A Lender's Guide to the Spanish Insolvency System

Produced by URÍA MENÉNDEZ

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January 2012

IMPORTANT NOTE

This guide is intended to provide a summary overview of certain important aspects of the Spanish insolvency law. The information contained in this guide is not intended to be used and must not be used as legal advice, either on general questions of insolvency law or on questions relating to any specific transaction.

Uría Menéndez would be pleased to provide advice upon request for general queries relating to insolvency law and regulation, as well as advice on specific transactions.

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Purpose of this guide

This guide summarises the most relevant provisions of the Spanish insolvency system from a lender's perspective and raises certain issues for consideration after the approval of Law 38/2011 of 10 October ("**Law 38/2011**") which amends Law 22/2003 of 9 July, on insolvency (the "**Insolvency Law**"). Law 38/2011 has introduced several significant amendments to the Spanish Insolvency Law, most of which are effective since 1 January 2012. This is the second substantial reform of the Insolvency Law after the changes introduced by Royal Decree-Law 3/2009 of 27 March ("**RDL 3/2009**").

Pre-insolvency

According to Spanish insolvency rules, there can be no stay of proceedings or enforcement prior to the court's formal declaration of insolvency. RDL 3/2009 introduced certain rules to regulate the period immediately preceding the declaration of insolvency (pre-insolvency period). These rules have been amended by Law 38/2011.

The Insolvency Law provides that a debtor must file for insolvency within two months of being in a situation of actual insolvency (*insolvencia actual*). A debtor is insolvent when it cannot regularly pay its debts as they fall due. As an exception to this obligation, the new regulation provides that if a debtor notifies the court that it has started negotiations with its creditors to seek support for either (i) an out-of-court refinancing agreement or (ii) an early composition agreement (*propuesta anticipada de convenio*) (see *Early and ordinary composition agreements*), it will have a three months additional grace period to reach the agreement and one more to file for insolvency, provided that it files the notice with the court within the two-month limitation period (the so called "2+3+1 rule"). Applications for insolvency filed by creditors during the three months following the filing of the pre-insolvency notice will not be accepted.

Until the recent approval of Law 38/2011, the Insolvency Law only allowed the debtor to notify the court and benefit from this grace period when it was negotiating an early composition agreement with its creditors. However, in practice, the grace period was seldom used to negotiate early composition agreements, which are a form of in-court restructuring. On the contrary, pre-insolvency filing was commonly used by debtors to negotiate out-of-court refinancing agreements with their creditors, mainly banks. The latter possibility is now expressly allowed. This amendment is welcome as it brings the Insolvency Law into line with current practice and reduces the risk of liability that directors faced when they filed a pre-insolvency notice instead of filing directly for insolvency during the two-month limitation period. Before this amendment, creditors could argue within future insolvency proceedings that by delaying the application for insolvency and using a mechanism that was designed to seek support for an early composition agreement and not to refinance the company out-of-court, the directors worsened the company's insolvency.

Law 38/2011 has introduced other relevant amendments that significantly improve the pre-insolvency period.

Firstly, the new regulation no longer requires the debtor to be in a state of actual insolvency to be able to file the notice with the court. The debtor can make the notification even though its insolvency is just imminent (*insolvencia inminente*). This will allow debtors to anticipate the whole process.

Secondly, in response to the opinion of certain courts, the new regulation clarifies that the grace period starts upon receipt by the court of a simple notice filed by the debtor, effectively depriving courts of the right to examine the merits of the notice at this stage of the proceedings. Some courts had adopted the view that the state of insolvency and certain other circumstances had to be proven by the debtor before the court could accept the notice.

Finally, the new regulation also clarifies (in line with the interpretation of most courts) that, upon expiry of the grace period, the debtor does not need to apply for insolvency if the debtor is no longer insolvent (i.e., if it has been refinanced).

Even though these amendments are welcome, Law 38/2011 could have taken a step further and established a mandatory stay on enforcement during the grace period. A stay of enforcement is now possible for court-approved refinancing agreements, see *Cram down*. In essence, they are another tool to favour out-of-court restructurings. Therefore, once the debtor files the notice, there is a risk that creditors will enforce security or set-off their claims, even though any filings for insolvency will not be processed until the grace period elapses. To mitigate the risk of a disgruntled creditor derailing a consensual restructuring process, it is normally advisable to execute a standstill agreement. Completely unheard of in Spain only three years ago, standstill agreements have become relatively common. If they are correctly drafted and signed by a significant part of the creditors (which may not be easy when, for instance, the debtor has a lot of trade creditors) they can also assist the directors of the debtor in arguing that during the standstill period the company is no longer in a state of actual insolvency. According to a recent court decision, tacit or implied standstills (also relatively common, especially when a small number of banks is involved) are not sufficient, *per se*, to release directors from their obligation to file for insolvency.

In addition to the possibility of making a pre-filing, the Insolvency Law contains rules dealing with two other matters that are relevant in a pre-insolvency context: rules that protect certain refinancing agreements from claw back (see *Claw back actions and refinancing agreements*); and rules that allow certain majority creditors to impose a refinancing agreement approved by the court on certain minority creditors (see *Cram down*).

Insolvency filing

Petition for insolvency

The Spanish Insolvency Law establishes a single insolvency procedure (*concurso*), applied to any insolvent debtor, which includes a common phase (during which, among others, the insolvency trustee is appointed, an inventory of the assets and a list of creditors are prepared, and claims ranked) and two potential results: (i) a composition agreement or (ii) the debtor's liquidation. The whole insolvency process is managed under the supervision of a judge that is specialised in commercial matters (*juez de lo mercantil*), including insolvency matters.

The declaration of insolvency may be requested by the debtor or by its creditors.

An insolvency is called *voluntary* (*concurso voluntario*) when the debtor files for insolvency. As mentioned above, and as a general rule, the debtor must file for insolvency with the court within two months of being in actual insolvency.

A debtor is *insolvent* when it cannot regularly pay its debts as they fall due (*actual insolvency*). In contrast to other European insolvency systems, the Insolvency Law does not include an insolvency test that allows debtors and creditors to accurately determine when an insolvency situation arises. The lack of precise rules leaves room for different interpretations and adds pressure on directors when they are faced with the decision of filing for insolvency, or delaying the filing as much as possible in an attempt to restructure the company before resorting to the courts.

The debtor may also, but is not required to, file for insolvency if its insolvency is imminent (*imminent insolvency*).

Pursuant to the Insolvency Law, directors that fail to file for insolvency within two months of being in a state of actual insolvency may be held liable for the payment of any debts that cannot be paid with the debtor's assets upon its liquidation, given that the law presumes -unless proven otherwise- that the insolvency has been fraudulent (*concurso culpable*). Law 38/2011 has extended this liability to general legal representatives of the debtor. It is worth noting that some Spanish courts have accepted that the negotiation of a refinancing agreement could release directors from liability, provided that they acted diligently and the financial situation of the debtor did not worsen as a result of the delay in filing.

An insolvency is involuntary (*concurso necesario*) when the insolvency petition is made by a creditor. A creditor can seek a debtor's declaration of insolvency if it can prove that it has failed to attach any assets, or sufficient assets, to pay the amount owed. A creditor may also apply for a debtor's insolvency if it can prove to the court:

(i) a general failure on the part of the debtor to meet its payment obligations;

(ii) the existence of attachments on the debtor's assets that will generally affect its business;

(iii) a general liquidation by the debtor of its assets in certain circumstances; or

(iv) a general failure on the part of the debtor to comply with tax, social security, salary and other employment obligations during the three-month period preceding the insolvency filing.

