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Impact of COVID-19 on Direct Lending and NPL transactions in Spain

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Introduction

The COVID-19 pandemic has brought a new economical landscape in Spain. Fortunately, after setting up a robust financial system architecture in terms of supervision and liquidity, our banking and financial system is in a completely different position than in 2008-2013 crisis —due especially, on the one hand, to high solvency ratios of such financial entities and, on the other, the liquidity profile supported both by national bodies and the European Central Bank.

In order to address the health emergency, the Spanish Government approved Royal Decree 463/2020 of 14 March, which declared a state of alert[1] for the management of the health crisis situation caused by COVID-19 ("RD 463/2020"), aimed at protecting the health and safety of citizens, containing the progression of the disease and strengthening the public health system.

To analyze the legal impact on the financial and credit system, we must consider the measures adopted by the Spanish government through several Royal Decree-Law (“**RDL**”). Such RDL are a piece of legislation approved by the Government itself with the same ranking as the ordinary Act/Law that approved by the Spanish Parliament. Such “legislative” power of the Government can only be used in case of urgency, as the case at hand. The RDLs need to be confirmed by the Spanish Parliament afterwards.

In general terms, COVID-19 regulation is provisional and limited to the duration of the state of emergency (and, as the case may be, to a limited extended period), other than the Foreign Investrment regime described below. Therefore, it does not entail a general moratorium, nor a standstill on obligations under financing agreements or on enforcement actions.

[1] The State of Alert has been extended until 21 June 2020. No further extension is foreseen.

Investment opportunities in Spain – direct lending and NPLs

Direct lending and NPL transactions are not a new phenomenon in Spain. Direct lending emerged strongly after the financial and real estate crisis (2008-2013) and it has rapidly developed in Spain through many specialized funds with different profiles and targeting diverse transactions and business niches, mainly in the construction, real estate and hotel industries.

We do believe that the COVID-19 crisis will provide further opportunities for direct lending. In our view, neither banks nor public financial aid will be capable of meeting all liquidity needs required after the significant impact of the COVID-19. In this respect, the Spanish Government, through the so called “ICO lines”, is being injecting funds in certain cases to some Spanish companies – nevertheless, such injections will not suffice for covering all the liquidity needs in the short and medium term – there is way more demand than supply in relation with such financings.

Therefore, opportunities for bridge, senior and mezzanine financing, along with other forms of financing for corporate needs, will dramatically proliferate in the short and medium term, and the main players of the direct lending sector should be prepared for those.

Likewise it should also be taken into consideration that the COVID-19 impact in the default level of secured and unsecured loans will probably increase the number of possibilities both in terms of primary and secondary NPLs market.

COVID-19 measures (I) - Moratorium on debt

The Spanish Government has introduced a legal moratorium on certain type of debts for certain individuals (not corporations). The moratorium period has been affected by RDL 8/2020 (as amended by RDL 11/2020) and RDL 19/2020.

The RDL 8/2020 foresees a mortgage-backed legal moratorium granted for the acquisition of first residences, for those debtors who prove to be in a situation of "economic vulnerability"[2].

[2] People who meet the following circumstances cumulatively are economically vulnerable:

- The potential beneficiary becomes unemployed or, in the case of an entrepreneur or professional, suffers a substantial loss of income or a substantial drop in turnover of at least 40%.
- That the total income of the members of the family unit does not exceed, a specific amount a month.
- The amount of the moratorium plus basic expenses and supplies is equal to or greater than 35 per cent of the net income received by all members of the family unit.
- That, as a result of the health emergency, the family unit has suffered a significant alteration in its economic circumstances in terms of its efforts to access housing.

By means of RDL 11/2020, this moratorium has also been extended to mortgage loans contracted for the acquisition of:

- property used for economic activity by entrepreneurs and professionals (individuals, not corporations) who can prove that they are in a situation of "economic vulnerability", and
- Rented residence where the owner and lessor has ceased to receive the rental income from the tenant.

RDL 11/2020 also extended the moratorium on debts arising from loans and credits not secured by mortgage.

The period of the moratorium is **three months** and can be extended by agreement of the Council of Ministers. During this period of the moratorium:

- no amount shall be due to the mortgage debtor,
- no interest will be accrued,
- no default interest shall be charged, and
- the early maturity of the loan in question cannot be declared.

