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PROPOSED NEW INSOLVENCY REGULATIONS - AND THEIR IMPLICATION IN SPANISH DISTRESSED DEALS

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1. Briefing

In the light of the current economic climate, some of the restrictive provisions of the Insolvency Act and the fears of rescission of transactions carried out in relation to companies in distress have resulted in a high number of the petitions of insolvency to end up in liquidation of the debtor. Also, the existing Insolvency Act (the "**Insolvency Act**") has somewhat acted as a deterrent to a Spanish distressed market and certain of its provisions have proven to be too strict to facilitate proper restructurings. This has forced market participants to find imaginative solutions, which in some cases include the use of foreign jurisdictions to carry out a restructuring plan.

With the aim of preserving the business activities of companies in distress, to induce capital investment in distressed companies and to facilitate pre-insolvency restructurings, the Spanish legislator is working on new regulations and a substantial reform of the Insolvency Act is due to come into force in the coming months (the **"Reform"**). The Reform introduces concepts which have been unknown to the Spanish market such as cram-down mechanisms or dip financings and allows for certain purchasers of debt of insolvent companies to keep their right to vote in a composition of creditors. We have tried to list those issues within the Reform which we think directly affects distressed investors, rather than citing all proposals made within the Reform. Some of the main novelties of the Reform affecting distressed transactions are set forth below.

2. Refinancing Agreements and Dip Financing (Fresh Money)

One of the biggest fear of investors in distressed companies is the two-year hardening period established by the Insolvency Act (the **"Hardening Period"**). With regards to the Hardening Period, section 71 of the Insolvency act establishes a series of presumptions (some of which are rebuttable), the aim of which are for the Insolvency Administration and the Courts to be able to rescind any acts carried out by the insolvent company within the two previous years from the date of declaration of insolvency, which may be deemed prejudicial to the insolvent company's estate.

For a debtor to be refinanced/restructured in an agreement with its creditors, mitigating the risks of rescission brought up by the Hardening Period, any agreements reached (the **"Refinancing Agreements"**) by the debtor's creditors and the debtor in a pre-insolvency stage have to comply with the following requirements[1]:

1 Fourth Additional Disposition of the Insolvency Act

a) The purposes of the Refinancing Agreement shall be: (i) to substantially increase the funds available to the debtor; and/or (ii) to amend the terms of the debt that is to be re-negotiated by means of the Refinancing Agreement;

b) The Refinancing Agreement shall be a part of a short and mid term viability plan of the debtor;

c) It shall be approved by creditors representing, at least, 3/5 of the liabilities of the debtor;

d) It should be executed before a Spanish Public Notary and recorded in a public deed; and

e) An independent expert appointed by the Companies Registry should issue a report assessing: (i) sufficiency of the information provided by the parties (in particular, by the debtor); (ii) reasonability of the Refinancing Agreement and that the viability plan is sensible and flexible; and (iii) any securities securing the Refinancing Agreement shall be proportional to the usual market practice.

If the Reform is approved, it will top-up the seniority of new money put in within a Refinancing Agreement. The Reform does this by widen the categories of Credits Against the Estate and Privileged Credits. In this regard, new wording of Section 84.2.11º of the Insolvency Act[2] will provide that any credits representing income for the debtor obtained in the light of a Refinancing Agreement of the new Section 71.6 (*"Fresh Money"*) mentioned above shall be deemed as 50% Privileged and 50% Against the Estate.

The exception to the above shall be any fresh money obtained from the debtor itself or its shareholders or specially related parties, resulting from a share capital increase, loans or similar or analogous acts.

This provision will entail more certainty and an incentive to any lending institutions and investors willing to carry out rescue financings. Note that the Refinancing Agreement will now not necessarily require 100% consent of the creditors (See 2 below), thus this solution is especially interesting when there would otherwise be no consent for an intercreditor agreement to be put in place recognizing seniority to the new money.

3. Cramdown Mechanisms resulting from Refinancing Agreements

To date, the general principle reads that there is no such provision under Spanish Law that entitles a majority of creditors to carry out a restructuring of the debtor without the consent of the minority creditors in an out-of-court situation (i.e. where no insolvency proceedings have been commenced).

The above has lead to a situation were if 100% consensus has not been obtained the company would file for insolvency as the only way to de-leverage, unless imaginative solutions are found such as foreclosing holdco security and applying release provisions under intercreditor agreements (when found, which is not the case in most Spanish Law financings) or looking for foreign jurisdictions with a reduced consensus requirement. To these effects the Reform introduces new wording so that, once the Reform is enacted, any Refinancing Agreements complying with the requirements set forth in Section 2 herein will be susceptible of approval by the relevant Commercial Court (*"homologación judicial"*) for as long as it is approved by

2 Once the Reform is enacted

creditors whose aggregated liabilities represent, at least, 75% of the total aggregate ordinary claims of the debtor. Once approved by the relevant Court, it will be binding on all ordinary creditors.

For this new mechanism to be approved and bind the creditors either opposing or which have not voted the Refinancing Agreement (the **"Dissident Creditors"**), the relevant Commercial Courts shall ensure their reasonability and make sure that the mechanism is not disproportionate on any Dissident Creditors.

In addition to the above, there are certain restrictions on imposing this mechanism to Dissident Creditors. The restrictions or boundaries are the following:

a) Specially Privileged creditors (i.e. secured lenders) will not be affected by the agreement;

b) creditors may not be obliged to condone the debt, creditors may only be forced to extend and stay ("*espera*"); and

c) creditors may not be obliged to capitalise the debt (debt-for-equity).

It seems evident that the restrictions under (a) to (c) above make this mechanism less efficient for deleveraging a company in distress. However, it does open certain routes to avoid minority creditors blocking a restructuring and is a first step which will most likely be welcomed to market participants.

4. Incentives for creditors to request Compulsory Insolvency of a debtor

In the event of lack of agreement between creditors in a pre-insolvency stage, the Insolvency Act establishes that insolvency proceedings can be commenced by the request of (i) the debtor (**"Voluntary Insolvency"**) or (ii) by the debtor's creditors (**"Compulsory Insolvency"**).

With regards to Compulsory Insolvencies, the current wording of section 91.6 of the Insolvency Act provides that upon request of commencement of proceedings by a Creditor, the claims held by such Creditor that are not subordinated, shall be considered as generally privileged up to a quarter of their amount.

When finally enacted, the Reform will amend section 91.6 of the Insolvency Act so that any Creditor requesting commencement of proceedings of a debtor shall see its unsubordinated claims considered as generally privileged up to 50% of the total amount of the Credit.

This new provisions enhances the likelihood of creditors filing debtors for insolvency and will most likely open an interesting investment angle for investors (among others, when the distressed debt is trading below 50%).

5. Voting rights and Purchasers

Maybe the biggest hold off for purchasers of distressed debt in Spain so far has been the lose of their potential voting rights in a creditors' Meeting when acquiring any debt of an insolvent debtor. Currently, section 122.1.2º of the Insolvency Act provides that any Purchasers who have acquired their debt claim by *inter vivos* acts after the commencement of an insolvency proceeding of the debtor were declared open shall not have any voting rights in a creditors' Meeting, except if the acquisition took place by universal title or as a consequence of a forcible realization.

Once approved, the Reform will introduce novelties so that any potential voting

3 Section 122.1.2º as amended by the Reform.

rights that would have been allocated to a Purchaser will remain vested on the Purchaser for as long as it is an entity subject to financial supervision[3]. This wording seems to deliberately include financial entities as well as funds which are subject to supervisions and will open the scope of potential debt investments to situations where the company has already filed for insolvency.