In practice, it can be difficult for a creditor to prove that the debtor is not *regularly* paying its debts as they fall due. For instance, proof of lack of payment of a single loan agreement will not constitute sufficient evidence. To facilitate the gathering of evidence and, thus, ease the creditor's burden of proof, some courts have issued disclosure orders at the request of creditors against the debtor or third parties (e.g., tax authorities, social security authorities, other creditors). If the court refuses to declare the debtor insolvent, the creditor may be sued for damages and ordered to pay the costs of the proceedings. The burden of proving that the debtor is insolvent, the risk of being sued for damages and the consequences that the declaration of insolvency will have in terms of provisioning have been deterrents for banks to file for a debtor's insolvency, although there are a few precedents.

It will come as no surprise that, currently, around 95 per cent of the insolvencies declared in Spain are voluntary, that is, requested by the debtor. Law 38/2011 tries to facilitate the creditors' insolvency filing by providing that if the creditor is unable to attach assets of the debtor it may request the declaration of insolvency and the court must approve the insolvency on the following business day, without giving prior notice to or hearing the debtor. Banks may be in this situation when they try to enforce before the Spanish courts a facility agreement formalised in a public deed containing certain provisions that, pursuant to the Spanish Civil Procedure Law (*Ley de Enjuiciamiento Civil*), entitle a creditor to use a summary enforcement procedure. After the declaration of insolvency, the debtor and other interested parties will be allowed to challenge the decision.

The time between the petition and the insolvency declaration by the court will depend on a number of factors: (i) whether the filing has been made by the debtor or the creditor, (ii) whether the debtor has challenged the petition made by the creditor, (iii) whether all appropriate documentation has been submitted on a timely basis or is incomplete, and (iv) on the workload of the court. Creditors should expect between two business days (voluntary and complete filing with no challenge) and two months (defective filing by a third party or filing challenged by the debtor). But it can take longer.

Group insolvency

Any creditor may request the joint insolvency declaration of two or more of its debtors if either (i) there is a commingling of the assets of the debtors, or (ii) they form part of the same group. Therefore, the joint insolvency of two or more companies can only be filed by a common creditor of the relevant companies and each of the affected companies must be separately insolvent. In addition, Law 38/2011 has expressly entitled directors of the debtor to file for insolvency of two or more companies of the same group, provided that they are all insolvent. In Spain, the insolvency of one company of a group, including the parent company, does not necessarily entail the insolvency of the remaining companies of the group.

Furthermore, if the insolvency of two or more debtors that belong to the same group or have their assets commingled has been separately declared, any of the debtors or the insolvency trustee may request that one court processes all the insolvency proceedings. In the absence of a petition by any of these parties, any of the creditors may file the request.

Until the recent approval of Law 38/2011, the Insolvency Law did not provide a definition of group of companies. Law 38/2011 has clarified that for insolvency purposes, the concept of group is the one included for general purposes in article 42 of the Spanish Commercial Code (*Código de Comercio*). According to this provision, a group exists whenever a company, directly or indirectly, controls one or more companies.

Pursuant to the Insolvency Law a "group insolvency" will not lead to a commingling of the debtors' assets and creditors. The system is basically a procedural one, aimed at making the insolvency proceedings as time and cost efficient as possible. In other words, in a so-called "group insolvency", two or more separate sub-proceedings would be conducted by the same court and the debtors would be under the supervision of the same insolvency trustee although the proceedings may have different outcomes. Law 38/2011 provides that insolvency proceedings that have either been declared simultaneously or have been subsequently referred to the same court will be processed in a coordinated manner.

Even if as a general rule creditors of one company of the group will not have recourse against other companies of the same group (except where crossguarantees exist), according to a recent court decision, in certain exceptional circumstances, the piercing of the corporate veil doctrine (*levantamiento del velo*) can be applied. In "group insolvency" proceedings this leads to the commingling of the debtors' assets and creditors. Furthermore, Law 38/2011 now expressly states that if there is confusion between the assets of the group companies and it is not reasonably feasible to separate the assets and liabilities of each company, the insolvency trustee may prepare a single list of creditors and a single inventory. It is unclear whether this provision allows for a commingling of assets and liabilities.

Effects of the declaration of insolvency

Effects on the debtor's management powers

When the court declares the insolvency of the debtor (*auto de declaración de concurso*), the insolvency proceedings are initiated and the so-called *common phase* begins. The declaration of insolvency will determine the scope of the restrictions imposed on the debtor's management powers and will include the appointment of an insolvency trustee (*administrador concursal*). In Spain, the insolvency trustee is appointed by the court, not by creditors or by a court at the request of creditors.

Before the reform introduced in the Insolvency Law by Law 38/2011, the general rule was that three insolvency trustees (a lawyer, an auditor or economist, and an unsecured creditor) should be appointed by the court. Currently, and also as a general rule, only one insolvency trustee must be appointed (either a lawyer, or an auditor or economist). An additional insolvency trustee (an unsecured creditor whose claim is within the first third of claims by amount) will be appointed when the insolvency is considered of "special significance". The court hearing the case will determine if the insolvency has special significance based on the existence of certain circumstances (i.e., if the debtor's revenues have reached or exceeded 100 million euros, if there are more than 1,000 creditors, if the estimated liabilities exceed 100 million euros, or if the debtor has more than 100 employees). Law 38/2011 also allows the appointment of legal persons (e.g., a Big Four or other audit companies) as insolvency trustees, provided that at least one lawyer and an auditor or economist is involved.

The insolvency trustee acts as a court assistant, either supervising the debtor's management (*intervención*) or taking control and replacing the debtor's management (*sustitución*). As a general rule, if the debtor files for insolvency, it will keep its management power (self-administration) subject to the supervision of the insolvency trustee. By contrast, also as a general rule, if the creditor files for insolvency, the debtor's management will be replaced by the trustee. In Spain, the appointment of interim managers is uncommon as it raises certain legal issues for creditors who manage their appointment and whose claims may risk facing subordination.

Law 38/2011 has elaborated on the consequences of the supervision by the insolvency trustee of the debtor's management. The insolvency trustee may request that the court cancel or reduce any compensation that the directors receive pursuant to the company's articles of association, change the auditors and vest in the insolvency trustee the debtor's voting rights in its subsidiaries. Furthermore, in line with the interpretation of most courts, once the insolvency has been declared, only the insolvency trustee will be entitled to exercise derivative actions (*acción social de responsabilidad*) against the directors. Actions brought against directors before the declaration of insolvency in connection with the breach of their duties when the company is in a statutory cause for mandatory dissolution will be stayed. Once the insolvency is declared, no further actions may be admitted by any court.

Finally, the court may decide as an interim measure (*medida cautelar*), unilaterally or at the request of the insolvency trustee, to attach the assets of the directors or general legal representatives of the debtor, if there are reasons to believe that the insolvency will be declared fraudulent and those individuals may be ordered to pay any debts that the debtor cannot pay upon its liquidation.

Effects on the continuation of business and contracts

One of the aims of the Spanish Insolvency Law is to support the survival of the debtor's business. The survival of the business in the hands of the debtor is, however, conditional upon (i) the debtor not willing to liquidate, by asking for a court liquidation (after the amendment introduced by Law 38/2011, the debtor is entitled to apply for liquidation at any time during the insolvency proceedings); or (ii) the debtor not being able to reach a composition agreement with its creditors, thus triggering court liquidation. Additionally, if the debtor ceases its business or professional activities, the insolvency trustee is entitled to apply for liquidation at any time.

Law 38/2011 has introduced very significant amendments to the liquidation rules that may contribute to the survival of the debtor's business, but in this case in the hands of a third party (see *Liquidation*).

The declaration of insolvency does not affect the contracts of the debtor, which remain in force. Bilateral contracts (e.g., loans) with outstanding reciprocal obligations will survive. Any contractual arrangements establishing the termination of a contract in the event of insolvency will be unenforceable, unless the debtor or the insolvency trustee, with the approval of the court, considers that termination is in the interest of the insolvency estate (*interés del concurso*). As an exception, there are special regulations permitting the termination of a swap agreement if the counterparty becomes insolvent. Any amounts due as a result of an early termination will be paid from the debtor's insolvency estate (see *Insolvency creditors and creditors of the insolvency estate*).

