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Spain

PRIVATE EQUITY

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This country-specific Q&A provides an overview of private equity laws and regulations applicable in Spain.

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SPAIN
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1. What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?

Spanish financial sponsor deal activity reached its second-best historical record in 2021 and a strong start in 2022, after difficult two years 2019/2020. In value terms, estimates available for 2021 suggest investments for an approximate aggregate value of EUR 7,572.7 million, representing a 21% increase compared to 2020 (not far from the EUR 8,527 million all-times record experienced in 2019). The number of transactions increased by 11% (933) compared to 2020 — according to the 2022 Activity Summary Report on Venture Capital & Private Equity in Spain published by the Spanish Association of Venture Capital, Growth and Investment (ASCRI, currently known as SpainCap). Additionally, 2021 set a new record in the number of investments carried out in Spain by international private equity houses and other managers (236, record number for the 9th year in a row). The large-cap transactions market recovered (increasing a 44% against 2020, from EUR 2,882 million to EUR 4,140 million invested amount), while the mid-cap market kept the good and strong performance seen in 2020.

From an exit and divestment perspective, 238 divestment deals were closed in 2021 for an aggregate value of approx. EUR 1,490 million, which represents an 8% decrease compared to 2020. Record levels in previous years were not reached (according to the same report), reflecting a slowdown in the portfolio rotation. Divestment to third parties represented approx. 50%, while secondary buyouts approx. 32%. Despite the complex period that Spanish companies have gone through during the pandemic, the number of write-offs remained in minimum and marginal levels.

Not specific data exists for Spain on the percentage of deals where a financial sponsor has been involved in the last 24 months. However, the abovementioned figures shows a very strong presence and activity of this type of investors in the Spanish M&A practice.

In any case, these figures reflect the positive global trend for M&A transactions in 2021 and until the first quarter of 2022. However, global M&A market has hit the pause button and slowed down the activity from Q2 and Q3 2022, a trend mirrored by the Spanish M&A local market as well. While there are no specific figures and data as yet, new investments from financial sponsors have been slowed down and, while not drastically stopped, assessed and implemented more carefully. In any case, effects on the new global trend may not be seen until early 2023 in Spain because the majority of deals continuing and/or being closed in Q3 and Q4 2022 were originated during Q1 or Q2 of the same year. Effects resulting from the recurring interest rises and inflation seem to have a delayed impact in M&A activity in Spain (although the effect on new deals has been quite clear). A number of M&A process have been put on standby by some sponsors selling their portfolio companies. Likewise, it is still too soon to see how divestment requirements from financial sponsors may have an impact on (and cheer up) the Spanish M&A market.

2. What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?

From the point of view of Spanish market standards, there would be four main differences: (i) the representations and warranties ("**R&Ws**"), which financial sponsors try to reduce as much as possible, or do away with completely; (ii) pricing mechanisms, with locked box being the financial sponsors' favourite option (although in recent deals in Spain, given the fall of demand for certain assets as a result of the current trends, financial sponsors have accepted completion accounts price mechanism to give more comfort to potential industrial buyers); (iii) non-compete and non-solicit undertakings; and (iv) the existence of debt at the seller's or target's level.

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Financial sponsors (as sellers) in Spain, following international practice, tend to reduce R&Ws to the more fundamental ones relating to the selling vehicle (title over shares, capacity, insolvency, etc.), or even replace them with a W&I insurance policy in favour of the buyer. For instance, it is not unusual to find W&I stapling in those auction processes in Spain where the financial sponsor insists that the buyer enters into a W&I buyer-side insurance policy to provide alternative recourse.

Additionally, financial sponsors prefer the locked box pricing mechanism because it facilitates auction processes. Bidders offer fixed prices determined on the signing date, which makes easier for the financial sponsor to compare multiple bids. Enterprise value is agreed on the signing date and includes clear adjustments ahead of closing; as such, unlike closing accounts, there is no need to negotiate post-closing adjustments to price. Given that the purchaser benefits from the profits generated from locked-box date until completion under a locked-box price mechanism, it is usual as well for deals in Spain for the seller to seek an upward adjustment to the consideration for the value accrual through a ticking fee. Both ticking fee taking the form of an agreed rate of return or a fixed amount per day can be seen in Spanish deals based on an auction process with multiple bidders.

Additionally, non-compete and non-solicitation provisions are usually not accepted by financial sponsors — since these restrictions may prevent future investments in sectors similar to that of the target's business. Likewise, most of the deals in Spain where a financial sponsor is involved (as a seller) would require the prepayment of the debt assumed by the selling vehicle to leverage the acquisition of the target by the financial sponsor (or even the debt at the target's level if the acquisition financing has been pushed down to the acquired business). This has an impact both on price and closing mechanics in the transactions we have recently seen, but no different from those faced in other international jurisdictions.

