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COVID-19: Impact on financial transactions

Legal flash

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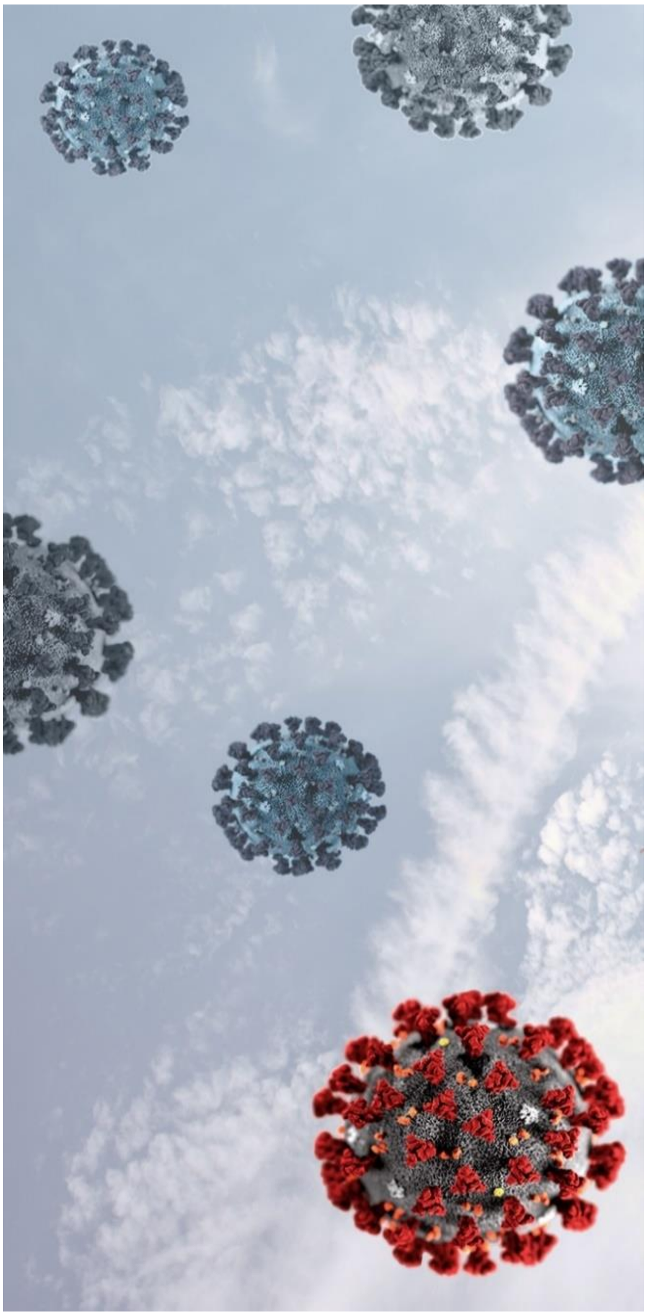

Content

Introduction

The purpose of this memorandum is to provide a complete and updated legal analysis of the impact of the exceptional situation caused by the COVID-19 crisis on contractual credit relations and fixed income capital markets. This has resulted from the “exceptional” regulations enacted by the Spanish government within the constitutional framework, as well as the measures adopted by the EU and its financial supervisory bodies.

Royal Decree 463/2020, of March 14, declaring the state of emergency due to the management of the health crisis situation caused by COVID-19 (“**RD 463/2020**”), sets out an exceptional legal framework to address and mitigate the social, economic and legal consequences of a health crisis that is affecting all economic activity. A response is required from different legal orders, both public and private, to keep the economy and productive activity afloat while ensuring the greatest possible legal certainty.

To analyze the legal impact on the financial and credit system, we must consider the measures adopted by the Spanish government through Royal Decree-Law 8/2020, of March 17, on urgent extraordinary measures to face the economic and social impact of COVID-19 (“**RDL 8/2020**”), Royal Decree-Law 11/2020, of March 31, adopting additional emergency measures to face the social and economic impact of COVID-19 (“**RDL 11/2020**”), and Royal Decree-Law 15/2020, of April 21, on urgent complementary measures to support the economy and employment (“**RDL 15/2020**”). It should be borne in mind that, unlike the 2008 solvency, liquidity and credit crisis, we now face a sudden health crisis that has exerted an immediate impact on the economy and the financial system. Fortunately, after setting up a robust financial system architecture in terms of supervision and liquidity, our banking system is in a completely different position —due especially, on the one hand, to high solvency ratios and, on the other, to a liquidity profile supported both by national bodies and the European Central Bank (“**ECB**”).