In the event of a material breach of a bilateral contract with outstanding reciprocal obligations, the non-defaulting party may request the termination of the contract. The court may still disregard the breach and force the parties to perform the contract for the remainder of its term regardless of whether the breach occurred before or after the declaration of insolvency. Any obligations arising from the agreement must be paid from the debtor's insolvency estate. To our knowledge, courts are reluctant to force a party to continue performing its obligations under a breached contract because debtors are usually unable to honour any payments under such contract.

In practice, suppliers will not finance an insolvent company and banks will not discount their accounts receivable or provide facilities.

Sale of the debtor's assets during the common phase

The Insolvency Law establishes that any sale or encumbrance of the debtor's assets or rights before the approval of a composition agreement or the opening of the liquidation phase requires authorisation from the court, except in the case of transactions in the ordinary course of business. Courts have traditionally held that this provision only allowed them to authorise transfers of specific assets, but not a transfer of the debtor's business. This interpretation has evolved and courts are now authorising the sale of entire business units during the common phase. This raises certain issues. In Spain, the transfer of a business unit qualifies as a transfer of undertaking for labour purposes and the purchaser will acquire by operation of law any employment and social security liabilities accrued before the sale. To facilitate the transfer of business units during the common phase, when approving the transfer some courts have limited the acquirer's employment and social security liabilities (a decision that has been questioned by the social security authorities) and have declared the cancellation of any liens existing before the declaration of the insolvency over the transferred assets.

Law 38/2011 has introduced certain exceptions to facilitate the transfer of assets during the common phase. Firstly, an authorisation from the court will not be required to carry out sales that in the opinion of the trustee are essential to guarantee the viability of the debtor or to meet the cash requirements necessary for the continuation of the insolvency proceedings. The insolvency trustee will have to inform the court of any decision taken in this regard and justify its need. We believe that to enhance legal certainty to the acquirer, the new legislation should have enabled the courts to confirm any actions taken by the insolvency trustee. Secondly, the assets that are not necessary for the debtor's activity can be sold if the insolvency trustee receives an offer that substantially matches the value allocated to such assets in the inventory. Any offer where the difference in value with the inventory is less than 10 per cent for real estate, or less than 20 per cent for movable assets, will be considered a substantial match provided that no higher offers have been received. The court will be informed of any offer that meets these conditions and will approve it unless a higher offer is received within 10 days.

Reinstatement of facility agreements

To ensure that the debtor's estate has the financial resources necessary to continue in business, the Insolvency Law sets out that the insolvency trustee, unilaterally or at the request of the debtor, may reinstate (*rehabilitación*) credit and other facility agreements to which the debtor was a party as a borrower and which were accelerated by the creditor as a result of a payment default (of principal or interest) in the three months preceding the declaration of insolvency. The exercise of this power by the insolvency trustee is subject to three conditions:

(i) the trustee must provide notice of the reinstatement to the relevant creditor before expiry of the term to communicate claims (that is, as a general rule, one month as from publication of the declaration of insolvency);

(ii) the trustee must satisfy or deposit any amounts unpaid at the time of reinstatement and "assume" future payments against the insolvency estate; and

(iii) the relevant creditor must not have opposed the reinstatement and, before the initiation of the insolvency proceedings, must not have started any actions to claim payment.

In practice, insolvency trustees rarely seek the reinstatement of credit or facility agreements because, most of the time, debtors cannot satisfy the unpaid amounts and the trustees cannot guarantee that future payments will be made by the debtor.

Set-off rights

Set-off is prohibited once the insolvency of the debtor is declared, unless the right to set-off exists before the insolvency is declared (and not, for instance, as a result of the declaration itself). Law 38/2011 has clarified that, under these circumstances, set-off will be permitted even if the court or administrative resolution that declares it is taken after the declaration of insolvency. Under Spanish law (articles 1195 *et seq.* of the Civil Code), set-off is only allowed:

(i) between two parties (i.e., a debtor and a creditor) that have reciprocal claims;

(ii) if the claims of each party are specific (i.e., not subject to further determination or calculation), due and payable; and

(iii) provided that no third party has notified either party that the set-off claim is subject to challenge or retention.

As an exception, set-off will be allowed when permitted by the law applicable to the obligation (e.g., a hedging agreement governed by a law that permits set-off after the insolvency declaration).

Enforcement of security interest

Once the debtor is declared insolvent, the enforcement of security interests over assets owned by the debtor and used for its professional or business activities (presumably most of the debtor's assets) will be stayed until the first of the following circumstances occurs: (a) approval of a creditors' composition agreement (unless the content has been approved with the favourable vote of the secured creditor, in which case it will be bound by whatever has been agreed in the composition agreement), or (b) one year has elapsed since the declaration of insolvency without liquidation proceedings being initiated. Enforcement will be stayed even if at the time of the declaration of insolvency the notices announcing the public auction have been published. The same stay will apply to any actions:

(i) aiming to recover assets sold with retention of title clauses registered with the Registry of Movable Assets (*Registro de Bienes Muebles*);

(ii) terminating real estate sale agreements; and

(iii) aiming to recover any assets transferred under financial leasing agreements registered in the Land Registry (*Registro de la Propiedad*) or the Registry of Movable Assets, as the case may be.

The stay will only be lifted when the court hearing the insolvency proceedings determines that the asset is not used for the debtor's professional or business activities or is not necessary for the survival of the debtor's business.

When it comes to determining which assets of the debtor are used for its professional or business activities, courts have generally embraced a broad interpretation and will likely include most of the debtor's assets.

Creditors and the insolvency estate

The insolvency estate (*masa activa*) is formed by all assets and rights owned by the debtor when the insolvency is declared, and by those that are clawed-back (see *Claw back actions*) or are acquired during the proceedings. Creditors are paid out of the insolvency estate.

Insolvency creditors and creditors of the insolvency estate

Before the insolvency creditors (*acreedores concursales*) are paid following the order described below (see *Ranking of insolvency creditors*), certain creditors, called *creditors of the insolvency estate* (*acreedores de la masa*) will have claims against the insolvency estate (*créditos contra la masa*) that will also be paid from such estate. As a general rule, these claims must be paid as they fall due and will therefore be deducted from the insolvency estate *before the distribution to the insolvency creditors begins*. By way of exception, assets subject to a security interest cannot be affected by the claims of the creditors of the insolvency estate.

The Insolvency Law contains a closed list of claims against the insolvency estate, which has been construed restrictively by Spanish courts. The most significant are as follows:

(i) Claims by employees for salaries accrued during the 30 working days immediately preceding the declaration of insolvency up to an amount that does not exceed twice the Spanish minimum statutory salary (*salario mínimo interprofesional*).

(ii) Fees and expenses of the insolvency proceedings, including the fees for filing for insolvency, for the publication of the declaration of insolvency or any other court resolution, and any fees incurred by the insolvency trustee.

(iii) Costs incurred for the survival of the business after the declaration of insolvency, including wages and employment restructuring costs.

(iv) Payments arising from agreements with outstanding reciprocal obligations surviving after the declaration of insolvency, and any amounts due as a result of their termination, either due to a breach or by a court order (see *Effects on the continuation of business and contracts*).

(v) Claims arising from the reinstatement of credit or facility agreements (see *Reinstatement of facility agreements*).

(vi) Claims arising in favour of a creditor subject to a claw back action, unless the creditor acted in bad faith (see *Claw back actions*).

(vii) Claims arising from obligations lawfully undertaken by the debtor with the approval of the insolvency trustee during the insolvency proceedings (this would include debtor-in-possession financing).