3. On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?

The transfer of shares process depends on the entity type and whether or not the shares are represented by share certificates. Assuming that signing and closing do not take place simultaneously:

a. If the target is a limited liability company (*sociedad de responsabilidad limitada*), the transfer formalities would take place on closing: the sale and purchase agreement originally executed in private must be executed in a notarial deed (*escritura pública*) before a Spanish notary.
b. If the target is a public limited company (*sociedad anónima*), but not listed, irrespective of whether its shares are represented by share certificates, the same notarisation formality is generally complied with as a market practice (despite not being strictly necessary). Additionally, if the shares are represented by share certificates, the transfer may be carried out just by delivering the certificates — however, such delivery is usually supplemented by the notarisation of the relevant sale and purchase agreement.

Specific concerns in terms of legal local requirements or legal analyses requirements affection the acquisition of shares are relevant and will affect the drafting of the sale and purchase agreement. There are also a number of formalities for signing / closing that need to be taken into account (notaries involvement, powers of attorney, tax identification numbers, funds flows logistics, etc.) and transaction management is one of the key issues to meet all parties expectations, particularly in cross-border transactions.

From a tax perspective, as a general rule, the transfer of shares in a Spanish company is exempt from indirect taxation (e.g. Value Added Tax, Transfer Tax and Stamp Duty). Exceptionally, the transfer of non-listed shares may be subject to Value Added Tax or Transfer Tax under an anti-abuse rule that applies whenever the aim of the parties in entering into a share deal transaction concerning real estate companies was to avoid the Value Added Tax or Transfer Tax that would otherwise have applied if the real estate assets had been transferred directly. In particular, the Securities Markets Act provides that a transfer of non-listed shares on the secondary market that leads to the acquisition of (or an increase in) control over Spanish real estate companies may attract Value Added Tax or Transfer Tax if, by means of the transfer, taxation of the real estate transfer is evaded. Unless evidenced otherwise, the anti-abuse rule presumes the avoidance intent in three cases:

a. when the acquirer of the shares obtains control of an entity at least 50% of which assets are properties located in Spain that are not related to business or professional activities (or when, once such control is obtained, the stake in it increases);
b. when the acquirer obtains control of an entity which assets include securities that allow it to

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exercise control of another entity at least 50% of which assets are real estate located in Spain that are not related to business or professional activities (or when, once such control is obtained, the stake in it increases); or

c. when the shares transferred were obtained in exchange for the contribution of real estate assets to the share capital of a company, provided that such assets are not related to business or professional activities and that less than three years has elapsed between the date of contribution of the real estate asset and the transfer of the shares arising therefrom.

As of 16 January 2021, the transfer of listed shares may be subject to the Spanish Financial Transaction Tax. Generally speaking, the Spanish Financial Transaction Tax is charged at a rate of 0.2% on the acquisition of listed shares issued by Spanish companies admitted to trading on a Spanish or other EU-regulated market, or on an equivalent market of a non-EU country, with a market capitalization exceeding EUR 1 billion on 1 December of the year prior to the acquisition. It will also apply to the acquisition of shares represented by depositary receipts or acquired by, for example, exercising an option to convert convertible bonds. The Spanish Financial Transaction Tax applies regardless of where the acquisition takes place and regardless of the place of residence of the parties involved in the transaction. The tax base of the Spanish Financial Transaction Tax is determined by the consideration paid, excluding transaction costs, and accrues on the date when the shares are registered in the acquirer's name.

4. How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?

From a seller's standpoint, the main concern in a transaction where the financial sponsor funnels the investment through a special purpose vehicle is the certainty of funds at closing. In the Spanish market, certainty can be achieved principally in two ways: (i) as regards the part of the price to be financed via equity, certainty of funds is usually achieved through an equity commitment letter ("**ECL**") issued by the financial sponsor and addressed to the seller (this irrevocable commitment to provide shareholder financing to the SPV on or before closing is usually formalised by means of a side letter executed on signing, simultaneously to the SPA; ECLs have become commonplace in Spain for transactions where financial sponsors are involved); and (ii) as regards the part of the price to be financed via external debt (usually provided by banks or debt funds), certainty of funds is a concern commonly shared by the financial sponsor and the seller and is usually dealt with through the execution of a commitment letter with the debt provider on signing (subject to customary carve-out such as the finance documents including market conditions, completion of the acquisition or the inexistence of a material diverse effect on international loans or capital markets). Even though this external debt commitment letter is exclusively addressed by the debt providers to the financial sponsor and/or the SPV, its disclosure to the seller on signing is usually permitted. That said, commitment letters have not been enough for sellers in certain Spanish deals with a high level of competition among bidders — being a requirement in practice for bidders to submit their final binding offer together with a signed long-form facility agreement to prevent any kind of risk of the commitment letter not being complied with by the debt providers (bridge financings are usually granted for this purpose, being the negotiation on the long-term financing postponed to the post-closing phase once the M&A transaction has been closed). Alternatively, some strong financial sponsors have decided to directly fund the price with equity, being partially refinanced through a dividend recap within three to nine months from completion.

