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Are The New Spanish Legally Enhanced Workouts That “Fancy”?

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Abstract[1]

Dealing with the arguable failure in preserving going-concern value, the reforms of the Spanish Bankruptcy Act have promoted a certain kind of out-of-court workouts as a prior step or even as an alternative to bankruptcy (the "Legally Enhanced Workouts). Perhaps oddly, while bankruptcy petitions increased, this sort of legally fostered out-of-court workouts decreased between 2009 and 2011. Statistics moreover suggest that going-concern companies drew on "unprotected" out-of-court workouts instead of filing the petition, which is still compulsory. This paper argues empirically, through the lens of lawyers, the reasons why distressed companies may disregard the legal incentives akin to the Legally Enhanced Workouts.

While strongly grounded on the economic analysis of corporate and insolvency law, the research work is empirical. It attempts to bring an alternative view to discuss the convenience of "importing" foreign best practices in accordance with the law and society approach. Practitioners are thus most likely familiar with the discussion. The paper is updated to the most recent reforms of Spanish law, while the empirical analysis is restrained to the data available until April 2013 (the date of the last interview). Hence, the research work is concerned with the statistics of 2011. Further empirical research may analyze the impact of the most recent reforms as per the data available for years 2012, 2013, 2014, 2015, and 2016.

Título: ¿Son realmente tan atractivos los acuerdos de refinanciación protegidos frente al concurso?

Keywords: out-of-court workout, fresh-money, claw-back, automatic stay, cramdown, transaction costs
Palabras clave: acuerdo de refinanciación, dinero nuevo, reintegración, paralización de acciones, extensión de efectos, costes de transacción

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1. Introduction[2]

The reforms of the Spanish Bankruptcy Act[3] foster the negotiation and conclusion of certain out-of-court workouts (the "Legally Enhanced Workouts") as a prior step or, under certain conditions, even as an alternative to bankruptcy, which has arguably failed to preserve "going-concern value"[4]. An out-of-court workout is a contract entered into between a company and its creditors to remove insolvency by restructuring the debtor's capital structure[5], so that an economically viable company may continue to run its potentially profitable business in the market[6].

The reforms[7] enhance the negotiations aimed at concluding Legally Enhanced Workouts and furthermore endeavor to address the concerns of debtors and creditors in case of subsequent bankruptcy. First, these schemes ease insolvent debtor's legal duty to file for bankruptcy[8]. Debtor's communication to the court[9] about the beginning of negotiations aimed at reaching a Legally Enhanced Workout or a pre-packaged composition agreement triggers a four month suspension

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[2] Although the paper is updated to the last reforms of Spanish law, the empirical analysis is restrained to the data available until April 2013 (the date of the last interview). Hence, the research work is concerned with the statistics of 2011. Further empirical research may analyze the impact of the most recent reforms as per the data available for years 2012, 2013, 2014, 2015, and 2016.

[3] Spanish Act 22/2003 of July 9, 2003, of Bankruptcy (the "SBA").

[4] Bankruptcy preserves going-concern value, arising out of synergies or profitable executory contracts, for instance, if it enables a financially troubled but economically viable company to reach a more efficient capital structure in order to keep on operating in the market. See Barry E. ADLER, Douglas G. BAIRD & Thomas H. JACKSON (2007, pages 23-29).

[5] Capital structure is used in the United States of America in the same sense as "estructura de pasivo" in Spain.

[6] See articles 71 bis and 231-242, as well as the additional provision fourth of the SBA.

[7] These reforms stem from the Royal Decree-law 3/2009 of March 27, 2009, on urgent tax, financial, and insolvency law measures in view of the unfolding economic situation, the acts 38/2011 of October 10, 2011, on partial reform of the SBA, and 14/2013, of September 27, on Support of Entrepreneurs (the "Act on Support of Entrepreneurs"), and the Royal Decree-law 4/2014, of March 7, on urgent measures concerning the refinancing and the restructuring of corporate debt (the "Royal Decree-law 4/2014").

[8] Under article 165 of the SBA, lack of compliance with this legal duty entails a rebuttable presumption of willful or grossly negligent behavior in generating or deepening debtor's insolvency, which may give rise to liability for the impaired claims if bankruptcy is classified as guilty (see article 172 bis of the SBA). The debtor is only entitled to file such a communication once a year. Significantly, other out-of-court workouts, those which not gather all the requirements of the Legally Enhanced Workouts, are deprived of this protection notwithstanding whether or not their conclusion may remove debtor's insolvency.

[9] See articles 5 and 5 bis of the SBA. Concerning the so-called "out-of-court arrangement of payments" (*acuerdo extrajudicial de pagos*), the debtor requests the appointment of a mediator to the Commercial Registray or to a Notary, who in turn communicates the beginning of negotiations to the court upon such appointment (see articles 232 and 233 of the SBA).

period of that duty[10]. As a result, holding-out creditors are deprived from filing mandatory bankruptcy petitions within this period of time[11]. Second, the onset of negotiations may also bring about a sort of pre-petition automatic stay of certain enforcement actions[12]. Third, the Legally Enhanced Workouts are provided with claw-back protection in subsequent bankruptcy. The degree of protection varies depending on the kind of Legally Enhanced Workout[13]. Fourth, the out-of-court

[10] However, the debtor does not have to be insolvent in order to file this communication, unless the Legally Enhanced Workout at hand is an out-of-court arrangement of payments (see articles 5 bis and 231 of the SBA).

[11] Although this may be of the majority of creditors' interest, the debtor remains the sole stakeholder with standing to file this communication.

[12] The communication to suspend debtor's legal duty to petition bankruptcy automatically forestalls the filing of in-court enforcement actions and suspends those already initiated that aim at assets necessary in order to run the debtor's business activity. However, it does not affect public claims. This automatic stay may also thwart both in-court and out-of-court enforcement actions sought by creditors with financial claims that aim at any good of the debtor. This requires a majority of 51 percent of the financial creditors (see article 5 bis and additional section fourth of the SBA). A financial creditor is a creditor who holds one of the claims set forth in section ninth of the general accounting plan approved by the royal decree 1514/2007, of November 16 [see (YÁÑEZ & NIETO (2014, page 27)]. In any event, however, the automatic stay does not concern actions seeking declaratory relief or setoff. Creditors holding public claims also escape from the automatic stay. Concerning out-of-court arrangement of payments, there is also an automatic stay as to enforcement actions. Yet, it does not affect creditors holding public claims or secured creditors (see articles 231 and 235 of the SBA).

