Restated Insolvency Act: Spain

by *Laura Ruiz Monge*, Pérez-Llorca

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A note on the amendments to the Spanish insolvency process introduced by Royal Legislative-Decree 1/2020, of 5 May, approving the Restated Insolvency Act (*Real Decreto Legislativo 1/2020, de 5 de mayo, por el que se aprueba el texto refundido de la Ley Concursal*), which entered into force on 1 September 2020.

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Scope of this note

This note sets out the key amendments to the existing insolvency procedure in Spain introduced by Royal Legislative-Decree 1/2020, of 5 May, approving the Restated Insolvency Act (*Real Decreto Legislativo 1/2020, de 5 de mayo, por el que se aprueba el texto refundido de la Ley Concursal*) (Restated Insolvency Act).

The key amendments focus on:

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- Broadening the jurisdiction of the insolvency judge (see *Interim enforceability of the Restated Insolvency Act*).
- Refinancing agreements (*convenio*) and their certification (*homologación*) by the insolvency judge (see *Refinancing agreements (convenio)*).
- The impact of insolvency proceedings on arbitration (see *Effects of insolvency proceedings on arbitration clauses*).
- The priorities of claims and subordinated claims (see *Subordinated claims: profit participating loans*).
- The applicable regime for guaranteed claims (see *Guaranteed claims*).
- Directors' liability (see *Liability of directors*).

In addition, simultaneously with the approval of the Restated Insolvency Act, some temporary measures have been approved in the context of the COVID-19 pandemic and the expectation of a significant increase in the number of insolvency cases in 2021 (see *Temporary measures adopted due to COVID-19*).

Why is a new Insolvency Act necessary in Spain?

The previous Insolvency Act entered into force in 2003 and was amended several times to adapt to the climate created by the 2008 financial crisis. These amendments made the text of the Act look disorderly and created uncertainty.

The Restated Insolvency Act intends to clarify the insolvency regime as well as to introduce certain court and practice trends.

The Restated Insolvency Act was published in the Official Gazette (*Boletín Oficial del Estado*) in May 2020 and entered into force on 1 September 2020, during the COVID-19 pandemic. The special and unexpected circumstances around the timing of publication and enforceability have resulted in certain aspects of the Restated Insolvency Act being subject to additional temporary amendments (see *Temporary measures adopted due to COVID-19*).

Interim enforceability of the Restated Insolvency Act

The Restated Insolvency Act cannot be considered a final version of an Insolvency Act, given that the regulation governing insolvency practitioners (*estatuto de la administración concursal*) has not entered into force. As such, regulation must be developed by means of the passing of a royal decree (*real decreto*). The previous regulation of insolvency practitioners (in existence under the former insolvency act) remains in force until the regulatory development of the Restated Insolvency Act is completed.

Certain provisions included in the Restated Insolvency Act may be considered controversial. For example, insolvency judges will lose some freedom regarding the appointment of insolvency practitioners, since the general rule is that they will have to appoint insolvency practitioners in accordance with the order of a list (although there are some cases in which the judge may appoint a different practitioner, if justified due to the specific circumstances of the insolvency and the features of the practitioner). Likewise, all practitioners must contribute to a deposit which is used for paying the fees of the practitioners which are appointed in insolvency proceedings lacking assets to cover such fees.

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However, some of the rules concerning insolvency practitioners still apply. For example, the limits on fees established by the Third Transitional Disposition of Law 25/2015 of 28 July, under which insolvency practitioners can only receive fees for the first year of the liquidation process. The Supreme Court, in its ruling dated 23 June 2020, declared that the limits must apply if, as of 29 July 2015, the first year of the liquidation process had already passed. This decision has been brought to the Constitutional Court by the association of insolvency practitioners.

Another reason why the Restated Insolvency Act cannot be considered final is that member states of the EU must adopt and publish the laws necessary to transpose the Directive on Restructuring and Insolvency ((EU) 2019/1023) by 17 July 2021. Lawmakers took the decision not to postpone the Restated Insolvency Act instead of transposing the Directive at the same time. The main reason seems to be that Spanish law included all the recommendations issued by the EU in 2015, although the current crisis situation may give rise to a reconsideration of the current framework of debt restructuring.

Broader jurisdiction of the insolvency judge (juez del concurso)

In the Spanish system, the insolvency judge benefits from *vis attractiva*, which means that, in general terms, the judge has jurisdiction to decide on any issues which are relevant to the insolvency process.

