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New restructuring plans

Impact of the insolvency reform on creditors, shareholders and directors

June 30, 2022

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Key aspects of the reform in terms of pre-insolvency for creditors, shareholders and directors

The imminent approval of the draft bill amending the Insolvency Act will bring about a significant change to restructuring transactions.
It will afford new debt restructuring opportunities giving a more prominent role to **creditors**, who will be able to benefit from pre-insolvency instruments providing greater speed and flexibility, and offering a greater scope, as they allow the possibility of cramming down all classes of creditors.

The reform will mean a paradigm shift for **shareholders** given that, if certain conditions are met, creditors may be able to impose a restructuring plan on them.

If companies face the risk of insolvency, their **directors**, acting with the duty of diligence required of them, must adopt measures to avoid that insolvency or mitigate any harmful consequences, encouraging, if applicable, the negotiation of a restructuring plan.

Impact of the insolvency reform on creditors, shareholders and directors

Today, June 30, 2022, is the end date of the moratorium on insolvency proceedings that, since April 2020, has suspended the obligation of insolvent debtors to file for insolvency and the possibility of creditors to request their declaration of insolvency.

The end of the moratorium was expected to coincide with the entry into force of the draft bill amending the Insolvency Act to incorporate the Directive on Preventive Restructuring (the "**Reform**"), which is currently being processed for approval by the Spanish Parliament. However, given the delay in parliamentary processing with regard to the schedule originally envisaged for implementation, it will likely be several weeks before it enters into force. In any case, we estimate that, despite the delay, the Reform will soon be approved and will enter into force during the third quarter of 2022.

The Reform will bring about a **complete overhaul of the Spanish insolvency system**, particularly with regard to pre-insolvency instruments. The purpose of the restructuring plans, which will replace refinancing agreements, may be to change the conditions or structure of the debtor's assets and liabilities, or its equity. The plans may also involve the transfer of assets, business units or of the whole company.

The entry into force of the Reform will afford **new debt restructuring opportunities** giving a more prominent role to creditors, who will be able to benefit from pre-insolvency instruments providing greater speed and flexibility, and offering a greater scope, as they allow the possibility of cramming down all types of creditors (financial, commercial and even holders of public law credits that meet certain requirements) and shareholders of insolvent companies.

To facilitate debt restructuring at an earlier stage, the Reform allows notifying the competent court that negotiations have been opened with creditors or that the negotiation and signature of the restructuring plan has been carried out when the debtor's circumstances indicate a "**likelihood of insolvency**," that is, when it is objectively foreseeable that if a restructuring plan is not agreed, the company will be unable to regularly meet its obligations falling due in the following two years. Also, it will still be possible to seek a pre-insolvency solution in cases of imminent insolvency, which has been redefined as the foreseeable inability to meet obligations falling due in the following three months. Current insolvency is still considered to be a financial state in which it is possible to seek a pre-insolvency solution.

As discussed below, how the debtor's financial state is qualified is vital when it comes to negotiating the restructuring plan and imposing the plan on the shareholders.

In terms of pre-insolvency, the new system includes new developments that greatly affect creditors, shareholders and directors of limited companies in a situation of pre-insolvency. We summarize the main points below, focusing first on the impact on creditors, and then on shareholders and directors. We will set out these developments[1] following the chronological order common to the negotiation of most restructuring plans:

- Start of negotiations and notice to the competent court that negotiations have been opened
- Negotiation of the restructuring plan between the creditors and the debtor's governing body
- Approval by the debtor's partners meeting, if required, of the measures affecting the shareholders' rights
- Court sanction

We refer only to Spanish public and private limited companies that are not considered SMEs (i.e., those with an annual turnover of at least EUR 10 million and at least 50 employees). The system applicable to SMEs imposes other rules that must be taken into account if applicable. Likewise, the Reform establishes a special procedure for micro-enterprises (those with fewer than 10 employees and less than €700,000 annual turnover or €350,000 in liabilities), in which creditors play a more decisive role, which we will not focus on in this newsletter.

[1] In this newsletter we refer to the draft bill initially submitted to Parliament with the amendments included in the Commission's opinion approved in the the plenary session today, June 30. Several compromise amendments have also been approved in this session, the text of which is pending approval. The project will now be discussed in the Senate. We will publish an updated version of this newsletter when the Reform is definitely approved.

Main new developments for creditors

Notice of the opening of negotiations: suspension of foreclosures and applications for mandatory insolvency

With a scope similar to the previous system, the debtor is still entitled to notify the competent court that it has entered into negotiations with its creditors to reach a restructuring agreement. The effects of that notice can last for up to three months with the possibility of requesting a three-month extension (if certain requirements are met). This notice is crucial for the role creditors play, as it enables the temporary suspension of individual, judicial or out-of-court enforcement over the assets required for the debtor to continue its business activity, as well as the start of new enforcements and the enforcement of securities *in rem*.