Additionally, in those M&A processes where the buyer is in an advantageous position, a new legal innovation can be seen in Spain: reverse equity commitment letters, pursuant to which the sellers (usually, special purpose vehicles divesting a portfolio company) and their shareholders or controlling funds commit to retain part of the price received to finance any potential liability arising as a result of a R&Ws breach. The idea is to keep a certain level of capitalization in the sellers' balance sheet to avoid buyer to claim any damage against an empty entity.

5. How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?

Although closing accounts was the pricing mechanism used traditionally in M&A transactions in Spain, the arrival and expansion of M&A transactions backed by financial sponsors and private equity firms in the last few years has become more prevalent, which has had a clear effect on pricing mechanisms. The trend followed by corporates now is to tend to use the closing accounts method, while financial sponsors use locked box pricing methods. In any case, private M&A deals in Spain have become more and more complex over the last two decades, and that has resulted in a plethora of pricing

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mechanisms.

Based in our experience, it could certainly be said that locked-box is prevalent in two scenarios: (i) where a financial sponsor sells a portfolio company, since locked box gives the seller more visibility on the profitability of its investment and the proceeds obtained from the sale can be more rapidly uplifted to its investors; and (ii) where the business to be sold benefits from permanent and stable cash flows (as would be the case of infrastructure management companies), since only non-material adjustments to the price would be required post-closing.

Without prejudice to the above, a comeback of the closing accounts pricing mechanism seems feasible for 2022 and 2023 due to the slowdown M&A is globally suffering, which may result in pro-buyer pricing mechanisms being accepted in a higher number of cases by sellers (as a way to give comfort to buyers ahead of the lack of visibility on the economic landscape).

6. What are the typical methods and constructs of how risk is allocated between a buyer and seller?

Multiple risk-allocation mechanisms are used in the Spanish M&A market, although they do not differ from the most frequent methods used in other jurisdictions:

a. Pricing mechanisms: locked box, closing accounts or a combination of both, are used to assign the risk over the business' performance to a seller from the signing or closing date. Likewise, the use of earn outs is gaining traction again to bring sellers' and bidders' valuations together — given the clear mismatch between bid and offer prices currently existing with respect to Spanish assets and deals.
b. Conditions precedent to the completion of the transaction are used to ensure the parties deal with regulatory risks —antitrust or, since March 2020, a foreign investment clearance regime in line with other European jurisdictions heavily discussed in the CPs regime. However, given the increase of auction processes as a divestment method, the CP regime has been trimmed by financial investors and PE sponsors to make the corresponding offer more attractive —in order to reduce non-completion risk. In these cases, CPs are usually reduced to regulatory ones. However, we cannot rule out that the approach towards CPs drastically swifts to a more buyer-friendly one because of the difficulties some auction processes are suffering since Q3 2022 (which is resulting in more balanced terms for sellers and buyers and a wider range of conditions to closing).
c. Representations and warranties are given under the sale and purchase agreement, as well as specific indemnities in cases when a contingent risk has been identified in the due diligence process. A common negotiating point that we have seen when negotiating the sale and purchase agreement are sandbagging or anti-sandbagging provisions. If the sale and purchase agreement is silent, the anti-sandbagging principle applies and, therefore, the buyer's knowledge works to the benefit of the seller. Sandbagging provisions are often now used in the Spanish M&A market.

7. How prevalent is the use of W&I insurance in your transactions?

W&I insurance policies were not widespread in M&A transactions in Spain until more or less the later years of the 2000s decade, when the increase in financial sponsor and private equity investments in Spanish companies became a catalyst for their use. Since then, the use of W&I insurance policies as an alternative to achieve clean exits by financial sponsors and private equity funds has gained traction as a valuable and increasingly popular tool. Though initially driven by private equity funds to liquidate or distribute the proceeds from the sale of an investment to their GPs, the product is now increasingly taken up by corporates.