Jurisdiction of the insolvency judge in relation to the sale of business units

The sale of business units during insolvency proceedings is one of the most useful mechanisms for preserving the activity of companies. The Restated Insolvency Act gives judges a central role in promoting such sale. On the request of the insolvency practitioner (*administración concursal*), and without any other requirements, the judge may authorise the sale of business units at any stage of the insolvency proceedings. The Restated Insolvency Act clarifies that such authorisations are not subject to appeal. This eliminates some uncertainties, as previously it was not unusual for interlocutory appeals (or even appeals before upper courts) to be filed by parties interested in hindering the sale.

Jurisdiction of the insolvency judge in relation to labour debts in the sale of business units

Article 221.2 of the Restated Insolvency Act makes it clear that:

- Only an insolvency judge has jurisdiction to declare that a business succession has taken place.
- The business succession declared by the insolvency judge only affects the employees taken on by the buyer.

This has clarified the position. It used to be unclear whether the buyer had to assume all outstanding obligations vis-à-vis employees and social security, or just the portion relating to the employees that the buyer acquired in the sale of the business unit.

Refinancing agreements (convenio)

Refinancing agreements may be reached during pre-insolvency proceedings.

Pre-insolvency proceedings can be initiated by submitting a communication to the insolvency judge who would be competent in the event of an insolvency, provided that the debtor is in a state of either:

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- Current insolvency: meaning that the debtor company can no longer comply with its payment obligations in a timely and regular manner.
- Imminent insolvency: meaning that the debtor company can still comply with its payment obligations, but it is aware that it will not be able to comply in the short term.
- (*Article 583*, *Restated Insolvency Act*.)

Under Spanish law, refinancing agreements approved by the insolvency courts have been widely used. Such agreements may only be entered into by the debtor company and its financial creditors. The main advantage of these agreements is that dissenting creditors may be bound by them in the event that large majorities of creditors of the same class support them. This mechanism therefore prevents the frustration of refinancing agreements due to the position of a small portion of dissenting creditors. Since these agreements limit the freedom of dissenting parties, insolvency judges must approve the agreements before they can be effective.

Challenging approved refinancing agreements

Dissenting creditors have the opportunity to challenge approved refinancing agreements via legal proceedings. The debtor company and any supporting creditors may oppose the challenge. The absence of an opposition to the challenge does not automatically lead to the success of the challenge, although the fact that no evidence is filed to defend the refinancing agreement will be assessed by the judge when rendering their decision. If the challenge is upheld, the challenging creditor will not be bound by the refinancing agreement.

Article 619 of the Restated Insolvency Act lists the following available legal grounds on which to challenge the approval of a refinancing agreement:

- Lack of the required majorities to approve the refinancing agreement.
- The existence of disproportionate sacrifice, which will be determined on a case-by-case basis by the insolvency judge. The sacrifice will be considered as disproportionate if:
  - equal or similar creditors receive different treatment; or
  - unsecured creditors would recover more if the debtor was liquidated.
  - (*Article 619.3*, *Restated Insolvency Act*.)

  Courts also usually apply the following criteria to determine the existence of disproportionate sacrifice:

  - lower ranked creditors are treated better than higher ranked creditors;
  - the conditions (reductions, deferrals and so on) are more severe than necessary for the debtor company to be viable; or
  - the debtor company is not viable at all, even after applying the conditions of the refinancing agreement.

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The courts already had the authority to suspend enforcement proceedings against the debtor company, but under the Restated Insolvency Act they now have the power to terminate such enforcement proceedings once the refinancing agreement is approved.

The Restated Insolvency Act establishes that if a breach of the refinancing agreement has been declared, the agreement will be terminated.

Effects of insolvency proceedings on arbitration clauses

The court may suspend arbitration clauses *ex sua sponte*, without being requested by any of the parties (*Article 140, Restated Insolvency Act*). However, Article 140 highlights that such a decision may only be taken before the arbitration has started. This means that contractual counterparties have an incentive to start arbitration proceedings if they believe their counterparties may file for insolvency proceedings in order to avoid the arbitration clause no longer being effective. Once they have started arbitration proceedings, the suspension will no longer be possible, although arbitral proceedings may be challenged on the grounds of fraud.

Subordinated claims: profit participating loans

Article 281.1.2º of the Restated Insolvency Act sets out that profit participating loans must be ranked as subordinated claims within the insolvency waterfall.

