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Bankruptcy, Insolvency & Rehabilitation Proceedings in Spain

ILN RESTRUCTURING & INSOLVENCY GROUP

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KEY FACTS OF BANKRUPTCY, INSOLVENCY & REHABILITATION PROCEEDINGS UNDER SPANISH LAW

I. INTRODUCTION -REGULATION OF INSOLVENCY OF COMPANIES AND INDIVIDUALS.

We believe that the opportunity to present this article comes at a perfect time as an important reform of insolvency regulation has recently entered into force in Spain.

This regulation is contained in a single text, Royal Legislative Decree 1/2020, of May 5, which approves the revised text of the Insolvency Law ("**TRLC**") which was recently amended by Law 16/2022, of September 5.

The aim, as stated in the preamble, is to preserve business and the underlying employment, for which purpose the law distinguishes between the insolvency proceeding per se, and what it calls pre-bankruptcy proceeding, which allows the insolvency situation to be dealt without the need to become immersed in the judicial procedure what is the insolvency proceedings.

It should also be noted that after two years of application of the amended referred (by Law 16/2022), it seems that the introduction of pre-bankruptcy proceeding has achieved the desired objective of saving profitable companies with financial difficulties by approving debt restructuring plans with their creditors, mostly financial creditors, and avoiding bankruptcy proceedings.

Before going into the most relevant aspects of the regulation, we must take into account that the last reform referred to above has introduced a specific procedure for the so-called "Micro-companies", which are those companies or individuals that, because they comply with certain parameters, the law understands that they must be subject to a special procedure due to their smaller size, reduced in terms of time and costs.

Having said the above, in the following sections we will first analyze the general procedure, applicable to all individuals and legal entities that are not considered as "Micro-companies", including the so-called pre-bankruptcy law.

We will refer later to the most relevant aspects of this regulation in relation to individuals.

And, finally, we will analyze the special procedure contemplated for "Micro-companies".

II. OF THE GENERAL INSOLVENCY PROCEEDING

The insolvency proceeding is regulated by a system of phases, with a first phase called "Common Phase" (Fase Común), and two subsequent phases depending on whether the debtor is viable or not. If the debtor is viable, it will enter the so-called "Agreement Phase" (Fase de Convenio), and if not, the "Liquidation Phase" (Fase de Liquidación).

Likewise, in parallel with the processing of the previous phases, the Law regulates the so-called "qualification of the insolvency proceedings", the purpose of which focuses on analysing whether the insolvency situation has been caused or aggravated as a result of the guilty or negligent actions of the directors.

Regarding pre-bankruptcy law, we will see the so-called "Restructuring Plans".

II.1. Commencement of the insolvency proceeding: declaration of insolvency and effects.

<u>II.1.1. Initiation of the procedure.</u>

From a subjective point of view, any legal entity or individual that is not included within the concept of "Micro-companies" may file for insolvency proceeding, with the sole exception of entities belonging to the territorial organization of the State, public bodies and entities.

From an objective point of view, only one condition will be required: that the debtor is in a "situation of insolvency", understood as the impossibility of regularly complying with its obligations. However, also the debtor may file for insolvency proceeding not only when such default occurs at the time of filing for insolvency proceeding (current insolvency), but also when the debtor foresees that the default will occur within the following three months (imminent insolvency).

The insolvency proceeding begins with the filing of a lawsuit for insolvency before the Commercial Court of the province where the debtor has the main centre of management and administration of the company.

The lawsuit may be filed by the debtor itself, in which case we will be dealing with voluntary insolvency proceedings, or by the creditors, in which case we will be dealing with necessary insolvency proceedings. The most relevant consequence between the two cases is that, as a general rule, in the case of voluntary insolvency proceedings, the administrative body will be maintained, whereas if insolvency proceedings are filed by the debtor, they will be dismissed and replaced by the Receiver. However, as we have said, this is not an imperative consequence.

Certain legal and financial documents must be attached to the lawsuit, the most relevant of which are as follows:

- The so-called "Legal and Economic Report" in which the debtor must justify its insolvency situation; describe the legal and economic background; identify the administrative body and partners; express the causes of the insolvency; and whether or not it considers the insolvency to be viable;
- A "List of Creditors" in which the debtor shall duly identify each of its creditors, contact details available to him and the specific debt owed and its status;
- An "Inventory of assets and rights" of which it is the owner with the identification, location and value attributed to each of them.

II.1.2. Declaration of the insolvency proceeding.