The ECB has adopted a set of measures to provide the market with the necessary liquidity (Decision 2020/441, of March 24, on the implementation of the corporate sector purchase program, and Decision 2020/440, of March 24, on a temporary pandemic emergency purchase program, with an overall envelope of €750 billion). This is intended to provide liquidity to both the national banking systems and private actors so that they can meet the immediate needs arising from the economic slowdown and from the closure of and restrictions on certain businesses.

An essential complement to the above, also aimed at increasing liquidity in the credit and capital markets, is the relaxation of the requirements affecting solvency and the equity of financial institutions, decided by the European Banking Authority (Decisions of March 12 and April 2) in coordination with the ECB, thus providing temporary flexibility regarding the credit risk management system.

However, legal relations in the financial and credit system are not driven by regulation alone. Current corporate finance goes hand in hand with "shadow banking," i.e., direct lending from regulated and unregulated entities. Therefore, here we also analyze the legal impact of providing liquidity to the productive economy, the relevance of which became apparent as a result of the 2008 liquidity and solvency crisis.

Furthermore, fixed income markets provide opportunities to supplement corporate financing at this time through securitization of all types of loans and credits, thereby providing liquidity both to credit entities and unregulated bodies.

As pointed out by some business researchers, "*recovery depends on preventing the lack of liquidity from mutating into a solvency crisis.*" Indeed, as we will explain below, legal solutions and the law's response to problems in credit financing and fixed income capital markets will play a major role in the financing of the productive economy, which is key to recovery. In this regard, new insolvency legislation was introduced, tested and implemented during the previous financial crisis to avoid situations of insolvency that could lead to the liquidation of the productive fabric. Pre-insolvency regulations, along with the legal framework set for restructuring and refinancing, under the regulations mentioned above, will play an important role in keeping companies in business.

As lawyers, we wish to offer answers to our clients to preserve the viability of companies and the productive economy. That is the challenge and the purpose of this memorandum and its analysis of the different areas, types of financial transactions and legal structures within our financial system.

Impact on current financing

To determine its actual liquidity needs, particularly through external resources, every company must assess the impact of all these circumstances on its current financial documents, in addition to analyzing its financial position and reviewing its cash flow expectations in the upcoming months.

COVID-19 regulation is provisional and limited to the duration of the state of emergency (and, as the case may be, to a limited extended period). However, it does not entail a general moratorium, nor a standstill on obligations under financing agreements or on enforcement actions. Only certain credits or loans (such as, those secured by real estate mortgages and granted for the acquisition of the main and habitual residence or for the acquisition of property used to carry out a professional activity) with debtors in situations of special vulnerability may benefit from a moratorium under RDL 8/2020 and RDL 11/2020.

If debtors detect a decrease in income, asset valuations, sales, EBITDA, and the like, or that other contractual breaches have occurred, they must notify their creditors promptly and with due transparency of the current breaches that may arise from this (e.g., representations and warranties, financial ratios, business plans, MAC or MAE events, events of default, and so on) and, if appropriate, request a waiver from their creditors. Moreover, if the impact on solvency is more significant, an amendment to the financing terms may be proposed. In any case, we can confirm that credit institutions are showing flexibility in the short term to solve these unforeseen issues and favor business continuity and recovery.

Therefore, in the face of cash-flow pressures, it would be advisable for companies —in addition to other measures regarding their fixed costs— to anticipate and increase their liquidity, making withdrawals from their current revolving and working capital facilities (even increasing them) to obtain liquidity. In any event, they should do so preventively before the situation deteriorates further and affects their financial statements to a greater extent, when weaker solvency positions and ratios would make withdrawals much more difficult. Equity could also be strengthened through shareholders' capital contributions, if possible, before the agreed ratios are breached (or at least to remedy any such breaches) and, alternatively, through subordinated debt or profit participating loans —if allowed under the financing agreement.

