Main amendments to the Spanish Insolvency Act introduced by Royal Decree Act 11/2014 and how they affect Spanish in-court restructurings

1. Introduction

On 7 September 2014, Royal Decree Act 11/2014 on *urgent measures in insolvency matters* ("**RD 11/2014**") came into force, introducing important changes in the Spanish Insolvency Act ("**SIA**"), especially regarding in-court proceedings, whether within a composition or a liquidation stage. This piece of legislation followed Royal Decree 4/2014 ("**RD 4/2014**), which introduced equivalent measures for pre-insolvency restructurings. The rationale for this new amendment seems therefore clear: it made little sense to have pre-insolvency restructurings with a more flexible regime than in-Court proceedings.

In this memorandum we address some of the main issues arising from the amendments introduced by RD 11/2014, in particular focusing on how RD 11/2014 affects in-Court debt restructuring proceedings within the composition stage, leaving the amendments affecting liquidation for a separate future analysis.

This memorandum is not comprehensive and does not constitute legal advice. Proper legal advice should be sought before taking any action.

2. Main amendments Affecting In-Court Debt restructurings

Rather than following the order contained in the RD we will describe the amendments on a timely manner, consistent with the development of a Spanish insolvency process.

Buying claims post-insolvency

The SIA used to deny voting rights to creditors in respect of claims acquired after the opening of insolvency proceedings in respect of the debtor unless (since 2012) the purchaser was an entity subject to financial supervision. This denial was based on the presumption that said acquisitions were made with intent to defraud. This limitation created a long and fascinating discussion about what was an entity subject to financial supervision: would a fund regulated outside Spain qualify?, what about the unregulated vehicle of a fund?, what about bondholders who bought after the insolvency event but where a regulated trustee/agent has filed the collective claim within the insolvency proceedings?

RDA 11/2014 has amended article 122)(1), eliminating the voting restriction if the purchase is post-insolvency (needless to say, subordinated creditors or specially related parties will still not be able to vote). This should now open an interesting market for post-insolvency claims, although market players should be aware of the timing limitations of this amendment since it will only apply to future proceedings or to those commenced proceedings in which the insolvency administration has not yet issued the insolvency report.

Value of the security

RD 4/2014 already introduced, for pre-insolvency situations, the concept of "value of the security", which has the intention of ensuring that a creditor which is secured by an asset can only be considered secured (for the purposes of the insolvency) for the value of said asset, and should be thus considered unsecured (or ordinary) for the rest.

This concept is now also introduced in the insolvency proceedings and to such effect the RD 11/2014 has included certain valuation rules which are, to some extent, consistent with those affecting pre-insolvency situations. In particular, the value of the security will be the result of deducting, from the 9/10 of the *reasonable value* of the asset over which the security has been created, the amount of outstanding debts secured with priority security over the same asset. For these purposes, *reasonable value* of the asset shall be understood as follows: (i) for securities listed in a regulated market: the balanced average price at which the securities have been negotiated within the last 3 months; (ii) for real estate assets: the value stated in a report to be issued by an appraisal company duly registered with the Bank of Spain; and (iii) for other assets different to those in sections (i) and (ii) and cash (including cash credited to an account): the value stated in a report to be issued by an independent expert.

The rationale for deducting 10% of the reasonable value is an estimated cost for the enforcement of the security, something which seems contradictory with keeping the same reduction in value in the case of liquid security (such as cash or listed shares) on which the enforcement may be quick and almost cost free. The wording used in this new RD also does not solve the question of security which secures various debts *pari passu* but which contractually, through an inter-creditor agreement, has a different ranking.

Concept of "classes" for privileged creditors

RD 11/2014 has introduced in Spain the long-awaited concept of classes, although perhaps not as expected. A new art. 94(2) states that privileged creditors (including both preferential and secured creditors) included in the list of creditors shall be classified in any of the following four classes, depending on the nature of their claim:

(i) Employment: employment law related claims.

(ii) Public: public administration claims.

(iii) Financial: creditors owning financial debt.

(iv) Remaining secured (fixed charge) creditors.

There are several interesting issues: (i) only secured and preferential creditors are distributed into classes, with ordinary creditors kept voting as one separate class, (ii) each of the above classes will then vote separately for the purposes of being bound by a composition, (iii) all secured creditors will vote together in their class (regardless of their ranking) although each will vote for the amount of their secured claim (as calculated above). Note that the voting of the different classes is not required to have a composition approved (which still only requires approval by the ordinary creditors) but only to be bound by it. In other words, a composition agreement may be approved by 51% of the ordinary creditors (or applicable majority, as described below) and 1, 2 or 3 of the 4 classes above. There are also doubts as to whether a composition can be agreed by the classes, binding only on such classes (without a majority of the ordinary creditors).

The concept of classes becomes relevant for the purposes of classifying insolvency proceedings as at-fault since now the stage to define the existence of fault opens up in the event that the approved composition of creditors establishes, for all creditors or for creditors belonging to one or several classes, write-offs (haircuts) of more than 1/3 of the amount of the creditors' claims or deferrals of more than 3 years.