(viii) Claims arising from obligations in applicable laws and tort liability incurred after the declaration of insolvency up to the conclusion of the proceedings.

(ix) Up to 50 per cent of claims arising from fresh money provided to the debtor in the context of a refinancing agreement meeting the conditions described below (see *Claw back actions and refinancing agreements*). This claim against the insolvency estate was introduced by Law 38/2011 and raises certain issues that need to be considered. Firstly, its practical implications may be limited given that banks will rarely provide fresh money on an unsecured basis to an insolvent debtor. Secondly, it is unclear whether or not loans provided to pay the interest or principal of financing agreements entered into with the same creditors providing fresh money will benefit from this new treatment. Our view is that they will not. Thirdly, this privilege should not have been limited to fresh money provided to the debtor in the context of a refinancing agreement meeting the conditions described below (see *Claw back actions and refinancing agreements*). In practice, such refinancing agreements are a minority. Law 38/2011 also includes among the claims against the insolvency estate in the event of liquidation, fresh money provided to the debtor to finance a viability plan under a composition agreement. Again, Law 38/2011 should have gone a step further and included fresh money provided to the debtor in other stages of the insolvency proceedings (e.g., during the common phase). Fresh money provided by persons specially related to the debtor (see *Specially related persons*) will not be claims against the insolvency estate, that is, shareholders will have no incentives to provide fresh money to the debtor as they will be considered subordinated insolvency creditors.

The claims against the insolvency estate described in paragraph (i) must be paid immediately. As a general rule, the remaining claims will be paid as they fall due. However, Law 38/2011 provides that if the insolvency trustee foresees that the insolvency estate will be sufficient to pay all claims against it, this rule may be modified and payment of certain claims postponed. This decision cannot affect claims by employees, tax and social security authorities.

Ranking of insolvency creditors

Within two months of being appointed, or one month in summary insolvency proceedings (see *Summary insolvency proceedings*), the trustee must issue a report including an inventory of assets and a list of the insolvency creditors (*acreedores concursales*) in order to establish the nature of and classify the claims against the debtor. Courts have the authority to extend the term that the trustee has to issue its report and court-approved extensions are very common (especially in complex insolvency proceedings).

Claims are ranked in the following order:

(i) *Secured or privileged claims* (*créditos con privilegio especial*) are those secured by a specific asset or right (mainly claims secured by a real estate mortgage, chattel mortgage, pledge, and pledge without transfer of possession).

Law 38/2011 has introduced a very controversial change in the list of secured claims. It provides that pledges created *to secure future claims* will only grant priority to: (a) claims arising or born before the declaration of insolvency; and (b) claims born after the declaration of insolvency when they arise from a reinstated facility agreement (see *Reinstatement of facility agreements*) or when the pledge was recorded in a public registry before the declaration of insolvency. Although it is clear that the first intention of the lawmaker was to address pledges *over* future claims, it refers to pledges created *to secure* future claims. The consequences of this confusion are that there appears to be an incentive to record pledges in a public registry and that creditors may receive different treatment depending on whether they have pledges over assets that qualify for registration or not. It is also unclear why claims arising from a reinstated facility agreement should be considered future claims if we agree that only claims that existed prior to the declaration of insolvency may be reinstated. We think this provision should be repealed as soon as possible because the courts could follow a literal interpretation of the rule.

Law 38/2011 also fails to address certain issues that arise with promissory mortgages and pledges. Should the beneficiary of a promissory mortgage or pledge be entitled to the privilege when at the time of the declaration of insolvency the security has not yet been granted? Taking into account the restrictive nature of the privilege and that, under Spanish law, a security is only effective when it is actually created, the courts will not acknowledge any privileges in this case.

(ii) *General preference claims* (*créditos con privilegio general*) are those paid from the assets of the debtor rather than from an entitlement to any particular asset and are therefore paid after secured claims but before ordinary claims. These include, among others:

- Claims for salaries up to a certain amount, severance payments and compensation for the termination of employment agreements up to a certain amount, compensation for work-related accidents or sickness and surcharges on dues owed for the breach of labour-related health and safety obligations established before the declaration of insolvency.
- Claims for amounts relating to unpaid withholding taxes and social security contributions.
- Claims for other amounts to be paid to the tax authorities and the social security authorities (up to 50 per cent of the aggregate amount).
- Claims for non-contractual liability (tort). Law 38/2011 has established a new preference for claims made by the social security or tax authorities arising from a criminal offence (*responsabilidad civil derivada de delito*).
- The remaining 50 per cent of the claims arising from fresh money granted to the debtor in the context of a refinancing agreement (see *Claw back actions and refinancing agreements*) which are not considered claims against the insolvency estate (see *Insolvency creditors and creditors of the insolvency estate*).
- Claims made by the creditor that filed the petition for insolvency, up to 50 per cent of the aggregate amount of such creditor's unsubordinated claims. It is unclear how the preference should be treated when an agent of a syndicated loan, acting on behalf of the remaining creditors, makes an insolvency petition. Should the agent be the only creditor benefiting from the 50 per cent preference who would then distribute it *pro rata* among the remaining creditors in accordance with the relevant inter-creditors' agreement or sharing clause, or should the preference benefit each of the lenders on whose behalf the agent acts? Some courts have already ruled that when the petition for insolvency is filed jointly by two or more creditors, the preference should be distributed *pro rata* among the petitioners. This is not surprising given that a general preference is a privilege that should be narrowly construed.

Claims that benefit from a general preference are paid after secured creditors and in accordance with the order outlined above. If the assets are insufficient to fully pay any of the subclasses listed above, creditors of the same subclass will be paid *pro rata* to the amount of their claims.

(iii) *Ordinary claims* are those that are neither expressly privileged (paragraphs (i) and (ii)) nor subordinated (paragraph (iv)). Ordinary claims rank *pari passu* and are paid *pro rata*.

(iv) *Subordinated claims* are those paid last. These include, among others:

- Claims that are not notified by the creditors to the insolvency trustee in a timely manner. Claims that appear on the debtor's accounts, claims evidenced in a deed granted before a Spanish notary public (which is common with financing agreements), and claims secured by a specific asset or right where the security is recorded in a public registry, will not be subordinated for lack of notification in a timely manner.

- Claims that are contractually subordinated to *all* remaining claims of the debtor. The subordination must be general, i.e., not limited to a particular claim (e.g., a senior loan). As a result, we believe that loans or claims will be considered ordinary if they are not subordinated to all remaining creditors, even if they are called "subordinated". Senior creditors should have a contractual right to request that any amounts received by the purportedly subordinated creditors in excess of what they would have received had they not qualified as ordinary are turned over to senior creditors. Participating loans (*préstamos participativos*) are construed by the courts as contractually subordinated claims.

- Claims for interest (accrued *before* the declaration of insolvency) and surcharges, except surcharges or interest in secured claims and subject to the limit of the value of the security. Claims will not accrue interest *after* the declaration of insolvency unless they are secured and subject to the limit of the value of the security.

- Fines and sanctions.

- Claims by legal or natural persons who are "specially related" to the debtor (see *Specially related persons*). Law 38/2011 has excepted from subordination those claims made by shareholders that are specially related to the debtor provided that they arise from contracts other than loan, facility or similar financing arrangements (which would be subordinated). The Spanish Supreme Court recently interpreted that *all* claims by persons specially related to the debtor are subordinated, irrespective of their nature and even if they are secured by a specific asset or right.

- Claims in favour of a creditor subject to a claw back action if the court has determined that the creditor acted in bad faith (see *Claw back actions*). The Spanish Supreme Court has stated that a creditor will be deemed to have acted in bad faith when, at the time it performed the transaction that was subsequently clawed back, the creditor knew that the debtor was insolvent and that the transaction would be detrimental to other creditors. Furthermore, the Supreme Court has interpreted that this can occur even in the absence of fraudulent intent.

