BANKRUPTY & RESTRUCTURING [1662 words]

Insolvency claims trading in Spain: key issues and practical problems

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The creation of a market in bankruptcy claims is believed by some to be one of the most important developments in the bankruptcy world in the last decade. Claims trading, which is envisaged as a complex, multi-dimensional and dynamic market, with a key impact on the success of an insolvency proceeding, has arguments both for and against.

Those for claims trading argue that this provides an immediate mechanism for creditors to exit the bankruptcy process and further allow the entrance for those investors who want to take time and effort to monitor the debtor and contribute expertise to the reorganisation process. They additionally argue that claims trading imposes market discipline on debtors and results in a higher and/or quicker return for creditors. Those against argue that claims trading raises transaction costs and enhances short-term strategies where traders may sacrifice the long term viability of a debtor for the ability to realise substantial and quick return on their investments.

However, when it comes to Spain a true debate regarding claims trading has never really taken place. The Insolvency Act of 2003 and the subsequent reforms, namely the October 2011 reform, have been approved without an in-depth analysis of claims trading and the benefits or prejudices that this mechanism can represent for Spanish insolvency proceedings. Instead, claims trading has always been approached by legislators from a prevention of fraud perspective. Indeed, the former Insolvency Act provided that holders of credit claims that had been transferred post-petition were deprived of their rights to vote for the approval of composition agreements as a reaction to certain conducts that had historically existed in Spanish insolvency proceedings – trading with claims to implement secret agreements between controlling shareholders and creditors to force compositions that breached the *par conditio creditorum* principle. This, of course, dried up the market for insolvency claims, resulting in no claims trading generally taking place in bankruptcy proceedings subject to Spanish insolvency law since 2004.

The 2011 reform amended the voting rules relating to composition agreements set forth by section 122.1.2 of the Act, allowing holders of credit claims acquired post-petition *inter vivos* to vote for approval of composition agreements if the transferee is an "entity subject to financial supervision". This reform was aimed to promote the involvement of professional investors in bankruptcy proceedings, allowing them to enter into, primarily, the unsecured layer of the debtor's capital structure – the critical mass of claims entitled to vote for composition agreement purposes – through the acquisition of insolvency claims post-petition, thus influencing in-court bankruptcy reorganisations. However, this reform has certain technical deficiencies and further, still does not address the whole phenomena of claims trading, thus affecting the potential development of a robust bankruptcy market in Spain. The main deficiencies and key problems are as follows.

First, the concept of "entity subject to financial supervision" set forth by section 122.1.2 has not been defined statutorily and, therefore, it can be understood that any entity subject to supervision by financial authorities – Spanish, European or international – will fall under this definition. This will, in principle, allow hedge funds and other similar institutional investors to trade claims within Spanish insolvency proceedings and be qualified transferees for insolvency voting purposes. However, it cannot be overlooked that in other sections of the Spanish Insolvency Act reference is made to “financial entities” – used in connection with entities subject to the Spanish Scheme introduced in 2011 rather than to “entity subject to financial supervision”. The concept of ‘financial entity’ is a statutory concept which can be found in the European Directive 2006/48/CE – developed in Spain by the Royal Decree 216/2008 – and which may not include certain insolvency investors depending on their specific investment profile.

Therefore, should this statutory concept be the one finally followed by Spanish courts (and not the broader “entity subject to financial supervision”) this could limit the number of transferees falling under the scope of section 122.1.2 and would impact the creation and development of a bankruptcy market in Spain. Therefore, section 122.1.2 will require further case law development in order to clarify the scope of this section, especially with respect to which legal concept will be followed by the courts and, therefore, which transferees will be qualified transferees and will not be deprived of their rights to vote for the approval of composition agreements when trading claims within insolvency. Any doubts in connection with what is a qualified transferee can affect the investors’ perception of the Spanish bankruptcy market and, therefore, jeopardise its present and future development.