The final maturity of the loan will be extended by the duration of the moratorium. The debtor will need to expressly ask for such moratorium. andthe lender is obliged to accept such extension within fifteen days from such request.

A debtor who takes advantage of this measure without qualifying for it shall be liable for damages and expenses incurred in the application of this measure and for any other liability that may arise from his conduct.

RDL 19/2020 introduces the so-called “moratorium by agreement,” establishing a special system for agreements reached between a debtor and a financial institution that are subject to the provisions of sectorial framework agreements between financial institutions through their representative associations (e.g., those entered into by the Spanish Confederation of Savings Banks and the Spanish Banking Association in April 2020, which are normally not applicable to players in the direct lending market).

In the framework of the measures to reactivate the tourism in Spain, the Spanish government is planning to grant a 12 month moratorium for the loans secured with real estate assets linked to the touristic sector. Only interest will be payable during such moratorium and the amount of principal postponed would need to be repaid either by extending the maturity of the facility or by increasing the amounts paid in each of the installments due after termination of the moratorium. In case the touristic asset is leased to

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a third party, the owner of the asset will be obliged to request the moratorium, benefiting the tenants for this liquidity measure. The piece of legislation approving this measure is yet to be enacted, but it is expected shortly.

COVID-19 measures (II) - Moratorium on rent

The Spanish Government has introduced the following measurement of Residential and Non-Residential Leases by means of RDL 11/2020, as follows:

Residential Leases:

- Eviction on "vulnerable" individual lessees with no alternative housing options has been suspended for six months.
- Extraordinary extension for up to 6 months of main residence lease agreements that expire between April 2, 2020 and 2 months following the end of state of alarm.
- In case the owner of an asset is a "large housing asset holder" (owning 10 or more urban properties, excluding parking lots and storage space or owning a built surface area of over 1,500 square meters), at the lessee request, the lessor can choose either (i) to apply a 50% reduction on the rental fee while the state of alarm lasts and, ultimately, for the following months after it ends if the term is insufficient owing to the situation of vulnerability (up to 4 months); or (ii) no collect rent (during the same term).

  The deferred rent must be paid back in instalments within 3 years (at least), and no interest will accrue on this amount.

Non-Residential leases:

- In case the owner of an asset is a "large housing asset holder" (as defined above), at the lessee request (either self-employed workers or SMEs under certain requirements), a moratorium in the payment of the rent must be accepted by the Landlord. The moratorium will affect the period that the state of alarm lasts (including its extensions) and the following monthly payments in case the impact of the COVID-19 prevails (which may be extended month by month), but in no case they may exceed 4 months.

The deferred rent must be paid back in instalments within 2 years from the moment the aforementioned situation or the 4 months expire, but always within the term of the lease.

COVID-19 measures (III) - Insolvency proceedings

Please find below what we believe are the two main points for direct lending and NPL participants that should be taken in respect with the COVID-19 measures on Insolvency Proceedings:

- (According to the Insolvency Act 22/2003 of July 6, insolvency proceedings are only triggered if the debtor is in a state of insolvency (actual or imminent insolvency). A debtor is deemed insolvent when it is regularly unable to meet its obligations as they become due (cash flow test). In general terms, the debtor has the duty to file for insolvency within two months from when it becomes aware or should have become aware of its state of insolvency. Director's personal liability can result if the debtor fails to fulfill this obligation.

  Notwithstanding the above the RDL 16/2020 (amending what previously regulated by means of RDL 8/2020) provides that, even if the debtor falls under the definition of voluntary insolvency, it will not be obliged to file for insolvency until December 31, 2020. Likewise, no mandatory insolvency proceeding will be accepted by the courts until such date.

- Likewise, it has been approved an improved treatment of financing by "inside parties" or "closely related parties" (*personas especialmente relacionadas*). To this respect in insolvency proceedings filed on or before March 14, 2022, financing granted by such "closely related parties" would not be subordinated, by rather considered as ordinary credits.

