"Value of real security" and "disproportionate sacrifice" in refinancing agreements under RD Act 4/2014

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In homologated refinancing agreements

1. According to paragraph 2 of the 4th additional provision, for the purpose of this provision the "value of real security" held by each creditor will be that obtained by subtracting the outstanding debts payable in priority with the property over which such security has been granted from nine-tenths of said property's fair value. Notwithstanding the foregoing, the value of the security can never be less than zero or greater than the value of the claim held by the appropriate creditor.

Scope

2. In principle, this regulation of the "value of real security" does not have effects outside the homologation (court approval) procedure under the 4th additional provision or, indirectly, the provisions of art. 71 bis (2)(c) of the Spanish Insolvency Act (IA). It shall not apply in the ordinary proof of claims on insolvency or, more importantly, in the determination of the security enforcement or sale price for the purpose of arts. 149 and 155 IA when the disposal of the secured asset is performed without auction or as part and parcel of a bulk transfer.

Importance of the "value of security"

3. Suppose the security in question is a highest-ranking claim and there are no charges payable in priority. In this case, the security cannot be greater in value than nine-tenths of the fair value of the asset over which the security rests. This means that the "secured" part of the claim exceeding this deducted value is deemed *in any case* (but only "for the purpose of this provision") as unsecured, *even if* the creditor could in fact settle the claim entirely by enforcing the secured property. This is the first ceiling of the value of an in rem security.

The second ceiling would be the amount of the secured claim, so that the value of security may never exceed the total amount of the secured claim, otherwise obvious as in insolvency proceedings a creditor cannot use the surplus from an enforcement to the satisfaction of other claims unsecured by the security in question. Consequently, the claim surplus not covered by the statutory value of the security shall have the consideration of unsecured liabilities for the purpose of majorities regulated under the 4th additional provision.

Deduction of charges payable in priority

4. "(O)utstanding debts payable in priority with the property" are deducted from the property's fair value. Therefore, *real security payable in priority* and *first-priority legal mortgages* are deducted whilst mere *preferential* claims ("liens") are not, even if *outside insolvency proceedings the latter would have ranked senior* to the fixed charge created by a security interest; such is the case of wage claims enjoying super-priority.

However, will the debts *enjoying an execution against property right of payment prior* to the real security in question – and which

according to extra-insolvency ranking rules were senior to said security – be deducted? Indeed, they must be deducted, even when involving a charge or quasi-security that would lose priority on insolvency, as occurs with execution caveat entries. This is so because, by definition, as long as the homologated agreement is subject to fulfilment, the debtor is not insolvent.

It is true that paragraph 10 of the 4th additional provision states that *to comply with the homologated refinancing agreement, the judge may order the cancellation of executions against property ordered in proceedings for the recovery of debts affected by the refinancing agreement*. "May cancel them", but may also not. In any case, this action would come after the homologation, not before, so it could hardly take effect in the security valuation stage. And finally, the vague term "cancellation of executions against property" can only mean a *stay of executions*, but not release of any caveat entry made. It would be arbitrary to propose this effect for the homologation, when not even the opening of insolvency proceedings has it.

5. Inevitably, *future* debts for which the debtor has advanced real security are not deducted either, not even in the *maximum amount of liability* agreed for this security against future liabilities.

6. Note the *amount of incentives* the secured creditor has to instigate as soon as possible the opening of insolvency proceedings and avoid being trapped in a situation covered by the 4th additional provision.

7. Are securities *pari passu in right of payment* agreed - over the same divisible asset – in the case of syndicated loans or other situations equivalent to a syndicated loan "securities payable in priority"? We know that for the purpose of enforcement of securities of *equal* rank the remaining co-extensive securities are regarded in the Spanish Mortgage Act as *senior* to the enforced security, but only insofar as the latter is enforced. Strictly speaking, in the joint real security stage there is no charge payable in priority or subsequent, since this condition is determined solely by reference to which creditor exercises, or exercises first, its right of enforcement.