As regards other relevant contracts the rights and obligations of which may also be affected, and the modification of which will have an impact on financing agreements, it should be assessed whether the current situation constitutes a *force majeure* event allowing for certain temporary adjustments without triggering the consequences set forth in agreements for ordinary situations. Prudent debtors should try in good faith to preserve economic and asset value, minimizing damage to ensure solvency in the medium and long term. On the other hand, in this extraordinary situation it is unlikely that the courts will support and safeguard intransigent creditors in their claims, except in the event of flagrant, serious, material and continued breach by the debtor and/or other obligors, or where the latter have not acted in good faith.

With regard to insolvency, RDL 8/2020 foresees many companies facing liquidity problems, at least temporarily. To avoid the risk of debtors having to face insolvency, article 43.1 provides that no debtor will be required to file for insolvency proceedings during the state of emergency (although they will still be able to do so if they wish). This will prevent company directors from being liable for not applying in due time and form. Moreover, creditors will not be able to file for compulsory insolvency proceedings, since the courts will not grant any applications filed during the state of emergency or until two months after its end. In addition, debtors' applications for voluntary insolvency proceedings will be prioritized.

On the other hand, article 43.2 of RDL 8/2020 establishes that debtors that have notified the court that negotiations have been opened with creditors, as provided under article 5 bis of the Insolvency Act (*Ley Concursal*), will not be required to file for insolvency proceedings during the state of emergency even if the deadline provided in it is exceeded. As well as suspending the deadlines set forth in article 5 bis of the Insolvency Act, RDL 8/2020 establishes that the grounds for dissolution will not apply during the state of emergency, thereby suspending all judicial deadlines and proceedings.

ICO facilities, state guarantees and the Spanish Export Credit Insurance Company's extraordinary facility

Under article 29 of RDL 8/2020, the Spanish government has approved a set of aid measures to companies and self-employed persons. These include, among others, financing to meet their liquidity needs through a state guarantee facility up to €100 billion, of which (i) a first tranche of €20 billion has already been activated (and deployed): 50% for the self-employed and SMEs, and 50% for non-SME companies; and (ii) a second tranche of €20 billion: 100% for the self-employed and SMEs.

This guarantee facility will be managed by the Spanish State Finance Agency (*Instituto de Crédito Oficial* or "ICO"). Companies and self-employed persons will have access to these guarantees through credit, financial and payment institutions or e-money institutions provided that they have signed the corresponding collaboration agreement with the ICO and are registered with and supervised by the Bank of Spain.

Self-employed persons and companies economically affected by COVID-19 will be eligible for the guarantee, new loans and other financing schemes, as well as for the renewal of transactions entered into or renewed as from March 18, 2020, subject to certain requirements (registered office in Spain, not in default according to the Bank of Spain's Risk Information Center at December 31, 2019, and not subject to insolvency proceedings as of March 17, 2020). The guarantee facility can be released until December 31, 2020.

The guaranteed financing shall be utilized to pay wages, invoices, working capital needs and other liquidity needs, including past due financial or tax obligations. This financing cannot be used for the cancellation or early repayment of pre-existing debts, or for loan restructuring. As a practical matter, unless the criteria changes, the financing shall be governed by Spanish law in order to benefit from the ICO guarantee. Likewise, if the financing agreement is in English language, a sworn Spanish translation must be provided to the ICO.

The guarantee will cover 80% of the new loans and renewals of operations requested by self-employed workers and SMEs. For the rest of companies, it will cover 70% of new loans and 60% of renewals. The guarantee only covers the principal, thus excluding interest, fees and other charges associated with the transactions.

The maximum amount will depend on the applicable aid scheme in accordance with EU regulations.

- Loans up to €1.5 million will be subject to the applicable *de minimis* aid scheme (with specific limits for certain industries such as agriculture, fisheries and road freight transport).
- Loans over €1.5 million, or of lesser amounts when the *de minimis* rules do not apply, are subject to the European Commission's State Aid Temporary Framework. Therefore, all transactions exceeding that amount and maturing after December 31, 2020 shall meet any the following alternative conditions:
  - The principal shall not exceed double the beneficiary's total payroll for 2019; or
  - The principal shall not exceed 25% of the beneficiary's total turnover in 2019; or
  - With appropriate justification of the beneficiary's liquidity needs, the principal may be increased to cover the liquidity needs from the moment it is granted for the upcoming 18 months for SMEs, and for the upcoming 12 months for large companies.