The insolvency proceeding shall be declared by means of an order issued by the Commercial Court, which shall contain, among others, the following pronouncements:

- The appointment of a Receiver to manage the proceeding:
- The commencement of the "Common Phase", as well as, in the event that the debtor has requested it in the lawsuit for insolvency proceedings, the simultaneous commencement of the "Liquidation Phase"
- An appeal to creditors to communicate their credits.

II.1.3. Effects of the insolvency proceeding.

The main effects of the declaration of the insolvency are produced by legal imperative, and are the following:

- The paralysis of any judicial or extrajudicial execution against the debtor's assets, except for labor executions, public law credits and secured credits, provided that

they are directed against assets or rights that are not necessary for the continuity of the debtor's activity and;

- The suspension of the accrual of any kind of interest, except ordinary interest on mortgage loans and up to the amount of the guarantee

The determination of whether or not the asset or right subject to execution is necessary for the continuity of the debtor's activity is the exclusive competence of the insolvency judge, and only once such declaration of unnecessary nature has been obtained may the execution continue, and only with respect to the three types of credits indicated in the preceding paragraph. For the rest of the credits, the impossibility to initiate executions is absolute.

Having said this, the declaration of insolvency of the principal debtor does not prevent the initiation of claims/enforcement against third party guarantors.

II.2. Processing of the insolvency proceeding.

As mentioned in the introduction, the procedure is structured and developed in three phases, the Common Phase, the Agreement Phase and the Liquidation Phase

Without prejudice to the foregoing, for organisational purposes of the procedure, it should be noted that the insolvency proceeding is divided into six sections within which all the procedure are integrated. Thus, the proceedings pertaining to the common phase are included in Sections 1, 3 and 4, and those relating to the Agreement Phase and Liquidation Phase in Section 5.

Having established the above, in the following points we will first analyze the most relevant aspects of each of the three phases, as it is through them that the bulk of the procedure is carried out, referring finally to section 6, known as "Qualification Section", as this is a very relevant aspect of the procedure whose regulation is outside the three phases mentioned above.

II.2.1. Common Phase: This is the first phase of the insolvency proceeding and its essential objective is to determine the debtor's situation, for which the Receiver must draw up a report containing the following elements:

- An analysis of the "Legal and Economic Report" submitted by the debtor with the lawsuit asking for its insolvency proceeding;
- A statement of the state of the debtor's accounts;
- An explanation of the main decisions and actions taken by the Receiver itself.
- A reasoned statement of the debtor's assets and any other elements that may be relevant to the proceedings.

The report must also be accompanied by an Inventory and a List of Creditors drawn up by the Receiver itself. The List of Creditors will include a classification of the creditors' claims according to their characteristics, which will determine their collection preference and their rights within the Agreement or Liquidation Phase.

Finally, in the case of a company, a valuation must be provided for the company as a whole and for each of the production units that make up the company, both in the hypothesis of continuity of activity and in liquidation.

Once the report has been issued by the Receiver, the creditors and the debtor himself may object to both the Inventory and the List of Creditors if they do not agree with

what is reflected in either of these documents.

In the event that no objections are filed or once those filed have been resolved, the Receiver will make the Inventory and the List of Creditors definitive, which may no longer be subject to variations.

II.2.2. Agreement Phase: The purpose of this phase is to process a payment proposal to creditors.

The proposal may be made either by the debtor or by all the creditors representing one fifth of the debtor's assets.

The filing of the proposal may be formalized at any time from the filing of the insolvency lawsuit and up to 15 days after the presentation of its report by the Receiver.

As for the content of the proposed arrangement, it must include proposals for a debt reduction, a waiting period, or both, as well as the conversion of credits into shares in the bankrupt company or the transfer of assets in payment of debts.

Together with the agreement proposal, a Viability Plan must be presented, specifying the resources with which the payments will be met, which must also be reflected in a Payment Plan that will be provided with the agreement proposal.

The proposed arrangement must be evaluated by the Receiver before being submitted to the creditors for approval at the relevant creditors' meeting.

Depending on the content of the proposal, its approval will require the adhesion (by electronic means) of the majority of the credits or up to 65% of the ordinary credits.

Once the creditors have voted in favour of the arrangement proposal, the judge will review compliance with the corresponding formalities and requirements and, if such compliance is verified, will issue a judgement of approval.

The judgement approving the agreement will entail the cessation of the effects of the insolvency proceeding and the dismissal of the Receiver, which will only be authorized to continue with the processing of any incidents that may be pending and to process the section on the qualification of the insolvency proceeding, which we will refer to later.

