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ARTICLE

The Projected Reform of Spanish Insolvency Law

Agustín Bou, Partner, JAUSAS, Barcelona, Spain

I. Introduction

On 17 December 2010, the Cabinet of Ministers passed the Amendment Draft Project of Insolvency Act 22/2003 of 9 July ('the Project').

The purpose of this article is to highlight the most important changes brought about by the Project, as well as to underline those aspects either not considered under the Project or those aspects which, in our opinion should have been developed to a greater extent.

The starting point of the Project is the practical experience under the existing *Insolvency Law* ('LC'), which as the Draft Project's Preliminary Recitals ('PR') acknowledge, has fallen short of the desired results given that its purpose was to provide continuity to companies in crisis and this has not been achieved. This is evident by the fact that most bankruptcy procedures (statistics reflect figures of 90%) end in liquidation, business closure and total employee layoffs.

As stated in the PR, this amendment's intention is to fix the mistakes made by the current LC in its approach, as well as to fill in the legal loopholes, which, in our opinion, is achieved only in relation to some of its aspects, as explained below.

II. Amended matters

Pre-Insolvency Institutions: One of the aspects which is emphasised in the PR more strongly is the changes brought about by the so-called Pre-Insolvency Institutions. These are the legal institutions whose intended purpose is to prevent a bankruptcy by anticipating company crises and encouraging extrajudicial solutions, thus avoiding work overload at the courts. In our LC, the elements which most resemble such legal institutions are the Refinancing Agreements and the Proposal of Early Agreement with Creditors ('PEA').

Following our analysis of the Project, our conclusion is that the amendment in this field is far too shy and cannot, under any circumstances, acquire the Pre-Insolvency Institutions denomination according to the criteria set forth by other legal systems.

Regarding the Refinancing Agreements (the clauses of which have been incorporated in Section 71.6 of the Project, even though the PR indicate that the deadline to reach such refinancing agreements have been extended, this extension has not been foreseen in such section. These extensions are essential in order to encourage the development of 'alternatives to the bankruptcy procedure'.

However, the new drafting of the abovementioned Section 71.6 and the Fourth Additional Provision ('AP') gives rise to a contradiction that must necessarily be corrected. While Section 71.6 talks about 'Creditors whose credits represent at least three fifths of the debt' when establishing majorities, the Fourth AP requires that majority be composed of '*Financial* creditors representing at least *seventy five* percent of the debt'.

The contradiction between both texts is evident and in practice, it implies that only those cases in which the debt is mostly of financial origin, for example, real estate developers, shall be protected in the case of a refinancing, but not most of the industrial insolvencies in which (although the banks are often heavily relevant in the debt structure) supplier creditors comprise a very important part of the overall creditor base. Such restructurings shall be excluded from the amendment's scope even when the suppliers have accepted the restructuring of their debt in time, without relief, which would fall under the characteristics of an early proposal.

When considering Refinancing Agreements further (and always holding that the financial institutions are their subjects), with the purpose of optimising recoveries for them, the Project implements new fresh money regulations considering 50% of new finanicng provided under such grounds as secured credit in case of a future insolvency, being the rest of the new financing, in the event of a later insolvency considered as unsecured credit. This measure is on the right track, but one must bear in mind that a modification of these characteristics should be accompanied by an amendment similar to that in the Circular 4/2004 of the Bank of Spain, regarding the provisions for bank arrears, for it to be really effective.

As regards the suspension of the obligation to file for bankruptcy due to the negotiation of a new PEA, previously set forth in Section 5.3 of the LC, the amendments are limited to a redrafting, without any significant changes.

In our opinion, the amendment should have gone much further, introducing Pre-Insolvency Institutions similar to those in French Law (Procedure de Sauvegarde) or in Italian Law (Concordato Preventivo), and not limited itself to a mere technical/cosmetic adjustment of the existing provisions.

The Insolvency Administrator: One of the important novelties foreseen by the present amendment, as mentioned in the PR, is the increase in professionalisation of the role of the Insolvency Administrator.

Firstly, we must underline that some of the measures adopted in this sense are very appropriate, for example, the requirement for an administrator to prove experience in at least five summary bankruptcy procedures in order to be appointed as a Insolvency Administrator in an ordinary procedure.

However, after taking this intention to professionalise Insolvency Administrator into account, it is astonishing that the new drafting of Section 27.1 of the Project has eliminated the requirement for lawyers, auditors and economists to have a minimum of five years practical experience in order for them to be allowed to be involved with the insolvency administration.

