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Spain to Implement and Apply Directive (EU) 2019/1023 to the Spanish Insolvency Act

The Directive will require Spain to adapt key areas of the Spanish Insolvency Act, affecting the rights of debtors, creditors, and shareholders.

On 26 June 2019, [Directive \(EU\) 2019/1023](#) of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, discharge of debt and disqualifications, and 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), was published in the Official Journal of the European Union.

The Directive entered into force 20 days after publication (*i.e.*, 16 July 2019), and Member States will be required to implement most provisions within two years (*i.e.*, 17 July 2021). In Spain, the Directive will address the amendment of the Spanish Insolvency Act.

The Publication of the European Directive on Preventive Restructuring and Second Chance

As part of efforts to build unified capital markets, to enhance legal certainty to cross-border investors and companies operating across the EU, and to prevent the build-up of non-performing loans, the European Commission has been seeking new ways to approach business failure and insolvency (see the [Commission Recommendation of 12 March 2014](#) on a new approach to business failure and insolvency).

Directive EU 2019/1023 is one of the most important directives recently approved at European level, and is a key element in the plan to attract investors to the European Union Market, for the resilience of European economy, and in particular for the preservation and creation of jobs.

The main goal of the Directive is that all Member States will implement preventive restructuring procedures to deal with financial difficulties across the European Union. In this framework, the Directive lays down minimum harmonisation, allowing Member States flexibility in how to implement its requirements.

The Directive also creates an extensive “tool box” with which Member States can equip entrepreneurs and enterprises seeking to respond to distress, without invoking formal insolvency proceedings, following the well-known Chapter 11 of the US Bankruptcy Code.

Key Features of Directive (EU) 2019/1023 on preventive corporate restructurings

- Access to early warning tools that can encourage restructuring at an early stage
- Four-month stand-alone moratorium (extendable up to 12 months) in order to protect the negotiation of restructuring plans
- No reliance on *ipso facto* clauses, which permit a party to terminate a contract due to the insolvency or the financial conditions of the counterparty
- Obligation to treat affected parties in separate classes, although Member States should be able to exempt debtors that are small and medium enterprises (SMEs) from this obligation on account of their relatively simple capital structure, be exempted
- Cram-down (the “best interest of creditors” safeguard) and cross-class-cram-down mechanism, which would constitute a huge advance in European restructuring law and practice

In the Directive's framework, Member States may choose between an *absolute priority rule* or a *non-compulsory relative priority rule*.

- Protected rescue financing (new money/bridge financing)
- Debtor in possession as an incentive for early restructuring
- Discharge of debt for insolvent entrepreneurs
- Practitioner in the field of restructuring

Transposition of the Directive into the Spanish System

The transposition of the Directive will entail reforms within the Spanish system, though, since 2009, the Spanish legislature has introduced and regulated under the Spanish Insolvency Act preventive restructuring arrangements between the debtor and his creditors, the so-called “acuerdos de refinanciación”.

Hence, the goal for the Spanish model is not to introduce *ex novo* an entire preventive restructuring framework, but rather to adapt three key areas of the existing model to implement the provisions of the Directive.

Preventive Restructuring Proceedings (acuerdos de refinanciación)

Early warning tools

The legislature shall provide early warning tools, particularly for SMEs. Access to one or more clear and transparent early warning tools should be ensured, which can detect circumstances that could give rise to a likelihood of insolvency and can signal the need to act without delay. According to the Directive (article 3.2), these tools may include one or more of the following, among others:

- Alert mechanisms when the debtor has not made certain types of payments
- Advisory services provided by public or private organisations
- Incentives under national law for third parties with relevant information about the debtor, such as accountants, tax, and social security authorities, to flag to the debtor a negative development

Viability test

The Spanish model does not currently provide for control *ex ante* of the viability of the debtor who wants to achieve a preventive restructuring agreement (acuerdo de refinanciación). This control may happen *ex post* in the Spanish model, when the affected creditors contest the arrangement before the Court.