- Claims arising from reciprocal obligations if the court rules, based on the trustee's report, that the creditor repeatedly obstructed compliance with the agreement against the interest of the insolvency estate (e.g., creditors that refuse to discount receivables under a discount facility).

The consequences of subordination are: (i) subordinated creditors are paid in the order listed above and if assets are insufficient to fully pay any of these subclasses, creditors of the same subclass will be paid *pro rata* to the amount of their claims; (ii) any security interest created to secure a subordinated claim will be declared null and void; and (iii) subordinated creditors will not be entitled to vote on any composition agreement.

Specially related persons

As previously discussed, claims of persons who are "specially related" to the debtor are subordinated. The Insolvency Law contains an exhaustive list of situations in which a creditor is deemed to be specially related to the debtor. The following creditors will be considered specially related to the debtor if the debtor is a legal person (i.e., not a natural person, for whom specific rules apply that are not addressed here):

(i) Shareholders with a stake of 10 per cent or higher of the debtor's share capital at the time the claim was born, or 5 per cent or higher if the debtor has securities listed in an official secondary market. Creditors that become shareholders *after* the claim was granted (e.g., as a result of a debt-for-equity or debt-for-asset transaction) will not be subordinated. Therefore, while as a general rule if the creditor meets the applicable threshold its claims will be subordinated, Law 38/2011 has introduced an exception: creditors reaching or exceeding the threshold will not be subordinated if their claim arises from a contract that is not a loan, facility or similar financing arrangement (that is, when they are commercial or trade creditors).

(ii) Directors, including *de facto* and shadow directors, liquidators and general attorneys of the debtor, and those who have held the said posts in the two years immediately preceding the declaration of insolvency.

Banks exercising strict control over the activities of a distressed debtor could face, in exceptional cases, the risk of being subordinated if the court decides that they have acted as *de facto* directors. This is one reason why chief restructuring officers (CROs) appointed at the request of banks are uncommon in Spain.

(iii) Entities belonging to the debtor's group and its common shareholders, if they meet the conditions described in paragraph (i). The addition of the word "common" by Law 38/2011 apparently seeks to limit the scope of this rule to certain shareholders but its exact meaning is unclear.

Claw back actions

The general rule

Any action carried out or agreement entered into by the debtor in the two years preceding its declaration of insolvency (the "suspect" period) can be set aside (rescinded) by the court if the trustee can prove that the action or agreement was "detrimental to the insolvency estate" (*perjudicial para la masa activa*). This may arise even in the absence of fraudulent intent. As a general rule, the creditor will be entitled to exercise the claw back action if the trustee does not seek the rescission within two months from the date of the creditor's written request.

The Insolvency Law does not define "detrimental" and the Spanish Supreme Court has not yet provided any interpretation. Several lower courts have provided opinions that are not always consistent but some conclusions can be drawn from them. In particular, actions, agreements or transactions that reduce the debtor's assets at the time they are carried out (e.g., a sale of assets below market price) are considered to be detrimental to the insolvency estate. Likewise, actions and transactions that adversely affect the *par conditio creditorum* (the right of all creditors to be treated equally) may be considered detrimental (e.g., actions, agreements or transactions that, whilst benefiting some creditors, reduce the likelihood of the remainder being paid). The analysis of whether an action, agreement or transaction is detrimental to the insolvency estate must be made on a case-by-case basis. Spanish courts take into account the following factors:

- the creditor's knowledge of the pre-insolvency situation of the debtor and that the relevant transaction was insufficient to avoid insolvency;
- the time elapsed between the date of the transaction and the date of the declaration of insolvency;
- the materiality of the asset transferred by the debtor to a creditor and its importance to the operation of the debtor's business; and
- the rationale of the transaction (particularly from an economic standpoint) and whether it was made on an arm's-length basis.

Most courts have unfortunately been embracing a broad interpretation of "detriment" and are likely to rescind debt-for-asset transactions made at market prices arguing that these transactions adversely affect the *par conditio creditorum*. Creditors must therefore be very cautious before concluding transactions with distressed debtors, particularly debt-for-asset transactions.

Notwithstanding the above, some recent decisions are favouring a narrower interpretation of "detriment". According to this new line of opinion, an action or agreement should be considered detrimental to the insolvency estate only if it entails an unjustified economic sacrifice. If the sacrifice is justified (i.e., the transaction was the most feasible alternative to prevent further deterioration of the insolvency estate) the transaction should not be considered detrimental to the insolvency estate and should not be rescinded.

The Insolvency Law contains some examples of detrimental actions. An action, agreement or transaction is presumed to be detrimental to the insolvency estate when:

(i) it is made, entered into or carried out for no consideration;

(ii) it constitutes a prepayment of future obligations (which, in the early application of the Insolvency Law, raised concerns in the context of refinancings, given that they usually involve the prepayment of a facility which is replaced by the new facility; this is why refinancing agreements in Spain are normally structured as an "amendment" or novation of the existing facility rather than as a brand new facility);

(iii) it is a disposal for valuable consideration to a "specially related" party; or

(iv) includes the creation of new security to guarantee existing debt or new debt that substitutes any existing debt.

The presumption described in paragraph (i) cannot be rebutted, and actions or transactions carried out for no consideration will be rescinded. Guarantees between companies of the same group must be closely supervised. Most courts have interpreted that guarantees granted by a company in favour of another company of the same group are transactions carried out for no consideration and should be rescinded. As an exception, pursuant to some recent court decisions, intra-group guarantees will not be considered transactions carried out for no consideration and, furthermore, detrimental to the insolvency estate, if the guarantee is granted by the parent company in favour of one of its subsidiaries (downstream guarantees). Courts are much more reluctant to come to the same conclusion when the guarantee has been granted by a subsidiary in favour of its parent company (upstream guarantees) or a sister company. Nevertheless, according to some recent decisions (a small minority among the existing case law) intra-group guarantees may not be considered transactions carried out for no consideration if they were granted for the benefit of the group as a whole.

The presumption described in paragraph (ii) cannot be rebutted and such prepayments will be rescinded, except if the obligation was secured by a specific asset or right. If secured, the presumption will be rebuttable, which at least afford banks and other creditors the opportunity to prove that the prepayment was not detrimental to the insolvency estate.

Finally, the presumptions described in paragraphs (iii) and (iv) are rebuttable.

Actions taken in the ordinary course of business under normal circumstances may not be rescinded; however, Spanish courts construe the exception restrictively.

Claw back actions and refinancing agreements

One of the objectives of the changes introduced in the Insolvency Law by RDL 3/2009 was to encourage refinancing transactions. After the reform, the taking of new security will not be subject to rescission if the security is granted in the context of a qualifying refinancing. A "refinancing agreement" is defined as one that significantly increases the funds available to the borrower or amends the terms of an existing financing agreement by extending its maturity date or by establishing new obligations that replace existing ones. There is no guidance as to what a "significant increase" of funds means; however, this is irrelevant in practice since the definition of refinancing agreement is extremely broad and, ultimately, one of the aims of the Insolvency Law is to ensure that the debtor is viable. Debt-for-asset or debt-for-equity deals could be difficult to include within the scope of the definition because they do not imply an amendment of the terms, but rather the extinction of the claims.

The rules introduced by RDL 3/2009 to encourage refinancing transactions have been partially amended by Law 38/2011.

A refinancing agreement must meet the following three requirements to be immune to a claw back action:

(i) The refinancing must be backed by creditors who hold at least 3/5 of the claims against the debtor at the time of the execution of the refinancing agreement. In this context, creditors include not only secured and ordinary creditors but also subordinated creditors (e.g., claims under shareholder loans) and trade creditors.

    Law 38/2011 has included specific rules applicable to refinancing agreements that involve a group of companies. In these cases, the refinancing must be supported by creditors that hold at least 3/5 of the claims against each individual debtor and against the whole group or subgroup of companies. Intra-group claims are excluded for this calculation.