Guarantee margin is set at between 20 and 120 basis points ("bps"), depending on the amount, the maturity (between 1 and 5 years) and the consideration of the beneficiary (according to the following table), except for transactions not exceeding €1.5 million, in which case the premium will be set at 20 bps.

Beneficiary	Transaction	1st year	2nd and 3rd years	4th and 5th years	Coverage
SMEs and self-employed	New financing and renewals ≥ 1.5M	20 bps	30 bps	80 bps	80%
Larger companies	New financing ≥ 1.5M	30 bps	60 bps	120 bps	70%
Larger companies	Renewals ≥ 1.5M	25 bps	50 bps	100 bps	60%

In sum, the purpose of ICO guarantees is for financial institutions to provide financing to the self-employed and companies to cover their liquidity needs caused by COVID-19 with the speed and flexibility required, while observing their relevant credit granting criteria.

Companies that do not qualify or whose financial situation had already deteriorated before the COVID-19 pandemic and need to restructure their debt will have to turn to alternative financing mechanisms.

RDL 8/2020 also creates an insurance coverage facility of up to €2 billion, granted by the Spanish Export Credit Insurance Company ("*CESCE*") for companies (small, medium or large, but not listed) facing liquidity problems or lack of access to financing as a result of the COVID-19 crisis. It will be available to companies (i) whose international business represents at least one third of their turnover; or (ii) are regular exporters. This facility, with a term of 6 months from March 18, 2020, shall be used for new financing needs (not pre-crisis situations), and its risk coverage will not exceed 80%.

Finally, RDL 15/2020, with the aim of promoting and maintaining alternative non-banking funding sources through capital markets, has amended article 29 of RDL 8/2020 to include promissory notes ("*pagarés*") which are listed either in AIAF or MARF markets as part of the assets that can benefit from the state guarantee facility which was mentioned above. The details on how those promissory notes can benefit from the state guarantee will have to be further developed.

Refinancing

The impact of COVID-19 on refinancing processes must be analyzed from a double perspective:

- First, the effect on refinancing processes that were being negotiated when the government declared the state of emergency or that had been closed few months before ("**Refinancings**").
- Second, the effect on refinancing processes that may arise as a result of the economic crisis stemming from the current situation ("**New Refinancings**").

As regards Refinancings, depending on a company's current situation, the COVID-19 crisis may provide an opportunity to obtain liquidity through the new ICO-guaranteed facilities created under RDL 8/2020 ("**ICO facilities**"), subject to the above requirements and provided that the financing is used for the specified purposes (under no circumstances for the cancellation or early repayment of pre-existing debts).

Through these ICO facilities, refinanced companies may (subject to certain criteria: not being subject to insolvency proceedings, not being in default according to the Bank of Spain's Risk Information Center, not being in financial difficulty, and so on) apply for additional financing to cover not only their fixed costs during the crisis, but also their ordinary repayments of the agreed refinancing or of the refinancing under negotiation at the outbreak of the crisis.

On the other hand, companies that are not eligible for the ICO facilities will find it very difficult to refinance. It is likely that the business plan considered in negotiations with the financial institutions did not take into account the crisis, so it will have to be updated, which will inevitably require a greater effort on the part of the financial institutions.

With regard to New Refinancings, we assume that in case there is a reduction of the borrower's income, making it impossible to meet ordinary repayments, a waiver will be requested from the financial institutions to postpone the relevant repayments between 6 and 12 months. The most obvious alternative would be to prorate the deferred amounts among the outstanding installments. In these cases, the principal is normally deferred while interest and any hedge payments continue to be made. Another alternative would be to use ICO facilities to meet the repayments that are immediately due.

Finally, in the case of New Refinancings, the referred ICO facilities may provide a solution to the company's financial and liquidity needs in the short term, but the economic devastation that will probably follow the state of emergency, together with the likely long-term income reduction, will require further negotiations to restructure the company's long-term financial debt. It is also possible that, if there are multiple financial institutions with bilateral instruments, they may require a framework agreement that includes all of them to regulate payments and risks globally.

