Debt buybacks in Spain: restructuring and insolvency considerations

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Debt buybacks in the distressed context

A debt buyback transaction generally involves the acquisition by a sponsor or a debtor of the latter's debt in the secondary market (through a private negotiation with selected lenders/bondholders or in the open market, including tender offers in some instances), usually incited by the discount that such debt (corporate loans or bonds) is being sold at.

However, an attractive price may not be the only goal behind these transactions. Among the wide variety of reasons why debtors use this tool to de-leverage, we can find better economic conditions vis-à-vis voluntary prepayments, decreasing financial costs, securing that certain financial covenants are complied with, or avoiding excess cash flow to fall under cash-sweep prepayment provisions.

Furthermore, debt buybacks can be a path for debtors to address the situation of financial distress and reduce polarisation and fragmentation of their capital structure, as well as a mechanism for a sponsor (if contractually allowed to do so) to gain leverage in a pre-restructuring scenario by building a negative control or blocking position in the capital structure.

When facing discussions regarding how to structure a particular restructuring, debtors and sponsors are increasingly considering debt buybacks among the different available options to be implemented. The aim of this article is to provide a legal overview of the key issues that from a Spanish law perspective should be considered when analysing buybacks.

Legal regime

General rules

Debt buybacks are not specifically regulated under Spanish law. Pursuant to the Spanish Civil Code,[1] the purchase by a debtor of its own debt automatically cancels/extinguishes the payment obligation (*confusion* or identity between debtor and creditor). Hence, debt buybacks will normally be allowed to the extent it is authorised in the underlying documentation and subject to the terms and conditions set forth therein.

While no special rules apply in relation to loans – its cancellation upon repurchase by the debtor or treatment after acquisition by the sponsor will depend on the law to which the loan is subject – the Spanish Companies Act[2] does provide some relevant rules in relation to foreign-law governed bonds.

Spanish law will apply to the legal capacity, competent body and conditions of the 'foreign' bond issuance, but the relevant law governing such bond will determine the rights of the bondholders vis-à-vis the issuer, the ways to set up collective organisation, reimbursement and repayment regime of the obligations, as well as the right to convert into equity in convertible obligations (within the boundaries of the applicable Spanish corporate rules), which is particularly relevant since recent trends indicate that bonds issued by companies incorporated in Spain are shifting to foreign laws and jurisdictions (among which Ireland, United Kingdom, Luxembourg or the United States – and particularly, New York – are the most common destinations).

In relation to 'local law' bonds, the Spanish Companies Act also sets forth that the acquisition by Spanish companies of their Spanish law bonds will imply the cancellation of the debt.

Insolvency law treatment – equitable subordination of specially related persons

The most relevant feature of debt buybacks in Spain comes to light within insolvency. While in principle the acquisition of its own debt by a debtor should not raise legal concerns outside of the applicable contractual framework (tax considerations aside which will not be analysed in this article), the acquisition of debt by the borrower's sponsor raises instead more issues from a Spanish insolvency perspective.

As a general rule, the Spanish Insolvency Act[3] sets forth that claims held by specially related parties (*persona especialmente relacionada*) to the debtor within an

insolvency proceeding shall be equitably subordinated. A specially related party will be connected persons or insiders which hold directly or indirectly:

- 10 per cent of the share capital of debtors with unlisted securities;
- 5 per cent of those with listed securities; and
- include, among others, companies within the same corporate group and common partners or shareholders of those companies meeting the referred thresholds.

The special relationship of the debtor and the acquirer based on holding the relevant equity must exist at the time the claim is acquired.

The effects of being considered a specially related party consist of the following:

(1) subordination of the relevant claim which will rank below all other claims of the estate: (i) administrative expenses – which benefit from a cash flow privilege over the claims; (ii) privileged claims – which in turn are divided into special privileged (secured) claims and (unsecured) general privilege claims; and (iii) ordinary claims;
(2) cancellation of any in rem or personal guarantees securing the claim; and
(3) disenfranchised (ie, stripped from voting rights) in an homologation[4] scenario or in relation to composition agreements (*convenio de acreedores*) within a full-blown insolvency (*concurso*) (in both cases different effects could be extended over the subordinated claim).

Hence, the main concern that a debt buyback transaction faces is the subordination risk. While in other jurisdictions (such as US law) subordination is equitable and depends on the existence of wrongful conduct in the form of illegality, breach of fiduciary duties, fraud, undercapitalisation, or the exercise by the lender of an unreasonable level of control by the debtor; in Spain the character of specially related person (objective determination based on the creditor holding a percentage of the debtor's equity) will prompt the subordination of the claim.[5] As discussed, such subordination risk implies the downgrade of the claim, losing any guarantees or securities it may benefit from and no voting rights within homologation or *concurso*.

Therefore, while being a mechanism to implicitly de-leverage a capital structure, it is not useful for the sponsor to gain leverage within a negotiation process, as it will have no voting rights and will see its claim subordinated. Moreover, the sponsor's position therefore will also become illiquid as it will be difficult to sell it in the market to third parties given that subordination of a claim held by a specially related person 'flows' with the claim itself (ie, a claim transferred to a non-specially related person would still suffer from subordination within the two years prior to the insolvency declaration of the borrower[6]).