This is consistent with the trend in the European market, where use of this insurance product has increased in recent years. However, the use of W&I insurance policies in Spain is increasing, it is not as widespread as in other European markets such as the United Kingdom, Germany, the Netherlands or the Nordic countries. There are insurance companies increasing their presence in Spain. Until the use of W&I insurance is more extended in Spain, negotiations of these protection may prove burdensome and time consuming.

All and all, our experience with recent deals in Spain where a financial sponsor is involved (as seller) is that in the majority of cases a W&I insurance policy is put in place or, at least, the possibility of enter into one is heavily discussed. For instance, it is quite usual that seller-driven auction processes count with a stapled W&I insurance — so that recourse against the financial sponsor seller is disregarded from the beginning.

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8. How active have financial sponsors been in acquiring publicly listed companies and/or buying infrastructure assets?

Historically in Spain, minority stake acquisitions of listed companies by financial sponsors or private equity firms outnumbered takeover bids for the acquisition of majority or controlling stakes. In the last decade, the number of takeover bids made by financial sponsors for Spanish listed companies was not significant — Spanish corporates have been the prevalent bidders in the takeovers launched since 2007. Other than a handful of transactions (e.g. the KKR, Cinven and Providence joint takeover of MasMóvil launched in 2020; IFM as regards the takeover of Naturgy and MasMóvil over Euskaltel in 2021), the main targets of financial sponsors in Spain continue to be private companies (at least in those transactions targeting controlling stakes), rather than listed ones — which is partly the result of public markets not being attractive as an alternative to traditional financing through the banking system. In any case, large-cap financial investors remain agnostic with respect to the Spanish business sectors in which they decide to invest, as it is reflected in the top large-cap transactions closed during 2021 and 2022: (i) 2022: Lyntia (invested by AXA, Swiss Life and Morrison & Co, fiber), Grupo Primavera (invested by Cegid, software), RESA (invested by PGGM, student hospitality), Natra (invested by CapVest, food), IVI-RMA (invested by KKR, health), Cupa Group (invested by Brookfield, ceramic), Altadia (invested by Carlyle, ceramic); (ii) 2021: ITP Aero (invested by Bain Capital; aerospace), Urbaser (invested by Platinum Equity; environmental management), Restaurant Brands Iberia (invested by Cinven; hospitality), Suanfarma (invested by ArchiMed; health), Idealista (invested by EQT, Apax Partners and Oakley Capital; internet), Alvinesa (invested by ICG; consumer products), Grupo BC (invested by SilverLake; financial services), JobandTalent (invested by SoftBank; internet), Palex (invested by Fremman Capital; health), or Imagina (invested by Orient Hontai Capital; communications) — according to the 2022 Activity Summary Report published by the Spanish Association of Venture Capital, Growth and Investment (SpainCap).

Without prejudice to the above, it should be noted that Spain is fundamentally a field for mid-market transactions (ranging from EUR 10 million to EUR 100 million). Special reference should be made to strong Spanish PE houses like Nazca Capital, Portobello Capital, ProA Capital, MCH Private Equity, Magnum Capital or Qualitas Equity (all of them, key players with a deep knowledge of the local market in Iberia).

9. Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?

Following a world trend of protectionism and other countries in Europe, a new foreign investment regime was introduced in Spain in 2020. The liberalisation of the regime for non-EU and non-EFTA investors in certain strategic sectors has been suspended and specific foreign direct investment screening mechanisms have been implemented in Spain (“**FDI Screening**”). Since then, a key matter of every investment in Spain lead by a non-European (and sometimes, even a European) investor is the design of the relevant CP to cover any regulatory risk resulting from the FDI Screening.

Pursuant to this regime, administrative authorisation is required before the investment can be completed. Failure to obtain this authorisation means the investment is null and void and has no legal effect, and fines can be imposed. For these purposes, foreign direct investments are subject to FDI Screening if, as a result thereof, the investors would (i) hold 10% or more of the Spanish company’s capital, or (ii) obtain control of the Spanish company per the criteria in article 7.2 of the Spanish Competition Law, and in both cases, provided one of the following circumstances occur: (a) the investors are residents outside the EU or the European Free Trade Association (EFTA); or (b) the investors are residents within the EU or the EFTA, but their real owners are residents outside the EU or the EFTA. However, not all of these foreign investments are subject to FDI Screening, as this depends on whether the Spanish target company operates in (i) strategic sectors (such as infrastructures relating to water, energy, telecoms, technology, healthcare, transportation or defence, or managing personal data); or (ii) any sector whatsoever if the foreign investor is controlled by a foreign government, has ever engaged in illicit activities or has already invested in any strategic sector in another EU or EFTA country. Until 31 December 2022, the FDI Screening also applies to EU/EFTA investors who invest, within the sectors mentioned previously, (i) in listed companies; or (ii) more than EUR 500 million in private companies. For these purposes, EU/EFTA investors mean (i) EU and EFTA residents in countries other than Spain; and (ii) Spanish residents beneficially owned by EU or EFTA residents in countries other than Spain, that is, those in which a non-EU and non-EFTA resident ultimately owns or controls more than 25% of the share capital or voting rights of, or otherwise exercises control over, the EU/EFTA resident. Additionally, the Spanish Government is preparing an extension to this foreign