Direct lending

Direct lending is not a new phenomenon in Spain. It emerged strongly after the financial and real estate crisis, and it has rapidly developed in Spain through many specialized funds with different profiles and targeting diverse transactions and business niches. These funds have provided short-term liquidity and long-term structural financing solutions to many companies and investors, in particular, in situations in which the banks did not participate. Also, although financial costs have steadily decreased in recent years in the Spanish market, they remain higher than those of bank financing.

This alternative source of financing is of utmost importance at present, i.e., when most active funds in Spain are highly liquid and can perfectly supplement more traditional forms of financing and liquidity facilities launched by public authorities and banks to urgently mitigate the impact of COVID-19 on companies' liquidity.

These financing schemes have many advantages, namely their flexibility in terms of structure and types of instruments, which is particularly remarkable now that quick responses are essential. Usually, transactions are individually designed to provide structured financing solutions tailored to each company. These are often transformational transactions affecting the capital structure of borrower companies and corporate conglomerates. Remarkably, direct lenders streamline their approval and execution procedures. This allows complex structured transactions to be implemented promptly, as required by current deadlines and companies' needs. Nowadays, banks are unlikely to be able to timely review all financing and restructuring proposals or applications submitted by their clients. Consequently, these funds will play again a prominent role in many transactions, thus favoring business continuity and recovery.

Direct lending is structurally complex and it often requires comprehensive contractual regulation of its concurrence with traditional banking. Moreover, it has a significant drawback: direct lending entails significantly higher costs than those of more traditional financing (particularly following the implementation of the ICO facilities), and thus direct lending facilities are not usually conceived for long-term transactions. Based on this characteristic, we expect direct lending funds to have a major impact in the medium term, yet not an immediate effect, since, in the short term and in first instance, companies will first try to exhaust the liquidity of less costly public financing options.

Direct lending has grown rapidly in the construction, real estate and hotel industries, and we expect it to continue growing after the COVID-19 crisis. In our view, neither banks nor public financial aid will be capable of meeting all liquidity needs. Therefore, bridge and mezzanine financing, along with other forms of financing for corporate needs, that banks will be either unable or unwilling to provide, will probably proliferate. Direct lending has also emerged in energy project finance, where mezzanine financing structures supplement traditional bank financing. In spite of the cost, we advise companies to keep direct lending funds in mind, since they can deliver immediate and optimal solutions for any kind of company experiencing a challenging situation.

High-yield bonds and securitizations

One of the first consequences of COVID-19 has been the downgrades or updates of the credit rating of certain bond issuers and bond issuances. As a result of the COVID-19 health crisis, several rating agencies have reviewed credit ratings of certain credit institutions. After this, we expect rating agencies to take further action regarding other issuers and to review the ratings of different bond issues.

First, we examine the impact of these rating downgrades on the contractual commitments included in the bond terms and conditions, where it may be necessary to replace counterparts. Also, there may be further or more stringent obligations to provide additional security or collateral. More importantly, these rating downgrades may further widen the gap between investment grade issuers and non-investment grade issuers in the bond market.

The bond market being almost closed over the last few weeks for most non-investment grade issuers, with a few exceptions, aptly exemplifies these effects of rating downgrades. However, the bond market has been open to higher quality investment grade Spanish issuers (e.g., Iberdrola, REE, Naturgy and Repsol), although with higher costs.

The ECB's asset purchase program announced on March 26, 2020 ("ECB's pandemic emergency purchase programme" (PEPP)), further widening the gap between issuers, is particularly significant. The announcement provides that, regarding corporate bonds, the ECB will only repurchase those bonds meeting a minimum rating quality requirement.

Impact on high-yield bonds

As noted above, the high-yield bond market has been almost closed over the past few weeks due to the uncertainty surrounding the economic impact and duration of this crisis. This uncertainty casts doubt on whether companies will be able to generate sufficient cash-flows to meet their payment obligations.

This situation has affected bond prices in the secondary market. In some cases, bonds are trading below par value, i.e., they are sold at a significant discount, and thus the coupon is lower and it becomes harder for companies to obtain liquidity at competitive prices. Consequently, the risk of default or insolvency increases.