[13] Court-sanctioned out-of-court workouts pursuant to the additional section fourth of the Spanish Bankruptcy Act enjoy the highest degree of protection against claw-back. This only requires a majority of creditors holding 51 percent of the debtor financial claims (the claims held by the debtor's specially related persons do not count towards this majority). The trustee may only seek avoidance drawing on the more restraining general private law actions (see article 71.6 of the SBA and articles 1111, and 1290-1299 of the Spanish Civil Code).

Under article 71 bis 1 of the SBA, creditors representing at least 60 percent of debtor's claims must consent to an out-of-court workout, which must entail a significant enlargement of debtor's credit or a change in the capital structure by either granting a longer term or replacing previous claims with new ones. This majority must be certified by an auditor. In the case of a group a companies, the majority refers both individually to each company and to the group as a whole (where the intercompany claims are not taken into account). This scheme must be granted before a Notary. The Royal Decree-law 4/2014 has removed the obligation of having an expert appointed to assess (i) the sufficiency of the information provided by the debtor, (ii) the reasonableness and attainability of a short-term or medium-term business plan, and (iii) the proportionality of the new security interests according to current market conditions. However, the debtor or the creditors may request such appointment, in which case they bear the risk of any qualification. All in all, the report of an independent expert is still compulsory as to the exemption to launch mandatory takeover bids following a debt-for-equity swap under article 8(d) of the Royal Decree 1066/2007, of July 27, on takeover bids. Likewise, this report allows creditors to argue the reasonability of a debt-for-equity swap in order to handle financial distress, which may give rise to liability of directors and even the shareholders who not vote in favor of such corporate decision that is consequently thwarted (see articles 165.4º, 172.2.1º, and 172 bis 1 of the SBA). Only the bankruptcy trustee has standing to seek avoidance of a Legally Enhanced Workout under article 71 bis 1 of the SBA, either on the grounds of lack of any of the foresaid requirements or in merits of general actions under the Spanish Civil Code. All in all, the declaration that any requirement is missing should not bring about claw-back automatically. The trustee must prove why the workout is detrimental to the estate or, according to the Spanish Supreme Court, whether it surpasses the equal protection of creditors from the same class.

Article 71 bis 2 of the SBA also provides claw-back protection to other out-of-court workouts that fail to gather the majority of 60 percent of debtor's claims. Only the bankruptcy trustee has standing to seek claw-back of any of such Legally Enhanced Workouts on the grounds that any of the following requirements is missing: (i) increase of the assets-to-liabilities ratio; (ii) non-negative working capital; (iii) the resulting value of the security interests not to workout may be crammed down over dissenting creditors holding financial claims[14]. Last but not least, prepetition new money resulting from the conclusion of a Legally Enhanced Workout earns a preferential treatment in subsequent bankruptcy[15], provided that creditors (non-related persons to the debtor) grant it[16].

Perhaps strikingly, the number of bankruptcy proceedings increased between 2009 and 2011, while the Legally Enhanced Workouts were used decreasingly. This might be at odds with the official statistics showing that the petition is normally delayed until the debtor has failed both financially and economically. Other sources of information suggest though that distressed companies drew indeed on "unprotected" out-of-court workouts instead of filing bankruptcy petitions.

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exceed 9/10 of the debt (the loan-to-value ratio must neither decrease as a result of the workout); (iv) the resulting interest rate not to exceed more than 1/3 of the former one; and (v) the workout to be granted before a notary public, having the parties to represent the economic reasons that justify the out-of-court workout instead of filing for bankruptcy. In addition, the trustee has standing to seek avoidance in merits of the general actions under the Spanish Civil Code. Again, the declaration that any requirement is missing should not encompass claw-back automatically.

Last but not least, unprotected out-of-workouts should not be automatically avoided since the trustee must prove the existence of prejudice. According to the Spanish Supreme Court (see below), the court must also consider whether or not the prejudice has enough consideration as a result of the workout. However, it remains to be seen whether or not Spanish judges turn to a sort of *probatio diabolica* (see below).

[14] Creditors holding 60 percent of the financial claims may cramdown the workout over dissenting creditors who hold unsecured financial claims. This cramdown includes stays of payments up to five years and the conversion of their claims into participative loans for five years. A majority of 75 percent enables to cramdown stays of payment up to 10 years, discharges, debt-for-equity and debt-for-asset swaps, as well as conversion of their claims into participative loans for 10 years, other subordinated or otherwise new debt instruments, or convertible securities. The same cramdown may affect also secured financial claims with a majority of 65 percent or 80 percent of the secured financial claims, respectively (see additional section fourth of the SBA). Significantly, the last reforms have extended the cramdown from financial entities to creditors holding financial claims, which shall enable to eliminate certain greenmailing strategies in the distressed claims market. See De CÁRDENAS y GARCÍA (2013). Concerning out-of-court arrangement of payments, a majority of 60 percent of non-public and unsecured claims is required in order to cramdown the scheme over the dissenting creditors (see article 238 of the SBA). By the same token, it does not affect public creditors (unless they consent to it) or secured creditors (in which case their claim does count toward the 60 percent majority).

[15] Fifty percent of prepetition fresh money has the priority of an administrative expense. The remaining 50 percent has a general privilege that ranks after security interests but over unsecured creditors (see articles 84 and 91 of the SBA). However, the Royal Decree-law 4/2014, of March 7, provides an administrative expense priority to the whole amount of the new money for two years (until March 7, 2016), notwithstanding who the lender is. Questionably, new money granted as a provision of an unprotected out-of-court workout does not enjoy this privilege.

[16] Nevertheless, the Royal Decree-law 4/2014, of March 7, sets forth that creditors becoming shareholders following a debt-for-equity swap as a result of the Legally Enhanced Workouts shall not be considered debtor's specially related persons. This shall avoid subordination of the claim akin to new money granted in merits of such workout following the debt-for-equity swap. See article 92.5 of the SBA.

