European Perspective

Spanish Parliament Approves Law
Amending the 2003 Insolvency Act

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Victor Casarrubios
Charo de los Mozos

On October 10, 2011, the Spanish Parliament approved Law n. 38/2011 (the "Amendment"), which amends the Spanish Insolvency Act of 2003 (the "Insolvency Act"). Except for certain of its provisions (which became effective on October 12, 2011), the Amendment will generally come into force on January 1, 2012.

The Insolvency Act, enacted in July 2003, was a milestone in the Spanish legal system, as it implemented a new unitary insolvency system for professionals and enterprises (both individuals and legal entities) governed by a single law and subject to the exclusive jurisdiction of specialized courts (the Mercantile Courts). However, eight years of experience and the current financial turmoil have highlighted certain defects that have prevented the Insolvency Act from achieving its main goal: preservation of an insolvent company as a business concern.

The Amendment does not radically change the legal principles of the Insolvency Act. However, it is a comprehensive update of Spanish insolvency regulations applying the Insolvency Act, implemented to respond to the current European Union economic situation. The main goals of the Amendment are:

(i) To avoid the liquidation of insolvent companies by exploring alternatives to an insolvency proceeding and offering a company a faster and less expensive solution to its financial crisis by means of refinancing agreements;

(ii) To encourage fresh-money infusions by granting priority to fresh credit over the claims of other creditors;

(iii) To offer certain kinds of creditors "insolvency credits," or claims, with full voting rights at the meeting of creditors after a company's declaration of insolvency;

(iv) To simplify insolvency proceedings and assist the overburdened Mercantile Courts;

(v) To improve the professional qualifications of insolvency trustees; and

(vi) To clarify the legal regime of insolvency proceedings by regulating, among other things, the order of payment among creditors in cases involving assets that are inadequate to satisfy the claims of all creditors in full.

The provisions in the Amendment addressing each of these six goals are discussed below.

Refinancing Agreements

Under the Insolvency Act, any agreement signed by an insolvent company within two years prior to declaring insolvency is subject to a "claw-back" action (*acción de reintegración*) if the agreement caused "economic loss" to the company's assets. A loss is presumed (among other cases) in agreements where new "*in rem*" security was pledged by the company to secure preexisting debt.

However, a refinancing agreement between the insolvent company and its creditors executed within two years prior to a declaration of insolvency is protected from a claw-back action if: (i) the agreement effectuates a significant increase of the funds available to the company or an extension of the maturity or replacement of existing obligations; (ii) the agreement was supported by a feasibility plan aimed at enabling continuation of the business; and (iii) the following conditions are fulfilled prior to the commencement of insolvency proceedings:

(a) The agreement is signed by creditors holding at least 60 percent of the insolvent company's debt;

(b) An independent expert designated by a mercantile registrar issues a technical opinion on the refinancing agreement stating that the information provided by the debtor is sufficient, the plan is reasonable and achievable, and that any new security granted as part of the refinancing is proportionate on the basis of market conditions at the time the agreement is executed. Under the Amendment, if a refinancing agreement applies to a group of companies, a joint opinion covering all related companies may be issued by the expert. If the opinion contains any reservations or limitations, the parties to the agreement must provide a detailed assessment of the relevance of any such caveats; and

(c) The agreement is formalized before a notary in a public deed, which should include all the evidence of compliance with the above-mentioned requirements.

Under the Amendment, it is now possible to obtain judicial approval (*homologación*) of a refinancing agreement prior to the commencement of insolvency proceedings if*, in addition to the requirements delineated above*, the following conditions are satisfied:

(a) The refinancing agreement has been executed by creditors holding 75 percent of the insolvent company's debt; and

(b) The refinancing agreement does not represent, in the court's opinion, a disproportionate sacrifice by nonsignatory creditors.