Second, in order to be a qualified transferee under section 122.1.2 the transferee needs to be the actual claimholder – or, for example, lender of record – within the insolvency proceeding. This can raise some problems for certain investors, especially hedge funds and other institutional investors, which usually implement their investments through special purpose vehicles set up solely to make investments and which are not subject to financial supervision. Instead, the investment manager of the portfolio – a separate entity which employs the people who manage the portfolio and which is the actual hedge fund business – that is subject to financial supervision but not the entity holding the claim on their books or being the claimholder for insolvency purposes. This will mean that the fund will not be allowed to vote for composition agreement purposes as it will not fall under the qualified transferee category set forth by section 122.1.2.

Even if this limitation can represent an unnecessary and relevant limitation to claims trading in Spain it can be circumvented through different legal structures such as participations or similar contractual instruments. Pursuant to a participation scheme the participant (transferee) is entitled to receive the proportion of monies paid to the seller of the participation (transferor) even if the participant will formally have no direct contractual rights against the borrower/debtor – the participant is not a claimholder as her rights and obligations *vis-à-vis* the borrower derivate of the rights and obligations of the seller of the participation.

In the particular case of insolvency claims trading, the participation would allow the fund to become the ‘economic owner’ of the claim even if the ‘political’ rights associated with this are still in the hands of the participant. This, of course, will require the negotiation of contractual restrictions in order to allow the participant to direct the seller of the participation on how to vote on a composition agreement or how to proceed with respect to any other decisions that may be necessary to make during the insolvency process – including the filing of the proof of claim within the insolvency process. Even if this contractual solution is very effective to overcome the limitations of section 122.1.2 it can also result in further uncertainty for the distressed investor. Therefore, in addition to the recovery risk and the notional amount risk normally involved in these transactions, the investor will face a heightened counterparty risk which will need to be mitigated by carefully negotiating the participation agreement and its restriction clauses to allow the transferee to have a 'material' control over the claim, even if, formally, the claimholder will still be the seller of the participation.

Third, the Insolvency Act does not provide for disclosure obligations to transferors and transferees nor for any other mechanism to facilitate claims trading within insolvency proceedings. This circumstance can make the bankruptcy market too opaque and, therefore, prevent its full development, even if some market participants will, for sure, have a different view on this. In this regard, instead of artificially limiting the scope of transferees that can benefit from the provision of section 122.1.2, the Act should introduce streamlined disclosure obligations – parties' identity, price, other credit positions that the transferee may have within the estate, and so on – to make the insolvency claims trading process transparent and consistent with the goals of the insolvency proceeding. Moreover, the Spanish Insolvency Act should utilise, for example, the insolvency trustee (a body which already exists in Spain and plays a key role in bankruptcy proceedings) as a platform for facilitating claims trading and entrusting such a body with the power to challenge *ex post,* any transfers which may have a bad faith motivation and result in conducts contrary to the goals and normal development of a bankruptcy proceeding. Of course, the powers of the trustee in connection with claims trading should be carefully drafted and highly limited, as well as the grounds on which claims trading could be challenged. Even if this proposal can have the risk of being a disincentive for claims trading we believe this solution is much better than the Insolvency Act's current approach based on artificially limiting who can be a transferee in a Spanish insolvency proceeding without regulating the key elements of this market.

While the Spanish Insolvency Act has made the first step for the development of a bankruptcy market in Spain (which is very positive) the development and consolidation of this market is far from close. For this purpose, the Act should not limit claims trading by (artificially) establishing categories of qualified transferees and, instead, should open this market to any market participant while setting up, in turn, disclosure obligations for these participants and *ex post* control of claims transfers – through an already existing body such as the insolvency trustee – to prevent opportunistic behaviours by these same participants which may affect the normal development of a bankruptcy proceeding. This solution will eliminate the current existing uncertainties and would provide the correct foundations for the development of a Spanish bankruptcy market.

However, until this happens, investors should be aware of the limitations imposed by section 122.1.2 and carefully structure their trades to prevent any problems when approaching a Spanish insolvency proceeding by contractually tackling the different legal issues identified in this article.

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