The notice alone will not affect agreements establishing reciprocal obligations pending fulfillment, and any contractual clauses stating otherwise will be considered void. Also, early termination of these agreements on the grounds of the debtor's previous non-compliance will also be suspended, as long as the agreements are necessary to ensure the continuity of the business activity.

Moreover, creditors will not be able to file for mandatory insolvency proceedings while the notice period regarding negotiations is in force.

Affected credits

One difference with the previsions on refinancing agreements under the previous system is that restructuring plans may have an impact on all kinds of creditors and credits, with very few exceptions, and all affected parties are entitled to participate in the approval of the plan. This means that financial and commercial creditors may be affected, including contingent credits and those subject to conditions, in which case special calculation rules apply. Public law credits will also be subject to conditions and restrictions with regard to the effects that can be imposed.

In contrast, credits for non-contractual civil obligations and labor credits will not be affected unless they involve senior management contracts, which may be affected if so required for the restructuring to be successful.

Formation of credit classes

One of the main aspects for new restructuring plans to be successful is the formation of credit classes, as this will be decisive for the approval of the plan and for establishing its content.

The criteria for class formation are relatively open, despite there being some imperative rules that must be observed at all times. Specifically, one mandatory general rule is that credit classes must always be formed on the basis of a joint interest of credits belonging to the same class. The guiding principle behind that joint interest is the rating established in the insolvency classification of credits, so that credits belonging to the same class have the same insolvency rating. Also, credits with securities in rem will make up an individual class and public law credits will make up a separate class within their respective insolvency rating.

However it is possible to separate credits belonging to the same insolvency rating into different classes when different joint interests exist within the same rating, in view of the open criteria (e.g., how the credit is affected, different guarantees, different credit nature).

The debtor or majority of creditors potentially affected by the restructuring plan may request judicial confirmation regarding the adequacy of class formation before requesting the court sanction of the restructuring plan, thus exhausting the possibility of opposing or bringing a challenge on these grounds if the class is confirmed.

Approval of the plan by creditor classes

The plan is voted on by the different credit classes. Approval of the plan requires the favorable vote of two-thirds of the class liabilities, or three-quarters if it is a class of credits with securities *in rem*.

The court sanction of the plan can be obtained with different levels of consensus by the creditor classes. The approval of the debtor is also required in certain circumstances, as explained below. Thus, first of all, the plan will be validated if it is approved by all of the creditor classes. Failing that, the sanction will depend on the approval of a majority of the formed classes, as long as at least one class of those voting in favor is a class with a privileged insolvency rating. And, failing that, it may be validated if it has been approved by at least one class that is "in the money."

Court sanction and cramdown effects on creditors

For the restructuring plan to be court-sanctioned, as well as the requirements of content, form and approval by the credit classes and, if applicable, by the debtor, it must offer a reasonable prospect of avoiding insolvency, ensure the debtor's viability in the short and mid term, and treat creditors of the same class equally. Other requirements have been determined as grounds for challenge and would eventually be monitored if a challenge is presented.

The court sanction of the restructuring plan can extend its effects to all credits affected by the plan. As a result of the Reform, there is a much greater possibility of extending the effects of a restructuring plan to dissenting creditors within the same category, and this extension of effects also applies to whole categories of creditors, even those in higher ranks.

Agreements establishing reciprocal obligations pending fulfillment. Contracts entered into with executive directors and senior management staff

Agreements establishing reciprocal obligations that the debtor has entered into will remain in force. Thus, the request for the court sanction of the restructuring plan, its admission to processing, and, logically, the court sanction itself will not affect these agreements, and any contractual clauses stating otherwise or allowing the parties to change this rule will be considered void. The Reform lays down the same rule regarding the notice that negotiations have been opened with creditors.

However, it introduces the possibility for the restructuring plan to terminate these agreements for the benefit of the restructuring, as long as the debtor has previously asked the other party's consent to amend the contractual terms or terminate the agreement. The affected contractual party can challenge the termination of the agreement, claiming that it is not necessary for the restructuring to be successful, and it can claim compensation for the early termination of the agreement. Compensation resulting from termination may be subject to the plan.

Likewise, it specifically allows the suspension or termination of contracts entered into with executive directors and senior management staff if so required for the restructuring to be successful. Any resulting compensation can be modified by the judge in charge of the court sanction, overruling any amount determined to that effect in the agreement.

Protection in cases of later insolvency: particularly, new money and interim financing

If insolvency is declared after a plan is court sanctioned, the Reform grants protection against clawback actions of acts carried out in the context of promoting or implementing the plan. Specifically, it protects transactions necessary for the negotiation of the plan to be successful, transactions necessary to implement the plan, and interim financing and new money, that is, financing granted during the negotiation of the restructuring plan to ensure above all the continuity of the business activity, or the financing described in the plan that is necessary for it to be successful, respectively.