This paper argues empirically, through the lens of lawyers, the reasons why distressed companies would turn to "unprotected" out-of-court workouts at the expense of the legal incentives akin to the Legally Enhanced Workouts. Relying on snowballing and semi-structured qualitative interviews addressed to leading finance, restructuring, and bankruptcy lawyers in Madrid[17], this paper contends that the reactiveness of the SBA's 2009 and 2011 reforms has arguably prompted a mismatch between Spanish branches' legislative actions and certain judicially crafted achievements, namely the "unjustified estate's sacrifice" doctrine. This delay has arguably made the Legally Enhanced Workouts more "expensive" than "unprotected" out-of-court workouts in relative terms. The inflexibility in the appointment procedure and independent experts' lack of legal expertise may also outweigh the advantages of turning to a Legally Enhanced Workout. In particular, independent experts' qualifications underscore the concerns about the possibility of seeking declaratory relief to challenge the "legal shield." On the other hand, concerns about past strategic behavior regarding banks' accounting incentives may still loom over "unprotected" out-of-court workouts. All in all, the empirical evidence suggests that the Legally Enhanced Workouts are definitely important for "big deals," particularly when there is enough time to engage in negotiations and gather the corresponding requirements. Indeed, other things being equal, external legal advisers turning to an "unprotected" out-of-court workout will endeavor to attach as well a business plan from an independent expert. The social impact of the SBA reforms carried out by the Act on Support of Entrepreneurs and the Royal Decree-law 4/2014, of March 7, remains to be seen.

Part II comprises a selected literature review of the public policy considerations that ground the debate between the compulsory judicial oversight of corporate insolvency and out-of-court transactional alternatives. Part III is concerned with the analysis of the data and the discussion about the reasons for the decreasing use of the Legally Enhanced Workouts. Lastly, part IV contains the conclusions.

[17] The empirical evidence stems from eighteen (18) interviews addressed to leading finance, restructuring, and bankruptcy lawyers from Madrid. They were selected using the most well known Spanish and international rankings: *Best Lawyers*, *Chambers and Partners* (Global and Europe), *IFLR 1000*, *PLC Which Lawyer*, *Expert Guides*, *The Legal 500*, and *Who's Who Legal*. The interviewees, all of them with no less than 10 years of experience in the legal restructuring arena, are litigators or transactional lawyers. They were screened as well according to their different background prior to becoming practitioners (former judges, professors, or bankruptcy trustees). The snowballing strategy led to contacting the restructuring in-house counsel of one of Spain's largest banks. This person is in charge of a team of 300 lawyers that currently provides legal advice in more than 2,000 bankruptcy proceedings. Regardless of the way the interview was conducted, all of the interviewees demanded confidentiality. Some of them reported at the end of the interview that the questions had led them to express a high criticism of the current legal framework, which they would not repeat publicly. The selection of lawyers from Madrid as the research population seemed sensible for two reasons. First, 35 percent of the 2011 bankruptcy-proof out-of-court workouts, which represented 82.7 percent of claims subject to one of such out-of-court workouts, were concluded in Madrid. Second, reportedly there is no leading finance, restructuring, and bankruptcy law firm in Barcelona without an office in Madrid according to Spanish and international rankings. Therefore, the costs outweighed the benefits of extending the research population to other cities. Yet, further empirical work may extend the research to other cities in light of the statistics of subsequent years. It would be advisable to wait at least until 2016 to observe the data once the SBA's reforms of 2013 and 2014 have settled among legal actors.

2. *The tension between out-of-court workouts and bankruptcy to manage corporate insolvency. The law on the books and the law in action approach*

Under Spanish law, corporate insolvency refers to the inability to meet liabilities as they come due[18]. However, an insolvent —a financially distressed— corporation may still be economically viable if it preserves its comparative advantage to compete in the market[19]. In such a case, the business has "going-concern value" because its assets are worth more put together as an operating business unit than if liquidated separately. Hence, an insolvent company may still succeed in the market place if it changes its capital structure through a workout, whether out-of-court or in bankruptcy[20].

Bankruptcy exists to address insolvency's collective action problem (the deadly race against the debtor's assets[21]) by reducing the transactions costs that creditors would otherwise bear. This being said, bankruptcy's transaction costs may outweigh the upsides of filing a petition. The issue is whether or not bankruptcy's hurdles (such as the automatic stay) are always that worth it for unsecured creditors, the new residual claimants of debtor's assets provided that the claims exceed the assets' value[22]. For instance, insolvency's collective action problem may be less severe in the case of going-concern companies with concentrated capital structure, where an out-of-court workout may enable going-concern companies[23] —and their creditors— to minimize transaction costs. It may also permit to avoid, for example, the brand prejudice that may occur in bankruptcy and the sure external interference in debtor's corporate governance. From this perspective, bankruptcy may be characterized as an optimal venue to handle corporate insolvency upon the failure of the rest of corporate and negotiated mechanisms (such as an out-of-court workout). In other words, bankruptcy may step in when asymmetric information and stakeholders' different incentives make transaction

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[18] See article 2 of the SBA.

[19] Differently put, corporate insolvency may be related to financial and/or economic distress. Whereas economic distress may stem from the loss of the debtor's comparative advantage, financial distress arises when liabilities exceed the company's assets (or, under Spanish law, when the debtor cannot pay the debts as they come due).

[20] A composition agreement is just a judicially supervised workout.

[21] This is an example of the prisoner's dilemma. See ADLER, BAIRD & JACKSON (2007, pages 7-19).

[22] Unsecured creditors step in the shoes of the shareholders as the residual claimants of the corporation upon insolvency provided that the claims exceed the assets' value. As such, unsecured creditors become the stakeholders with best incentives to maximize the assets value since they benefit from an efficient management in the margin (they may recover a higher percentage of their claims). As a result (or, at least, as holders of the residual decision rights), unsecured creditors should have standing to file a derivative lawsuit, as well as voice and voting rights as per the solution to remove insolvency, whether it is handled out-of-court or in bankruptcy.

[23] To be sure, both financially and economically failed companies may also prefer dealing with corporate insolvency out-of-court for a lot of reasons. On the other hand, atomized capital structures may convert bankruptcy into the only attainable venue to handle corporate insolvency.

costs related to the hidden action and the moral hazard problems unmanageable. Thus, going-concern companies, especially those with a high degree of debt concentration, may find it attractive to draw on an out-of-court workout to deal with corporate insolvency. This should be an *ex ante* choice almost exclusively grounded on the economies of transaction costs, though conveniently monitored *ex post* by the residual claimants of debtor's assets.