The Insolvency Administrator has been granted new powers that do indicate progress. The new Section 43.2 of the Project, which states that 'in the interest of the bankruptcy procedure, the Insolvency Administrator shall be entitled to perform any acts of disposal necessary to guarantee the company's viability or the treasury needs required by the procedure's continuity, which must be immediately communicated to the insolvency procedure's Judge, accompanied by proof of its necessity and of the performed acts' deserves a specific mention. This measure will help to decongest the Courts as any alienation will require an authorisation from the Judge to date.

Moreover, and with the purpose of avoiding litigation relating to challenging the list of creditors, and the consequent delay in the bankruptcy procedure, it is established that creditor communications shall be carried out directly before the Insolvency Administrators, rather than before the Court – thus reverting back to the system under the old Suspension of Payments Act – which shall relieve the Courts of the heavy workload involved in matters of creditor communications and the related controversies which they bring about.

The above mentioned communications, as well as everything concerning communications between the Insolvency Administrator and the creditors for the creation of the list of creditors, shall be carried out electronically. The implementation of new technologies in the field of bankruptcy procedures is, without a doubt, a great leap, although in our opinion the electronic signature should have been established as mandatory for all of these communications in order to avoid possible problems.

Telematic Impulse: Another important element of the Project is the *impulse of telematic media*. Its purpose is to ease communication between creditors and the Insolvency Administrator, both by postal and electronics means. A clear example is the *conditio sine qua non* for the Insolvency Administrator to allow it to designate its postal and electronic addresses so that creditors can communicate through whichever means they deem most convenient.

The Project should have been regarded as an opportunity to develop things further in the field of new technologies, for example by permitting full communication between the judicial entity and the Insolvency Administrator by electronic means. However, we must not forget that Insolvency Administrators are exempt from representation at the Court, and therefore, the efficiency of the current notification system is doubtful, given that the intensity with which they receive Court notifications depends on the frequency of their visits to Court. At a time in which notification systems for representatives like LEXNET exist, communications with the Insolvency Administrator should be quicker.

The Insolvency Administrator's Report: We believe that an exhaustive review with regard to the *extension-filing of the provisional report-deadlines for both* is necessary, as the current regime gives rise to absurd situations.

One clear example is Section 72.2.2nd of the Project which states that if the term for communication of credits has not been concluded within the two month due date, at the request of the Insolvency Administrator, the term for the filing of the report will be extended up to five days following the closure of the communication term. Meaning that the Insolvency Administrator will only have 5 days to elaborate and close the report. This conflicts with the Insolvency Administrator's obligation under Article 95.1, explained above.

These problems regarding terms are even more substantial if we bear in mind that Section 74.2.1st of the Project forbids those administrators that have been designated in at least three ongoing bankruptcy procedures from requesting an extension. Such a prohibition is frankly surprising and defective in its writing for the following reasons: (i) those cases involving administrators with more ongoing appointments are precisely the ones in which the extension becomes the most necessary. We imagine that its intent is for those administrators with more appointments to provide themselves with sufficient flexibility and infrastructure and (ii) the amendment does not clarify what will occur in those ordinary insolvency procedures (in which three bankruptcy administrators are appointed) in which administrators with more than three ongoing bankruptcy procedures concur with others not affected by such a circumstance. In the said case, which criteria shall prevail?

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Direct Action: the Project solves one of the greatest controversies in bankruptcy procedures relating to the real estate sector, which presented disparities in its Court precedents. The controversy related to the possibility of filing lawsuits, against the owner of the construction project, exercising those actions acknowledged to those who provide their workforce and materials in a construction adjusted on a lump sum, by virtue of Section 1,597 of the Civil Code (known in the doctrine and jurisprudence as a 'Direct Action'). Under such a proceeding, subcontractors can file the claim directly against the main contractor in order to be paid from the money the main contractor owes to subcontractor's contractor. The new drafting of Section 50.3 of the LC sets forth that the Judge of First Instance shall not admit proceedings of this type, under penalty of closure and invalidity of all the actions.

The pending procedures in which these actions are filed shall be suspended, according to Section 51.bis 2: '... that sets its suspension until the insolvency proceeding is terminated'.