(ii) The refinancing agreement must be consistent with a "viability plan" that evidences the viability of the debtor in the short and medium term.

The plan must be supported by a report issued by an independent expert appointed by the Commercial Registry (*Registro Mercantil*). In this report, the independent expert must assess, amongst other matters, the reasonableness and feasibility of the plan and whether the granting of the new security is proportionate taking into account prevailing market conditions.

This requirement raises several issues.

The meaning of "short and medium term" is not clear.

It is also unclear whether or not the court can review the opinion of the independent expert if the debtor subsequently enters into insolvency and rescinds the security granted in the context of a refinancing agreement that was apparently protected.

How can an independent expert (in most cases an auditor) determine if the granting of new security is proportionate?

Can the independent expert include any qualifications and disclaimers it considers appropriate and still issue a report that protects the creditors? In issuing its opinion, the expert will take into account certain hypothesis provided by the debtor and assume that the restructuring takes place (e.g., rescheduled debt payments; haircuts; assets acquired by the banks to reduce the debt, provide liquidity, or both). The hypothesis should be reasonable. Law 38/2011 has added that if the report contains any reservations or limitations, their importance should be expressly assessed by each of the signatories to the agreement.

Apart from these issues, which would require a separate in-depth analysis, under RDL 3/2009 the application of this condition involved two additional problems in practice, which have been expressly addressed by Law 38/2011.

Firstly, under RDL 3/2009 the treatment of groups of companies was unclear. Law 38/2011 clarifies that a single expert may be appointed by the commercial registrar of the domicile of the controlling company, or by the commercial registrar of the domicile of any of the companies of the group, if the controlling company is not part of the agreement.

Secondly, commercial registrars have not always been as cooperative as one would expect or desire. Some registrars, particularly in the first months of the application of the rule, held that they would only appoint the independent expert after the refinancing agreement had been reached or signed. This position also raised a number of issues. One of the concerns involved timing and how to ensure that a refinancing process does not continue indefinitely. Another issue was how to treat situations in which the expert rejects or modifies a viability plan which had been negotiated at length between the creditors and the debtor. Law 38/2011 attempts to resolve these issues by establishing that the commercial registrar will appoint the expert "*at his/her prudent discretion*" as opposed to the previous approach which simply referred to the Commercial Registry Regulations.

(iii) The refinancing and related documents must be notarised.

Law 38/2011 has confirmed that these requirements can be fulfilled at any time prior to the declaration of insolvency. Unfortunately, Law 38/2011 has failed to expressly establish that refinancing agreements that formally comply with the mentioned requirements will not be rescinded except in cases of fraud (i.e., the court should not be entitled to analyse the hypothesis used for the preparation of the viability plan once it is proven ineffective by the debtor becoming insolvent).

Cram down

Until the approval of Law 38/2011, Spanish law did not have an equivalent to the English scheme of arrangement or any other type of out-of-court cram down mechanism. This has proved to be a competitive disadvantage with other systems and some Spanish companies with connections with England (the cases of La Seda de Barcelona and Metrovacesa are well known) have been forced to apply for a scheme of arrangement in the English courts to cram down blocking minority creditors.

Law 38/2011 attempts, but in our opinion fails, to create an effective cram down mechanism. It provides that a "refinancing agreement" meeting the conditions described above (see *Claw back and refinancing agreements*) which, in addition, is entered into by creditors representing at least 75 per cent of the debtor's liabilities with financial entities at the time the agreement is entered into, may be sanctioned by the court at the request of the debtor provided that the court considers that the agreement does not impose a "disproportionate sacrifice" to the creditors of the same class which have not entered into the refinancing agreement or do not support it. Once the debtor requests the application of the cram down mechanism to a refinancing agreement, it may not file another application for one year.

Once sanctioned by the court, any extensions (principal or interest payment deferrals) will be binding on the dissenting financial creditors, excluding secured financial creditors. The cram down mechanism introduced by Law 38/2011 will not work because almost all of the financial creditors that participate in a restructuring previously have some form of security (even if they are under-collateralised). In addition, Law 38/2011 unfortunately limits the effects of the cram down to extensions agreed within the refinancing agreements. This is insufficient considering that refinancing agreements include much more than mere extensions (e.g., debt reductions).

Creditors affected by the cram down may challenge it, but only based on the following reasons: (i) the refinancing agreement has not been entered into by the required number of financial creditors; or (ii) it imposes a "disproportionate sacrifice" to such creditors. The effects of the refinancing agreement, once sanctioned and published, will not be stayed by a challenge from creditors.

The debtor may, in its request to the court to sanction a refinancing agreement, also seek a court order to stay enforcements while the court evaluates its application for a maximum term of one month. If the court sanctions the refinancing agreement it may decide, at the request of the debtor, to order a stay of enforcements during the extension period established in the agreement up to a maximum of three years. The court will decide whether or not to grant such stay after considering the circumstances of the case. Court approved refinancing agreements do not prevent creditors from filing for insolvency.

Outcome of insolvency proceedings: composition agreement or liquidation

Insolvency proceedings are aimed at either achieving a composition agreement between the debtor and creditors (*convenio*) or the liquidation of the debtor. Both outcomes are discussed in the following sections of this guide.

Composition agreements

Early and ordinary composition agreements

There are two types of in-court composition solutions between the debtor and creditors: the early composition agreement (*convenio anticipado*) and the ordinary composition agreement (*convenio ordinario*).

Only the debtor can file a proposal for an *early composition agreement*. To process such a proposal, the debtor will need the support of creditors (of any type) representing (individually or on aggregate) at least 20 per cent of the overall amount of the claims included in the list of creditors (10 per cent if the anticipated proposal is filed with the debtor's petition for insolvency). To process the proposal, the debtor may collect the support of subordinated creditors. Therefore, debtors can submit an early composition agreement proposal with the support of intra-group creditors. Debtors that have breached certain laws cannot propose an early composition agreement. The proposal can be made at any time between the petition for insolvency and the expiration of the term in which creditors must communicate their claims against the debtor (i.e., one month after the publication of the declaration of insolvency). The term is short and, in many cases, not enough to gather the support of creditors holding the required percentage of claims. This explains why debtors rarely submit early composition agreement proposals.

As a general rule, the court only determines whether sufficient creditors have adhered to the early composition agreement and, subject to certain conditions, approves the proposal of early composition agreement without calling a creditors' meeting (*junta de acreedores*) after it has ruled on all challenges brought against the trustee's report. This generally takes a long time. This is another reason that explains why early composition agreements have seldom been approved.

In an attempt to remedy this situation, Law 38/2011 introduces specific rules for the approval of composition agreement proposals (including early composition agreement proposals) filed by the debtor with its voluntary insolvency petition, provided that the court decides to follow the summary insolvency proceedings (see *Summary insolvency proceedings*). Under the new rules, early composition agreement proposals may be approved by the court before it rules on all challenges brought against the trustee's report.

The debtor may file a proposal for an *ordinary composition agreement* if it did not file a proposal for an early composition agreement or request liquidation. Creditors holding (individually or on aggregate) at least 20 per cent of the overall amount of claims may also file a proposal for a composition agreement at any time between the end of the term to communicate their claims and the court ruling on all challenges brought against the trustee's report. However, creditors usually do not file composition agreement proposals. If no proposal for a composition agreement is filed and the debtor does not request the liquidation within the period of time specified before, then the debtor and the creditors holding (individually or on aggregate) at least 20 per cent of the overall amount of claims have a second opportunity to submit proposals for a composition agreement. Such proposal must be submitted at any time between the date on which the court calls the creditors' meeting (that is, the date on which the court issues an order declaring the end of the common phase and the commencement of the composition phase) and the date falling 40 days prior to the date set for such meeting. In this case, the meeting will occur within three months of the court's order. The Insolvency Law provides that when there are more than 300 creditors the court may decide to initiate written composition proceedings instead of calling the creditors' meeting. Law 38/2011 has reduced the term that creditors have to adhere in writing to the proposal whenever the court decides to follow written proceedings from 90 days to two months.