Under Spanish law, however, bankruptcy petition is compulsory. Filing is a must within two months as from debtor's actual or constructive awareness of its insolvency[24]. As a matter of law, bankruptcy judges must oversee corporate reorganization or the liquidation of insolvent debtors' assets through a bankruptcy proceeding. Hence, the SBA establishes that bankruptcy is the sole venue to deal with corporate insolvency. This is arguably a response to past strategic behavior in detriment of unsecured creditors[25].

In contrast, the law in action approach shows that bankruptcy is not the first choice for going-concern companies, which usually draw on out-of-court alternatives to handle corporate insolvency[26]. In fact, corporate debtors petition bankruptcy where it is not possible to turn to out-of-court restructuring alternatives. Instead of bankruptcy compositions, going-concern companies draw on out-of-court workouts "in the shadows of bankruptcy" to handle corporate insolvency.

First, whilst the SBA formally pursues corporate reorganization through a composition agreement as bankruptcy's "normal" solution to maximize creditor recovery, official statistics show that more than 90 percent of bankrupt companies are liquidated[27]. Moreover, only 7.13 percent of the pending bankruptcy proceedings in 2011 (202 out of 2,835) were aimed at reaching a composition agreement[28]. Official data shows that this figure ultimately stems from the impaired economic and financial condition upon the filing[29]. Most companies filing a bankruptcy petition have already failed

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[24] See article 5 of the SBA.

[25] See preamble to the SBA.

[26] Indeed, the SBA's oversight of privately conducted out-of-court schemes never prevented stakeholders from turning to this possibility at all. See ROJO (2003, page 30). Notably, Professor ROJO does not dispute that the petition should be compulsory for insolvent debtors. Quite the opposite, he notes the convenience of out-of-court solutions to deal with pre-insolvency.

[27] According to official statistics, the debtor's assets were liquidated in 92.7 percent of 2011 bankruptcy proceedings. Only 287 bankruptcy proceedings out of 2,920 (9.83 percent) concluded in 2011 with the judicial approval of a composition agreement. It is important to note, however, that liquidation may follow if the composition fails. Indeed, 2.8 percent of total liquidations in 2011 followed a previously failed composition agreement. See VAN HEMMEN (2012, pages 19-36).

[28] See VAN HEMMEN (2012, page 21). Ninety-two (92.87) percent of 2011 unconcluded bankruptcy proceedings were aimed at liquidating debtor's assets.

[29] Without challenging the convenience of further incentivizing post-petition financing as some authors contend, this issue may not have such a direct relationship with the number of companies that are liquidated. To be sure, this paper

both financially and economically. Sixty-one percent of 2011 bankrupt companies had negative operative margin, whereas 72 percent of 2011 bankrupt companies would not be able to pay back their claims in less than 25 years[30]. Not surprisingly, economic scholars estimate that only 11 percent of companies going bankrupt in 2011 would be able to reach a composition agreement[31]. As a result, the primacy of liquidation over composition is not expected to turn around, at least, for three years[32]. Although liquidation does not necessarily entail piecemeal liquidation and the shuttering of business units[33], compositions are far from consisting of the "normal" solution to bankruptcy.

Second, the largest financially troubled companies prefer to turn to out-of-court workouts. The size (total liabilities) of a bankruptcy proceeding in Spain is on average 6.5 million Euros, while the mean is 1.27 million Euros[34]. Only 10.6 percent of companies going bankrupt in 2011 have liabilities over 10 million Euros. Furthermore, the data shows a decreasing size of the companies going bankrupt. On the other hand, companies turning to a Legally Enhanced Workout[35] have on average liabilities of 310 million Euros (mean 37 million) [36]. Although bankruptcy is formally compulsory to manage insolvency, blue-chips do endeavor in actuality to avoid the petition until the last moment. In other words, the filing occurs when piecemeal liquidation seems to be the most feasible solution to insolvency's collective action problem. Bankruptcy has also become the residual option to handle corporate insolvency of financially distressed but economically viable flagships.

Therefore, under Spanish law insolvent corporate debtors *must* file a bankruptcy petition, which most likely will lead to their piecemeal liquidation. As a result, the SBA's twofold goal has arguably failed. Going-concern companies dislike bankruptcy, which, far from being a venue for corporate

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does not intend to criticize such proposals. It does, however, put emphasis on the actual data to argue the reasons of the unsettling statistics regarding creditor recovery in bankruptcy.

[30] See VAN HEMMEN (2012, page 14).

[31] See VAN HEMMEN (2012, pages 18 and 99).

[32] No less than three years is the average duration of bankruptcy for companies with liabilities over €10Million. In addition, only 11 percent of 2011 filing companies are expected to avoid liquidation in light of their financial accounts and accounting ratios upon petition. See VAN HEMMEN (2012, pages 18 and 99).

[33] Liquidation promotes the sale of business units as a going-concern. Yet, this occurs when the business is economically viable, which is not what the statistics suggest. See articles 149 and 191 ter of the SBA.

[34] See VAN HEMMEN (2012, pages 6-9).

[35] Although the Legally Enhanced Workouts are "totally" out-of-court (for instance, without judicial or administrative oversight), one of the former requirements to shield the workout against claw-back consisted of the appointment of an independent expert by the commercial registrar. This has permitted to track a statistical record of the Legally Enhanced Workouts until the Royal Decree-law 4/2014, of March 7.

[36] See VAN HEMMEN (2012, pages 133-135).

reorganization, has turned out to be chiefly a liquidation proceeding for both financially and economically distressed companies.

The Spanish branches reportedly attempted to address this issue in the SBA's reforms of 2009[37] and 2011[38]. The Legally Enhanced Workouts were thought to partially fix this problem. This flagship of the "new Spanish pre-bankruptcy law" received a general positive assessment in broad terms[39]. Hence, the Legally Enhanced Workouts, the "luxury product" of the out-of-court workouts, were arguably expected to contribute to fix the unsettling recovery statistics and to protect "going-concern value" [40]. In a way, however, certain scholars assessed their success by looking at "best foreign insolvency law practices" from German, French, Italian, the U.K., or the U.S. legal systems. They pointed to some aspects that were still missing. Other authors claimed straightforwardly that the Spanish legislature tried to import unsuccessfully the U.K. scheme of arrangement.

