Obstruction of refinancing agreements and at-fault classification of insolvency proceedings

Fernando Marín de la Bárcena
Professor of Commercial and Company Law, Universidad Complutense de Madrid
Academic Counsel Member, Gómez-Acebo & Pombo

I. Approach

The overhaul of companies in crisis sometimes requires the adoption of measures that affect the financial and legal position of a shareholder, thereby warranting the adoption of resolutions by the general meeting. Debt-equity swaps or the issue of convertible securities and bonds are paradigms of the aforementioned, as they invariably involve an actual or potential dilution for shareholders who do not exercise their pre-emption rights, but there are many other conceivable situations (e.g., amendments to the company's objects, divisions to clear the books, subsidiarisations traceable to management powers integral to general meetings, etc.).

In the context of insolvency proceedings, Spanish law does not allow the adoption of measures that affect the insolvent's governing body and capital structure, however necessary these measures may be to achieve corporate reorganisation (e.g., compulsory appointment or termination of appointment of company directors, expulsion of shareholders, court-ordered debt capitalisation, etc.). This is due to the nature of the rules that shape such law, which only fall on the company's assets and liabilities and only affect the holder of the same as far as necessary to achieve their goal.

The inadequacy of the legal framework makes it necessary to find solutions such as those contained in *Royal Decree Act 4/2014, of 7 March, on company debt refinancing and restructuring* with regard to the at-fault classification of the insolvency proceedings on account of obstruction of refinancing agreements. Imposing on shareholders the duty to collaborate with the overhaul is not easy and so the legislature has opted for a preventive - not punitive - rule: those shareholders who, without good reason, reject a debt-equity swap or issue of convertible securities or bonds and thereby defeat a refinancing agreement, shall be regarded as persons affected by the classification and, among other consequences, held liable for the shortfall on insolvency.

Below we will discuss some of the conditions of this new at-fault classification of the insolvency proceedings and we will make a first attempt at offering some criteria that, in our view, may serve as guidance for its implementation.

II. Elements of the case

2.1. Refusal without good reason

The new rebuttable presumption of article 165(4) makes it possible to classify insolvency proceedings as at-fault where the debtor or, if applicable, their legal representatives, directors or liquidators:

> "4. Have refused, *without good reason*, the capitalisation of debt or the issuance of convertible securities or bonds, thereby defeating a refinancing agreement under

article 71 bis (1) or the fourth additional provision. For these purposes, *it is presumed that the capitalisation responds to a good reason when so declared* by a report issued, prior to the refusal of the debtor, by an independent expert appointed in conformity with the provisions of article 71 bis (4). If there is more than one report, the majority of the issued reports must agree on this assessment.

In any case, for the refusal to establish fault in the insolvency proceedings, the proposed agreement must *recognise, in favour of the debtor's shareholders and as a result of the proposed capitalisation or issue, a pre-emption right* on the shares, securities or convertible instruments subscribed to by the creditors in the event of subsequent disposal of the same.

However, the proposed agreement may exclude the pre-emption right on transfers carried out by the creditor to a company belonging to the same group or any undertaking whose purpose is the ownership and management of interests in the capital of other undertakings. In any case, disposal shall mean that made in favour of a third party by the creditor or by the companies or undertakings referred to in the preceding line."

Article 172, which regulates the content of the classification ruling and provides the legal consequences, states that the ruling may regard as persons affected by the classification managers and:

"(…)the shareholders who have refused, without good reason, the capitalisation of debt or the issuance of convertible securities or instruments according to the terms of article 165(4), depending on the degree to which they contributed to obtaining the majority required for rejection of the agreement".

It should be noted that the reference to *the degree to which they contributed to obtaining the majority required for rejection of the agreement* is in order to decide on the attribution of the "person affected by the classification" characterisation and not to "adjust" the associated legal consequences.