Guaranteed claims

Regime of guaranteed claims ranking as subordinated

The Restated Insolvency Act resolves the uncertainty regarding the cancellation of guarantees granted in favour of the debtor's related parties (subordinated creditors):

- The only guarantees that may be cancelled are those relating to the insolvent debtor's debts to related parties. The Restated Insolvency Act clarifies that guarantees granted by third parties in favour of the insolvent debtor remain in force, since the cancellation is only provided in connection with guarantees liable to be paid out of the insolvent debtor's assets.
- Cancellation can only take place once the guarantee claim is confirmed to be subordinated (this could be because such subordination condition established by the insolvency receiver was not challenged, because a challenge against such condition was unsuccessful or because a challenge asserting that the guarantee claim should be subordinated was successful).
- The Insolvency Court will issue a decision declaring the cancellation of the guarantees, that the assets are to be returned to the insolvent debtor (if the assets were pledged) and that the records in public registries acknowledging the granting of guarantees are to be cancelled. This does not amount to a statement that the guarantees are null and void, but this mechanism is aimed at preventing subordinated creditors seeking the enforcement of guarantees outside of the insolvency proceedings.

Regime for holders of in rem guarantees who are not creditors within the insolvency proceedings

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Holders of *in rem* guarantees are the beneficiaries of a secured guarantee given by the now-insolvent party in respect of another company's debt. Under the previous regime, it was a contentious issue whether the holder of such *in rem* guarantees had to be subject to the limitations of the insolvency proceedings (for example, whether they should be considered as a creditor, or even a contingent creditor) since their claims against the insolvent guarantor had not crystallised, even though they held a security over assets of the insolvent guarantor.

The majority trend in case law was that the beneficiary was only an unsecured creditor in the insolvency of the debtor, but it was not a creditor in the insolvency of the company owning the mortgaged or pledged asset. This did not mean that the guarantee ceased to exist, but only that the beneficiary of the guarantee did not have the same rights as a secured creditor. The key point for this distinction is that the conditions of creditor and guarantor must not always occur simultaneously: there can be creditors without guarantees (unsecured creditors) and beneficiaries of guarantees who are not creditors of the guarantor at all (this is the type this section covers).

The Restated Insolvency Act clarifies the role of holders of *in rem* guarantees who are not creditors. The applicable regime is as follows:

- The holders of secured guarantees granted by the now-insolvent company (asset holders) cannot initiate enforcement proceedings against the secured assets if the assets are deemed necessary by the insolvency judge (on their request) and enforcement proceedings already initiated will be suspended (*article 145, Restated Insolvency Act*).
- Asset holders can request the insolvency judge to issue a declaration stating that the assets are not necessary, and can initiate or continue enforcement proceedings if the insolvency judge upholds their request (*article 147, Restated Insolvency Act*).
- Asset holders can initiate enforcement proceedings, or continue those already initiated, if one year has elapsed as from the insolvency declaration or a composition agreement not affecting their rights has been approved (*article 148.1, Restated Insolvency Act*).

The last restriction regarding enforcements is that such proceedings cannot be initiated once the liquidation phase has been opened; it is not clear, though, if this restriction applies to holders of *in rem* guarantees, who are not at the same time creditors, given that the Restated Insolvency Act literally extends such limitation to creditors only. Concerning this restriction, *article 404.2* of the Restated Insolvency Act establishes that creditors may initiate enforcement proceedings if a composition agreement they were bound by has been breached.

Appraisal of the asset securing the debt

Assets securing debts must be valued, in order to avoid an asset with a negligible value leading to any debt being ranked as secured. *Article 272.2* of the Restated Insolvency Act establishes that the appraisal is only carried out for the purpose of calculating the majorities in composition and refinancing agreements. Therefore, regardless of the appraisal value filed during the insolvency proceedings, all proceeds deriving from the sale of the asset will be used to satisfy the secured creditor.

Liability of directors

The Restated Insolvency Act has increased the number of liability actions (specifically corporate liability actions based on the general breach of the fiduciary duties of directors) that fall under the jurisdiction of the insolvency judge. The insolvency judge will also decide on liability actions filed against a natural person representing a director

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that is a legal person and against the persons (regardless of their formal title) who hold the highest positions in the company, provided that the board of directors has not granted powers to managing directors (*consejero delegado*).

As regards liability for actions causing or worsening the insolvency situation, *article 455* of the Restated Insolvency Act excludes those holding general powers of attorney (*apoderados generales*) from the potential liability but includes general managers (*directores generales*), along with directors and shadow directors.

One of the potential consequences for liable persons that caused or worsened the insolvency situation is being ordered to cover the insolvency deficit. This is defined as the shortfall between the value of the assets as recognised in the report by the insolvency practitioner and the value of the debts included in the report.