Thus, sponsors will need to try to mitigate such subordination risk by, for example, refinancing the outstanding debt (not at par) and attempt to benefit from the better treatment that the temporary Covid-19 measures explained below offer; or exploring alternatives involving an EquityCo/DebtCo structure where the vehicle acquiring the debt is not considered a specially related person. Nevertheless, in general, Spanish law does not seem to favour any of these mechanisms.

Covid-19 new money relief: limited protection to sponsor debt buybacks and interpretative uncertainties

Among the different legal measures passed by the Spanish Government in order to tackle the economic consequences the Covid-19 pandemic has brought along, Royal Decree-law 16/2020[7] has 'enhanced' the position of certain specially related persons and facilitated financing by these parties.

In relation to insolvency proceedings filed within two years following the formal declaration of state of alarm (*estado de alarma*) in Spain (dated 14 March 2020), both: (i) new money granted by specially related persons after the state of alarm declaration; and (ii) those claims into which specially related persons have subrogated following payment of ordinary or privileged claims after the state of alarm declaration, will be considered ordinary claims (and hence will not be subordinated).

From the authors' perspective, this measure is insufficient as it makes little sense that if a sponsor is willing to get more 'skin in the game' and injects money in a company, which eventually turns out to be viable for over two years but then becomes insolvent, that new money claim will be subordinated; while conversely the money injected in the company which initiates an insolvency proceeding within, for example, one year, will be considered an ordinary claim. The logical consequence is that creditors will be forced to grant financings with maturities set below two years, which is far from ideal and could put the viability of companies at risk especially in these uncertain times when it is unclear how long it will take for the economy to recover from the negative impact of the Covid-19 crisis and the lockdown that has resulted from it.

Regarding the latter scenario (subrogation), the rule seems to be referring to the claims which arise as a consequence of the enforcement of a personal guarantee by its beneficiary, which leads to a new claim

arising from the guarantor vis-à-vis the original debtor. While the courts still have to interpret this new rule and case law will need to be closely monitored, the Spanish legal market seems to agree on its limited scope, within which debt buy-backs would not be included, and would therefore remain as subordinated if held by specially related persons in insolvency scenarios.

In the authors' view, debt buy-backs should have been included in the exceptions to the specially related persons' subordination set out in Royal Decree-law 16/2020, as debt buy-backs are one of the natural mechanisms to address the situation of the debtor's financial distress to secure the viability of the company and allow for its implicit de-leverage. The role of the shareholder-lender must be reconsidered under Spanish law, as companies are being deprived from a source of financing which may turn out to be essential in distressed situations (more so if it is taken into account that the Spanish new money privilege regime is not ideal in the first place).

Contractual limitations

Besides the statutory framework, contractual limitations may apply in the form of, among others: events of default (eg, a debt buy-back could give rise to an acceleration right of the lender); holding restrictions (eg, a threshold regarding the amount of debt to be held by the sponsor or the debt); assignability limitations (eg, transfers may need to be conducted through a Dutch auction process); or restricted payments/investment covenants.

Hence, one of the keys to performing a debt buy-back transaction is carrying out a thorough analysis of the underlying debt instruments in order to ascertain whether the envisaged acquisition is contractually possible from multiple standpoints (pre-requisites like notifications, amount sought, ratios compliance, etc).

Conclusion

When performing a debt buy-back in a Spanish situation (essentially, when the debtor is a company incorporated under Spanish law, whether the relevant loan or bond is governed by a foreign law or not) attention should be paid to the contractual framework and in particular to the legal limitations, covenants and restraints to which such a transaction could be subject.

While a self-debt buy-back acquisition should, in principle, give rise to no difficulties from the legal standpoint (a tax analysis of the particular transaction sought should nevertheless be carried out), sponsors should keep an eye on the subordination risk, seeking expert legal advice and exploring alternative structures in order to avoid subordination and the negative effects that can result from it.

Notes

1 Real Decreto de 24 de julio de 1889 por el que se publica el Código Civil.

2 Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital.

3 Ley 22/2003, de 9 de julio, Concursal. An amendment to the Spanish Insolvency Act (Real Decreto Legislativo 1/2020, de 5 de mayo, por el que se aprueba el texto refundido de la Ley Concursal) will enter into force in the coming months (1 September 2020), repealing most of the Act currently in force (but not the Covid-19 relief measures). Such amendment does not include new rules which could alter the subject hereby analysed.

4 *Homologación*, occasionally referred to as the 'Spanish scheme of arrangement', consists of a court sanction of a workout negotiated out of court by a borrower and its lenders, with the purpose of restructuring the borrower's financial debt.

5 There is still no settled case law on the subordination of a claim acquired by a specially related person to the debtor in the secondary market (ie, a claim that is born 'untainted' – originally held by a third party – and is later acquired by a connected party). We understand that the arguments to sustain the non-subordination of such a claim would be weak.

6 The amendment to the Spanish Insolvency Act referred to in n 3 above specifically clarifies that no voting rights will be granted in homologation to the acquirer of a claim from a specially related person.

7 Real Decreto-ley 16/2020, de 28 de abril, de medidas procesales y organizativas para hacer frente al COVID-19 en el ámbito de la Administración de Justicia.

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