Insolvency

Main Keys to the Reform of Insolvency Law in the Pre-Insolvency Scenario

Analysis of the main changes introduced by the amendment to the Insolvency Act that will come into force on 26 September 2022[1] in the pre-insolvency scenario.

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1. Introduction

On 6 September last, the Official Journal of Spain published Act 16/2022, of 5 September, amending the recast version of the Insolvency Act, approved by Royal Legislative Decree 1/2020, of 5 May, for the transposition of Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

This brings to a close the tortuous and belated passage of the amendment that we began to learn about just over a year ago, when the Spanish Government submitted to public consultation the Draft Insolvency Act Amendment Bill.

This is a profound reform of the Spanish insolvency system, taking advantage of the obligatory transposition into Spanish law of Directive (EU) 2019/1023[2], which has had

[1] The insolvency amendment will enter into force on 26 September, except for the changes introduced in the Third Book ("Special Proceedings for Microenterprises"), the entry into force of which is postponed to 1 January 2023.

companies and legal operators on tenterhooks since its inception due to the concern generated by the difficult economic situation that our country is going through just at the time of its passage.

According to data published by Axesor[3] in the month of August, following the lifting of the insolvency moratorium in force until 30 June 2022[4], insolvency proceedings in Spain increased by 21.72% in July compared to the same month the previous year. Meanwhile, according to studies carried out by Cepyme[5], the slowdown in the recovery of the Spanish economy and the adverse impact of inflation on company accounts increased business delinquency by 42%.

In this context of growing cases of insolvency, with a depressed economy and a notable increase in business delinquency, the amendment introduces new features of real significance in our insolvency system.

Throughout this article we will analyse the profound renewal of pre-insolvency law, which has the clear objective of resolving - as soon as possible - the financial difficulties that debtors may face, thereby avoiding the opening of insolvency proceedings.

2. Reform of Spanish pre-insolvency law.

This is undoubtedly the most important development of the reform, which amends Book Two of the Insolvency Act, entitled "Pre-insolvency Law", in its entirety.

With a view to ensuring that the pre-insolvency scenario facilitates the achievement of agreements between debtor and creditors, avoiding the commencement of insolvency proceedings, the amendment introduces the following new features:

- In order to facilitate the earliest possible action, the "insolvency scenarios" are extended to three, adding to imminent or current insolvency that of likelihood of insolvency, which will be the case when it is objectively foreseeable that the debtor will be unable to meet the obligations falling due in the following two years and which will allow the debtor to communicate the start of negotiations with creditors[6].

[2] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt. The deadline for this, after its extension, expired on 17 July 2022.

[3] https://www-eleconomista-es.cdn.ampproject.org/c/s/www.eleconomista.es/economia/amp/11900149/Los-concursos-de-acreedores-aumentaron-%E2%80%A6.

[4] Royal Decree-law 27/2021, of 23 November, extending certain economic measures to support the recovery, approved the extension of the moratorium granted on the duty to petition the opening of insolvency proceedings until 30 June 2022. It also specifies that the two-month period available to the debtor to petition the opening of insolvency proceedings - ex Art. 5 of the Recast Version of the Insolvency Act (hereinafter, "TRLC") - must be calculated as from 1 July 2022, which means that its expiry is on 1 September.

[5] https://cepyme.es/wp-content/uploads/2022/07/NdP-Morosidad_1T2022.pdf

[6] Note that we have gone from being able to apply for pre-insolvency proceedings in the two months prior to being in a state of insolvency to being able to do so two years before that moment arrives, although in that context it will not be possible to drag the shareholders or impose the Plan on the debtor itself - which seems reasonable given that the value of the company (and therefore of its shares or holdings) in that very initial insolvency scenario may not have deteriorated substantially.

- The schemes of arrangement that we knew until now have been replaced by Restructuring Plans, whose scope of action is much broader.

- Thus, the new Restructuring Plans will not only affect liabilities, but may also affect the debtor's assets, with measures such as the sale of assets or production units or even the entire company, with the novelty - which may be important in some processes - of allowing the termination of contracts with outstanding mutual obligations and senior management contracts.

- With regard to liabilities, unlike the current system, in which the effects of a scheme of arrangement could only be extended to creditors with financial claims, the Restructuring Plan will also allow the carry-over of other liabilities (including expressly those of a contingent or conditional nature), such as commercial liabilities, general government claims and even shareholder claims (the latter two with certain limitations).