II.2.3. Liquidation Phase: Although the objective of this phase is to achieve the liquidation of the debtor's assets with the greatest possible degree of satisfaction for creditors, the truth is that the trend in recent years has been to sacrifice this objective in favour of any operation that allows the business activity and employment to be maintained, which is achieved through the creation of viable production units within the insolvent company.

The opening of the Liquidation Phase may be initiated at the same time as the insolvency proceedings are declared, if the debtor so requests in its claim, and it is then processed simultaneously with the Common Phase, or subsequently when an agreement is not approved or the approved agreement is not complied with. In addition, the debtor may request liquidation at any time, and the Receiver may also do so in the event of total or partial cessation of the company´s activity.

The opening of the Liquidation Phase will entail the dismissal of the company directors, who will be replaced by the Receiver.

Liquidation operations shall be subject to the general rules established by the TRLC, unless the Judge in the insolvency proceeding may establish special rules after hearing the Receiver,

The general rules of liquidation give priority to the sale of all establishments and production units as a whole and through electronic auction.

In addition, every three months the Receiver must submit a report on the state of the liquidation.

Once the liquidation has been completed, the Receiver must submit a final report with the result of the liquidation and a rendering account of its actuations, together with a request for the termination of the insolvency proceeding.

If the rendering accounts of the Receiver are approved, the judge will issue an order terminating the insolvency proceedings.

II.3 Pre-bankruptcy law. The Restructuring Plan.

The way that the TRLC contemplates to save the insolvency without the need to file for insolvency lawsuit consists of reaching and approving a Debt Restructuring Plan.

This may or may not be preceded by a communication to the Court of the commencement of negotiations with the creditors.

From the moment this communication is made, which may be reserved, two effects will take place:

- The period of three months to try to reach the restructuring plan will begin;
- During the same period, no execution may be initiated or continued on the assets and rights necessary for the continuity of the debtor's activity.

If such an agreement is not reached, the debtor must file for insolvency proceedings within the following month.

Focusing on the Restructuring Plan, its essential notes are the following:

- Its purpose is to modify the composition of the debtor's assets and liabilities or equity;
- It contemplates the possibility of appointing a restructuring expert;
- Extends its affectations to creditors who do not vote in favor of the plan;
- It may affect any type of credit, although with special provisions with respect to public law and secured claims;
- The credits will be grouped by classes according to their insolvency rank and specific characteristics;
- The Plan will be considered approved if more than two thirds of the credits corresponding to each class of credits vote in favor of the Plan;

The Plan must be judicially approved if it is intended to extend its effects to creditors who have not voted in its favor; if it is intended to terminate contracts in the interest of restructuring; or if it is intended to protect any transaction carried out under the Plan (financing granted, etc.) from possible rescission.

During the two years that Law 16/2022 has been in force, introducing restructuring plans, it is worth noting that many Spanish companies have resorted to this method of debt refinancing/restructuring as it is a much quicker process than insolvency proceedings, which, like any judicial procedure, require certain formalities and, above all, much longer deadlines, with the disadvantages that this entails for a company in difficulties.

Likewise, the configuration of restructuring plans through the conformation of classes of credits based on broad and flexible classification criteria, although always based

on objective and justified criteria, is allowing companies room for maneuver to configure these classes of credits in such a way that they can manage to approve restructuring plans and carry forward dissenting liabilities with small percentages of adhered liabilities.

Thus, restructuring plans have been approved with extension of effects to all affected liabilities with adhesion percentages of less than 10% of total liabilities.

Although these are restructuring plans approved in the first instance, and judgments are pending to be handed down resolving the appeals filed in many cases, the truth is that beyond the fact that some abuses may be corrected as artificial configuration of classes by the debtor, it seems that the case law will confirm the criteria applied by the commercial courts, since there is not much room for interpretation of the wording of the rule and it is quite clear that the intended purpose of saving companies with high indebtedness, but which are economically viable and profitable, is being achieved.

II.4. The qualification section.

The purpose of the qualification section is to determine whether the insolvency situation was generated or aggravated by the willful or culpable conduct of its directors, ghost directors or general directors

The qualification phase will be opened at the end of the common phase.

For an insolvency to be classified as guilty, the Spanish Insolvency Law (LC) requires that there has been an aggravation of the willful and / or culpable insolvency of the Debtor, establishing two types of factual assumptions: (i) assumptions that, if concur, determine guilt of the bankruptcy without the need to prove that insolvency was caused or aggravated as a result (called “iure et de iure” assumption) where no proof to the contrary is admissible); (ii) and assumptions that, although they concur, must cause or aggravate the insolvency (“iuris tantum” assumption) and where contrary evidence is permissible. Likewise, the consequences that for the affected persons may derive from the characterization of the contest as guilty are several, from the disqualification to manage assets and rights, to the liability to cover the deficit of assets not satisfied in the insolvency proceeding.