Additionally, companies having outstanding bonds should pay careful attention to the covenants included in their contractual documents limiting or restricting any additional debt being incurred, particularly if they are expecting to increase indebtedness in the future. Debt covenants are often based on a debt-to-EBITDA ratio calculated for the trailing four quarters (in light of the crisis, the companies' EBITDA is expected to decrease over the next few months, thereby lowering the ratio and furthering the applicable debt restrictions).

As mentioned above, another potential effect relates to rating downgrades, particularly for companies on the border between investment grade and non-investment grade. If they lose the investment grade rating, suspended covenants may become applicable again under the bond terms and conditions, thereby making it difficult for companies to incur in additional debt.

Ultimately, bond issuers and investors should assess their current and potential liquidity needs and ability to incur in additional debt.

Impact on securitizations

The COVID-19 crisis could also impinge on securitization transactions, which may be affected in several ways.

First, COVID-19 might have an impact on the type of transactions. In Spain, over the last few years, credit institutions have mostly performed transactions focusing on freeing up capital, whether through synthetic transactions or securitization funds seeking significant risk transfers ("SRT transactions"). The new situation of capital markets and liquidity needs of credit institutions may first affect these type of transactions. Instead of witnessing this kind of transactions, credit institutions might, yet again, issue debt mostly aiming to obtain liquid assets to provide collateral, and thus force discounts on the ECB.

As for liquidity transactions carried out by companies to sell their invoices, over the next few months we will see whether the market remains open or if these transactions are temporarily halted. The credit rating of the different assignors involved may also be significant in this regard.

Regarding already existing issuances, attention must be drawn to (i) the potential effects on securitized loans of the mortgage, consumer loan and other moratoriums enacted by the government; and (ii) how these moratoria are implemented. The instructions to manage securitized loans are also particularly significant to determine the limits applicable to contractual moratoria (or even to the ability to write-off loans) required by clients or offered by credit institutions.

Derivatives

We will broadly assess the effects of the current COVID-19 crisis on any entity's derivative portfolio. To do so, we must first identify the framework agreement governing each transaction. We will focus on the Framework Agreement for Financial Transactions (*Contrato Marco de Operaciones Financieras*, of "CMOF"), published by the Spanish Banking Association, and on the 1992 or 2002 versions of the ISDA Master Agreement published by the International Swaps and Derivatives Association.

As for derivative transactions governed by a CMOF, it is noteworthy that there are no specific provisions regarding non-payment or non-delivery as a result of extraordinary events occurring after the transaction has been entered into such as those triggered by COVID-19. Accordingly, unless otherwise agreed under Schedule I of the CMOF or, where appropriate, under the transaction confirmation, the Spanish Civil Code (general civil law) will apply to any breaches.

Transactions entered into under the ISDA Master Agreement are subject to a more comprehensive contractual framework. This will allow the parties to infer solutions to solve any issues resulting from the current situation. It is worth taking into account the following mechanisms provided by the ISDA Master Agreement:

- Disruption Events and Fallback Provisions

  The various sets of definitions provided by the ISDA address several events that can affect the regular course of the transaction (Disruption Events). The ISDA Master Agreement also sets out solutions that would apply under the relevant circumstances (Fallbacks).

The first step is to examine the type of underlying of the derivative, subsequently determining which definitions apply. Also, it must be verified that the parties have agreed to be subject to these definitions.

On the one hand, the definitions qualify as Disruption Events, among others, any market disruptions, negotiation suspensions and events that impact on pricing or prevent settlement. On the other, the ISDA Master Agreement provides for Fallbacks or pre-established solutions for these issues; for instance, setting reference or benchmark prices, broadening the calculation agent's scope of discretion or giving effect to grace periods.

- Force Majeure Event

Within the context of ISDA framework agreements, there are major differences between the 1992 ISDA Master Agreement and the 2002 ISDA Master Agreement regarding the consequences of force majeure events. Therefore, it is important to differentiate whether the relevant transaction is governed by the 1992 or the 2002 version.

The 2002 ISDA Master Agreement provides for Force Majeure Events in Section 5(b)(ii), whereas the 1992 ISDA Master Agreement does not. Therefore, we will need to confirm whether both parties have adhered to the ISDA Illegality/Force Majeure Protocol.