Temporary measures adopted due to COVID-19

Certain temporary measures were introduced by act 3/2020, of 18 September, on procedural organisation measures to address COVID-19 within the justice administration (*ley 3/2020, de 18 de septiembre, de medidas procesales y organizativas para hacer frente al COVID-19 en el ámbito de la Administración de Justicia*) (*Act 3/2020*). These measures were amended by:

- Royal decree-law, 34/2020, of 17 November, of urgent measures to support corporate solvency and the energy sector, and tax matters (*Real Decreto-ley 34/2020, de 17 de noviembre, de medidas urgentes de apoyo a la solvencia empresarial y al sector energético, y en materia tributaria*) (*RDL 34/2020*).
- Royal decree-law 5/2021, of 12 March, on extraordinary measures to support business solvency in response to the COVID-19 pandemic (*Real Decreto-ley 5/2021, de 12 de marzo, de medidas extraordinarias de apoyo a la solvencia empresarial en respuesta a la pandemia de la COVID-19*) (*RDL 5/2021*).

References to Act 3/2020 will include the amendments introduced by RDL 34/2020 and RDL 5/2021.

These measures were adopted with the intention of promoting the refinancing of companies.

Refinancing and pre-insolvency mechanisms

The general rule prevents debtors from certifying refinancing agreements more than once a year. The purpose of this rule is to avoid refinancing agreements becoming mere provisional solutions that do not guarantee the viability of the insolvent company.

Article 5 of Act 3/2020 permits insolvent debtors to amend the refinancing agreement more than once or enter into more than one refinancing agreement within a one-year period. Under RDL 5/2021, this temporary measure will remain in force until 31 December 2021.

The following (expired) temporary measures also provided some protection from applications requesting a declaration that prior refinancing agreements have been breached:

- **Applications dated between 31 October 2020 and 31 January 2021.** These applications were communicated to the debtor but not processed by the insolvency judge until 28 February 2021.

  During the month of February 2021, debtors were entitled to file for pre-insolvency, giving them three additional months to reach a new refinancing agreement. If a new agreement was not reached in this period,

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the insolvency judge would allow applications for declarations of breach of refinancing agreements to proceed.

- **Applications dated between 31 January 2021 and 30 September 2021.** These applications are already communicated to the debtor, but will not be processed by the insolvency judge until 30 October 2021.

  Until 30 October 2021, debtors are entitled to file for pre-insolvency, giving them three additional months to reach a new refinancing agreement. If a new agreement is not reached in this period, the insolvency judge will allow applications for declarations of breach of refinancing agreements to proceed.

  This also applies to requests filed and processed between 31 January 2021 and 13 March 2021. For such purposes the proceedings will be suspended.

In addition, the insolvent company's related parties (for example, shareholders, directors, companies within the same group of companies, and so on) that made new cash contributions since 14 March 2020 will improve their ranking in the insolvency waterfall by ceasing to rank as subordinated creditors if the insolvency is declared on or before 14 March 2022. This ranking will be extended to the purchasers of the claims in the event of credit assignments.

Possibility to delay filing for insolvency until 31 December 2021

Directors of insolvent companies have to file for insolvency within two months following the moment in which they became or could have become aware of its state of insolvency. Breaching such an obligation is one of the grounds for an insolvency being declared tortious.

Directors will have no obligation to file for insolvency until 31 December 2021 and they will be protected until such date against applications for insolvency filed by creditors. Act 3/2020 clarifies that the two months to file for insolvency will start from 1 January 2022, which in practice means that the debtor would not have the obligation to file for insolvency until 1 March 2022. The wording of Act 3/2020 seems inconsistent since between 1 January 2022 and 1 March 2022, the debtors would have no obligation to file for insolvency but at the same time insolvency requests filed by creditors would be processed. In view of this contradiction, the cautious position for the debtor is to file for insolvency before 1 January 2022.

If directors initiated pre-insolvency proceedings (known as the "5 bis proceedings") before 31 December 2020, they have six months to file for insolvency (instead of the usual four months).

Although the intention of these measures was to avoid a large number of insolvency proceedings during the state of alarm, many market commentators consider that these insolvencies will simply be shifted to 2022, and that at that time the companies will be in a much worse situation (for instance, less liquidity, a decrease in activity, greater liabilities, and so on).

