Legal structuring of direct lending deals: Spain

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1. Introduction

The Spanish banking sector has experienced a radical transformation in recent years due to the financial crisis and the latest regulation at local and EU level, which has introduced a new framework and several measures to improve their control and supervision and eventually, if required, to deal with their dissolution. As a result, after a consolidation process involving several Spanish financial entities and the disappearance of the savings banks (*cajas de ahorros*), the Spanish banking sector has been reduced to few financial institutions (mainly, banks and credit financial entities – *establecimientos financieros de crédito* or 'EFCs').

This situation has provided an opportunity to new players, non-traditional lenders or debt funds, to come to Spain to provide loans and alternative financing. Lending is not a reserved banking activity in Spain. As a result, there is significant flexibility, since neither a licence nor an authorisation is required to grant loans and credit (and consequently to become a beneficiary of any related security or guarantee). This flexibility extends to both origination of loans and those becoming secondaries by assignment. As a result, shadow banking is increasingly becoming an alternative source of financing alongside the traditional banking system in Spain.

For the past five years these new financial players have been very active in direct lending and secondary debt trading, in particular for short-term financing. Normally, such direct lending in Spain is focused on small and medium-sized enterprises rather than individuals, since consumer loans are subject to special and more restrictive regulation. In addition to debt funds and alternative lenders, asset managers and loans servicers have also emerged as new actors in Spanish financial transactions. Until a few years ago, the arranger or the leading lender would be willing to undertake these tasks and to become an agent under the loan due to its commercial relationship with the debtor, but now this role has been adopted by more specialised entities.

With this flexible set-up for lending activities in Spain, there have only been a few specific pieces of legislation which have regulated new financing alternatives. For instance, Law 5/1015 on Promoting Business Financing, deals with crowdfunding, requiring that this activity only be rendered through a platform that complies with certain legal requirements and that should have been previously authorised and registered in the special registers of the Spanish National Securities Market Commission (the CNMV). Law 5/2015 also introduces certain measures to facilitate access to funding for small and medium-sized enterprises and to promote alternative sources of financing and corporate financing mechanisms.

In addition, new opportunities for non-traditional lenders at attractive returns have opened up because of new limitations, levels of provision, the cost of capital and controls affecting traditional banks; all of which have served to act as disincentives for traditional lending transactions in certain sectors or for certain players.

Despite the flexibility outlined above, any individual or entity entering into financial transactions or providing financial services in Spain could eventually be required by the Ministry of Economy periodically to disclose any information in connection with its activities, or be subject to inspections by Bank of Spain to evidence whether the activity performed is subject to supervision.

In general, Spanish law contemplates a number of legal limitations in connection with lending transactions. We will elaborate further in other parts of this chapter, but by way of introduction, at this stage, we will mention the following:

- anti-money laundering regulations and 'know your customer' requirements;
- forms of security available (in particular, mortgages) and associated costs (especially, stamp duty, notarisation fees and, if applicable, registration fees);
- withholding tax on interest paid (normally solved by having a Spanish or EU entity as the lender);
- the requirement for non-Spanish entities to have a Spanish tax identification number for statistical purposes; and
- other general limitations on financial assistance, corporate benefits and insolvency law, which may be applicable to the deal.

2. Structuring direct lending transactions

As we have previously noted, Spanish law does not require any specific licence or authorisation for lending activities, and therefore there is no need to have a regulated entity for these purposes. Only in the case of entities lending to consumers does Law 2/2009 require lenders to be registered in the consumer registry of any autonomous community where it provides lending activities.

Therefore, the investment vehicle can be selected by the lender on the basis of considerations of tax efficiency.

From a Spanish tax perspective, when considering the structure to be adopted in this type of transaction, it is important to take into account the general tax consequences arising from the payment of interest, the running of the business and the potential withdrawal of investment.

In this regard, when funding is granted by an entity that is non-resident in Spain for tax purposes (the lender) for the benefit of an entity resident in Spain for tax purposes (the borrower), the common structure is for the lender to be resident for tax purposes in another EU member state in order to benefit from the exemption on Spanish domestic withholding tax on interest. According to the relevant Spanish legislation, interest would be exempted in Spain and, therefore, no withholding tax would arise, provided that:

- the lender is resident for tax purposes in an EU member state;
- it is the beneficial owner of the interest payment; and
- it does not obtain the interest through a permanent establishment in Spain,

nor through a permanent establishment located outside the European Union, nor through a tax haven.