Yet, no research work has empirically analyzed the actual "social impact" of the Legally Enhanced Workouts. Indeed, while corporate bankruptcy proceedings increased steadily (16.79 percent) between 2009 and 2011, the Legally Enhanced Workouts experienced a significant drop (55.56 percent) within the same period of time[41]. Given the increase in bankruptcy proceedings, this evidence is surprising. Most importantly, unofficial sources of information suggest that stakeholders drew on unprotected out-of-court workouts[42]. This is puzzling because stakeholders would prefer

[37] Royal Decree-Law 3/2009 of March 27, 2009 on urgent tax, financial, and insolvency law measures in view of the unfolding economic situation.

[38] Spanish Act 38/2011 of October 10, 2011, which partially reforms the Spanish Act 22/2003 of July 9, 2003 of Bankruptcy.

[39] However, practitioners have criticized practical issues akin to the Legally Enhanced Workouts. See DE CÁRDENAS (2012, pages 11-12 and 29-34), and COTTA & VIDAL (2012, pages 21-36).

[40] See PULGAR (2012b, pages 8-11). Professor PULGAR concludes that the 2011 reform was a necessary update to adapt the SBA to comparative law's reforms. More specifically, she refers to German, Italian, and the French legal systems. While she acknowledges that the SBA is still improvable, she praises the new legal tools that would enable the restructuring of insolvent companies, either out-of-court or in bankruptcy.

[41] One hundred and eighty two Legally Enhanced Workouts were concluded between March 27, 2009 –the date of the SBA's 2009 reform– and December 31, 2011. While there were 90 Legally Enhanced Workouts in 2009, only 40 were concluded in 2011. See VAN HEMMEN (2012, pages 129-137). Yet, the Legally Enhanced Workouts are definitely significant in qualitative terms (15 billion in 2009; 3.148 billion in 2010; and 12.395 billion in 2012). Nevertheless, this research work is primarily concerned with the reasons that may explain why someone would turn to an "unprotected" workout ignoring the advantages of drawing on a Legally Enhanced Workout. Notwithstanding the importance of the global figures, this analysis requires to focus primarily on the number of workouts.

[42] According to an unofficial source of information (Thomson), at least the conclusion of 247 out-of-court workouts was communicated between March 27, 2009 and December 31, 2011. Consequently, at least 65 of all the concluded workouts (26.31 percent) did not turn to the Legally Enhanced Workouts' privileged regime. Importantly, any noise can only mean a higher number of total workouts. This data may have been obtained from public companies' information duties and social media because Spanish companies do not have a duty to file an out-of-court workout with any authority or registrar. Only public listed companies, which represent a very little percentage of the total,

turning to "unprotected" out-of-court workouts at the expense of the legal incentives akin to the flagship of the so-called "Spanish pre-bankruptcy law"[43]. While bankruptcy is, in fact, the residual solution to deal with corporate insolvency, "unprotected" workouts seem to be beating the Legally Enhanced Workouts in the "shadow" out-of-court restructuring arena. Why would stakeholders turn to "unprotected" out-of-court workouts at the expense of the legal incentives akin to the Legally Enhanced Workouts? This paper intends to fill in the gap in the literature and empirically explore, through the lens of lawyers, the reasons that might explain the apparently low degree of "social impact" of the Legally Enhanced Workouts[44].

3. *Analysis of the data and discussion: reasons that account for the decreasing use of the Legally Enhanced Workouts between 2009 and 2011*

3.1. General overview: the SBA's 2009 and 2011 reforms were reactive

The data leads to the rejection of the null hypothesis[45]. Persuaded by previous scholarship, I intended to assess whether or not the decreasing use of the Legally Enhanced Workouts was actually related to the alleged failed attempt to copy foreign "best legal practices". I speculated that the SBAs' 2009 and 2011 reforms might embrace a case of "magic legalism"[46]. Thus, I hypothesized that lawyers might be "undermining" the "social impact" of these reforms (advising their clients to turn to "unprotected" workouts) for whatever reasons I wanted to explore.

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have a duty to report to the Spanish security exchange commission ("Comisión Nacional del Mercado de Valores") about the negotiation and eventual conclusion of a workout. Thus, a higher number of total workouts would mean a lower percentage of use of the Legally Enhanced Workouts.

[43] See FERNÁNDEZ (2009, pages 64-65). Pre-bankruptcy and pre-insolvency law may be treated as synonyms because bankruptcy is still compulsory to deal with insolvency under Spanish law.

[44] In other words, rather than criticizing doctrinally the alleged Spanish legislature's failure for having fallen short in "copying" best foreign legal practices, this paper seeks to understand empirically, from a "law in action" approach, why the Legally Enhanced Workouts are used decreasingly. Perhaps it is true that a legal device similar to the UK scheme of arrangement might fix some issues. There may be, however, other reasons beyond those normative arguments. Thus, the aim of this paper is to explore what is really missing in the Spanish restructuring legal framework.

[45] The null hypothesis was the following: the Legally Enhanced Workouts had not had as much social impact as expected because the Spanish branches would have made a transplant of foreign rules without taking account of local legal culture.

[46] See ALGUÍNDIGUE & PÉREZ-PERDOMO (2008). The authors use the concept of "magical legalism" to show that foreign successful legal practices may not work in a society with a different legal culture (citizens' legal concerns and expectations). See also PISTOR, BERKOWITZ & RICHARD (1999).

The data actually suggests that the Spanish branches did not proactively decide to import "foreign best practices" without analyzing their "social impact" in the restructuring arena. Quite the opposite, the research throws out that the reforms were prompted by a social outcry and lobbying pressure to introduce foreign tools that might address the deficiencies of the SBA in preserving going-concern value. However, the reforms, at least the reforms finally enacted, did not succeed as expected. Practitioners do endeavor to adapt their advice to the risks raised by debatable judicial criteria and by the overdue or even unhelpful legal reforms. Rather than playing a role as "double agents" [47], Spanish practitioners struggle to address their clients' concerns and expectations. Legal advice deals with a challenging framework, where inadequate reforms sometimes worsen the situation. Some of the interviewees expressly criticized the lack of practical expertise of the majority of the members of the legislature's commission that drafted the 2011 reform. One of the interviewees even asserted that the idea of importing the U.K. scheme of arrangement had been advised by a Spanish law firm.