The Directive allows the Member states, and therefore the Spanish legislature, to choose between a control *ex ante* or *ex post* of the company's viability. Hence, the Spanish legislature may choose to maintain this option or change it to an *ex ante* control of the viability.

Restructuring practitioners

Currently, the Spanish model does not regulate restructuring practitioners in the preventive framework.

The Directive introduces this regulation as a compulsory measure in some cases (article 5.3 of the Directive). Hence, the Spanish legislature should consider regulating the restructuring practitioner, at least in compulsory cases (general stay of individual enforcement; restructuring plan needs to be confirmed by a judicial or administrative authority; if requested by the debtor or by a majority of creditors).

Stay of individual enforcement actions

Stay of individual enforcement actions are regulated under Spanish law in the framework of article 5 bis of the Spanish Insolvency Act.

Notwithstanding the above mentioned regulation, the transposition of the Directive into the Spanish model will entail reforms in this framework that will affect:

- Duration of the stay: possibility to allow an extension of initial duration or a new stay
- Prolongation of the stay in duly justified circumstances
- Maximum period of the stay after prolongations and new stays (12 months)
- Netting arrangements must be exempted from the stay
- Possibility to have the stay lifted

Executory contracts and essential contracts

In addition, and according to the Directive, the Spanish legislature shall introduce the treatment of executory contracts and essential contracts that will be affected by the stay of individual enforcement actions.

Additionally, the inapplicability of *ipso facto* clauses when the debtor starts negotiations or is granted a stay, not regulated currently under the Spanish model, should be regulated.

Affected creditor classes

Creditors must be treated in classes, according to their interest, which entails the formation of classes of affected creditors. Until now, the Spanish model regulated only two types of creditors: secured and unsecured.

The current provision fits into the Directive's provisions, but it is important for the Spanish legislature to take a step forward and distinguish more classes of affected creditors.

In this framework, the Spanish legislature must choose an option regulated in the directive to exclude the SMEs on account of their relatively simple capital structure from the obligation to treat affected parties as

a separate classes. Another option will be to decide whether employees constitute a separate class of creditors.

Confirmation of restructuring plans

The implementation of the Directive implies that if plans are adopted by creditors, courts must confirm if they:

- Comply with the best interest of creditors' test
- Have been duly notified to creditors
- Respect the *pari passu* principle
- Demonstrate that new financing is necessary to implement the plan

Cram-down

The Spanish model has introduced a particular cram-down based on the best interest of creditors by virtue of the disproportionate sacrifice concept (*sacrificio desproporcionado*) which means, according to case law, that no dissenting creditor may be worse off under a restructuring plan than it would be in case of liquidation.

Notwithstanding, the Spanish model must include a true cram-down in connection with the class formation of affected creditors.

Introducing a “best interest of creditors” test is also necessary to cover not only a liquidation scenario, but also the next-best-alternative scenario if the restructuring plan were not to be confirmed, in accordance with the provisions of the Directive.

Cross-class-cram-down: “absolute priority rule” versus “relative priority rule”

The regulation of cross-class-cram-downs to ensure that dissenting classes of affected creditors are not unfairly harmed under the restructuring plan as well as the provision of sufficient protection for such dissenting classes are key elements of the Directive

The Directive establishes two main requirements (preconditions for a cram-down against a dissenting class):

- Appropriate number of supporting classes: as a minimum, one single class of “in the money” creditors should be sufficient
- Adequate protection on dissenting classes

Regulating conditions under which the courts may confirm plans against the dissent of certain classes using a cross-class-cram-down mechanism is also necessary. The Directive allows in this framework two protection mechanisms of dissenting classes of creditors: the traditional absolute priority rule (APR) and the relative priority rule (RPR). The APR requires that no claimant class ranking below the dissenting one should receive or retain anything under the plan unless each member of the dissenting class has been paid the full face value of its outstanding claim.

The Directive establishes that Member States should be able to derogate from the absolute priority rule. For example, equity holders keeping certain interests under the plan despite a more senior class being obliged to accept a reduction of claims may be deemed fair; or essential suppliers covered by the provision on the stay of individual enforcement actions may be paid before more senior classes of creditors.