In any case, in order to apply this exemption, the lender should provide the corresponding tax residency certificate issued by the relevant tax authorities prior to the payment of interest.

Ireland and Luxemburg are the countries most frequently chosen to incorporate vehicles that would act as lender to a Spanish entity, as the legislation of these countries contains favourable tax regimes for the day-to-day business of the vehicle and for its potential exit from the investment. Borrowers are usually companies, either *sociedades anónimas* (SAs) or *sociedades limitadas* (SLs). There are differences between these two forms of entity (minimum share capital level, shares versus units representing the capital, etc). However, for the lenders' perspective both entities are suitable borrowers.

The structure of a loan transaction will primarily depend on the capital structure of the company. Generally, small and medium-sized Spanish companies are mainly financed by banks with which they have a long-standing relationship, and, depending on the level of indebtedness, these banks may have security over a substantial part of the assets of the company. There is therefore a need to ensure that the borrower can offer the lender security in the form of unencumbered assets, and ideally to structure the financing in such a way that there is no need for recourse to other assets.

The 'double luxco' structure has become relatively common in Spain, especially when the lender is a foreign entity, as they are generally more comfortable with a structure that has been tested and proved to work in terms of allowing effective enforcement of security over shares. The enforcement of security rights over shares is not really a form of proceeding that could work efficiently in Spain, with the exception of pledges of shares granted in accordance to the Royal Decree Law 5/2005, which implements the EU Directive on financial collateral arrangements (Directive 2002/47/EC) and which has proved to work efficiently in several cases, particularly with regard to pledges over shares of listed companies.

In those cases where the financing is secured by real estate assets, lenders will generally be comfortable with the asset itself as collateral altogether with the cash-flow generated by the project.

Additionally, we have recently seen a substantial number of transactions secured with the rights over the invoices of the debtor companies and their other receivables, either directly or indirectly. Where this happens in a direct manner, the borrower pledges the rights over the amounts to be paid under invoices issued to its debtors. Such pledges of credit rights, unlike pledges of shares, do work efficiently in Spain and allow the creditor to receive payment under the pledged invoice by way of a set-off against the amounts due from the borrower or by assignment of promissory notes (*pagarés*) issued by the debtor.

Indirect factoring transactions have been implemented by the issuance of commercial paper instruments by the borrower. The commercial paper is issued on the Spanish Alternative Fixed-Income Market (MARF) and subscribed to by the

lender, who at the same time can obtain liquidity by selling the bonds on the market. MARF has been a great tool for small and medium-sized undertakings seeking to access financing for SMEs, and even for large companies such as El Corte Inglés, which, as publicly reported, recently issued a €300 million promissory notes programme on MARF.

3. Key Spanish legal issues

3.1 Security

From a security perspective, any *in rem* security over Spanish assets (mainly mortgages and pledges) and personal guarantees provided by Spanish obligors would be governed by Spanish law. When structuring the Spanish security package, either on origination or on secondary trading by means of subrogation, it is critical to analyse the assets available and how to mitigate potential costs when granting and executing the security in Spain (ie, stamp duty, registration and notarisation fees, etc). Also note that non-credit institutions cannot benefit from certain types of security such as floating mortgages (Article 153-*bis* of the Spanish Mortgage Law). Finally, note that lenders should be recorded as direct beneficiaries of the security in the applicable registers (ie, land register or moveable asset register), and that it is not possible to appoint a security agent or trustee as beneficiary on behalf of the lenders in the applicable public register.

3.2 Enforcement

From an enforcement perspective, it is critical, in order to be entitled to enforce in Spain through straightforward executive summary judicial proceedings (*procedimiento ejecutivo*), that the finance documents are notarised as public documents. Appropriate Spanish language on enforcement in Spain should also be included in the facility agreement. In particular, reference to enforcement through the mechanisms provided under Royal Decree Law 5/2005 which implements in Spain the EU Directive on Financial Collateral Arrangements, is a must for enforcement of pledges of credit rights and of shares, even provided all other requirements are fulfilled. Notarial enforcement proceedings are also available, but are not the usual route selected by the creditor due to timing and formality constraints. Finally, as we will explain in detail below under heading 4, not all breaches and defaults under a facility agreement will lead to an event of default which Spanish courts would admit for enforcement purposes. Traditionally, only essential, continuous and severe breaches will allow the lenders to enforce the security. Other limitations and restrictions to enforcement apply when the obligor is an individual person according to consumer protection legislation (ie, when the mortgaged property is the debtor's main domicile).