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investment protection until 31 December 2024, which will comprise not only the direct acquisition of shares in listed companies or private companies (if the investment is EUR 500 million or higher), but the acquisition of assets as well (to clearly cover asset acquisitions in the energy and infrastructure sectors).

In the event that the FDI filing is required, the sponsors would not be able to close the investment before obtaining the required authorization. The legal term is up to 6 months since filing (although there is an amendment proposal (pending to be passed) which may reduce this term to 3 months), but in practice should be much less (around 3 months, 4 if the filing is complex). Our experience is that FDI screening is now another key element of cross-border transaction into Spain but that the relationship with the foreign investment authorities and the management of the pre-filing and filings have been fluid and not impeding the closing of transactions on time.

10. How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?

Merger clearance risk is usually covered under the sale and purchase agreement through a condition precedent to closing. From the perspective of financial sponsors as acquirers, other than the risk of the transaction not being cleared by the relevant competition authorities, the main risk they face would be the authorities requiring clearance commitments from them.

These conditions are usually classified in Spanish market practice as follows:

a. Material conditions: those conditions or commitments imposed or accepted by the antitrust authorities in connection with the clearance of the transaction that could reasonably be expected to materially adversely affect the target business as a going concern. In these cases, the financial sponsor is usually entitled to walk away from the transaction (considering the condition not fulfilled) given the impact of these material conditions on the economics of the transaction. Therefore, the seller assumes the risk if material conditions or commitments are imposed.
b. Non-material conditions: in this scenario, the risk is usually assumed by the financial sponsor as buyer, since the introduction of these conditions would not prevent the transaction from being completed. Usually, the sale and purchase agreement would deem these condition to be met — since the economics of the transaction would not be negatively affected by fulfilling the commitments required by the authorities.

11. Have you seen an increase in the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside?

Other than in venture capital (where financial sponsors usually agree to take minority stakes in subsequent rounds or to invest through warrants, options, or convertible loans supplemented by equity kickers), the number of transactions by private equity firms targeting controlling or majority equity stakes far outnumber minority stake deals in the Spanish market. However, it is common, in particular in the case of family-owned companies opening up to financial sponsors, for a majority stake to be acquired but the founders to keep material control rights.

While still not common, the number of minority investments is increasing gradually, especially in top-tier mid-market and large transactions, and usually involves bidding consortia.

In any case, we have seen debt-like instruments are typically used by financial sponsors for their investments in venture capital or recently created and fast-growing businesses, where the participation in equity upsides is usually guaranteed by triggering events that enable the financial sponsor to convert its debt into equity.

On a separate note, “continuation funds” transactions are not usual in Spain, although there have been some exceptions recently (mainly due to the fact that trends in the markets for certain Spanish assets do not match the investment phase of the controlling fund): (i) funds management by Apax Partners in the sale to EQT and the subsequent reinvestment in Idealista; (ii) funds managed by Bridgepoint in the sale to Partners Group and subsequent reinvestment in Rovensa; (iii) funds managed by Bridgepoint in its portfolio company Grupo Dorna; or (iv) funds managed by Cinven in the sale and reinvestment in Ufinet (together with Antin Infrastructure Partners). Notwithstanding the above, the existing economic outlook and the recent slowdown in the M&A market during 2022 may result in a higher number of “continuation funds” in Spain in the coming months or

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years.

12. How are management incentive schemes typically structured?

Following international market practice, typically, the target’s management team benefits from a management incentive scheme (“**MIP**”) in private equity buyouts structured as sweep equity schemes: either in the form of stock option plans (where managers are granted shares of the target (or other entities of its group) upon certain vesting events) or as phantom share plans (instead of granting shares of the target, a cash award is granted to the management team for an amount equivalent to the share price at which the manager would have exercised an option over existing shares). Of these two structures, the second one has become more prevalent in Spanish targets due to: (A) the general prohibition on limited liability companies (*sociedades de responsabilidad limitada*) acquiring their own shares (which makes it difficult to create pools of shares to structure stock option plans); (B) the strict limitations to the sale of own shares; (C) the complex procedure for issuing new shares under a share capital increase (which prevents stock option plans from being implemented automatically); and (D) other tax reasons.

