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Client briefing
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Schemes of arrangement in the reform of Spain's Insolvency Law?

The text of the Draft Bill for the Reform of the Spanish Insolvency Law has recently been published and is currently pending approval before Parliament.

One of the main changes is that the Draft Bill introduces a Fourth Additional Provision in relation to refinancing agreements, the contents of which draws its inspiration from other European systems, mainly from the UK model for Schemes of Arrangement.

However, the regulation contained in the Draft Bill still has a long way to go before it mirrors the UK model, as there are significant factors which will determine whether or not it applies; and in any event, it is still limited in scope.

Therefore, it is necessary to explain what this mechanism, which is intended to be incorporated into Spain's insolvency system, includes and what it does not.

As an initial remark, it does not seem to be the legislator's intention to create a system whereby the decision of a majority can be imposed upon dissenters, but rather to grant the debtor temporary protection from financial creditors who oppose the refinancing.

With that in mind, it is easier to understand the limited scope of the reform, as well as its place in the context of the refinancing agreements which are protected against claw-back risk.

We refer below to the three requirements for the application of the new Fourth Additional Provision: i) subjecting refinancing agreements to the existing protection process under the Insolvency Law, ii) obtaining support from 75% of the financial liabilities, and iii) obtaining court approval for the insolvency.

Refinancing agreement protected under the current Additional Provision Four (which will be the new Art. 71.6 of the Insolvency Law)

The starting point for the regulatory reform, i.e. the main factor which determines if the new mechanism is applied or not, is the existence of a refinancing agreement such as those referred to in the currently existing Additional Provision Four of the Insolvency Law (which will become Article 71.6), that is, one of those agreements which avoids claw-back risk.

Therefore, in order for this new mechanism to be applied, it will be necessary, in short, for a refinancing agreement supported by 3/5 of all creditors to be executed as a public document, and the evaluation of the viability plan by an independent expert appointed by the Mercantile Registry.

Only those refinancing agreements which fulfil these requirements may request the application of the new Additional Provision Four, which we explain below.

This means that those refinancing agreements not subject to this protection (in practice, the vast majority) will be beyond the scope of application of the new provision.

Majority of the financial liabilities

The new Additional Provision Four will make refinancing agreements subject to judicial approval, provided they are supported by 75% of the financial creditors.

It is important to note that this new Provision would imply that, for the first time ever, Insolvency Law will be paying attention to the type of creditor involved, an aspect which may create practical problems, since neither the law nor case law has ever defined what should be understood by the term "financial creditor".

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This new Provision of the Insolvency Law uses this concept as a starting point, not only in order to calculate the majority of the liabilities supporting the refinancing agreement, but also to determine the effects of the agreement on the creditors of this same type, as we will see below.

Judicial approval

Those refinancing agreements which fulfil the above requirements may be subject to Court approval for the purposes indicated below.

The reference to judicial approval is somewhat confusing. In theory, it seems the Judge will only verify if all conditions exist (as a sort of voluntary-jurisdiction process in which no objection is allowed).

However, this new Provision would permit the Judge to assess the appropriateness of the contents of the agreement (the assessment would supposedly be done "in equity", as the law does not establish any parameters in this regard, it only requires that the agreement not entail disproportionate sacrifice).

In addition, the law permits that financial creditors whose liabilities may not have been taken into account may object to the Court approval, which would only make sense for the purposes of including their debts. However, these creditors would also be allowed to make allegations as to the extent of the "sacrifice". Therefore, we feel that any dissenting creditors should also be allowed to make allegations in this regard, as they would have an equally legitimate interest, as would those creditors not taken into account.

Considering the above, we cannot tell yet if this judicial approval will represent, in practice, actual proceedings, or if it will really be a mere formality. The latter is the more likely.

Effects of the agreement

Judicial approval of the agreement will have two effects: one that is necessary and one that is optional: i) in any event, the effect of imposing upon dissenting financial creditors a moratorium on debt established in the agreement, and ii) if so requested, the effect of imposing upon financial creditors a restriction on enforcement actions. We will refer to these separately.

The natural effect of judicial approval will be the extension of the agreement or the moratorium of debt to all financial creditors holding unsecured loans. On the contrary, this will mean: i) in subjective terms, that the refinancing agreement will not be imposed upon creditors holding *in rem* security (which, in many cases, will be the vast majority), nor upon non-financial creditors (e.g. suppliers); all of them will maintain their credits intact and will remain free to take action, and ii) in objective terms, that the refinancing agreement can only be imposed insofar as extending its duration, but not insofar as the rest of its contents (e.g. cancellation of debt, conversion of credit into capital, or granting new financing). Thus, it will have a very limited effect, only referring to the agreement for the moratorium of debt.

Furthermore, if so requested when seeking judicial approval, a Judge may also decide to prevent enforcement actions initiated by creditors (the latter being understood as the financial creditors, since, although the law does not specify this, it would not make sense to extend this accessory effect to creditors who will not be directly affected by the refinancing. Apart from that, it seems that such a request will have to be made when seeking judicial approval and not afterwards, which makes little sense, since enforcement may not yet have commenced (or they may as yet be unknown to the debtor).

Conclusion

Although we can value positively the introduction of a mechanism which will serve to protect a debtor's assets against the actions of its creditors (and we stress that this is the fundamental aim of the new Fourth Additional Provision), this new mechanism cannot be deemed as a debt novation instrument by virtue of the majority criteria. Its limited scope sets it, at this time, still apart from the pre-insolvency mechanisms existing in other legislations in neighbouring countries.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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