Classification of claims under a refinancing agreement pursuant to Royal Decree Act 4/2014

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According to its Explanatory Notes, RD Act (Order in Council) 4/2014, of 7 March, adopting urgent measures on business debt refinancing and restructuring, aims to facilitate the financial repair and recovery of companies facing an economic crisis. To this end, a set of rules varying in scope and significance have been laid down, which I here discuss with regards to the treatment reserved to loans granted under refinancing agreements - as provided by the Spanish Insolvency Act (IA) - and their signatory creditors.

1. The superseded legal regime in respect of "fresh money".

Article 84(2)(11) IA, in its wording prior to entry into force of RD Act 4/2014, classified as claims against the asset pool, though limited to fifty percent of their value, claims arising from fresh money granted under a refinancing agreement as provided in the erstwhile art. 71(6) IA. Further, it was stated that this consideration did not apply when the fresh money had been provided by the debtor itself (how could it apply given that the insolvent company can hardly be a creditor – on insolvency or against the asset pool – in respect of itself?) or by specially related persons through share capital increases, loans or other acts with a similar purpose (the reference to capital increases is equally puzzling since claims do not arise for the person who becomes a shareholder or increases his stake in the company). In fact, claims in these cases were classified as subordinated by virtue of art. 92(5) IA.

The foregoing was completed with the provisions of art. 91(6) IA, under which claims deriving from fresh money granted under a refinancing agreement would be preferential in the amount not recognised as a claim against the asset pool (although not specified by the Act, even if meaning fresh money, loans granted by persons specially related to the debtor would be deemed to not enjoy such preference).

This regime was criticised by some, contending that it did not sufficiently encourage fresh money in the case of viable companies in distress. On the one hand, because attributing a (sixth-place) preference to 50 per cent of the value of the claim did not ordinarily entail a great advantage if insolvency proceedings were to be opened. And, on the other, because it meant maintaining the subordinated claim classification for claims of people specially related to the debtor (which are often the natural - and sometimes only – source of financial resources in times of economic hardship).

2. The legal regime provided for the next two years: the temporary reinforcement of favourable treatment to "new money"

The new regime intends to forestall the criticism mentioned in the preceding paragraph. And it does so with a technique that is certainly peculiar inasmuch as it alters only temporarily the described situation. Indeed, the second additional provision of RD Act 4/2014 states that, during the two years following its entry into force, the content of the aforementioned arts. 84(2)(11) and 91(6) IA shall not apply. Actually, the rule cannot be understood literally: these provisions will continue to apply during the next two years for all loans involving fresh money granted in refinancing agreements concluded before 9 March 2014.

Anyway, during said two-year period, loans involving fresh money and granted under a refinancing agreement *signed after the entry into force of RD Act 4/2014*, on the terms of the new art. 71 bis or the new 4th additional provision IA, will be considered, *for the full amount*, claims against the asset pool. Note that even loans granted by the debtor itself (?) and by persons specially related to the insolvent company will be considered claims against the asset pool. The RD Act views as an exception to the latter rule the case where fresh money been made obtained through a share capital increase, which is hard to comprehend for the reason previously outlined.

The 2nd additional provision of RD Act 4/2014 also provides that the interest accruing from the aforementioned loans shall be subordinated (art. 92(3) IA). This rule represents a worsening with respect to the situation that would arise if it had not been made; in the absence of a special rule, interest of a claim against the asset pool would also be considered a claim against the asset pool. Thus, the so-called "fresh money preference" only affects the principal provided.

Finally, the same 2nd additional provision states - keeping for this two-year period the criterion followed in the current wording of art. 84(2)(11) IA - that in the event of liquidation, loans granted under a composition with creditors to finance the viability plan will also be considered claims against the asset pool.

Importantly, after a period of two years from the date of grant (which must be construed as from coming into existence), the loans we have been discussing will be claims against the asset pool in the terms of art. 84(2)(11) IA. A truly enigmatic rule, which seems to imply that, once two years have elapsed, 50 per cent of claims arising from unpaid fresh money will be included in the list of creditors as preferential claims and that those held by people specially related to the debtor will be classified as subordinated claims (thus producing a change in the consideration of claims on insolvency). The (possibly unacceptable) consequences of this rule makes it advisable to narrow its scope and regard it as referring to the event of the insolvency proceedings not having been effectively opened within two years from emergence of the claim (so that if a such a procedure had already begun at the time, the consideration of such claims would not be altered on insolvency). Nothing is said in the rule in respect of interest, which creates uncertainties regarding the treatment to be applied thereto.

Nor is the construction to be put upon the single transitory provision of RD Act 4/2014 clear with regard to the matter at hand. According to this provision, refinancing agreements negotiated under the former art. 71(6) IA at the time of entry into force of the new set of rules will be subject to the previous regime if the debtor has already requested the appointment of an independent expert. This, followed to the letter, could lead to the conclusion that the 2nd additional provision would not apply in these cases, but rather arts. 84(2)(11) and 91(6) IA, even if the refinancing agreement is finally signed after such entry into force. However, this interpretation must be rejected, construing instead that it is intended that the transitory provision only refer to the requirements refinancing agreements must meet (in particular, concerning the appointment of an independent expert). Hence, if the appointment of an independent expert had already been requested by the time RD Act 4/2014 came into force, the regime previously contained in the former arts. 71(6) and 71 bis IA would apply, unless the parties chose, within the refinancing agreement, to be subject to the regime of the current art. 71 bis (1) IA (the positive formulation of the latter qualification confirms the proposed interpretation on the scope of the single transitory provision).