- In order to proceed with its approval, the Restructuring Plan must group creditors into classes. The amendment grants great leeway to the parties pushing forward the Restructuring Plan for the configuration of each class, simply providing general guidelines or principles to ensure objectivity in the differentiation of each class (i.e., the existence of a common interest, equality of insolvency rank or type of claim)[7].

- The Restructuring Plan shall be deemed to be approved, as a general rule, when it has the favourable vote of each and every one of the classes affected by it.

  To do so, a favourable vote must be obtained in each class by creditors holding more than two-thirds of the liabilities included in the class, if it is a class without security interests, or by creditors holding more than three-quarters of the liabilities, if it is a class consisting of secured claims ("with special privilege")[8].

  The amendment not only envisages the intra-class cramdown (the cramming down of dissenting creditors within a class that has voted in favour, already provided for in the previous regime), but also the so-called inter-class cramdown, i.e. the cramming down of entire classes of creditors that have voted against the Restructuring Plan. For this, the Restructuring Plan must have been approved

[7] Certain classes are provided for, the configuration of which is already determined by the amendment. Thus, secured claims must constitute a single class, unless the heterogeneity of the encumbered assets or rights justifies their separation into more than one class. The amendment also clarifies that general government claims will also constitute a single class.

In any case, we can already predict that the configuration of classes will surely be, given the flexibility that the TRLC grants to the parties, one of the main reasons for discussion in the processes of approval of Restructuring Plans that are not entirely consensual.

[8] When the Restructuring Plan affects claims linked by a syndicate voting agreement, the contractual agreements on procedure and exercise of voting rights shall be respected and the majorities established in the previous section shall be applied, unless the syndicate voting agreement itself provides for a lower majority to approve these effects. In both cases, if the necessary majority votes in favour, it shall be understood that all the syndicated claims accept the Restructuring Plan. If the necessary majority is not obtained, the votes shall be counted individually, unless the syndicated claims form a single class, in which case the Restructuring Plan shall be deemed not to have been approved by that class.

by a simple majority of classes (provided that any of those voting in favour corresponds to secured claims) or, failing that, by at least one class that is "in the money", i.e. that can be presumed to receive some payment following a valuation of the debtor as a going concern.

- An important new feature of the amendment is the possibility of imposing the Restructuring Plan on the debtor, the shareholders or both, provided that the majority votes of creditors indicated in the previous sections are obtained and, in addition, the company is in a state of current or imminent insolvency[9].

- The duration of the protective period granted by the communication of the commencement of negotiations with creditors has also been extended, as the amendment allows a three-month extension to be requested in addition to the three months initially granted[10]. In other words, there would be a total of 6 months, plus the additional month granted to prepare and present the insolvency petition, in the event that it has not been possible to achieve a Restructuring Plan that allows the state of insolvency to be avoided or overcome.

- In order to facilitate the continuation of the business activity and thus the possibilities of reaching an agreement, the amendment establishes two important rules for contracts with mutual obligations:

  — On the one hand, it reiterates the rule that notification of the commencement of negotiations does not affect the validity of such contracts, and clauses to the contrary are deemed not to have been put in place[11].

  — On the other hand, the possibility is introduced for the Restructuring Plan to terminate these contracts[12]

[9] In this regard, a new feature with respect to the current system is that, when the Restructuring Plan contains measures that require the agreement of the debtor's shareholders, the general rules applicable to the debtor's type of company will apply, but with the special features regarding deadlines, calls for meetings and rules for passing and challenging resolutions provided for in Article 631(2) TRLC. These rules generally provide greater agility and flexibility in the approval by shareholders. Likewise, the amendment grants the directors -or whoever is appointed by the approving judge at the proposal of any creditor with standing - the power to carry out the necessary acts for its execution when the Plan contains measures that require the agreement of the shareholders in general meeting and these have not been agreed.

[10] The extension must be requested before the expiry of the first three months and must be requested or approved by creditors holding 50% of the liabilities that may be affected by the possible Restructuring Plan. In any case, the amendment grants creditors the power to lift the effects of the extension, provided that creditors holding 40% of the affected liabilities request it. A creditor is also allowed to request that the effects of the extension not be applied to it if the extension would cause it unjustified prejudice (in particular, its insolvency) or would entail a significant decrease in the value of its collateral.