Judicial approval of a refinancing agreement has the following advantages:

(a) Any standstill period under the refinancing agreement is extended to nonsignatory creditors, unless their claims are secured by "*in rem*" security, such as a mortgage. Affected creditors may object within 15 days of publication of judicial approval of the agreement in the *Spanish Official Bulletin* and the *Public Insolvency Register*. However, the grounds for objection are limited to: (i) failure to satisfy the required debt percentage threshold; and (ii) a challenge to the court's conclusion that dissenting creditors would not be disproportionately prejudiced by approval of the agreement. Any objections interposed are adjudicated and resolved in a single proceeding before the court, and the court's final decision is not subject to appellate review. Judicial approval becomes effective on the day following publication of the final decision on objections in the *Spanish Official Bulletin*.

(b) The court granting approval of a refinancing agreement may order the suspension of any foreclosure proceedings initiated by any creditor during the standstill period established under the refinancing agreement, which may not exceed three years. However, creditors retain their rights against those jointly obligated with the insolvent debtor as well as any guarantor of the debt; guarantors do not have recourse to the court to oppose payment on their guarantees.

Should the debtor not fulfill the terms of the refinancing agreement, any creditor may request a judicial declaration of breach from the same court that approved the agreement. Once this declaration is issued by the court, creditors may request a declaration of insolvency with respect to the debtor or initiate individual collection actions against it. The debtor may not petition for another judicial approval of a refinancing agreement during the year following its initial request for judicial approval.

The Insolvency Act provides that a debtor is obligated to initiate an insolvency proceeding no later than two months after it becomes, or should have become, aware that it is insolvent. In addition, a creditor may commence an insolvency proceeding against the debtor if the creditor becomes aware that the debtor has become insolvent. Under the Amendment, the two-month deadline is extended if the debtor has initiated negotiations to reach a refinancing agreement and the court is notified of the debtor's situation before the two-month term expires. However, the Amendment provides that the debtor must commence an insolvency proceeding if it is still insolvent three months after delivering the required extension notification to the court.

Priority for Fresh Money

The Insolvency Act did not originally contain any specific protection or priorities for claims based upon fresh-money infusions into an insolvent company. In practice, fresh money was protected with specific additional security (for example, mortgages or pledges) granted in connection with a refinancing agreement. Pursuant to the Amendment (and with effect from October 12, 2011), 50 percent of "fresh money" (*i.e.*, new capital obtained by the company under a refinancing agreement that meets the requirements for protection described above) is conferred with priority in the form of a "credit," or claim (discussed below), against the assets of the insolvent debtor (*crédito contra la masa*). The remaining 50 percent is conferred with priority in the form of an insolvency credit with priority as a "general privilege."

Claims against the insolvent debtor's estate are satisfied from assets of the insolvent company that are not mortgaged, pledged, or otherwise used as collateral security for specific credits. The remaining assets of the insolvent company are used to pay, in descending order of priority, credits with general privilege, ordinary credits, and subordinate credits.

The new priorities for fresh money under the Amendment do not apply to new capital in the form of either equity or debt financing provided by existing shareholders or affiliated companies holding more than 10 percent in the share capital of the insolvent company or by company directors.

Acquisition of Insolvency Credits

Under the pre-Amendment version of the Insolvency Act, with certain exceptions, creditors that acquired claims after the initiation of an insolvency proceeding had no right to vote at the creditors' assembly convened to vote on the debtor's reorganization plan (*convenio de acreedores*). Pursuant to the Amendment (which applies to reorganization plans proposed after January 1, 2012), any creditor "subject to financial supervision" that acquires insolvency credits after the initiation of an insolvency proceeding will have the right to vote at the creditors' assembly. The Amendment does not define the phrase "subject to financial supervision," but Spanish law governing this issue provides that the Bank of Spain has control and supervisory authority over, among others, banks, savings banks, credit cooperatives, branches of foreign financial entities, and mutual guarantee companies.

Simplified Insolvency Procedure

In connection with insolvency proceedings to be initiated beginning in 2012, the Amendment implements a simplified insolvency procedure if the court determines that an insolvency is not complex, in accordance with the following criteria:

(a) The list of creditors filed by the debtor with the court includes fewer than 50 creditors;

(b) The initial estimate of aggregate indebtedness is less than €5 million;

(c) The initial asset valuation is below €5 million; and

(d) The debtor files a proposed composition agreement providing for the merger, sale, spinoff, or transformation of the company in a transaction involving a transfer of substantially all of the debtor's assets and liabilities to another entity.