3.3 Tax

From a tax perspective, the lender is normally a Spanish limited company (SL) or an EU entity, in order to avoid withholding tax on interest paid.

As regards stamp duty, applying for certain tax exemptions (for instance, under

Law 2/1994 in the case of subrogation or amendment of mortgage loans) or executing certain security before the Spanish notary by means of a *póliza* document as opposed to a public deed, may avoid triggering stamp duty while allowing the instrument to enjoy the same benefits as public documents.

3.4 Insolvency

From an insolvency perspective, if the borrower is declared insolvent, a two-year claw back period applies, and all transactions entered into by the debtor will be scrutinised. Any act or agreement which is deemed to be detrimental for the debtor's estate will be null and void. If the loan provides new money, in general, it will be presumed that it is not detrimental. However, if the new loan merely replaces a previous obligation and enjoys additional new security it will be avoided. On the other hand, security subject to Royal Decree Law 5/2005 could be enforced and no insolvency rules would apply since it would be ring-fenced. Restructuring agreements at pre-insolvency stages which comply with certain requirements and majorities would also be ring-fenced and would not be rescinded.

3.5 Corporate law

From a corporate perspective, it should be noted that some specific rules will apply in certain cases. For instance, Spanish entities are required to approve the transaction at shareholder level when selling, contributing or charging their 'essential assets', meaning assets of a value of more than 25% of the company's balance sheet (Article 160(f) of the Spanish Law on Corporations). It may be the case in certain situations that the Spanish borrower cannot be restricted from making distributions to shareholders. Finally, be aware of financial assistance prohibitions which could also be applicable to Spanish obligors in the context of share purchase deals.

3.6 Governing law

Regarding the governing law of the finance documentation, although Spanish law provides a creditor-friendly environment and offers a reliable judicial enforcement procedure, English law is often used as an alternative applicable law in the finance documentation in Spanish lending transactions. Loan Market Association templates, either on origination or trading, are often used since international debt providers are more familiar with such documentation. However, in any case, Spanish security will be subject to Spanish law. Notarisation in Spain of the finance documentation, even if it is subject to English law, would also be advisable for eventual enforcement purposes.

When English law is the governing law of the finance documentation, this also allows access to restructuring tools such as the English scheme of arrangement. However, now Spanish insolvency law provides several similar tools, such as the court-sanctioned restructuring agreement (*homologación del acuerdo de refinanciación*), and this advantage is not so important anymore. In most cases, the choice of English law has a purely commercial motive, since the debt at issue will be more easily transferable to potential international buyers.

However, Brexit may impact the use of English law in the near future, due to the

uncertainties that may result in connection with the recognition of English law in some foreign jurisdictions.

4. Enforcement considerations

Under Spanish law, not all the events of default listed under a standard loan agreement will be admissible for enforcement purposes before Spanish courts. In any case, it is also usual to grant to the borrower a rectification period to solve the default situation. Only essential, continuous and severe defaults will be admissible at Spanish courts for enforcement purposes. Therefore, non-payment, breaches of financial ratios or undertakings granting additional security are typical situations which Spanish courts would accept when enforcing security. Cross-default and cross-acceleration provisions might not be enough. On the other hand, a mere breach of an information covenant will not lead to an enforcement proceeding before Spanish courts.

Individual enforcement is usually available in Spanish loan documentation if the majority level for enforcement has not been reached. However, in general, individual enforcement will not allow enforcement of security, only of personal guarantees, if applicable.

Intercreditor agreements are usually part of the finance documents in Spanish loan transactions; in particular when dealing with different layers of debt. These agreements regulate the relationship between different creditors and are critical due to the sharing and turnover provisions, waterfall clauses, limitations to enforcement and the process of making decisions requiring majority levels among creditors. Insolvency courts will not have regard to the intercreditor arrangements, but only to insolvency law, in order to determine the classification of credit claims, distributions and privileges. However, each creditor may claim under the intercreditor agreement against the other creditors, forcing them to honour the terms agreed.

5. Key insolvency issues

Insolvency proceedings against the borrower will preclude enforcement of the lender's security rights (or would stay or suspend any proceedings already initiated). A declaration of bankruptcy triggers an automatic stay of all the enforcement actions (with certain exceptions, such as security interests over collateral that is not necessary to continue the ordinary course of business).