III.INSOLVENCY PROCEEDING OF NATURAL PERSONS

Although there is nothing to prevent natural persons from using the insolvency proceeding referred to in the previous sections, with the necessary differences derived from their status as natural persons (documentation to be provided, shorter processing time, etc.), the fact is that the only reason for individuals to initiate it is that through it they can get their debts discharged.

This is the so-called "Benefit of Exoneration of Unsatisfied Liabilities" ("BEPI"), which is the essential differentiating element in the regulation of the insolvency of natural persons with respect to legal persons, since the latter will not have the option of obtaining such exoneration insofar as, as legal persons, they only are able to approve an agreement and thus continue with their activity, or they are liquidated and extinguished.

Having established the above, in order for a natural person to achieve BEPI the following is required

a) By means of a debt payment plan. This means of exoneration does not require the prior liquidation of the debtor's assets or;

b) When after the liquidation of the debtor's assets there is a continuing insufficiency of assets to satisfy the debts.

In both cases, in order to obtain the BEPI, a series of subjective requirements are established for the personal debtor that focus on his consideration as a debtor in good faith, i.e., not having been declared bankrupt, not having been convicted of crimes against assets, public finances, or against workers in the previous ten years;

In any case, certain credits are not exonerable, among others, those of public law with a limit of up to 10,000€, the credits for alimony, or the expenses and costs for the processing of the bankruptcy.

IV. SPECIAL PROCEDURE FOR MICRO-COMPANIES.

This is the first time that a specific and exclusive regulation for a certain type of company, the so-called micro-companies, has been introduced in the insolvency regulations.

The reason for contemplating this special regulation now is twofold, on the one hand, because most companies that go into insolvency proceedings end up in liquidation, and on the other hand, because the Spanish productive composition is made up of a high percentage of companies that meet the parameters of Micro-companies, which makes it necessary to give them a specific treatment with respect to the rest of the insolvency proceedings in order to reduce the costs of the procedure and its duration in view of the smaller size and complexity of these companies.

The aim is that if a company is viable, the agreement can be approved as soon as possible, and if it is not, it can be liquidated as soon as possible.

Having said the above, the defining parameters of a micro-companies are to have less than 10 employees and a turnover of less than Eur. 700,000 euros or liabilities of less than Eur. 350,000, all according to the annual accounts corresponding to the last fiscal year.

Entering the procedure, any company or individual that meets the parameters indicated in the previous paragraph and is in current, imminent (three months) or probable insolvency (forecast of up to two years) may request the insolvency proceeding, which will be processed through this special procedure.

As mentioned above, this procedure is characterized by the streamlining of procedures by providing for appearances to be made by telematic presence (hearings, appearances, declarations) and acts of communication by electronic means and using forms. However, as a counterbalance to this streamlining of formalities, the submission of seriously inaccurate information or documentation is considered as a cause of guilty insolvency.

As with the general procedure, the Micro-company procedure may or may not be preceded by a negotiation period to try to reach an agreement with your creditors. This period will have a maximum and non-extendable duration of three months after which, without having reached an agreement, the insolvency proceeding must be filed provided that you are in actual insolvency (not if it is imminent or probable).

The main effects of the negotiation period are the suspension of judicial or extrajudicial executions of the assets and rights necessary to continue the activity, except with respect to public creditors, and the impossibility for creditors to file for insolvency proceeding.

The special procedure for microenterprises can be processed in two ways:

a) As a continuation procedure, for which it will be necessary to approve a Continuation Plan that must be approved by the creditors, which must be homologated in order to affect public law claims, with certain exceptions.

   In addition, with the application for the Continuation Plan, it is possible to request, among other measures, the suspension of the foreclosure of credits with real or public guarantee on the assets or rights necessary to continue the activity for a maximum period of three months.

b) As a liquidation proceeding, which will be opened at the request of the debtor, when the continuation plan is not approved, homologated or not complied with and, very importantly, if the debtor is not up to date with its tax or Social Security obligations accrued after the opening of the insolvency proceeding.

Also in the liquidation proceedings, certain measures may be requested, the most important of which is the suspension of the execution of secured claims on the assets or rights necessary to continue the activity for a maximum period of three months.

The liquidation will be carried out through the electronic platform system and cannot last more than three months, extendable for an additional month.