As well as protection against clawback actions, interim financing and new money could be given preference for payment under certain conditions.

Both types of protection are also provided for in cases where interim financing and new money have been granted by persons closely related to the debtor, although stricter requirements must be met.

Challenge of the court sanction by creditors

Dissenting creditors can oppose the court sanction of the restructuring plan through two mutually exclusive channels: before the court sanction, if the party requesting the court sanction presents a previous challenge stating the opposition of the affected parties to the same competent legal authority; or by challenging a confirmed court sanction before a higher court (court of appeals). The grounds and legal basis are the same, but they will depend on whether the plan has been approved by all creditor classes. There will be fewer grounds for challenge or opposition of plans approved by all classes.

With regard to substantive grounds for opposition or challenge, one of the grounds to challenge any restructuring plan is based on the **best interest of creditors rule**, which allows dissenting creditors to file a challenge if they would have received more in hypothetical insolvency liquidation proceedings carried out two years after formalizing the plan.

In the case of opposing or challenging plans that have not been approved by all classes, the most noteworthy involves the infringement of rules that seek equity in the solution provided in the plan, i.e., equal treatment among classes belonging to the same rank, the prohibition on granting one or several classes an amount or rights that exceed the value of their credits, and the prohibition on granting a lower-ranking class, or the shareholders, any amount or rights when the higher-ranking class to which the challenging party belongs has not been paid all of its credits (**absolute priority rule**). Exceptions will apply to the fulfillment of this rule if it is essential for the company's viability and damage to the affected credits is not unjustified.

The challenge will only render the plan ineffective if the grounds for the challenge are an insufficient majority or the inadequate formation of credit classes. Otherwise, the dissenting creditors will be released from any effects under the restructuring plan. If the effects cannot be reversed, they will be entitled to compensation for damages payable by the debtor.

Main new developments for shareholders and directors

For shareholders, the reform will mean a paradigm shift given that, if certain conditions are met, creditors may be able to impose a restructuring plan on them. In short, the new system subjects the plan to the shareholders' approval when it contains measures that require their agreement, although it sets out special rules to favor approval. In a situation of current or imminent insolvency, the plan can be sanctioned even against the shareholders' will, although this does not rule out the possibility of challenging it.

In the case of directors, the Reform does not impose a specific legal regime on the pattern of conduct they should follow in a pre-insolvency situation (as proposed in the Pre-insolvency Directive), as the Reform considers that it is implicit in the regulations on their duty of diligence, in the rules on compulsory dissolution due to serious losses, and in the insolvency liability regime.

Notice of the opening of negotiations: suspension of the legal duty to seek wind-up and suspension of the request for voluntary insolvency proceedings

The reform lays down detailed provisions on notifying the competent court of the opening of negotiations with creditors to establish a restructuring plan. Notice must be given by the debtor's governing body and it enables the temporary suspension of individual, judicial or out-of-court enforcement over the assets required for the debtor to continue its business activity during the negotiation of the restructuring plan, among other measures designed to safeguard the company's activity.

The reform introduces two important developments affecting the debtor's directors regarding this notice:

- First, the effects of the notice are extended to the legal duty to seek wind-up due to losses provided under corporate law, thus coordinating insolvency and corporate regulations. Thus, it is clarified that, while the effects of the notice are in force, **the legal duty to seek wind-up owing to serious losses** will be suspended in cases where the company's equity is reduced to an amount lower than half of the share capital. This makes pre-insolvency regulations consistent with corporate law and significantly affects the debtor's directors, who, during that period, will not have joint and several liability provided under corporate law for the company's debts.

- Second, at the creditors' or the restructuring expert's request, the judge can suspend the application for voluntary insolvency proceedings of a debtor if it is negotiating a restructuring plan and it can be proved that the plan is likely to be approved. This means that the debtor no longer has an instrument that, in practice, was sometimes used by its directors to force negotiations in more favorable circumstances.

Approval of the plan by the general meeting of shareholders

If the restructuring plan incorporates measures that, under the general rules of corporate law, must be decided by the general meeting of shareholders (e.g., the transfer of essential assets, debt for equity swaps, mergers and spin-offs), the plan will require the **approval of the debtor's general meeting of shareholders**.

To facilitate the process and the approval of the plan, the Reform introduces **special rules on calling meetings and on majorities** for the agreement to be adopted by the debtor's general meeting:

- It establishes a reduced period to call the meeting (10 days for public and private limited companies, and 21 days for listed companies).
- The only item on the agenda will be the approval or rejection of the restructuring plan on all points.
- The shareholders' right to information will be restricted to this single item.
- The resolution will be adopted, regardless of its content, following the ordinary legal quorum and majority rules. Neither the legal reinforced majorities nor those established in the debtor's bylaws will apply.