Under the 2002 ISDA Master Agreement, early termination resulting from a *Force Majeure* Event covers the situation where one or both parties are prevented from performing any obligation to make a payment or delivery under the framework agreement by reason of *force majeure* or act of state. This event must make it impossible or impracticable for the affected party/parties to perform the specific obligation. The courts tend to interpret this notion restrictively or narrowly, i.e., understanding that this event must be beyond the control of the affected party/parties, so that if the party/parties, after using all reasonable efforts, can overcome this prevention, impossibility or impracticability, it/they must perform its/their obligation. In case of a Disruption Event for which a Fallback occurs, if the parties have provided for its application in the agreement, or is otherwise applicable by default subject to the express application of the definitions, this Fallback (disruption fallback) shall apply.

Additionally, to determine whether the *Force Majeure* Event applies, it is worth examining the impact of the specific event on the rest of the agreement and, particularly, the prevalence of the *Force Majeure* Event and the Events of Default set out in the agreement.

- Waiting Period

If a *Force Majeure* Event under the transaction documents is deemed to have occurred, the 2002 ISDA Master Agreement provides that grace periods and waiting periods should be granted before giving effect to the early termination of the affected transaction(s).

These safeguards may not apply to the obligations to provide collateral previously agreed between the parties. Thus, some counterparts would have to fulfill burdensome obligations to provide additional security. The breach of these obligations usually gives rise to early termination of the framework agreement. It is necessary to review the terms entered into under the relevant Credit Support Annex (CSA) or under the Security Assignment Agreement (*Acuerdo de Realización de Cesiones en Garantía*, Schedule III of the CMOF) so that the parties are clear on which collateral to provide, currency, valuation percentages and, if appropriate, collateral replacement possibilities.

Non-performing loans ("NPLs")

Obviously, based on the events of the past few weeks, as mentioned, Spanish banks have reversed their strategies. They now focus on accumulating liquidity to meet the financing needs of persons and entities affected by COVID-19. Temporarily, they have disregarded other lines of action, such as availing of non-performing assets, mostly sub-performing and impaired loans or NPLs.

We believe there are at least four factors leading banks to temporarily stop selling NPLs portfolios: (i) rent and mortgage enforcement moratoria; (ii) the uncertainty regarding the impact of COVID-19 on the valuation or appraisal of real estate assets (collateral); (iii) the impact on housing rental agreements involving large homeowners; and (iv) the increase in unemployment and its impact on individuals' ability to meet their payment obligations. These factors make it harder for investment funds intending to purchase NPL portfolios or single names to appraise these assets or, at least, to obtain valuations that do not entail losses exceeding the accounting provisions allocated in the budget of selling credit entities. Similarly, it is worth paying attention to the regulatory approach that regional and local authorities will take, which could also impact real estate collateral.

However, there are several factors that should revitalize the sector as soon as COVID-19-related uncertainty vanishes, namely (i) the €60 billion worth of NPLs (at least) currently recorded in Spanish banks' balance sheets and the divestment commitments entered into with banking authorities, which remain in place and should be fulfilled by the banks; (ii) the acceleration of the secondary market by funds and other investors that have acquired NPLs portfolios over recent years (considering that many of them are rotating their portfolios and assets), and (iii) the restructuring in NPLs portfolio refinancing and the strengthening of securitization schemes.

We must also bear in mind that, in the medium term and having implemented the flexibility measures proposed by the ECB regarding the provisions to cover losses for unpaid loans, this economic crisis will lead to increases in the volume of NPLs. Therefore, we consider that this area will remain highly active.

Finally, this situation will entail significant changes in the portfolio management strategies, which will be required to adapt their recovery mechanisms and expectations to the new economic scenario. Servicing companies able to react swiftly will most likely increase their market share within a very mature industry, such as the Spanish credit and REO sector.

Distressed transactions: purchase of debt, court-sanctioned refinancing agreement and debt-for-equity swaps

There are many kinds of distressed strategies. They are typically control oriented, i.e., intended for the funds to gain control of the target companies. Generally, these are companies with high debt levels but operationally feasible. Debt purchase transactions from target companies often result in the company refinancing through total or partial debt-for-equity swaps to gain control of the target company.

From a legal and financial standpoint, these transactions are sometimes very complex in practice, since they require a control-oriented strategy tailored to the target company, as well as a comprehensive analysis of the target company's capital structure, of its activity, of its industry and of its ability to generate future cash flows. This turnaround process becomes even more challenging in the current scenario.