In order to anticipate the outcome of insolvency proceedings, Law 38/2011 provides that if challenges brought against the trustee's report represent less than 20 per cent of the insolvency estate or of claims, the court may declare the end of the common phase and the opening of the composition agreement or liquidation phases. As a result of this reform, the court could call the creditors' meeting before ruling on all challenges brought against the trustee's report. This provision, which applies both to ordinary and summary insolvency proceedings, should anticipate in some cases the approval and effectiveness of composition agreements.

Voting on the composition agreement

If the (ordinary or early) composition agreement is approved by the creditors, the court will formally approve the agreement and lift any limitations imposed on the debtor during the insolvency proceedings (see *Effects on the debtor's management powers*).

Different *voting rights* are vested in each group of creditors. Privileged creditors have the right to abstain from voting. If the creditor abstains, it will not be affected by the composition agreement. If the creditor votes, it will be bound by the agreement. Ordinary creditors are entitled to vote and will be bound by the decision of the majority, whether or not they vote or abstain. Subordinated creditors cannot vote.

The Spanish Insolvency Law establishes identical voting requirements for both early and ordinary composition agreements. In general, the favourable vote of creditors representing at least *50 per cent of the total amount of ordinary claims* is required to approve a composition agreement. As an exception, the majority vote of ordinary creditors attending the creditors' meeting (which does not necessarily include all ordinary creditors) is sufficient to approve the composition agreement if the agreement involves the payment of (i) no less than 80 per cent of ordinary claims without any stay or (ii) 100 per cent of ordinary claims with a deferral of no more than three years.

If the composition agreement provides special treatment to specific groups of creditors (e.g., shorter deferral), the agreement will require the approval of the majority of the creditors not affected by the special treatment.

The situation of persons who acquire a claim *after* the declaration of insolvency (distressed investors) deserves special attention. As a general rule, such acquirers are not entitled to vote. However, Law 38/2011 has introduced an exception to the rule if the acquirer is an entity subject to financial supervision. This amendment is controversial considering that many distressed investors are not subject to financial supervision. It is unclear what would happen if the distressed investor is not the lender of record but the beneficial owner under a participation agreement or a similar arrangement.

Unless otherwise agreed between the creditor and the guarantor, guarantors of a debtor will benefit from the terms of the composition agreement (debt reductions and deferrals) if the relevant creditor voted in favour of the composition agreement. Creditors holding claims guaranteed by a third party usually seek a bilateral agreement with the guarantor as a condition to vote in favour of any proposal of composition agreement.

Content of the composition agreement

Composition agreement proposals filed by the debtor or by creditors must first be evaluated by the court to determine if they comply with all the requirements of the Insolvency Law. If that is the case, the court will accept the proposal for consideration. Furthermore, in some cases, the court will have to approve certain provisions of the proposal (i.e., debt reductions and deferrals that exceed the limits set forth in the Insolvency Law). In addition, composition agreement proposals must be assessed by the trustee, who must issue a report regarding its content.

A composition agreement will include a detailed repayment schedule. It will also include limited deferral proposals, debt reductions, or a combination of the two. It could also include the conversion of loans into shares or participating loans. It will include a viability plan if the repayment plan is based on the debtor's future cash flow.

A composition agreement proposal may not:

(i) Include a reduction of more than 50 per cent of the amount of the ordinary claims or a deferral of more than five years from the court's approval of the composition agreement. These limits can be exceeded with the court's approval if the debtor is a significant company for the economy, or when the debtor submits an early composition agreement proposal. However, in practice, courts are authorising debt reductions and deferrals that exceed the limits even if they do not fall within any of these categories. In some cases, courts have approved debt reductions and deferrals that largely exceed the limits (i.e., reductions of more than 90 per cent of the amount of ordinary claims and deferrals of up to 12 years).

(ii) Include an assignment of assets for the repayment of claims (debt-for-asset deals) or any other form of global liquidation of the debtor's assets. Law 38/2011 has introduced an exception to this rule when the relevant assets are subject to a security interest. It states that a composition agreement proposal may include debt-for-asset deals with creditors that hold a security over such assets, or a third party appointed by said creditor, provided that the secured claim is completely settled or that the remaining claim ranks as an ordinary claim. This provision may only be applied to creditors that approve the composition agreement.

(iii) Entail a change in the ranking of creditors established in the Insolvency Law (see *Ranking of insolvency creditors*).

(iv) Be conditional, although the proposal can be subject to the approval of the composition agreements of other companies of the group affected by insolvency.

(v) Impose additional obligations on any creditor, unless accepted by every affected creditor.

Law 38/2011 provides that the proposal for a composition agreement may contain *alternative* repayment proposals for all or some creditors, and not necessarily for a class of creditors as previously established. It is doubtful that these alternative proposals may establish privileges and better treatment to some creditors because it would imply a breach of the equal treatment rule and would require the approval of the majority of the creditors not affected by the special treatment (see *Voting on the composition agreement*).

The composition agreement may also include the *sale of the whole business* or specific production units to a third party. In both cases, the acquirer must assume, in the terms agreed in the composition agreement, the obligation to continue with the business activity and to pay the creditors.

If the composition agreement entails the payment of less than 2/3 of the claims of any class of creditors, or a deferral of more than three years, the court must decide if the insolvency is fraudulent (*concurso culpable*) or not (*concurso fortuito*).

Under the Insolvency Law, as a general rule, the insolvency will be considered fraudulent when it has been generated or worsened by the debtor or its directors wilfully or with gross negligence. The Insolvency Law presumes such circumstances -unless proven otherwise- in certain cases, including when directors fail to file for insolvency within the two-month limitation period (see *Petition for insolvency*). In addition, the Insolvency Law contains a list with a limited number of situations which necessarily entail the declaration of the insolvency as fraudulent, including when the debtor has committed relevant accounting irregularities that prevent third parties from understanding its real financial situation.

Court-ordered liquidation will ensue if a composition agreement is not approved by the debtor or the required majority of creditors.

Liquidation

Who can request liquidation

If neither the debtor nor a creditor proposes a composition agreement, or if no proposal is approved by the required majority at the creditors' meeting or by the court, the court will declare the liquidation of the debtor.

One of the aims of Law 38/2011 is to anticipate the outcome and thus speed-up insolvency proceedings. To this end, Law 38/2011 has introduced several significant amendments to the liquidation regime.

Under Law 38/2011, the debtor may apply for liquidation at any time during the insolvency proceedings. By contrast to the previous regulation, the court must now open the liquidation phase within the following ten days without even waiting for the trustee's report.

Furthermore, Law 38/2011 specifically allows the debtor to submit a liquidation plan at the start of the proceedings (with its insolvency petition) attaching a previously negotiated binding purchase offer for the business. In this case, the court is obliged to follow summary insolvency proceedings (see *Summary insolvency proceedings*). The court will also follow the summary insolvency proceedings when the debtor submits a liquidation plan with its insolvency petition if its business or professional activity has ceased and there are no employment contracts in force.

Special rules will apply when the debtor submits a liquidation plan with its insolvency petition. Under the new regime, in such case the liquidation phase will be immediately opened to facilitate a quick sale of the whole or part of the business. This development is welcomed as it enables a speedy sale of the business, without further reducing its value, while the trustee and the court continue to deal with the classification and payment of the debtor's liabilities. If properly structured, this could be considered an alternative to pre-pack agreements.

If the court approves the liquidation plan, it can also decide to terminate all bilateral agreements with outstanding reciprocal obligations, except those connected with the purchase offer for the debtor's business.