Other developments in insolvency regulations

On 7 May 2020, Royal Legislative Decree 1/2020 of 5 May was published in the BOE, approving the revised text of the Bankruptcy Law (TRLC). The TRLC will come into force on 1 September 2020 and, among other regulations, will repeal the current Law 22/2003, of 9 July, on Bankruptcy (LC) and some - but not all - of its additional and final provisions.

The Insolvency Regime should not be considered as amended, but only restated and developed, clarifying certain aspects already provided by the relevant case law. It has also better structured the pre-insolvency regulation.

Likewise, it is foreseen that Spain will adapt its insolvency regulation to the European Regulation (no. 2019/2023). This regulation will probably grant more leverage to a direct lending participant towards any debtor and its shareholders, as the European Regulation even envisages potential equity cramdowns (which are not available as per current Spanish regulation). This developments should be followed and be taken into consideration for any pre-insolveny restructuring.

Foreign investments in Spain

We highlight herein a new regime applicable to foreign investments in Spain.This should be taken into consideration for both direct lending and NPLs transactions in case the debtor is operating in one strategic sector, which affects "public order, public security, and/or public health", or regardless of the sectors in which the debtor operates, if the investor meets certain requirements as explained below.

In such cases, it should be noted that any pledge over shares of Spanish borrowers would be permitted, but the enforcement of such pledge of shares should take into consideration the references set out herein. This is the reason why this foreign investment regulations should be taken into consideration both in direct lending and NPLs transactions.

Until March 2020, foreign investments were liberalized in Spain, with some exceptions (related to certain sectors, such as national defense, air transport, gambling and telecommunications).

Following the declaration of the state of alarm by Royal Decree 463/2020 of 15 March, the Spanish Government has suspended the regime of liberalisation of certain foreign investments by means of RDL 8/2020 (as amended by RDL 11/2020). The Spanish government provides a prior authorization system for so-called "direct foreign investments" in two cases: one based on the type of company in which the investment is made, and one on the investor's profile. We explain both situations below.

The Memorandum of the RDL 8/2020, which introduces a new art.7 bis in Law 19/2003, justifies the measure in view of the Government's concern to protect Spanish companies against possible acquisitions in a disadvantaged situation due to the crisis caused by COVID-19: "*The recent impact of the crisis triggered by COVID-19 on the world's stock markets poses a certain threat to listed Spanish companies, but also to unlisted companies, many of which are seeing their asset value reduced in strategic sectors of our economy, from the launch of operations to acquire them by foreign investors*".

Please also note that this regime is still subject to further development by the Spanish authorities and we are aware that new regulation is currently being developed, so the situation may change in the following weeks or months.

"Direct foreign investments" are those equity investments:

- in which the investor goes on to hold a share equal to or greater than 10% in the Spanish company's capital or, when as a result of the transaction, takes an active part in managing or controlling that company; and
- made by investors resident in states outside the European Union (EU) or the European Free Trade Association (EFTA); or by investors resident in an EU or EFTA state whose beneficial ownership ("titularidad real") is held by a non-resident (i.e., when a non-resident holds, or ultimately has direct or indirect control of over 25% of the company's capital or its voting

rights, or when, through any other means, it exercises direct or indirect control over the investor).

"Direct foreign investments" will require the prior authorization when comprised in any of the following situations:

- Based on the **target company's profile**, when the target company operates in strategic sectors, that affect "*public order, public security, and/or public health*". More specifically affected sectors include, among others, critical infrastructures, critical technologies, provision of fundamental inputs such as energy and sectors with access to sensitive data.
- Based on the **investor's profile**, regardless of the sectors in which the investment is made, affecting, among others, all sovereign funds and public companies dependent on third countries.

Generally, authorization for Direct Foreign Investments in the circumstances provided in paragraphs 1. and 2. must be granted by the Spanish Council of Ministers. However, there is a simplified authorization system, to be resolved by the corresponding person at the General Directotate of International Trade and Investment, for transactions for a value of between 1 million and 5 million euro. Also, investments under 1 million are exempt.

Investments executed in Spain without prior authorization, if deemed mandatory, will be void and of no legal effect and they will be considered an infraction punishable with fines of up to the economic value of the transaction and at least €30,000.

For more details, see our Legal Flash on Foreign Investment in Spain: key aspects.

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