Additionally, Spanish phantom shares or cash incentive plans are usually linked not only to the performance of the target’s business, but to the successful outcome of a divestment by the financial sponsor: ratchet upon divestments, where the managers are entitled to receive an exceptional non-recurring and non-cumulative bonus upon the divestment by the financial sponsor of its shareholding in the target. This kind of “exit bonus” has a direct impact on the capitalisation table of Spanish target entities, reducing the equity value to be received by shareholders or other kind of investors (e.g. holders of convertible debt). While phantom shares are treated as debt (reducing the base consideration), they are usually seen in Spanish deals as another kind of invertors having a claim against the target entity upon its exit.

13. Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?

No, Spanish MIPs are taxed under ordinary rules and do not benefit from a specific legal framework (with the sole exception mentioned below in the Basque Country and Navarre, and, from 1 January 2023 onwards, in the common territory, with regards to carried interest granted by specific closed-end alternative-investment funds and entities).

Under Spanish law, any consideration or compensation, whether monetary or in kind, direct or indirect, deriving from the personal work undertaken by an employee is deemed taxable employment income at a progressive sliding scale ranging from 18% to 54%, depending on the region where the employee is tax resident.

A 30% reduction is available up to EUR 300,000 (hence, EUR 90,000 is tax free) provided that the employment income (i) is generated over a period of time exceeding two years and (ii) is paid in a single tax period. This 30% reduction can only be applied by a taxpayer once every six years and is progressively reduced in the case of severance payments exceeding EUR 700,000 (so that it cannot be applied to severance payments exceeding EUR 1,000,000).

Yearly or exit bonuses, free or discounted shares, ratchets and stock options granted to Spanish resident managers are generally taxed as employment income. In the case of non-transferable stock options granted for no consideration, managers would only be taxed on the date of exercise on the difference between (a) the market value of the shares received and (b) the strike price paid (if any).

As mentioned, in Spain there are no specific tax regulations that ensure capital gains treatment of sweet equity or carried interest schemes. Consequently, any equity investment by managers must be implemented at arm’s length in order to secure capital gains treatment upon exit (taxed at lower rates than ordinary employment income). The likelihood of employment income characterization should be analysed on a case-by-case basis in light of the shareholder rights and obligations granted to the managers (specific limitations on share transfers, good/bad leaver clauses, retention obligations, different economic rights, etc.). The risk of employment income characterization is high when the economic rights granted to managers are disproportionate to the value they invest compared to non-employed shareholders. MIPs are subject to increasing scrutiny and reassessments from the Spanish tax authorities.

For the first time, in 2020 two regions of Spain (the Basque Country and Navarre) have enacted regulations that reduce the tax burden on certain carried interest income earned by private equity investment managers who are resident for tax purposes in one of those regions. Marginal tax rates range between 24.5% and 26% depending on the region. In order for the income to qualify for this special carried interest tax treatment, the following requirements (among others) must be met: a) The managers’ remuneration must be set out in the

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investment vehicle's by-laws, which must also make reference to the minimum guaranteed internal rate of return for the private equity investors. b) The managers' (direct or indirect) stake in the target entity must be held for a minimum period of five years. c) The application of the special tax regime must be notified to the tax authorities.

In the same vein, the Act (*Ley de fomento del ecosistema de las empresas emergentes*) provides for common territory that income from carry shares realised by managers will be treated as employment income, subject to Spanish Personal Income Tax (at marginal rates up to 45% to 54%). However, only 50% of this income will be subject to tax and, hence carried interest will be taxed at an effective maximum tax rate between 22.5% to 27%. The Bill includes a number of conditions for the application of the 50% reduction of carried interest income:

a. The grantor must be a specific type of entity (Spanish venture capital entities, European venture capital funds, European social entrepreneurship funds, European Long-Term Investment Funds and other analogous entities).
b. A minimum return must be guaranteed to the remaining investors and included in the entity's by-laws.
c. The shares or rights must be held for five years (with exceptions).
d. The 50% reduction cannot be applied if this "carried interest" derives directly or indirectly from an entity that is tax resident in a tax haven or in another territory without a tax exchange of information agreement with Spain.

Final approval of the Act took place on 1 December 2022 (although is pending its publication in the Official Gazette) and the new tax treatment of carried interest is scheduled to enter into force on 1 January 2023.

