noticed that, as the Credit will be acquired by the Purchaser at a discount, the difference between the price paid and the principal finally received would be taxed as interest, according to the rules explained above.
- 3.5. *Tax formalities:* Even if the interests are exempt by application of the above-said rules, a Non Residents Income Tax Return should be filed within the Spanish Tax Authorities declaring the exemption and the legal grounds of the exemption.
- 3.6. *Indirect Taxation:* Regarding indirect taxation, the transfer of the Credit will be exempt from VAT.
- 3.7. *Stamp Duty Tax:* As referred in paragraph 2.5, the transfer of a credit guaranteed with a registered guarantee or with a guarantee that may be registered, Stamp Duty Tax will be due, being the tax rate 1 %, applicable on the total amount secured.

4. Conclusion

- 4.1. Acquiring distressed debt in Spain is a straightforward process, as credits may be freely transferred without neither requiring the consent of the Debtor, nor complying with specific costs or formalities (save as otherwise described above).
- 4.2. On any transaction we would recommend to ascertain whether any obligation of disbursements is in force and it shall be ensured that such obligation, if any, is not transferred to the Purchaser, so that it only acquires a part or the whole of a credit (*i.e.*, the economic credit rights); not a full participation.
- 4.3. When purchasing a credit, any security will generally also be transferred to the Purchaser, some of which may need compliance with some formalities.
- 4.4. Be wary of any acquisitions of: (i) credits in litigation, as the Debtor may exercise its right to repay the credit at the purchase price; (ii) purchase of subordinated credits or credits against an insolvent company, as any voting rights in a Creditors Meeting will be restricted; (iii) credits from parties especially related to an insolvent company; and (iv) credits from any Seller who may be in financial distress as the transaction may be rescinded if the Seller files for insolvency and the insolvency administrators deem it to be prejudicial to the Seller's estate.
- 4.5. When calculating the costs, taxes and expenses for the acquisition of distressed debt, it needs to be taken into account that: (i) Stamp Duty Tax may be due in respect of transactions recorded in a public deed which may need to be filed in a public registry (1 %); (ii) if the Purchaser is not an EU member, payments of interests will be subject to taxes at a taxable rate of 19 %; (iii) if the Purchaser is Spanish tax resident, interests would be subject to withholdings at a fixed rate of 19 % unless the creditor is a financial institution registered within the Bank of Spain; and (iv) any difference between the price paid by the Seller and the price paid by the Purchaser will be taxed as interests.
- 4.6. In general, Spanish local counsel should be sought before and during the closing of a distressed debt transaction to ensure that the Credit being purchased is duly transferred, has the envisaged ranking and attached rights and there are no unexpected costs involved.

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