[11] In addition, the amendment provides that the early termination of such contracts due to previous defaults by the debtor will also be held in abeyance, provided that the contracts are necessary for the continuity of the business activity.

[12] It also provides for the possibility of suspending or terminating the contracts signed with executive directors or senior management personnel of the debtor company when this is necessary for the successful completion of the restructuring. The resulting compensation may be adjusted by the judge responsible for the court approval, leaving without effect any compensation agreed in the contract.

when such termination is in the interest of restructuring, provided that the debtor company has previously requested the other party to modify the contractual terms or the termination itself. The affected contractual party may challenge both the termination of the contract itself, arguing that it is not necessary for the successful completion of the restructuring, and the compensation provided for such early termination. And the compensatory claim arising from the termination may be affected by the Restructuring Plan itself.

- With the same objective of maintaining the business activity, the amendment promotes the protection of interim and new financing, i.e. that granted during the period of negotiation of the Restructuring Plan or that provided for in the Plan that is necessary for its fulfilment. In addition to protecting said financing from avoidance actions in subsequent insolvency proceedings, interim and new financing may also have priority in collection if certain conditions are met[13], even in the case of financing granted by persons especially related to the debtor.

- In order to facilitate the capitalisation of claims, the amendment provides that, in the event of the conversion of claims into shares in the debtor company, the claims will be deemed to be a fully liquidated sum, due and payable, and the shareholders' preferred rights will be excluded even in a combined capital reduction and increase offsetting claims when the Plan is initiated in a state of imminent or current insolvency of the debtor company.

- Similarly, if as a result of the capitalisation of claims there is a change in control of the debtor company, it is provided that contractual change of control clauses that the debtor may have agreed in contracts that are deemed necessary for the continuity of the business will not apply.

- With regard to enforcements that could affect the debtor's estate and jeopardise the approval of the Restructuring Plan, the amendment also contemplates the possibility of extending the prohibition on initiating enforcements or the stay of those already initiated that justifies the notification of the commencement of negotiations with creditors to assets and rights that are not necessary for the continuity of the business activity, as well as to guarantees provided by companies belonging to the same group as the debtor (something that was not provided for in the legislation in force until now), provided that such enforcements would jeopardise the negotiations and/or the viability of the debtor and the guarantor.

- Finally, in line with the objective of encouraging the adoption of Restructuring Plans that avoid the opening of insolvency proceedings, the amendment introduces two important new features:

[13] Both interim and new financing will not be avoidable if the Restructuring Plan affects creditors holding at least 51% of the total liabilities (more than 60% if granted by specially related persons). Likewise, if these percentages are met, 50% of the financing provided to the debtor will be a claim against the insolvent estate and the rest will be classified as a preferred senior claim ("with general privilege").

— While the effects of the notification of the commencement of negotiations with creditors are in force, the legal duty to resolve the winding-up due to losses that reduce the net assets to an amount of less than half of the share capital will be suspended, thus resolving once and for all the doubt as to whether the presentation of the pre-insolvency communication is sufficient cause for the directors' liability to be extinguished when a statutory winding-up event has also occurred.

— And, on the other hand, in an unprecedented move in Spanish insolvency law, it allows creditors representing more than 50% of the liabilities that will be affected by the Restructuring Plan to request the judge to stay the insolvency petition filed by the debtor.

The amendment also envisages a series of measures aimed at preventing an abusive use of the above tools:

- The amendment establishes that approval of the Restructuring Plan - and therefore judicial control of the Plan - will be required when it is intended to cram down on creditors, entire classes of dissenting creditors or shareholders; also when it is intended to terminate contracts or protect interim financing and new financing provided for in the Restructuring Plan - as well as acts, operations or business carried out in the context of the Plan - against avoidance actions[14] that may be brought in subsequent insolvency proceedings.

- A notable novelty is the inclusion of a prior incidental procedure of pre-approval by the approving judge of the configuration of the classes that has been carried out at the request of the debtor or of creditors representing more than 50% of the liabilities that are to be affected.

- The amendment provides for the necessary appointment of a "restructuring expert" when approval is requested for a Restructuring Plan whose effects will extend to one or more classes of creditors or to shareholders who have not voted in favour of the Plan when their vote is required under company law[15].

- In order to limit the inter-class cramdown to which creditors holding secured claims may be subject, the amendment allows them to request the realisation of the encumbered assets or rights within one month of the approval order being issued, provided that they have voted against the Restructuring Plan and belong to a class in which the favourable vote was lower than the dissenting vote.