14. Are senior managers subject to non-competes and if so what is the general duration?

Post-termination non-compete provisions are generally accepted by management teams in Spain, but their specific structure depends greatly on the background and context of the company's business. The maximum period of a non-compete for managers (with an employment relationship rather than a services one) in Spain is two years from the termination of the agreement.

Spanish companies are obliged to compensate the manager for such non-compete provisions, otherwise, the non-compete may be deemed null and void. Additionally, neither the company nor the manager may waive the fulfilment of the other party's undertakings under the non-compete provision.

Spanish courts have held that the two-year maximum length of non-competes also applies if the manager holds shares in the company.

15. How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?

Control over a portfolio company is usually ensured through: (i) the right to appoint the majority of the managing body of the company, even if this exceeds its entitlement based on its participation in the share capital; (ii) the allocation of certain material business decisions to the general shareholders meeting in those cases where Spanish law authorises the managing body to decide on them; and (iii) the provision of veto rights and consents over certain business matters both at the general shareholders meeting and the managing body levels — which would require the financial sponsor's consent to approve or reject material business decisions.

In our experience, this allocation of control is usually formalised in the portfolio company's articles of association and in a shareholders agreement (all the shareholders of the company should be a party to that agreement in order to avoid its enforcement being jeopardise). Shareholders agreements cover governance matters that Spanish law does not allow to be addressed in the articles of association (or that Spanish law may regulate in a different way).

Finally, Spanish authorities may require reinforced separation between the investors and the managing body in companies in heavily regulated sectors, which may result in the financial sponsor not having control even if it holds a controlling stake. This requirement usually takes the form of the authorities requiring commitments to grant clearance to the transaction.

16. Is it common to use management pooling vehicles where there are a large number of employee shareholders?

Management pooling vehicles are unusual in private

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equity transactions in Spain. Despite certain types of shareholders usually funnelling their investment in the target company through specific entities (which is very common in the case of stakes held by the founder's family), managers usually receive sweet equity under MIPs directly rather than through a special purpose vehicle grouping the management. This type of structure is not that market standard in Spain, despite it being widely used in other European countries.

17. What are the most commonly used debt finance capital structures across small, medium and large financings?

Medium private equity transactions carried out in Spain are normally leveraged through banking syndicated financings. They are usually structured through a secured senior financing with different types and degrees of security package depending on the target (which largely relies on the tax implications that granting certain collateral may have). Additionally, in the last few years, there has been an increase in the use of direct lending provided by private equity debt funds for mid-market buyout transactions where banking financing does not fit well (in particular, in those acquisition transactions where there is some kind of commercial or legal risk that banks cannot take due to credit risk regulations).

As exceptions to the ubiquitous use of banking finance, acquisition financings for small and large targets is the area where alternative finance capital structures are more common:

a. Small businesses (including start-ups not having reached breakeven): debt may take the form of debt-like investments (such as convertible loans) provided by private investors rather than banks — allowing these investors to step into the equity if any equity upside arises in future rounds or following exits. Occasionally, the issuance of notes is also proposed.
b. Large capital financings: sources of debt are more varied. Together with the use of bank syndicated financings, private equity firms usually opt to issue bonds or notes that can be traded on a secondary official market (given the time gap between closing the acquisition and issuing bonds is usually covered by bridge loans with a three to six-month maturity).

Some private equity houses focused in the Spanish NPLs business are using securitisation structures as a way to finance or refinance acquisition of NPL portfolios. Pursuant to these structures, all or part of the acquisition price is financed or refinanced with proceeds obtained by a securitisation fund through the issuance of different kind of notes (some of them retained by the sponsor of the deal). Such notes are usually subject to English, Irish or Luxembourg law (and listed in international debt exchanges). Two separate phases are usually seen in these transactions: (1) the acquisition by the PE of the NPL portfolio (using a bridge financing); and (2) the securitisation of the NPL portfolio through its transfer to a securitisation fund, which in turn issue notes to partially finance the acquisition of the NPL portfolio.

Without prejudice to the above, sources of debt may swift during 2023 due to the impact of interest rate rises and inflation on the offer of banking debt. Availability of banking debt since September 2022 for the purposes of LBOs has drastically drop, which has had an impact on the number of deals financial sponsors have carried out in Spain recently. As banking debt has become more expensive, direct lending may finally surge as a key source of debt for leverage transactions.

18. Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?

Except for very limited exceptions, financial assistance is prohibited under Spanish corporate law. Thus, target companies cannot in any way, directly or indirectly, advance funds or grant any kind of security or guarantee as collateral for the acquisition of their shares or the shares of a company in the group to which it belongs (limited liability companies) or of its controlling company (public limited companies).