3.2. The 2009 reform, though important, was reactive, inadequate, and overdue

The SBA's 2009 reform was not only an attempt to copy Italian or French law to protect out-of-court workouts against claw-back. The data shows that the Spanish government was prompted by a very strong lobbying effort[48], which reacted against certain unsettling judicial decisions for lenders' interest[49]. This was the first time Spanish law referred to out-of-court workouts explicitly, arguably as a result of the social outcry[50] (including an allegedly very important lobby by the *Asociación Española de la Banca*, the Spanish bank association)[51]. One of the interviewees furthermore claimed that the out-of-court workouts' protection against claw-back had actually become a need following *Martinsa-Fadesa, S.A.'s* bankruptcy proceeding, the largest bankruptcy proceeding ever in Spain at

[47] Because lawyers, expert jurists, "translate" legal reforms to their clients, one may argue that they serve two different and sometimes conflicting interests. See LANGEVOORT & RASMUSSEN (1997).

[48] One of the interviewees furthermore asserted that the SBA's 2009 reform was prompted to "bless" an out-of-court workout aimed at refinancing an important Spanish public listed company (ACS -*Actividades de Construcción y Servicios, S.A.*-). Another one suggested that one of the reasons for which Martinsa-Fadesa, S.A. filed a bankruptcy petition in July 14, 2008 was banks' reluctance to reach a new out-of-court workout in light of the claw-back risk in subsequent bankruptcy. *See* PULGAR (2009a, 2012, pages 1-8, and pages 409 ff.), respectively, and SÁNCHEZ-CALERO (2009, page 11). According to the latter, a former successful workout was concluded in May of 2008. Just following the declaration, the bankruptcy trustees sought a preliminary restraining order in merits of a claw-back action dated May 7, 2008, which aimed at avoiding the security interests granted in that workout. The author also reminds the reader of the media coverage of this case. See:

http://www.expansion.com/2009/01/16/empresas/inmobiliario/1232142180.html.

[49] Perhaps the most well known case is the order against *Banco Espirito Santo* from the commercial judge nº 1 of Madrid as of May 21, 2007 (AC 2008, 1603; Reporting Judge: Antoni Frigola). In addition to avoiding the new security interests, the claim was subordinated on a bad faith basis. This case led to the so-called "*probatio diabolica*".

[50] See FERNÁNDEZ (2009, pages 64- 65). According to him, the social demand leading to the protection of the Legally Enhanced Workouts was unprecedented in Spain.

[51] Various interviewees referred to the lobbying work of this association.

that juncture[52]. Not surprisingly, the 2009 reform was enacted as a royal decree-law by the Spanish government, which was eventually confirmed by the legislature[53].

Despite any similarities with the French and Italian regulations of claw-back protection, the interviews suggest that the SBA's 2009 reform was actually a reaction to social outcry and lobbying pressure. First, it was an accelerated reaction to "legally bless" out-of-court workouts. The SBA's plain language did not mention them, which encompassed certain judicial decisions that were particularly severe in deciding claw-back cases. The reform aimed at protecting out-of-court workouts against claw-back to "fix" that unsettling judicial interpretation in order to give comfort to professional adjusting creditors. Second, the Spanish government reportedly became aware in 2009 of the statistics showing that more than 90 percent of bankrupt companies were liquidated. The reform tacitly underscored for the first time the SBA's failure to preserve going-concern value.

Although welcome in broad terms (perhaps rather the intention than the actual reform), the reform was also overdue. The majority of the interviewees pointed to a specific judicial order that unsettled the credit and the restructuring Spanish markets. *Banco Espirito Santo* suffered on May 21, 2007 both the avoidance of a security interest granted in favor of an antecedent debt and the subordination of its claim on the debatable grounds of bad faith[54]. This case brought about the concept of *probatio diabolica* with regard to the claw-back's rebuttable presumptions under the SBA[55]. The reform, dated March 22, 2009, arrived too late to fix the issue. On February 6, 2009, the 15th section of Barcelona's Court of Appeals (and eventually the Spanish Supreme Court in September of 2010[56]) had already come up with a new interpretation of claw-back's legal presumptions as per out-of-court workouts[57]. This new judicial doctrine was purported to fix the foresaid challenging precedent that was deterring banks from engaging in out-of-court workouts. The court referred to the concept of "unjustified

[52] *Martinsa, S.A.*, a non-listed corporation, had obtained a syndicated loan to take over and subsequently merge with *Fadesa, S.A.*, a listed company, in the largest public-to-private transaction of 2006 in Spain. It consisted of a syndicated loan of €4.100 Billion participated in by 45 Spanish and international banks.

[53] Former Spanish Minister of Justice (Mr. Francisco Caamaño) announced a new reform with a broader scope during the Spanish legislature's debate to confirm and validate the SBA's 2009 reform. Mr. Caamaño represented that the 2009 reform was the most efficient device to address the current and urgent needs of companies and workers. He explained that the Spanish Government would entrust the General Codifying Commission ("Comisión General de Codificación") to appoint a sub-commission to prepare a draft bill that eventually gave rise to the 2011 reform.

[54] The commercial judges of Catalunya underscore this resolution in their paper of July 5, 2013, which contains their criteria as per certain practical issues of the out-of-court workouts.

[55] Some interviewees argued that, though technically incorrect (as it consists of second-guess business judgment in hindsight), it was hard to rebut the burden of proof of prejudice. Evidently enough, the workout and its economic scenario ended-up failing as shown by the subsequent bankruptcy.

[56] Judicial order of September 16, 2010 (RJ 2010, 5597; Reporting Judge: Jesús Corbal).

[57] Docket number 607/2008.

estate's prejudice" to embrace a wide perspective of the multiple transactions or considerations a workout may consist of. According to it, the mere presence of prejudice, either directly or through the application of the SBA's legal presumptions, should not lead directly to avoid the transaction at issue. Avoidance should only follow inadequate consideration for the estate. In short, creditors ought to have the chance to justify, with a kind of shift in the burden of proof, why the workout made economic sense instead of filing for bankruptcy, regardless of whether or not the out-of-court workout eventually failed.