As previously mentioned, Law 38/2011 provides that the debtor may file for liquidation at any time during the insolvency proceedings. Therefore, if an offer for the purchase of the business is received after the petition for insolvency, the debtor could decide to file for liquidation to allow the transfer of the business at any stage of the proceedings. We believe, however, that the liquidation plan may only be produced by the trustee and not by the debtor.

The liquidation phase may also be opened at the request of the trustee if the debtor's business or professional activity has ceased. The court will give the debtor three days' prior notice and will decide whether to open the liquidation phase within the following five days. This is another major amendment introduced by Law 38/2011 with the aim of pre-empting the outcome of insolvency proceedings where it is clear that liquidation is the only possible outcome but the debtor is nonetheless unwilling to apply for it.

Effects of the liquidation

The opening of the liquidation phase entails serious consequences for the debtor and its management, including the following:

(i) The debtor's management will be replaced by the trustee.

(ii) The court will declare the dissolution of the debtor (which would have otherwise required the approval of the shareholders).

(iii) Deferred claims will be accelerated.

(iv) The court will decide if the insolvency is fraudulent (*concurso culpable*) or not (*concurso fortuito*).

If the court determines that the insolvency has been fraudulent, directors may be held liable for the payment of the claims that cannot be paid with the debtor's assets upon its liquidation. Creditors may participate in this section of the insolvency proceedings and submit allegations.

It is worth noting that some Spanish courts are stricter than others when it comes to holding directors liable. For some courts, the liability regime should be construed as a sanction and, therefore, directors should be held liable whenever the court rules that the insolvency has been fraudulent (strict liability). Other courts consider that in order to hold a director liable, the court must be able to determine that the individual director generated or worsened the insolvency wilfully or with gross negligence. The Spanish Supreme Court has recently issued a decision where it seems to adhere to the latter interpretation. The Supreme Court has interpreted that the liability regime does not constitute a sanction and that courts have to analyse and determine, taking into account the facts of the case at hand, the actions of each individual director and the consequences of his/her actions, before holding any director liable for the payment of the debtor's debts.

If the court orders liquidation, the debtor's business operations may continue until the court approves a liquidation plan and could even continue during the liquidation process.

The liquidation plan

As a general rule, a liquidation plan (*plan de liquidación*) must be produced by the trustee and approved by the court. The debtor is also entitled to submit a liquidation plan with its insolvency petition. In this case, the trustee will issue a report on the liquidation plan submitted by the debtor before it is approved by the court. The liquidation consists on the sale of the business operations and the assets of the debtor in order to pay its creditors. The Insolvency Law provides that the debtor's assets will be transferred as a whole (i.e., as a going concern) whenever possible. Liquidation plans normally foresee direct transfers for the sale of the debtor's assets as a first alternative. Only when a direct transfer is not possible, assets are sold in an auction.

In the absence of a trustee's liquidation plan or if the approved liquidation plan does not provide any guidance (very unlikely scenarios), the assets will be transferred as a whole unless the court considers it advisable to divide or transfer the business in parts after hearing the trustee. Assets will be sold at an auction. The court may order the direct sale of the assets if the auction is unsuccessful. At the request of the trustee, the court may approve, at any stage of the proceedings (including during the liquidation phase), debt-for-asset deals with any creditor holding security over such asset (or a third party appointed by said creditor) provided that the secured claim is completely settled or that the remaining claim ranks as ordinary.

Law 38/2011 has added that, in approving the transfer of a debtor's assets, the court will also cancel all liens over the assets (e.g., attachments relating to unpaid withholding taxes and social security contributions) existing before the declaration of the insolvency, but not any security interests created thereafter. This new provision follows the interpretation that many courts where making. Nevertheless, the clarification is welcomed as it will reduce the problems that frequently arise due to the opposition of the beneficiaries of the liens and, thus, facilitate the direct transfer of assets.

Summary insolvency proceedings

The court *may* decide, if the insolvency is not complex, to apply the summary proceedings if there are less than 50 creditors, or if estimated liabilities (or the appraisal of the assets) do not exceed five million euros. The court may also follow the summary proceedings if the debtor files a proposal for an early composition agreement (see *Composition agreements*) or a composition agreement that includes a corporate restructuring consisting of the assignment of all the debtor's assets and claims.

The court *must* follow the summary proceedings if at the time of the voluntary insolvency filing the debtor submits a liquidation plan attaching a previously negotiated binding purchase offer for the business (see *Liquidation*). Law 38/2011 has amended the rules that govern summary insolvency proceedings to facilitate a quick sale of the business in this case. This new regulation, which can be considered an alternative to pre-pack agreements, is one of the most significant amendments introduced by Law 38/2011 to the Spanish insolvency system and is generating high expectations.

Other considerations relevant to financial creditors

Filing for insolvency has some advantages and disadvantages for the creditors and for the debtor but in Spain it is likely to continue to be the least desirable alternative, albeit a slightly improved one. Creditors and borrowers generally favour out-of-court agreements (e.g., restructuring agreements, refinancings, sales of the business). The cost and time associated with insolvency proceedings in Spain are in most cases prohibitive. Nonetheless, there are examples of quick and successful restructurings within insolvency proceedings. The amendments introduced by Law 38/2011 to the rules that govern liquidation and composition agreements should significantly shorten the term of the proceedings and may help the effective rescue of businesses within insolvency proceedings.

As in most cases, the key to a successful out-of-court restructuring in Spain is understanding each creditor's situation and restructuring incentives and finding the minimum common denominator. Understanding who is secured and who is not will likely be the pivotal factor. The following considerations are also important:

- Trade creditors (e.g., suppliers) are rarely secured but are normally critical to the borrower's day-to-day business.
- Bilateral facility agreements and how to deal with them and coordinate unrelated lenders is a particularly common problem in Spain. The borrower's financial advisor may play a critical role.
- The issue can become increasingly complicated if there are several layers of debt based on the observation that, unlike the LMA Form of Intercreditor Agreement, Spanish finance documents do not contain provisions allowing senior creditors to "cut loose" junior creditors when the latter are "out of the money".
- Even if there is a single layer of debt, some creditors will have different approaches. For example, a bank that purchased protection under a credit default swap may have an interest in triggering a "credit event" in order to be repaid by the hedge provider. By contrast, a bank belonging to the same syndicate and which is unprotected will probably have the exact opposite interest. Distressed investors, increasingly common in Spain, also have different motivations.
- Large creditors have a strong incentive to restructure. When the main creditors have much at stake, minority creditors will sometimes try to hold them up in order to be bought out. Prepayment of small participations in syndicated loans is not possible, since syndicated loans include a sharing

clause that prevents any bank from being paid before the rest. Other alternatives will need to be considered but there is no obvious solution.

- Foreign banks normally take a more aggressive approach and are less vulnerable to political and other pressures (from peer banks). The bank's restructuring or risk officer is normally located outside Spain. They are also more likely to go "by the book". On the other hand, in comparison with Spanish banks, some will be less reluctant to agree to out-of-court write-offs, to the capitalisation of part of the debt, or the conversion of all or part of their claims into a participating loan when it is clear that the capital structure of the debtor is unsustainable.

In some cases, insolvency will of course be inevitable. This will occur when the debtor is not deemed viable or when, for any reason, a viable debtor is unable to reach an out-of-court agreement with its creditors. However, non-viable borrowers (zombie companies) have clearly been supported in the past, sometimes to delay provisioning bad loans or to survive the hardening period for security. Whether artificially extending the life of a non-viable company by providing credit will aggravate the company's financial situation, create an appearance of normality to other creditors and constitute sufficient grounds for an action against the banks should be carefully considered. There is currently no case law in Spain on this area, although the issue has been addressed in France and Germany.

It is critical to seek legal advice.

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