In addition, according to Article 61.3 of the Spanish Insolvency Act, any clause establishing the right to terminate an agreement, based only on the borrower or obligor's declaration of insolvency, will be held not to have effect and become null.

Where a Spanish borrower or obligor claims pre-insolvency status following the filing before the Spanish courts of Article 5-*bis* notice, this will, in general, stay or suspend any enforcement proceeding already initiated. During the insolvency proceedings this stay on enforcement will continue for a maximum period of one year.

Equitable subordination is regulated in Article 93.2.1º of the Spanish Insolvency Act. Creditors holding a stake of at least 5% in the debtor (if the shares are listed) or 10% (if the debtor is not a listed company) at the time of granting the loan (ie, when

the credit arises), will qualify as a specially related party, with its claim being subordinated (and its security avoided).

Should the lender act as a *de facto* administrator (shadow director), this would also mean that the lender will qualify as a specially related creditor and its claim, even if it is deemed to be privileged, will be subordinated (Article 93.2.2º of the Spanish Insolvency Act) and any security will be declared void. For instance, forcing the debtor to take certain business decisions at board level due to covenants under the finance documents, or controlling the debtor's bank accounts, or exercising voting rights at a shareholders' meeting would lead the courts to consider the creditor to be a *de facto* administrator or shadow director and its claim will be subordinated.

According to Article 93.3 of the Spanish Insolvency Act, it is presumed that assignments of credits from specially related parties would be classed as subordinated, provided that the acquisition occurred within the two-year period before the declaration of insolvency.

As mentioned, claw-back actions or stays of proceedings would not apply to security granted under Royal Decree Law 5/2005, which implements in Spain the EU Directive on Financial Collateral Arrangements, since such security will be ring-fenced and Spanish insolvency law will not apply.

Spanish insolvency law also provides that a director may be personally liable for the debtor's credit claims under certain circumstances.

6. Rescue financing

Spanish insolvency law provides for different treatment for out-of-court and in-court rescue financing. Out-of-court financing is also treated differently depending on whether or not it is granted within the scope of a refinancing agreement.

6.1 Rescue financing granted in connection with a refinancing agreement

Financing granted under a refinancing agreement which meets all the relevant statutory requirements, is considered in its entirety as an administrative expense (*crédito contra la masa*) with priority over any other insolvency claims (except privileged secured claims), and is paid as it becomes due (a waterfall privilege).

This privilege will only apply within two years from the date that new money was granted. Additionally the new money would have to be granted under a refinancing agreement executed before October 1 2016. After this two-year transitional period, the 'old' new money regime applies (meaning, 50% will be considered as an administrative expense, and the other 50% as a general privileged claim).

The main limitations are that:

- this new money does not have a super-priority, and therefore in a liquidation scenario, the new money ranks junior to any other administrative expenses; and
- there are no priming liens available in Spain over previously encumbered assets.

Additionally, there is a possibility for the insolvency administrator to modify the ordinary payment schedule established by the new money agreements and to extend

the terms of payment. This circumstance results in heightened uncertainty for the rescue lenders and does not encourage this type of deal, due to the fact that a third party (the insolvency administrator) may affect the amortisation schedule that has been negotiated and contractually agreed by the new money lender.

The new money privilege applies even when funding is provided by the debtor or an inside party, except for new money resulting from increases in share capital. Interest payments will be deemed to be subordinated claims, however.

With a new money transaction structured in the context of a court-sanctioned scheme the claw-back risk is mitigated. Indeed, in the context of a court-sanctioned scheme the claw-back risk, according to the letter of the law, is eliminated.

In any event, and from a practical perspective, it is key to include contractual mechanisms within the credit facilities to allow the lenders of rescue funding to benefit from the new money privilege on an ongoing basis within the insolvency proceedings. These mechanisms could consist of an acceleration of the maturity schedule, or prepayments within the insolvency proceeding, or other contractual provisions which allow the new money lender to capture the insolvency cash flows.

6.2 Rescue financing granted outside a refinancing agreement

Rescue financing granted outside a refinancing agreement does not benefit from any privilege or senior ranking against other creditors of the debtor and, therefore, the general rules regarding claim classification within an insolvency proceeding will apply. In the case of rescue financing granted outside a refinancing agreement, it is key for the new money lender to structure a security package which may provide a satisfactory loan-to-value ratio. In those instances where no security package can be implemented, the new money lender's claim will be classed as an unsecured claim in the context of the debtor's insolvency proceeding, ranking equally with other unsecured claims and being junior to secured claims.