An additional challenge that directors have to deal with is their liability in the event that the company has a negative equity value due to accumulated losses. If this were to happen, they must react quickly (by re-establishing the value of equity or by taking the necessary decisions so that the company is liquidated), or they will be declared jointly and severally liable for the debts of the company. With the purpose of avoiding a huge number of companies disappearing, the temporary measures establish that, when assessing the amount of the accumulated losses, those corresponding to the tax year 2020 will not be taken into account. However, the losses of the year 2021 will be considered and the directors will be obliged to comply with their duties to avoid liability.

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Measures to protect companies in the process of complying with a composition agreement (convenio de acreedores)

One of the possible (and desirable) solutions in an insolvency process is for the creditors to reach an agreement that enables the debtor to remain viable by applying measures such as haircuts and deferrals. However, when the agreement cannot be fulfilled, the debtor has the obligation to file for liquidation to avoid the value of its assets decreasing. In the event that the debtor does not file for liquidation, a creditor can do so and the directors of the debtor company may be held liable.

Until 31 December 2021, the debtor is allowed to reach an agreement to amend the composition agreement, thus avoiding the need to file for liquidation (*article 3, Act 3/2020*).

Depending on the content of the agreement and the sacrifice creditors are requested to make, the amendment may require:

- A single majority of the ordinary claims.
- A majority of 50% of the ordinary claims.
- 65% of the ordinary claims.

Secured creditors can be dragged along by the original agreement if the majority thresholds of creditors of the same class are reached. However, they cannot be bound by the amendment unless they specifically approve it.

In the event that creditors filed an application for a declaration of the breach of the agreement between 30 October 2020 and 31 January 2021, the judge will not allow them to proceed until 30 April 2021. In the meantime, the debtor is given the opportunity to react and negotiate an amendment so that the company is not liquidated.

If the application is filed between 31 January 2021 and 30 September 2021, the judge will not allow the creditors to proceed until 30 December 2021. In the meantime, the debtor is given the opportunity to react and negotiate an amendment so that the company is not liquidated.

This will also apply in the event that the application was filed and processed by the court. For such purpose, the proceedings will be suspended.

In the same way as for the refinancing and pre-insolvency mechanisms (see *Refinancing and pre-insolvency mechanisms*), if the debtor fails to comply with its payment obligations, the agreement is ultimately breached, and the liquidation phase is opened by 14 March 2022, new money will rank as claims against the estate (that is, they will improve their ranking in the insolvency waterfall), even if the money was provided by parties that are related to the debtor.

Timing of the application of the Restated Insolvency Act

In Spanish law, there have been other cases of restatements, including substantial amendments (such as the Companies Act, which was restated in 2010). In such cases, courts have highlighted the application of the criterion *tempus regit actum*, which means that the acts are governed by the applicable law in force at the time they are carried out. This means that the restatement should not have retroactive effects, but also that it must apply to any future actions, regardless of whether the proceedings were initiated before or after the restated version entered into force.

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The only exception to the criterion *tempus regit actum* is if the new rules are merely interpretative or intend to clarify former rules. However, there are some articles of the Restated Insolvency Act which have entailed in practice a material amendment of the Insolvency Act in force before 1 September 2020.

There is a lack of agreement among scholars and commentators as to what judges must do in the event that they consider that the Restated Insolvency Act has exceeded the purpose of restating the existing Insolvency Act. Some commentators consider that judges must ignore the substantial amendment, following case law of the Spanish Constitutional Court, since such amendment would have been passed ultra vires. Others have the position that the interpretation of a potential ultra vires amendment must be very narrow and that these kinds of situations are exceptional. The general opinion is that this issue can be avoided if the Spanish Parliament approves an amendment of the Restated Insolvency Act concerning the provisions which have raised doubts regarding whether they amount to an ultra vires amendment or not. If this does not happen, it is certain that Spanish practitioners will be discussing which provisions are new and which are not, and which may have gone beyond the purpose of a restatement.

The courts have already issued decisions asserting that some of the rules of the Restated Insolvency Act have been passed ultra vires. The ruling of the Barcelona Labour Court 5 dated 29 January 2021 [JUR 2021\54685], in relation to the jurisdiction of the insolvency judge concerning labour debts in the sale of business units considered that labour courts, and not the insolvency courts, had jurisdiction in such issues. Likewise, the ruling of the Barcelona Insolvency Court 7 dated 8 September 2020 and the ruling of the Valencia Insolvency Court 3 dated 8 February 2021 [JUR 2021\76126] considered that the rules concerning the cancellation of debts in the case of individuals (*exoneración del pasivo insatisfecho*) are also a case of ultra vires legislation. In such cases, the courts have applied the rules in force before the Restated Insolvency Act.

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