3.3. Accounting incentives and strategic behavior during the credit crunch

According to the "law on the books", the SBA's 2009 reform only protected out-of-court workouts aimed at preventing insolvency. In fact, stakeholders drew on them to deal with both pre-insolvency and actual insolvency.

While unsettling liquidation statistics and other flaws of the bankruptcy proceeding may contribute to understand stakeholders' runaway from bankruptcy, this phenomenon is also explained by banks' accounting incentives to engage in strategic behavior. Annex IX to the Spanish Bank's regulation 4/2004 on claims' losses was puzzling for banks' financial statements in a no less challenging financial environment. It obliged banks to register accounting losses upon bankruptcy's declaration, regardless of whether or not the debtor had a chance to reach a judicially approved composition agreement. In other words, the duty to register a loss was exactly the same for debtors with prospects of reorganization and for those irremediably condemned to liquidation. In contrast, banks could avoid such loss with the removal of insolvency out-of-court. Hence, there were important accounting incentives to promote out-of-court workouts instead of going bankrupt notwithstanding the debtor's economic viability.

The reader may wisely point out that accounting losses ought to be registered well ahead of a bankruptcy declaration. At any event, accounting registration should not depend on whether the workout was out-of-court or judicial. Yet, it is important to note the economic context in which this issue took place. At that moment (from 2008 to the beginning of 2010), the Spanish government still contended that the Spanish banks comprised the safest financial system in the world.[58] Thus, this would have been just an example of the accounting tools and strategic behavior that permitted certain Spanish banks to delay reporting their unsettling financial situation.

Banks' strategic behavior also raised a public policy issue. The out-of-court workouts were not merely pursued as a more efficient way to deal with corporate insolvency in order to reduce bankruptcy's transaction costs. True, this was an economic decision. However, it did not consist of a "market" correction to a government problem: the lack of efficiency of the official mechanisms (the bankruptcy proceeding) to handle insolvency's collective action problem by preserving going-concern value. Stakeholders were not turning to a loophole to reduce transaction costs. Banks did not

[58] See: http://www.expansion.com/2008/09/24/economia-politica/economia/1168531.html.

prefer the out-of-court restructuring arena —merely— to handle corporate insolvency in a more efficient manner. Accounting incentives led banks to avoid or at least delay bankruptcy petition the longer the better. As a result, the combination of bankruptcy petition's duty suspension period and banks' accounting incentives thwarted one of the two main goals pursued by the Spanish legislature in the SBA's 2009 reform. In contrast to the reform's purpose of preserving going-concern value, banks' strategic behavior permitted insolvent and economically distressed companies to avoid bankruptcy and remain in market place as "zombies". The reader may think of certain real estate companies that, unfortunately, wishfully expected better market conditions from 2011 onwards.

In any event, the legal actors and the policy makers ended up learning the reasons that led banks to avoid bankruptcy beyond the scary liquidation statistics. Not surprisingly, the Bank of Spain ended up reforming the administrative regulation that supported this strategic behavior. Indeed, this regulation has been amended ten times from January 20, 2010, to October 3, 2012[59]. Nowadays, banks must register a loss of 25 percent of a claim's face value upon a bankruptcy's declaration. The head of restructuring of one Spain's largest banks asserted that banks do totally register now the loss at the beginning of the negotiations of an out-of-court workout. The reforms of Spanish Economy Minister (Mr. de Guindos), he said, do not leave any further room for strategic behavior. Another different thing, he acknowledged, is the bank's goal of trying to "de-register" losses with an offsetting profit as soon as possible.

No doubt, this strategic behavior may contribute to explain why a significant number of out-of-court workouts did not turn to the legally enhanced regime. A workout just aimed at delaying bankruptcy could have never met the requirement of a short-term or medium-term economic viability plan. A "zombie" company could never qualify for the legally enhanced regime. However, the strategic behavior does not seem to shed light on the decreasing use of the Legally Enhanced Workouts. All in all, this issue might have negative externalities for the rest of the out-of-court workouts that, for any of the other reasons explained below, did not draw on the legally enhanced regime.

The "in-house" head of restructuring of one of the largest Spanish banks confirmed this scenario[60]. Two of the interviewees however considered that the Bank of Spain's reforms may give rise to a higher number of bankruptcy proceedings and, somehow, also to a decreasing use of the Legally Enhanced Workouts. To be sure, the strategic behavior previous to the reforms may help to explain the steadily increasing number of bankruptcy proceedings between 2009 and 2011. But, again, as "zombie companies" could never qualify for the legally enhanced regime, the accounting incentives cannot explain the stakeholders' decision to draw on "unprotected workouts" at the expense of the

[59] Further amendments have followed after the completion of this research work.

[60] He insisted, nevertheless, that this strategic behavior is no longer feasible after the last reforms of the Bank of Spain's regulation. He moreover asserted that not all of the Spanish banks had developed the same strategic behavior, as, he said, one may now figure out retrospectively.

incentives akin to the Legally Enhanced Workouts. This strategic behavior has nothing to do with the choice between reaching a "general" workout or a Legally Enhanced Workout, other things being equal. When inquired about the reasons of the connection of the Bank of Spain's reforms with the increasing number of other "unprotected workouts", these interviewees argued that economic agents are still afraid of the discouraging statistics of the bankruptcy proceeding. Instead of providing creditors with the chance to deal with corporate insolvency, bankruptcy deters stakeholders from filing the petition, they said. According to them, the disappearance of accounting incentives has encouraged banks to not engage in strategic behavior regarding the choice between an out-of-court workout or filing the bankruptcy petition. Still, this assertion cannot explain why stakeholders turn to "unprotected" out-of-court workouts at the expense of the incentives akin to the Legally Enhanced Workouts. Fortunately, another interviewee shed some light on this issue. She first of all confirmed that accounting incentives had nothing to do with the choice between "unprotected" or Legally Enhanced Workouts[61]. Interestingly, she then affirmed that the myriad reforms of the Banks of Spain's regulation have not yet totally erased the incentives that may lead to strategic behavior. While she admitted that the 25 percent difference between the out-of-court workout and the bankruptcy petition has balanced the initial decision, she pointed to another misbalance between an out-of-court workout and a pre-packaged composition. The difference lies in the flexibility to register an offsetting profit once insolvency is removed. In fact, banks are not entitled to set off losses immediately after the judicial approval of the composition agreement, while they have more discretion to do so outside of bankruptcy[62]. Under Annex IX to the Bank of Spain's regulation 4/2004, banks must not register an offsetting profit (i) until debtor pays 25 percent of the claims participating in (and as amended by) the judicially approved composition agreement, or (ii) after two years as from the judicial approval, provided that there are no doubts about debtor´s solvency to make future payments. In actuality, it makes no sense that a judicially overseen workout raises more accounting issues than a workout that is privately conducted out-of-court.