This general prohibition has a clear impact on the design of acquisition financing structures in Spain: the target company cannot directly, from day one, assume or guarantee the acquisition debt; it cannot grant any securities over its assets either. These legal restrictions should be factored as early as possible in the process when structuring from a tax or accounting point of view only a deal in Spain to avoid inefficiencies in the structure or delays or frustrations. However, there are several ways to mitigate the effects of this prohibition:

a. Separate facilities: debt deployed in leveraged buyouts in Spain is usually used to pay not only the acquisition price, but also prepay existing debt at the target's level. Separate tranches or facilities are usually put in place to encapsulate the acquisition financing in one of them (so that the prohibition does not

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apply to the remaining facilities or tranches).

b. Merger leveraged buyouts: subject to certain formalities and procedural requirements, Spanish law allows target companies to be merged with the special purpose vehicle used for its acquisition. Financially speaking, this merger would have a similar effect as a debt push-down. Alternatively, financing of dividend recaps is sometimes used as a way to refinance equity deployed for the acquisition of a certain target entity (although the use of dividend recaps financings for these purposes should be assessed on a case by case basis since several corporate and tax requirements apply to them).
c. Limited security package: even though the target company would not be allowed to grant securities or guarantees to secure the acquisition financing, the acquired shares can be put in place as collateral — the financial assistance prohibition would not apply.

19. For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?

No standard form of credit agreement exists in Spain similar to the one published by the Loan Market Association. As a consequence, in-house or forms prepared by local firms are used for small and mid-cap large financings. However, the Loan Market Association form has been used widely for top mid-market and large financings during the last decade, subject to the required adjustments from a Spanish law perspective — especially when the debt provider is a foreign bank or private equity debt fund.

Where the LMA facilities agreement form is followed, its structure is not negotiated (so long as it has been properly adapted to Spanish law) and is accepted by both lenders and borrower. Negotiation is typically focused on commercial issues.

However, the trend to use the LMA form facilities agreement has not been extended to security documents, given the particularities of the Spanish legal requirements and regulations. From the perspective of interest rate credit agreements, the financial transaction framework agreement published by the Spanish Banking Association is widely followed (in those cases where the hedging agreement is not subject to ISDA).

20. What have been the key areas of negotiation between borrowers and lenders in the last two years?

Negotiations over the last two years in acquisition financings have largely focused on: (i) the definition of financial ratios and, especially, the EBITDA and other accounting concepts; (ii) the cure mechanisms in case of a breach of a financial covenant and how funds contributed for such purpose should qualify and whether they should be used to prepay debt; (iii) in the case of financings granted by private equity debt funds, the utilisation period (in order to enable the fund to make the required capital call); (iv) the definition of “change of control”; and (v) whether individual acceleration by lenders should be permitted and, if so, in which cases and scenarios.

Additionally, a matter being discussed increasingly in Spanish acquisition financings is the possibility for financial sponsors and private equity firms to establish accordion or incremental facilities to facilitate future add-ons that may undertake the initial target company. Not only conditions for establishment, but also their ranking vis-à-vis previous debt and the right of first refusal of the existing lenders are negotiated — even though the LMA accordion facility clause is generally followed in Spain too.

21. Have you seen an increase or use of private equity credit funds as sources of debt capital?

Yes, in Spain there has been an exponential increase in the use of direct lending by private equity credit funds over the last decade, but banking financings remain strong. According to the report “*Deloitte Alternative Lender Deal Tracker Autumn 2022*” published by Deloitte in September 2022, 42 direct lending transactions were carried out in Spain, which represent a relevant increase with respect to the 35 and 29 transactions during the two previous years 2020 and 2021, respectively. In our experience, direct lending is becoming a mainstream source of debt and now competes as the main financing alternative with banks for those projects with a certain degree of complexity or in which banks cannot participate because of risk allocation issues. There might be other transactions not publicly reported.

Despite such increase from a previous phase in which this kind of financing was almost nonexistent, the number of direct lending transactions has not reached the levels forecast for 2010 – 2020. Additionally, the trend seen in other European markets where credit funds are increasingly looking to deploy capital in large

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transactions, the Spanish market has not yet overcome the small or mid-market approach.

Among others, the most active players in direct lending in Spain are private debt businesses of private equity houses such as Alantra, Ares, Bridgepoint, Hayfin, H.I.G. Whitehorse, ICG, Tikehau Capital, Cheyne Capital, KKR and Pemberton.

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