A new legal tool for debt restructuring in Spain

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The 4 th Additional Section (4^{th} AS) of the Spanish Insolvency Act (SIA) was reformed last month to facilitate financial restructurings.

Following the reform, companies in financial distress can achieve a debt restructuring by reaching an agreement with their financial creditors that meet the following conditions:

i That a majority of at least 55 per cent of the claims of financial entities support the agreement (the required majority before the reform was 75 per cent);

ii That an independent expert issues a report endorsing a short and medium term viability plan to be prepared by the company;

iii That the legal documentation is done in notarial form; and

iv That the competent commercial court considers that the terms of the agreement do not entail a disproportionate sacrifice for the financial creditors that have not entered into the agreement.

Through this type of agreements, a company can obtain:

i A moratorium or extension (*espera*) of the maturity of its financial debts, which will be binding not only upon the financial creditors that entered into the agreement, but also upon those that dissented or simply did not sign it, except in case they have an *in rem* collateral (typically, a pledge or a mortgage); and in addition,

ii The court can impose a moratorium on the enforcement of financial claims (*paralización de ejecuciones*) of up to three years. The court will decide to impose a moratorium to the extent it is deemed necessary for the viability of the company. The moratorium can be imposed also on secured claims.

However, other terms of the refinancing agreement such as new interest rates, granting of additional financing, new covenants, etc. cannot be imposed upon creditors that have not accepted to become a party to it.

One has to note that the extension or *espera* and the moratorium or *paralización de ejecuciones* are different things. *Espera* means an extension of the maturity of a financial debt, in the form of a simple postponement of the maturity date or of a new amortization schedule, for instance. *Paralización de ejecuciones* means a stay of court enforcement actions. However, except as regards the length of the extension (five, ten or even more years), as opposed to that of the stay (three years), the practical consequences of this distinction are far from clear.

4th AS poses, however, some questions for which certain answers have been proposed, but which have not yet been completely tested in court:

1. Does the term "financial entities" that is used by this provision refer only to credit institutions or does it also refer to other types of creditors of a financial nature (for instance, hedge funds or bond holders)?

   The SIA does not provide a definition of "financial entity", but section 3.5 of the Spanish Law on Venture Capital Entities does, and does it in a way that could allow extending the scope of 4th AS well beyond credit institutions.

2. Is there a limit to the extension of the maturity of the financial debts?

   Initially, it was considered that the maximum duration of the *espera* was three years, but a number of recent court decisions have accepted longer extensions (five, seven, ten and even fifteen years), on the grounds that 4th AS does not set any limit for the *esperas*, but only for the *paralizaciones* (three years), and also that the extension needs to be long enough to allow the viability of the company in the short and medium term, which is the very aim that this provision intends to facilitate.

3. What are the criteria to be used in the proportionality test that the court has to make in relation to the sacrifice suffered by the financial creditors that have not entered into the refinancing agreement?

   Certain court decisions have mentioned a number of criteria to gauge the proportionality of the sacrifice. One is the percentage represented by the financial creditors that support the agreement: a high degree of support, well above the minimum required of 55 per cent, would justify a heavier sacrifice by dissenting creditors. The interests at stake is another element to bear in mind (those of the creditors that support the agreement, the dissenting creditors, other non-financial creditors, the debtor itself and its employees, the impact that the failure of the debtor could have in the national or regional economy, etc.). A third criterion is whether or not it is reasonable to think that the refinancing agreement will leave dissenting creditors in a better position than the declaration of insolvency of their debtor.

The fact that the debtor was in default under the original financing agreements, i.e. previously to reaching the refinancing agreement, is not considered to be relevant for this test.

4. Can financial creditors that have not entered into the refinancing agreement benefit from new security or collateral granted by the debtor?

   The only effects of a refinancing agreement pursuant to the 4th AS are, as noted above, the *espera* and the *paralización de las ejecuciones*. For this reason, this type of agreements cannot impose upon financial creditors that are not a party to them the obligation to provide additional financing or other terms different from those included in the original financing agreements, which cannot be amended. The flip side of this is that, as a recent court decision has claimed, dissenting creditors cannot benefit from new collateral created under the refinancing agreement. The same goes for other rights the debtor may have granted to the lenders that have executed the refinancing agreement. This, in the court's view, does not amount to a disproportionate sacrifice upon the dissenting creditors.

5. Can the extension be imposed upon secured financial creditors when their security relies on assets that are essential to the activity of the company (as is the case under formal insolvency proceedings)?

   Although 4th AS clearly states that financial creditors with an *in rem* security are not bound by an extension approved by the relevant majority of creditors, it has been claimed that the spirit must prevail over the letter of this legal provision, and so one court has recently decided that a financial creditor with a security over assets that were deemed to be essential for the business of the debtor cannot enforce its collateral during the term of the extension. Note, however, that the extension in this particular case was only a few months.

   The rationale behind this decision is the fact that the SIA provides a stay on the enforcement of security over essential assets during a certain period of time when the debtor is under insolvency proceedings. However, this interpretation is being questioned by scholars and courts.

6. What is the effect of 4th AS on syndicated lenders?

It has also been claimed that a lender within a syndicated loan that cannot enforce the security on its own because a majority of lenders is required, cannot be immune to the extension agreed in the refinancing agreement. This view is being supported by numerous scholars and judges.

7. Does default interest accrue on financial claims of dissenting creditors?

A recent court decision has deemed that 4th AS cannot have the effect of suspending the accrual of default interest under the original financing agreements. However, it is unclear whether default interest can accrue equally on secured claims (subject to a maximum stay of three years) and on non-secured claims (subject to a potentially much longer extension).

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