The risk of claw-back cannot be ruled out as such loans are not protected by statute. However, there are strong arguments (based on existing case law) to justify the view that claw-back would not apply if the refinancing involves new money and an extension of maturity, where security is in place and the level of security is reasonable for the amount of new money provided.

With regard to such transactions, it is always advisable to obtain the opinion of independent experts, particularly as to fairness, in order to protect them from future claw-back actions, and to build up a comprehensive record of the negotiation, the risks involved at the time of granting the new money and the transaction documentation, in case any challenges are brought against the transaction in the context of a claw-back action.

6.3 Rescue financing within insolvency proceedings

The absence of provision for debtor-in-possession financing is probably one of the main omissions from the various reforms of insolvency law that have been enacted in Spain during recent years. This is one of the reasons, albeit not the sole reason, for liquidation being the default outcome when a company files for insolvency (the liquidation rate in Spain is still around 90% of insolvencies filed, with very low

creditor recovery levels). This is likely a result of the Spanish Insolvency Act ignoring the fact that, when filing for insolvency, companies unable to meet their financial obligations often need further financing to pay for the administration expenses of the case and to continue operating. Without this financing, the only outcome is liquidation. There is no incentive for post-petition financing at the initial stage of the insolvency process such as is provided for in other jurisdictions (such as, for example, Section 364 of the US Bankruptcy Code), and there is no statutory framework for the debtors promptly to access during the initial phase of any financing mechanisms which is not too burdensome and is subject to the general rules applicable to the administration of the debtor's estate and does not benefit from specific incentives or privileges. On the contrary, the entirety of the new money claim will have the status of an administrative expense, but with no super-priority over other administrative expenses and, on the contrary, ranking junior to other administrative expenses, such as labour law claims. As mentioned above, unfortunately, Spanish insolvency law does not provide for priming liens over previously encumbered assets.

New financing within an insolvency proceeding will require the approval of the insolvency administrator and, in some instances, the insolvency judge (when the financing transaction entails the granting of liens or encumbrances over any of the debtors' free or unencumbered assets). The risk of claw-back will not be applicable since the financing is authorised within the insolvency process.

Further, Spanish insolvency law has clarified the regime applicable to the financing of viability plans that support reorganisation (ie, exit financing). Under the Spanish Insolvency Act, claims resulting from exit financing granted in connection with composition agreements (*convenio*) are considered an administrative expense in their entirety, benefiting from the privileges of this type of claim.

Spanish insolvency law's failure to establish a statutory scheme to promote debtor-in-possession financing is made all the more clear by the total absence of a debtor-in-possession market in Spain (while in other countries, it is a very active and significant market) and the lack of liquidity that characterises Spanish insolvency proceedings, where debtors find themselves with no liquidity available to fund their ongoing operations unless they have been able to stockpile cash.

7. New money strategies

Of great relevance for new money lenders is consideration of how to structure and plan their exit strategy when entering into a new money transaction. In this regard, special attention should be paid to the mechanisms available under Spanish insolvency law to disenfranchise shareholders.

Debt-for-equity swaps are technically structured under Spanish law as capital increases by means of set-off (debt being set off against a certain number of shares of the debtor) or contribution in kind (the contribution being transfer of the debt, which is automatically extinguished by confusion). In both cases shareholders' support (up to certain relevant majorities) is necessary.

Under Spanish law there are no mechanisms which facilitate the takeover of

distressed companies by creditors by way of a debt-for-equity swap. The cram-down of the equity, even in those cases where shareholders may be 'underwater' and they may have no economic interest in their equity, always requires the approval of shareholders. This provides shareholders with leverage in these situations, despite the fact that the real value at stake is zero or close to zero.

To tackle this issue, and perhaps as a middle ground, Spanish insolvency law includes a rebuttable presumption as to the liability of the debtor's shareholders when they reject, without a reasonable cause, a debt-for-equity swap, another capitalisation process or the issue of convertible obligations, where the result is frustration of a collective refinancing or a court-sanctioned scheme. As a result, should the debtor finally file for insolvency, the shareholders could be held liable for any shortfall for creditors within the insolvency.

Despite this, it is still the case that , unless a consensual deal is reached, it is very difficult for a new money lender to take control of the equity of an undertaking in a distressed situation, unless it opts for other more cumbersome strategies such as the enforcement of a pledge over the shares (if such a pledge was included within the security package) or it can force a strategy within the insolvency proceeding aimed at taking control of the assets through, for example, liquidation.

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