In my opinion, pari passu securities are not discounted for the purpose of calculating the value of security. But neither is it sensible to notionally multiply the value of an asset by as many securities as there are of equal rank. For example, if an asset with a value of 10 is charged with 5 securities of equal rank in favour of as many creditors, each of which is a creditor in respect of an amount of 4, the value of security for each creditor cannot be 10 or 4, but 2, since it is clear that the five creditors cannot be fully secured in this case. Consequently, we must proceed in the manner provided in paragraph 2 *in fine* when security is undivided.

8. Instead, real security will be deducted when it favours senior creditors in structured financing where a particular class of creditors has been subordinated by agreement. However, in this kind of structured finance another factor, more important than that expressed above, must be considered. It comes as no surprise if a Creditors' Agreement agrees that the holders of senior debt may hold, agree, negotiate and compromise in respect of the entire security, with effects against subordinated creditors. In this case there will not be a deduction as such, but a binding of these under-secured creditors by the vote of the senior creditors.

"*Value of security*" *and classes of creditors*

9. The legal procedure for calculating the value of real security introduces an equation giving the common economic value of any class of real security, be it a real estate mortgage loan, a pledge of inventory or security over future claims which are virtually devoid of pledge value.

If each of these securities were to be managed as a whole within the refinancing agreement, the secured creditors would need to be divided in as many classes as creditors (or syndicate of creditors) as security rights are, since the existence of two securities with equivalent consistency is almost inconceivable.

Consequently, a class with the majority of 65% or 80% to which paragraph 4 refers could not be formed, and each would vote and form a majority in respect of itself as a class. However, the reduction of security to a quantitative amount covered by the priority in payment makes it possible, within the

value of the security (which will be higher in respect of the mortgagee and almost nil in respect of a pledgee over future claims), for all secured creditors to be treated equivalently[1].

Calculation of the value of illiquid security

10. Suppose now that there is no market or objective procedure for determining the "fair value" of the property. In this case, sub-paragraph c) of paragraph 2 of the 4th additional provision states that, unless the exception provided therein applies, fair value shall be that determined by an independent expert - appointed by the Register of Companies under the terms of art. 71 bis (4) IA - in accordance with the generally accepted principles and standards of valuation for such property.

This implies that an independent expert's report (and not only the auditor's report) will be required where there are liabilities payable in priority by reason of real security (other than real estate: in such case an official appraisal would have to be provided). Excepted of this provision are security rights on financial instruments negotiated in regulated markets.

The burden of proving the value of security

11. It is unclear on who bears the initiative or the burden of providing this expert report. The instigators of the agreement? The debtor? This seems logical and almost necessary in view of the wording of paragraph 5 (*The application must be made by the debtor and is to be accompanied by the adopted refinancing agreement, the auditor's certification on the sufficiency of the majorities required to adopt the agreements with the effects provided for each case, the reports issued (if any) by independent experts appointed in accordance with article 71 bis (4)*). But the debtor may not know *bona fide* what securities are enjoyed by certain financial creditors. Will valuation be required from the auditor issuing the "sufficiency" of financial liabilities report? Probably not. If not appointed by the Registrar as an "independent expert", is this auditor in the same situation of not been able, even if knowing it, to determine the value of security? Chances are that the burden *ultimately* lies - as with ordinary proof of claims on insolvency - on those who intend to *not be included in the class of unsecured creditors*. And they will have to do so in the time limbo existing between the publication of the order giving permission to proceed and the homologation decision made by the "fast track procedure" to which paragraph 6 refers.

In ordinary non-homologated agreements without a qualified majority

Conditions of non-rescission (no unwinding)

12. An essential requirement for a refinancing agreement - not qualified by art. 71 bis (1) and not homologated by the 4th additional provision- to enjoy the resistance on insolvency to which art. 72(2) refers, is that *the value of resulting security in favour of the involved creditors does not exceed nine-tenths of the value of the outstanding debt in favour of the same, or the security to outstanding debt ratio prior to the agreement*. The value of security is as defined in paragraph 2 of the 4th additional provision.