From a legal perspective, below are some considerations that should always be taken into account in these transactions:

Purchase of debt

Having removed the restrictions imposed by article 122.1.2 of the Spanish Insolvency Act (which limited the voting rights of assignees that had acquired rights after the declaration of insolvency while not "subject to financial supervision"), there are no relevant restrictions on the purchase of credits (claims) other than those provided in financing agreements and other financial documents. However, investors will have to consider the following aspects:

- The assignees of credits acquired from "inside parties" or "parties closely related" to the debtor ("*personas especialmente relacionadas*", "PER") within two years prior to the declaration of insolvency will qualify as PER. Therefore, their credit claims in the debtor's insolvency proceedings (and probably also in court-sanctioning procedures, although the provision does not specifically mention this aspect) will be considered subordinated.
- Under article 153 bis of the Spanish Mortgage Act, only "financial institutions referred to in article 2 of Act 1/1981, of March 25, on the Mortgage Market" and "public authorities" are eligible to be beneficiaries of floating mortgages. Therefore, this article prevents any other entities from being floating mortgage holders (investment funds, for example). This has an additional implication: any investment funds purchasing floating mortgage-secured credits in the secondary market will be unable to become beneficiaries. This will require seeking alternatives, such as sub-participation or similar agreements.

Court-sanctioned refinancing agreement

Court approval or judicial homologation is governed by the Fourth Additional Provision of the Spanish Insolvency Act. It is a commonly used mechanism in refinancing arrangements in Spain, since it allows a set of effects previously agreed between the debtor and its creditors to be extended to the non-participating or dissenting financial institutions, including those whose claim is secured by *in rem* security.

Court approval requires compliance with several formal and substantive requirements, including that any court-sanctioned refinancing agreement shall be entered into by creditors representing at least 51% of financial liabilities, although the majorities set out in the Spanish Insolvency Act are required to extend its effects. As for the effects of the court-sanctioned refinancing agreement on dissenting creditors, the provision differentiates based on whether the creditor's liabilities are secured by *in rem* security or not. The scope of the effects on dissenting creditors will depend on whether the voting majorities required are reached.

Distressed financing and the "fresh money" privilege

The "fresh money" privilege is granted to any "new money" or cash injection under refinancing agreements as follows: 50% of the new cash will be considered as a credit claim against the insolvent estate (*crédito contra la masa*) or "superprivileged" claim, and the remaining 50% will be considered as a general secured claim (*privilegio general*). This privilege will not apply to cash injections from the debtor or from inside parties (PER).

Credit capitalization (debt to own)

The Spanish Insolvency Act fosters credit capitalization within refinancing agreements, including several measures aimed (i) at clarifying the situation of creditors that follow this refinancing strategy (particularly regarding their consideration as PER), and (ii) at encouraging this alternative and that debtors and their shareholders accept it as a refinancing mechanism.

Regardless, as a result of the measures implemented by the Spanish government to tackle the effects of COVID-19, any investors that carry out these transactions should consider the screening and authorization of “foreign direct investments”, which will also affect these transactions.

“Foreign direct investment” means:

- an investment made by (i) a non-EU/non-EFTA resident, or (ii) an EU/EFTA resident where the actual investment owner is a non-resident;
- when one of the above investors holds a share of at least 10% in the Spanish company’s capital or takes an active part in managing or controlling that company;

in either scenario:

- The investment affects one of “Spain’s strategic sectors”.
- The investor (i) is controlled by a third-country government; (ii) participates in sectors affecting the public order, public security, and public health of another Member State; and (iii) has had administrative or court proceedings brought against it in another Member State for exercising criminal or unlawful activities.

If the current liquidity crisis is not solved in the short term due to a ramp-up in the economic recovery, it is likely that the projected financial aid, not immediately but eventually, will be insufficient for many companies. No doubt that this will ultimately affect capital structure of all type of companies, thus requiring a more comprehensive debt refinancing to determine the level of sustainable debt and triggering a new wave of distressed transactions to address complex and financially critical situations. Distressed funds provide greater value precisely within these processes in the course of business recovery. Surely, alternative private debt will play a major role in this new crisis in Spain and they will navigate these waters with the advantage of having the experience of the previous financial crisis.

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