Corporate transactions included in the plan will be governed by the rules applicable to them, except the abovementioned rules on the adoption of resolutions at the general meeting. Also, the Reform disallows the preferential suscription right of the debtor's shareholders when it comes to capital increases laid down in the plan if the debtor's financial state is one of imminent insolvency or current insolvency.

Corporate measures to protect creditors adopted for these transactions are also inapplicable, particularly creditors' right to challenge structural modifications, as they will be replaced by the pre-insolvency protection rules.

The agreement of the general meeting approving the restructuring plan can be challenged in accordance with corporate law, but only using the channels and within the periods provided under insolvency law to oppose or challenge a court sanction.

Debt for equity swaps

Debt for equity swaps are likely to be a key element in restructuring plans. To facilitate these transactions, in the case of credits being converted into the debtor's shares, the credits will be considered fully liquid, due and payable, thus meeting the requirements imposed under corporate law. As mentioned above, shareholders cannot exercise preferential suscription rights even in situations of reduction of the share capital to zero and simultaneous increase made through credits set-offs if the debtor is in a situation of imminent insolvency or current insolvency.

Also, if the debt for equity swap triggers the debtor's change of corporate control, the contractual clauses on change of control that the debtor may have agreed to in agreements necessary to continue its business activity will not apply.

Court sanction and cramdown effects on shareholders

The court sanction of the restructuring plan can extend its effects to all of the debtor's shareholders. As pointed out above, shareholders attending the debtor's general meeting must vote on the plan when it includes measures falling within the scope of its powers. However, although the Reform acknowledges shareholders' voting rights, in certain cases it is possible to sanction the plan against their will and extend the effects to dissenting shareholders.

Thus, in a situation of likelihood of insolvency, and if the plan includes measures falling within the scope of the general meeting's powers, the court sanction will require an agreement from the general meeting to approve the plan. In this case, any dissenting shareholders will be crammed down by the majority principle, in the same way as other corporate resolutions. If the plan does not contain measures falling within the scope of the general meeting's powers, approval will be given by the debtor's governing body.

In a situation of imminent insolvency or current insolvency, the court sanction is not subject to the debtor's approval of the restructuring plan. If the shareholders attending the general meeting vote against the plan, this will not prevent the sanction and the effects of the plan from subsequently being extended to all of the shareholders and the debtor. Naturally, if the general meeting approves the plan, the effects will be extended to dissenting shareholders owing to the majority principle. If the plan does not contain measures falling within the scope of the general meeting's powers, whether it is approved or rejected by the governing body will not affect whether the court sanction is successful or the extension of its effects.

Any corporate transactions envisaged in the court sanctioned plan must be carried out according to the procedure set out under corporate law. However, if it is necessary for the debtor's general meeting to authorize those transactions and it has not given its approval, the company directors will have the powers to carry out any actions required to implement the plan and to make any necessary changes to the bylaws. If the directors fail to do so, the judge can grant powers to another person to carry out these actions. The court order sanctioning the plan will be sufficient to register the bylaw amendments established in the plan in the commercial registry.

Challenge of the court sanction by shareholders

It is also envisaged that, if certain circumstances are met, the debtor's shareholders can challenge the court sanction of the restructuring plan.

If the shareholders' challenge against the court sanction is successful, the effects will not be extended to the challenging parties, but will remain valid against the others.

However, if the effects cannot be reversed, the challenging shareholder will be entitled to compensation for damages.

If the debtor's general meeting approves the plan, the shareholders cannot challenge the court sanction. The resolution of the general meeting approving the plan could still be challenged.

Directors' duties in pre-insolvency situations

Under the Reform, as under the current system, the debtor will still have management and administration powers over the company's assets while a pre-insolvency solution is being sought, even if a restructuring expert is appointed.

The Spanish lawmaker does not consider it necessary for insolvency law to include a specific regime on the duties of the debtor's directors in pre-insolvency situations, as they are already implicit under applicable law. If companies face the risk of insolvency, their directors, acting with the duty of diligence required of them, must adopt measures to avoid that insolvency or mitigate any harmful consequences. In exercising their functions and fulfilling their duties, the debtor's directors have the necessary powers to open negotiations with creditors, submit the notice of the opening of negotiations to the judge, and ask the court to sanction the restructuring plan.

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"Consistently shown not only a deep understanding of the legal aspects of the situation but are also able to understand the commercial strategy." Chambers, 2022

"Pragmatic and constructive in negotiations." Chambers, 2021

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Firm recognized as one of the main law firms in Restructuring and Insolvency category, 2021

Law firm of the year in Restructuring and Insolvency in Spain

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