The "waiver" of real security

13. At least one-tenth of each claim resulting from the agreement must be *under-secured* and the total claims as a whole must not increase their secured part vis à vis the secured-unsecured ratio pre-existing the agreement. Consequently, if the claims prior the agreement were fully secured or over-secured, involved creditors must waive security rights or inject new unsecured claims and, in general, the involved creditors cannot improve their position in respect of a hypothetical liquidating dividend on the debtor's insolvency. But they may also *waive* the priority rank of their claim above this ceiling, though in fact it may be that the claim would be satisfied in full with the

[1] That the rate of depreciation of a given real security may be much higher than that of other real security is problematic, nonetheless. Movable security loses value quickly; a mortgage security may not lose value. This would make it necessary to continuously recalculate the value of securities in order to determine if just before court approval the required qualified majority proportions are maintained.

value of the security if enforced. Note that the fresh money that may have been granted with the agreement can be secured, but cross-collateralization of old claims is not allowed.

The "disproportionate sacrifice"

14. In the original version of the 4th additional provision, the judge would homologate the agreement if it did not impose a "disproportionate sacrifice" on dissenting creditors. In the text resulting from the reform of 2014, the judge will not make this assessment prior to homologating the agreement. The disproportionate sacrifice will only be taken into account if a (dissenting) creditor challenges the agreement already homologated. It is the only substantive reason that can be alleged in a challenge.

When is there a disproportionate sacrifice?

15. Whether or not a sacrifice is disproportionate must be determined on the basis of the criteria contained in recommendation 22 c) of the EU Commission Recommendation of 12 March 2014, according to which "the restructuring plan does not reduce the rights of dissenting creditors below what they would reasonably be expected to receive in the absence of the restructuring, if the debtor's business was liquidated or sold as a going concern, as the case may be". In other words, a sacrifice is disproportionate when the refinancing agreement forces dissenting creditors to bear a liquidating dividend lower than they would have received upon a direct sale of insolvency assets. No creditor is obliged to sacrifice himself beyond his hypothetical liquidating dividend to sustain an insolvent company as a going concern.

16. The above standard only makes practical sense for secured creditors to which the refinancing agreement is "extended" against their will and for dissenting (secured) creditors of the syndicate to which the agreement reached by 75% of the creditor syndicate is "imposed", pursuant to the aforementioned paragraph 2 of the precept. A creditor whose claim is *fully* secured would not be subject, prima facie, to accept against his will the extension of *any* effects of the refinancing agreement described in paragraph 4 of the 4th additional provision, *since any of the effects places him in a situation worse* than that he would find himself in if he had enforced his security in accordance with the terms of art. 56 IA.

17. There is a very sensible situation where this conflict is heightened. In any case, if a creditor (or syndicate) has a pledge over the total capital of the holding company or over all of the shares in the operating subsidiaries, any measure that does not deliver *as payment* the same shares, which eventually would be awarded (or transferred to a third party) in the event of enforcement of the security, entails for the creditor(s) a disproportionate sacrifice. Moreover, in such cases allowing the debtor to negotiate and present a different agreement constitutes a disbursement, as it could only result in a deduction of the expected value from the secured creditors to partially compensate others interested parties in the insolvency proceedings, who, in the assumption of enforcement, almost certainly have a liquidating dividend of zero value.

Once again, the statutory value of security

18. To determine the liquidating dividend of these *fully* secured creditors, the "value of real security" must be calculated in accordance with the terms explained above. The value of real security *may not exceed* nine-tenths of the fair value of the encumbered asset, and therefore the *fully* secured creditor will have to discount or waive one-tenth of the value of security in calculating its liquidating dividend. The loss of expected value of the asset as a result of the imposition of the stay under 4th additional provision or art. 56 IA, must also be deducted from this value. These two deductions determine the threshold of disproportionate sacrifice.