Acceptance and extension of a composition of creditors

Up until RD 11/2014, secured creditors could not be bound to a composition without their consent. The level of hold-out value in these claims was thus significant and in many occasions it made compositions unviable. Following concepts already introduced in pre-insolvency restructurings under RD 4/2014, the new RD provides the following majorities:

a) *Ordinary/unsecured creditors*: a composition of creditors shall be deemed as accepted by the meeting of creditors if the following majorities are obtained:

   (i) if at least 50% of unsecured unsubordinated liabilities vote in favour of the composition of creditors in cases where the composition consists on haircuts (or debt discharges) equal to or less than 50% of the claim, deferrals for a period no longer than 5 years and conversion of debt into profit sharing loans, also for a period no longer than 5 years (in the case of creditors different from public and employment creditors). However, when the proposal consists in (i) the full payment of unsecured claims in a period of no more than 3 years, or (ii) in the immediate full payment of unsecured outstanding claims with a haircut of less than 20%, the favourable vote of a portion of the liabilities greater than the portion voting against will suffice for its acceptance.

   (ii) if at least 65% of the ordinary/unsecured liabilities vote in favour of the composition of creditors in cases where the composition consists on haircuts (or debt discharges) of more than 50% of the claim; deferrals (for a period between 5 and 10 years) and conversion of debt into profit sharing loans, also for a period between 5 and 10 years (in the case of creditors different from public and employment creditors).

b) *Secured/preferential creditors*: the effects of an approved composition can be extended to secured and preferential creditors (in respect of the part of the claim covered by the reasonable value of the security), provided that the relevant composition of creditors has been approved by the following majorities of creditors on a per class basis:

   (i) 60%, as regards measures stated in section (a) (i) above.

   (ii) 75%, as regards measures stated in section (a) (ii) above.

In the case of secured creditors these majorities are to be calculated on the basis of the proportion of the value of the "assenting security", over the total value of the security granted to each class. In the case of preferential creditors, these majorities are to be calculated on the basis of the proportion of the value of the "assenting liabilities" over the total liabilities with a preferential claim in each class.

One issue however is left hanging in the air: what about binding the shareholders? The new RD has included that a debt for equity swap will only require a simple majority approval at the shareholders meeting (just as in pre-insolvency restructurings) but has surprisingly ignored the other relevant change introduced in RD 4/2014: the risk of shareholder and director liability in the event of rejecting a reasonable debt-equity swap.

Although the wording of the Royal Decree could have been clearer, it seems that the provisions contained in this section will apply to insolvencies on which there is yet no report from the insolvency administration.

Extension of a composition within syndicated facilities

Following the regulation contained in RD 4/2014, the new RD contains an additional regulation for compositions where there is a "syndicated regime or agreement". In the particular case of syndicated agreements, art. 121(4) now states that if 75% of the liabilities of such syndicated agreement vote in favor of a proposed composition, said composition shall be deemed approved by all liabilities under the said syndicated agreement, and its effects extended to all of them. However, if the syndicate rules envisage a majority below said 75% (unlikely), said smaller majority shall be applicable. This provision logically raises a number of questions as to what constitutes a syndicated agreement (in particular, when inter-creditor agreements are in place), who can or cannot vote within such syndicate (i.e., can an insider vote?) and as to what terms and conditions can be extended (is it only those that can be extended under a normal composition?). Also note that this extension arguably should only be applicable if the 75% requirement is met and there is a composition approved (with the majorities described above).

This provision should be applicable to any process in which a composition agreement has not yet been voted.

Breach of a composition agreement and effects for secured creditors

Again following the regulation contained in RD 4/2014 for pre-insolvency situations, the new RD contains the concept that if a composition agreement is breached then secured creditors should not be impaired by a reduction in their claim and thus will be able to enforce their collateral and keep the proceeds in an amount not exceeding the original debt (should it not be to the amount of the debt secured by said asset?).

Amending a composition of creditors

The 3rd Transitory Provision of RD 11/2014 provides for the possibility of amending the terms of a composition of creditors upon a breach within 2 years from the date in which RD 11/2014 came into force. The amendment must be requested by the debtor or by creditors representing at least 30% of the total liabilities existing at the time of the breach, and it shall be deemed as accepted if it is subscribed by creditors representing the following majorities:

a) In case of unsecured/ordinary creditors: (i) 60% to adopt terms included in (a) (i) of the section above (*Acceptance and extension of a composition of creditors: necessary majorities)*; and (ii) 75% to adopt terms included in (a) (ii) of the same section above;

b) In the case of secured and preferential creditors: (i) 65% of liabilities of each class to modify the terms included in (a) (i) above; and (ii) 80% of liabilities of each class to modify the terms included in (a) (ii) above.

RD 11/2014 includes a variety of other amendments which are significant in insolvency proceedings and which will be dealt with in future analysis.

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