Hence, under the new Directive, the Spanish legislature should choose which of the above-mentioned protection mechanisms to put in place. This is one of the most crucial choices for the Spanish legislature.

The traditional rule for preventive corporate restructuring had been the absolute priority rule as a core element in chapter 11 of the US Bankruptcy Code. The introduction of the relative priority rule in the Directive at the last moment has been controversial.

Encouraging new and interim financing

The Spanish model regulates the “new money privilege”, 50% qualifies as secured credit (*crédito privilegiado*) and 50% is qualified as against the estate credit (*crédito contra masa*) excluding the loans granted by the shareholders). This does not cover the requirements of the new Directive. The implementation of the Directive will entail:

- Exemption of new financing and interim financing from avoidance actions
- Exemption of providers of such new financing from civil and criminal liability, where it exists
- No protection should be granted in case of fraud

Rights and duties of shareholders

According to the Directive, shareholders should not be able to oppose a plan which returns the enterprise to viability if they are “out of the money”. Valuation of the company is a key element in determining whether a creditor is “out of the money”.

The Directive provides two options:

- Apply articles 9 to 11 of the Directive to shareholders. Hence, consider shareholders as a separate class of affected creditors.
- Allow the judge or an administrative authority to substitute the decisions of the General Shareholders' Meeting.

Director's duties and liabilities in the vicinity of insolvency

Article 19 of the Directive regulates the duties of directors if there is a likelihood of insolvency. This article sets out that Member States shall ensure that in this framework directors have due regard as a minimum towards:

- The interest of creditors, equity holders, and other stakeholders
- The need to take steps to avoid insolvency
- The need to avoid deliberate or grossly negligent conduct that threatens the viability of the business

Article 19 contains a provision to regulate this framework, but does not specify which model should be used. Therefore, the Directive allows different legislative options:

- To regulate specific director's fiduciary duties vis à vis creditors, following the Anglo-Saxon model that traditionally regulated these duties in the legal framework (*i.e.*, the United Kingdom) or on a jurisprudential basis (*i.e.*, the United States); or
- To merely encourage directors to adopt early measures to avoid or, at least, to minimise the impact of insolvency according, traditionally, with the continental European model (which has not been followed by Germany)

The Spanish model fits into the continental model and currently does not regulate specific fiduciary duties vis à vis creditors. The director only has fiduciary duties towards shareholders and the company (duty of

care / duty of loyalty). The implementation of the Directive into the Spanish model entails the need to choose between the two options set out by the Directive mentioned above.

Contingent Credits

The treatment of contingent credits (*e.g.*, guarantees, credit lines, procedural claims) is not regulated under Spanish Law in the context of calculating the majorities and rights of its holders in a pre-insolvency refinancing agreement. The Directive sets out that Member States must regulate this matter, but does not indicate how.

Therefore, the Spanish legislature needs to decide on the treatment that will be given to contingent credits in the framework of refinancing agreements in connection with the total amount of the liabilities accountable for the effects of the homologation. This issue has been problematic in Spanish case law, and in particular, it was raised in the high-profile “Caso Abengoa” case.

Discharge of debt for insolvent entrepreneurs

The Spanish model has regulated a discharge of debt for insolvent entrepreneurs. The approval of the Directive entails some reforms to the Spanish model in this regard:

- Full discharge after a maximum of three years for honest entrepreneurs (acting in good faith)
- Extending the discharge also to consumers, on which the Spanish legislature must decide
- Consolidation of proceedings when entrepreneurs have both professional and non-professional debts
- Limitation of the duration of disqualification orders for honest entrepreneurs
- Extending the discharge to public creditors, which are currently excluded by the Spanish model currently are excluded of the discharge, therefore the Spanish legislature must decide if it includes public credits in the framework of the discharge for individuals

Enhancing the efficiency of insolvency proceedings

- Training and specialisation of insolvency judges
- Training and professional standards for insolvency practitioners
- Digitalisation of proceedings

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