The last line of this precept adds a rule with reference to directors:

"The presumption under article 165(4) shall not apply to directors who have recommended the recapitalization with good reason, even if such was subsequently rejected by the shareholders".

The new art. 172 bis IA provides the legal consequence regarding the redress of the shortfall on insolvency, which operates without prejudice to the other consequences inherent in the classification (disqualification, damages, etc.):

"When the classification phase has been established or reopened as a result of the opening of the liquidation stage, the court may order all or any of the directors, liquidators, de jure or de facto, or general attorneys-in-fact of the legal person subject to insolvency proceedings, *as well as the shareholders who have refused, without good reason, the capitalisation of debt or the issuance of convertible securities or instruments according to the terms of article 165(4*), who have been held persons affected by the classification and liable to meet all or part of the shortfall, *to the extent that the conduct that determined the at-fault classification created or aggravated the insolvency*".

The wording of these rules and their integration into the regulatory system of the classification will generate problems in respect of their practical application, which was inevitable considering the hastiness of this legislative intervention.

In general, it can be said that the basic case of the presumption consists in

defeating a refinancing agreement by refusing without good reason the capitalisation of debt or the issue of convertible securities or instruments (art. 165(4) IA), but from there some doubts arise as to the elements that comprise the unlawful conduct.

First one must assess whether the rule presupposes the holding of a general meeting and presentation of a proposed agreement rejected with the casting of votes against or whether the rule may also apply when the general meeting has been prevented from taking place due to absence of quorum, as defined under the law or the articles of association. The answer to the latter should be in the affirmative because the obtainment of the required majority is the result of a process comprising the holding of the general meeting and, if such is prevented, so will the obtainment of the majority. The basis of this case of at-fault classification is hindrance and, therefore, it is our understanding that all possible events should be included. It would make no sense to treat differently that which is the same.

Good reason (to which, where appropriate, the experts reporting on the content of the agreements must satisfy themselves) presupposes the *appropriateness* of the measure in respect of the attainment of the ends pursued by the refinancing. On the basis of the wording of the rule one can deduce that refusal to recapitalise must have defeated the refinancing, so the condition must be not only appropriate, but also essential. Certain *proportionality* must also be found between the sacrifice imposed on the shareholder and the situation which would arise in case of rejection (e.g. loss of value of the shareholder's position in a liquidation context). Even if pre-emption rights are recognised, disproportionate sacrifices may not be imposed on the holders of capital from a qualitative (type of measure) or quantitative (extent of dilution) point of view. In principle, when shareholders lack real pecuniary interest in the transaction because the company has insufficient assets, no refusal may be deemed reasonable.

The reasonableness of the proposal must be demonstrated by whoever intends to avail himself of this presumption in the classification phase of the subsequent insolvency proceedings (if opened). The statements specifically provided in the reports of independent experts shift the burden of proving whether the adoption of these agreements (debt capitalisation, issue of securities, finance instruments) was appropriate and necessary to achieve the purposes of refinancing and whether such adoption causes a disproportionate sacrifice.

2.2. The rebuttable nature of the presumption

The scientific doctrine and case law widely consider that the rebuttable presumptions of at-fault insolvency proceedings (art. 165 IA) serve to prove the subjective element of the general clause (intent or gross negligence), but that the at-fault classification also requires proving the presence of an objective element (creation or aggravation of the insolvency) that is associated with the idea of causation of financial damage to the debtor (art. 164(1) IA).

According to this view, the unjustified refusal to recapitalise only proves the subjective element of the at-fault classification (intent or gross negligence) and those who seek to avail themselves of it must prove that such refusal caused financial damage that brought about or aggravated the insolvency (the objective element). Proof of financial damage caused by the refusal of the refinancing agreement, with all that that implies, is thus required. This understanding of the scope of rebuttable presumptions raises serious questions because in many cases it will be impossible to prove the connection of the conduct comprising the same with the creation of financial damage, and surely another understanding

of this rule, more consistent with the method of regulation (e.g., the thoughtful reflections of the Judgment of the *Audiencia Provincial* of Barcelona, of 21 February 2008), is possible.