[14] In order to protect new and interim financing against termination actions in subsequent insolvency proceedings, approval of the Restructuring Plan is required. Such protection will be complete for Restructuring Plans whose claims affect 51% of the total liabilities, unless it is proven that they were carried out in fraud of creditors. If this majority is not reached, they will be avoidable if they are detrimental to the insolvent estate, without the presumptions established by law to determine the existence of such detriment being applicable. Interim financing or new financing granted by specially related persons shall only be protected if the claims affected by the Restructuring Plan represent more than two thirds of the total liabilities.

[15] Their appointment will also be mandatory if requested by the debtor or creditors holding 50% of the liabilities affected by the Plan or if agreed by the judge in the event of a general stay of enforcements or an extension of such a stay.

- Finally, as regards the rules for challenging the judicial approval, the following aspects should be highlighted:

  — On the one hand, it establishes the possibility of lodging an opposition before the approval order is issued, the judgment that is to be issued not being subject to appeal. Alternatively, the amendment allows for the challenge of the approval order once it has been issued, but its resolution will no longer be the responsibility of the approving judge, but of the Provincial Court[16]. Both routes are exclusive, so that if the first route is chosen, it will no longer be possible to access the second.

  — The grounds and standing to challenge will depend on whether or not the Plan has been approved for all classes of claims, with fewer grounds of opposition or challenge for plans approved for all classes. With regard to the grounds of opposition or challenge, it should be pointed out that:

    1. The rule of the best interest of creditors[17], which allows dissenting creditors who would have received more in a hypothetical insolvency liquidation two years after the formalisation of the Plan, is provided as grounds for challenge of any Restructuring Plan (whether or not it is approved by all classes).

    2. With regard to the opposition or challenge of the Plans not approved by all classes, the grounds that seek to ensure the existence of equity in the solution promoted by the Restructuring Plan stand out; thus, the Plan that does not respect equivalent treatment between classes of the same rank, the prohibition to grant one or more classes amounts or rights greater than the value of their claims and the prohibition to grant a class of a lower rank, or the shareholders, any amount or right when the higher class to which the challenger belongs has not received the total of its claims (the "absolute priority" rule), can be challenged. The latter rule can be excepted if the viability of the company so requires and the prejudice to the claims concerned is not unjustified.

  — If the challenge is upheld, the Restructuring Plan shall be ineffective only if the grounds of the challenge is the insufficiency of the majorities or the defective formation of the

[16] The amendment also makes it possible to challenge the termination of contracts with outstanding mutual obligations that have been agreed in the approval order.

[17] In the case of the grounds for challenge relating to creditors suffering a reduction in the value of their claims manifestly greater than that which would be necessary to ensure the viability of the debtor company, the version finally approved has kept the reference to the fact that in the case of assignment of claims, it will be presumed that this circumstance is not present when the challenging creditor has acquired the claim at a discount greater than the reduction in value suffered by the claim.

classes of claims. In other cases, if the challenge is upheld, the effects of the Restructuring Plan will not be extended to the challenger; if it is not possible to reverse the effects, the challenger will be entitled to damages to be paid by the debtor company.

3. Conclusion

In short, we are faced with substantial and far-reaching new developments in pre-insolvency tools.

As we have seen, the amendment proposes a complete transformation of pre-insolvency law with several aims: *a*) to anticipate actions at the earliest possible stage in order to protect the value of the company; *b*) to provide it with the necessary tools to facilitate the achievement of pre-insolvency solutions, and *c*) to give more room for manoeuvre to creditors, who may in some cases impose the restructuring on the debtor's shareholders.

In the same line of articulating truly effective pre-insolvency mechanisms for the protection of business value, the inclusion in the amendment of the historical demand for the possibility of affecting liabilities of a nature other than financial or the capacity to operate on contractual relations could be read as possible content of the Plan. It would have been desirable, if the aim is to tackle situations of insolvency at an early stage without having to resort to insolvency proceedings, to take a more decisive step towards a greater degree of submission to the Restructuring Plans for general government claims, this being one of the most controversial and criticised aspects of the amendment.

In any case, the pre-insolvency proposal is positive and we believe that it should help to overcome the situation to which a large number of companies in this country may regrettably be plunged in the near future.

In any case, from now on it will be necessary to closely monitor the practical implementation of the passed law in order to verify whether it finally allows the set objectives to be achieved.