Summary Proceedings: Of particular surprise is the theoretical intention to boost the use of summary proceedings as if they were one of the solutions to what the PR call a 'temporary problem'. What this implies is that, while the current version of the law sets a maximum debt limit of EUR 10 million for cases which can be heard under summary proceedings, the Project reduces this limit in half to EUR 5 million.

Notwithstanding the above, the amendment without a doubt implements multiple changes which, if carried out in practice, will greatly expedite summary proceedings, especially those actions concerning abiding by procedural terms by the courts.

Credit Purchase: the Project modifies the current wording of Section 122.1.2nd, which declares that any credit being purchased once the insolvency proceeding has been filed or in the previous six months, loses its voting rights. With these modification, there are two exceptions when the voting right is not lost: (i) universal (inheritance) and compulsory purchase (Court Executions) and (ii) purchases by an entity subject to financial supervision from said loss.

Once again, our insolvency regulations insist on going in the opposite direction, possibly as a consequence of the lawmaker's suspicions deriving from the fact that, by the means of a credit acquisition, a third party can gain control of the bankrupt company. The lawmakers seem to ignore that (i) the said sale is the consequence of a free transaction between two parties; (ii) in many cases, creditors can recover a part of their loss; (iii) when grouping into the credit, the control that can be carried out upon a bankrupt company will be much greater, provided that the parties that invest in such a transaction expect to recover their investment; and (iv) to ignore the enormous market that this type of debt caters to worldwide is a grave mistake. The present amendment should be used as an opportunity to eliminate any restrictions on the purchase and sale of credit.

Early Liquidation: Regarding early liquidation, its fulfilment is expedited by allowing the opening of the liquidation stage as soon as the debtor requests so. The Insolvency Administrator, in extraordinary cases, shall be entitled to request its opening, which is a significant step forward.

The Qualification Stage: The Project recognises that the qualification stage shall not open if a PEA is agreed upon. What appears to be an advance in the shortening of the procedure's duration, may very well favor fraudulent use of this provision in avoiding Director's liability.

This novelty cannot be understood if we keep in mind that, currently, when the PEA is accepted, the bankruptcy procedure's qualification is usually unforeseeable and the proceeding of the qualification stage does not bar continuation of business activity in any way.

III. Unmodified matters

Effects of the Bankruptcy Procedure: The current criteria to establish the effects of the bankruptcy procedure since the date of the decision to admit the filings is maintained. This would be without a doubt adequate if the deadlines set forth in the LC were met, but considering that, in certain circumstances, the admission can be delayed for months, a protective measure should be introduced in order to avoid certain situations which currently occur in the said intermediate period of time, particularly those concerning enforcement by Public Administrations.

Proposal of Early Agreement: The Project does not change the term to file the proposal of early agreement**.** In many situations, the deadline to communicate the credits (which, in summary proceedings, is only 15 days) is too short to file the said proposal of early agreement, as the term is clearly insufficient to arrange a consensus between the company's creditors and draft a proposal agreement and viability plan.

Credit of Public Administrations: Another particularly striking aspect of the Project is that, on one hand, it modifies Section 164 of the General Tax Act, but on the other hand, it fails to amend the Royal Decree 1415/2004, of June 11, which passes the *General Rules for Collection by the Social Security*, to co-ordinate the performance of the TGSS in each bankruptcy procedure.

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Insolvency of Individual Persons: Finally, we must point out that the lawmakers have not tackled one of the most important problems found within the current regulations: the insolvency of individuals. Practice has without a doubt proved that the procedure foreseen in the LC is not useful when faced with insolvency of this type of debtor, particularly consumers.

The old distinction between corporate and non-corporate debtors should be recovered and a specific procedure for this type of debtor should be approved, for example, by introducing arbitrating systems of debt waiver in specific cases, as other legal systems have regulated. In practice, the problem with the natural person lies in credit over extension and not corporate insolvency, making it often impossible to approve a proposal agreement, which ultimately gives rise to those procedures with the current structuring for the liquidation of the natural person, which is, fortunately and by definition, impossible.

IV. Conclusion

In conclusion, we can point out that the amendment has begun to pave the way for a necessary modification of the insolvency regulations, and it is quite laudable that it has not waited until the regulations were outdated. However,it lacks determination regarding those aspects which imply greater procedural expedition and requires adaptation to corporate reality.

We must highlight several improvements that the amendment implements, in different procedural aspects, and which we hope shall give rise to a greater procedural efficiency.

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International Corporate Rescue

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