In our opinion, proof of conduct comprising the presumptions of 165 IA is prima facie evidence of disorderly management and causation (objective imputation connection) between the insolvency and such management which is what is required to classify the insolvency proceedings as at-fault. Proof of damage is only relevant at a later time, to assign the consequences associated with the classification (damages, liability for the shortfall, disqualification, etc.).

Thus, the insolvency of the legal person that refused to approve an agreement to refinance with debt capitalisation (adequate and without disproportionate sacrifice) that would have averted insolvency (creation) or corrected the direction in a context of proximity to insolvency (aggravation) will be held, prima facie, attributable to careless conduct in relation to the sphere of company creditors. This will exclude no-fault insolvency proceedings, declaring them at-fault.

Rebuttal evidence is possible. Refinancing is not always the only way to deal with the business crisis and there will be other diligent options from the point of view of creditor protection (e.g., in the face of imminent insolvency, it was resolved to instigate a petition for insolvency proceedings with immediate opening of liquidation). If there was no alternative, the mere refusal of refinancing will determine an at-fault classification in accordance with the terms above and with all its consequences.

2.3. The imputation to shareholders as persons affected

Reading all these legal provisions makes it clear that the reform, as a whole, is intended to punish the owners of capital who hinder the refinancing of a company in crisis which, in turn, requires the capitalisation of debt or the issue of convertible securities or instruments, and not to create a new case of classification and liability of directors.

The last line of article 172 tries to recall this. When the legislator warns that "The presumption under article 165(4) shall not apply to directors who have recommended the recapitalization with good reason, even if such was subsequently rejected by the shareholders" does not mean the opposite, that is, that directors who do not recommend the adoption of the measure will be considered affected by the classification by applying this new at-fault classification of insolvency proceedings.

Directors who do not recommend the adoption of overhaul measures already infringe general duties to protect the sphere of company creditors that fit in the standard clause of at-fault insolvency proceedings (art. 164(1) IA. In the legal model, the collaboration of the managers negotiating the refinancing agreement and the preparation of a proposed recapitalization agreement or issue of convertible securities or instruments is taken for granted.

The reference to *the degree to which they contributed to obtaining the majority required for rejection of the agreement* gives rise, however, to implementation problems.

As a general rule, the attribution of the characterisation of person affected by the classification is done somewhat automatically, because when it comes to directors it is only necessary to prove the position of director at the time of the events leading to the at-fault classification of the insolvency proceedings, and it is the person affected who must prove that the breaches giving rise to said classification are not attributable to him by reason of intent or gross negligence.

(T)he degree to which they contributed to obtaining the majority required for rejection of the agreement must serve the courts to handle this rule with some discretion according to the circumstances of each case.

With respect to closely-held companies it is difficult to know how the rule applies because all votes count and the hindering shareholder is easily identifiable. The nuance may have been intended for listed companies where it will be possible to distinguish between shareholders who actively hinder by requesting proxies to prevent the Board of Directors' and shareholders' proposal from going through and those investors who have confined themselves to granting their representation or who simply have not attended the general meeting to which they never attend. Clearly, the latter shareholders have contributed to preventing obtainment of the required majority, but it seems that the penalty should be reserved for those who actively defeated the proposal.

For any queries on the above please contact any of the following members of Gómez-Acebo & Pombo:

Miguel Lamo de Espinosa Abarca
Partner, London
Tel.: 44 (0)20 7329 5407
mlamo@gomezacebo-pombo.com

María José Paz-Ares Rodríguez
Partner, Madrid
Tel.: (34) 91 582 91 00
mjpazares@gomezacebo-pombo.com

Verónica Romaní Sancho
Partner, Madrid
Tel.: (34) 91 582 91 00
vromani@gomezacebo-pombo.com