Under the Amendment, the court is obligated to apply the simplified procedure if the debtor submits, in a liquidation plan, a binding proposal by a third party to acquire an operating unit of the debtor or if the debtor has ceased doing business and its employment contracts are no longer in force. At any time, the court may convert the insolvency proceeding from an ordinary proceeding to a simplified proceeding and vice versa, on the basis of a change in circumstances relative to the criteria for eligibility.

Insolvency Trustees

The Amendment increases the scope of liability and qualifications required for insolvency trustees, who are entrusted with examining the bankruptcy estate and existing debts. In addition, the number of members sitting on the panel of insolvency trustees in any particular insolvency proceeding is reduced from three to one, although an ancillary trustee (*auxiliar delegado*) may be appointed, as discussed below. With certain exceptions, an insolvency trustee must:

(a) Be a practicing lawyer with at least five years of experience and an accredited education specializing in insolvency law; or

(b) Be an economist, chartered accountant, or auditor with at least five years of experience and accredited expertise in insolvency.

Organizations may also be appointed as trustees, provided they include a lawyer, economist, chartered accountant, or auditor who satisfies the requirements set forth above and that they guarantee due independence and dedication in performing their obligations as an insolvency trustee.

The Amendment imposes specific requirements on trustees in insolvency proceedings involving banks, insurance companies, and other regulated entities. Any expert rendering an opinion required for approval of a refinancing agreement is ineligible for appointment as a trustee in any ensuing insolvency proceeding commenced by or against the same debtor.

In connection with an insolvency proceeding of "special significance," the Amendment provides that the court shall appoint, as an additional member of the panel of trustees, a creditor holding an ordinary insolvency credit or an unsecured insolvency credit with general privilege. According to the Amendment, insolvency proceedings have special significance if:

(a) The annual turnover of the debtor was €100 million or more in any of the three fiscal years preceding the date of commencement of the insolvency proceeding;

(b) The aggregate indebtedness declared by the debtor exceeds €100 million;

(c) The number of creditors declared by the debtor exceeds 1,000; or

(d) The number of the debtor's employees exceeds 100 or did so in any of the three fiscal years prior to the insolvency-proceeding commencement date.

In addition, in cases involving a single insolvency trustee, the court, after convening a hearing on the issue and concluding that the existing trustee is not a legal entity (*i.e.*, an association, corporation, partnership, proprietorship, trust, or individual that has legal standing under the law), may appoint an additional, or ancillary, trustee. The appointment of an ancillary trustee is mandatory in certain cases specified in the Amendment.

Payment of Claims Against Insolvency Assets (*Créditos contra la Masa*)

The Insolvency Law and the Amendment provide that certain claims (*e.g.*, claims for legal costs incurred in connection with insolvency proceedings, post-insolvency declaration claims arising from business operations, and salaries payable during the 30-day period prior to the declaration) shall be paid from unencumbered assets of the insolvent company. Eligible assets are therefore reserved or reduced (prior to the payment of any other claims) for the purpose of satisfying this special class of claims (*créditos contra la masa*). These claims are paid as they mature, but the Amendment gives the trustee(s) the power to alter the order of payment among different claims within this special class, provided the trustee(s) conclude that it is in the best interest of the proceedings and that there will be sufficient eligible assets to pay all claims in the class.

If at any time after the declaration of insolvency, the trustee(s) should determine that eligible assets are not sufficient to pay all the claims in this class, the Amendment provides that the insolvency proceeding will terminate, unless the court finds that the obligations are guaranteed by a third party. In the event of such a termination, claims in this class shall be paid in the following order:

(i) Claims for salaries earned during the final 30 days of employment in an amount not exceeding double the national minimum salary;

(ii) Claims for salaries and other compensation in an amount computed by multiplying triple the national minimum salary by the number of salary days for which payment is due;

(iii) Claims for judicial costs and expenses associated with the insolvency proceeding; and

(iv) Any other claims against the insolvency assets (including claims based upon fresh money).