3. The applicable legal regime after two years from the entry into force of RD Act 4/2014

After the two-year period provided in the 2nd additional provision, arts. 84(2)(11) and 91(6) IA – and, therefore, the regime outlined above under section 1 - will regain their validity. The aforementioned reform thus reveals itself to be merely circumstantial (not structural).

In any case, it should be noted that although the first of the two abovementioned provisions has been amended by RD Act 4/2014 (so that it now refers to art. 71 bis and the 4th additional provision IA), the same has not been done with the second, which still mentions art. 71(6) IA. This is of no consequence as it is clear that the referral to the new art. 71 bis and the new 4th additional provision should be deemed done once the said two-year period elapses.

4. The claims of creditors who have capitalised all or part of their claims

The RD Act 4/2014 reserves a specific treatment for creditors who have capitalised all or part of their claims under a refinancing agreement adopted pursuant to art. 71 bis or the 4th additional provision IA. *This new regime is applicable from the entry into force of the aforementioned RD Act and its validity is not subject to a time limit*.

The problem addressed is that raised by the possibility of creditors who have, under a refinancing agreement, capitalised their claims (through a share capital increase offsetting claims) being regarded as persons specially related to the debtor. Indeed, upon becoming shareholders, the rule of art. 93(2)(1) IA could be applied, which would discourage the granting of further financial facilities under said agreement (there would be no problem, however, with claims prior to the acquisition of the stake, since insofar as the holders thereof were not shareholders at the time of their coming into existence, subordination would not come into play).

Well, what has been done is to include a new paragraph under art. 92(5) IA, which reads as follows: "*Creditors who have directly or indirectly capitalised all or part of their claims under a refinancing agreement adopted pursuant to article 71 bis or the 4th additional provision, shall not be considered persons specially related to the insolvent company for the purpose of classification of claims held against the debtor as a result of refinancing granted in consequence of such agreement*."

Thus, the inconvenience previously discussed is resolved and the creditors that have capitalised their claims as a result of a refinancing agreement (only these creditors) are guaranteed that subsequent loans granted under the same agreement (only these claims) will not be subordinated later on account of being considered persons specially related to the insolvent company.

However, it is desirable to make some additional clarifications as to the scope of the new rule: (i) since one of the objectives of the reform is to facilitate debt-equity swaps as a method of financial repair, there should be no obstacle in the application of the rule even if the creditor who has capitalised his debt was prior to that already a shareholder with a relevant stake within the meaning of art. 93(2)(1) IA (although this, of course, will be relevant regarding the classification of non-capitalised claims existing prior to the refinancing agreement); (ii) the legal diction seems to cover others who could also be persons specially related to the insolvent company, such as group companies and (de facto or de iure) directors, liquidators or ordinary attorneys-in-fact. That is: not only are refinancing loans excluded from subordination where granted by creditors who. as a result of the capitalisation of claims, acquire the status of specially related persons, but also those of other persons who, having also proceeded to capitalise, could see their claims subordinated by other circumstances, regardless of whether they have acquired or not a significant stake through a debt-equity swap.

5. The (intended) conceptual delimitation of the de facto director

One of the "risks" that "refinancers" have had to endure was that of being classified as de facto (shadow) directors to the extent that refinancing agreements often include clauses that, in varying degrees, allow these creditors to "oversee" (or even "influence") the debtor's actions.

This de facto director classification actually has several consequences, one of which is its consideration as a person specially related to the debtor (insolvent company after), which entails the subordination of all claims held by said person.

Naturally, the possibility of this happening can sometimes discourage the participation of certain creditors in refinancing agreements. However, to reduce the described risk, a new sentence has been included in art. 93(2)(2) IA, according to which: "*Unless proven otherwise, creditors who have signed the refinancing agreement provided in article 71 bis or the 4th additional provision* *shall not be considered de facto directors in respect of the obligations assumed by the debtor in relation to the viability plan*".

From a technical point of view, the new rule is highly questionable since it seems to part (doubtlessly mistakenly) from the existence of a presumption that needs to be destroyed (when this is clearly not the case; one of the few clear points surrounding the de facto director is that the burden of proof lies with whoever alleges the existence of such person). Note that the rule states that if there is no evidence to the contrary, a creditor who has signed a refinancing agreement will not be considered a de facto director by reason of the existence of certain obligations assumed by the debtor under the business viability plan (as if, in the absence of evidence, such creditor could be considered a de facto director; and as if the other creditors who have not signed the agreement could be so considered under those conditions of lack of evidence). And, at the same time, it follows that when there is evidence that a person is a de facto director...such person will be effectively considered a de facto director! Therefore, the only thing that can be reasonably inferred from the new rule is that the mere assumption of certain liabilities by the debtor under a viability plan cannot be considered, by itself and without other considerations, as evidence of the presence of a de facto director. This, on the other hand, was already so before.

In this way, a substantially useless rule is included (the result would be the same in its absence) that raises, however, some problems. Among these, that it leaves the field open to logical fallacies (using the always dangerous art of interpreting *a contrario*) that lead to the conclusion that if there are refinancing agreements that do not meet the requirements of art. 71 bis or the 4th additional provision IA, the signatory creditors are to be presumed de facto directors. In any case, as the rule lacks any new regulatory content, asking oneself whether it is made only for the purpose of the classification of claims or also for the characterisation of the insolvency proceedings, is of no relevance.