Without countering this issue (the mismatch in the flexibility to register an offsetting profit), the in-house head of restructuring of one of the largest Spanish banks stressed that accounting incentives are not currently a key factor in any decision related to insolvent companies[63]. Asked about whether or not this may depend on the bank's policy, this interviewee insisted that Mr. de Guindos' reforms did not leave any room for discretion. In furtherance of this, another interviewee who is a leading professor of commercial law and a practitioner agreed that the recent reforms of the Bank of Spain's accounting regulation eliminate any likelihood of strategic behavior. According to her, these reforms

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[61] She referred to other reasons explained below.

[62] Flexibility refers to the fact that banks are not compelled to act in either way. However, the accounting policy of a particular bank may lead to the same result out-of-court as the one compelling under bankruptcy according to the Bank of Spain's regulation.

[63] Whether this assertion may be true for all of the employees in charge of the particular cases is likely to entail an agency problem that requires empirical analysis beyond the scope of this research work.

have increased dramatically the monitoring powers of the Bank of Spain over the economic viability of debtors reaching an out-of-court workout. This modification, she stressed, shall oblige banks to register an accounting loss up to 25 percent of their claim regardless of whether the workout is reached out-of-court or in bankruptcy.

The social impact of this change remains to be seen. Certain interviewees were very skeptical. Most of them were very critical about the role of the Bank of Spain after the recent scandals. As a matter of law, the out-of-court workouts and the related accounting practice are certainly subject to a stricter level of supervision nowadays. Annex IX to the Bank of Spain's regulation 4/2004 includes every kind of workout within the category of "transactions that require a special monitoring". Furthermore, transactions with defaults in principal or security interests for more than three months are not "cured" with the conclusion of an out-of-court workout, unless certain additional requirements are met (for instance, the granting of a new security interest on account of an antecedent debt, which may be definitely subject to claw-back in turn). Apart from the flexibility to register an offsetting profit, the regulation seems all in all to have fixed the misbalance in banks' accounting incentives, at least formally. Again, it is hard to determine whether or not its actual implementation may be effective in deterring strategic behavior. It will logically depend, first of all, on the resources of the supervisors.

This has not changed as a result of the Royal Decree-law 4/2014, of March 7. As per the mandate to set forth the criteria to consider a refinanced debt instrument to have "normal risk" [64], the Bank of Spain communicated on March 18, 2014 that such classification shall follow provided that there are objective items that allow concluding the probable recovery of the new amount as a result of the workout. In this regard, the Bank of Spain further stresses that attention shall be focused on the impact that the discharges and the debt-for-equity swaps may have over the recovery of the claim, which shall take account of the corresponding business plans.

To sum up, the misbalance of incentives arising out of the Bank of Spain's accounting regulation does not appear to have a direct relationship with the decreasing use of the Legally Enhanced Workouts. As a short-term or medium-term business plan is a requirement for the legally enhanced regime, "zombie" companies' out-of-court workouts could have never qualified for the legally enhanced regime, in principle[65]. Hence, those incentives do not explain the decreasing use of the Legally Enhanced Workouts within the analyzed period of time. However, these incentives are a key

[64] It is important to note that this mandate is only referred to the Legally Enhanced Workout of article 71 bis and the additional section fourth of the SBA.

[65] Although none of the interviewees was asked about the actual independence of the independent experts, no one suggested any hint that may challenge that assumption. All in all, the Act on Support of Entrepreneurship and the Royal Decree-law 4/2014, of March 7, have addressed this issue. The independent expert must meet the requirements related to the appointment of the bankruptcy trustees under article 28 of the SBA. In addition, the independent shall comply with the incompatibility requirements under the auditing regulation.

fact to understand why banks wanted to delay or avoid the bankruptcy petition beyond claw-back, subordination, or even lender liability risk. The choice between an out-of-court workout (either "protected" or "unprotected") or a bankruptcy petition accounted for this aspect, at least, until the beginning of the Bank of Spain's reforms in 2010. Although the incentives are currently more balanced, banks are still better off outside of bankruptcy[66]. Unfortunately, this might cast suspicion over those out-of-court workouts that do not draw on the legally enhanced regime for any of the reasons set forth below. This is the remaining negative externality of banks' strategic behavior, which should prompt the greatest level of resources from the supervising authorities.

3.4. Flaws making the Legally Enhanced Workouts too expensive in relative terms

Banks' legal advisers represented their astonishment when they learned about these statistics. They had not realized the decreasing use of the Legally Enhanced Workouts. They put forward that the assessment by an independent expert is actually a covenant to engage in negotiations aiming at reaching an out-of-court workout. Rather than challenging the official statistics, this point of view confirms that the Legally Enhanced Workouts are still qualitatively significant. This was agreed by all of the interviewees. Other things being equal, the interviewees would turn to a Legally Enhanced Workout when it comes to refinancing a major debtor, as long as the case is handled with sufficient time, which is rarely the case. The average case gets to their office very late, without enough time to figure the "ideal strategy" out, or even to gather all the corresponding requirements. In practice, external legal advisers endeavor to explain in the transactional documents the practical constraints that impeded the use of a Legally Enhanced Workout. One of the interviewees contended that his firm attaches a business plan from an independent auditor in every out-of-court workout regardless of whether or not it qualifies for the legally enhanced regime.

On the other hand, external legal advisers with more experience in rendering legal assistance to debtors, especially litigators, offered some very interesting insights that may help to explain the "practical shortage" of the Legally Enhanced Workouts. In broad terms, they contended that the Legally Enhanced Workouts have become comparatively more expensive for several reasons. First, the judicial doctrine of "unjustified estate's prejudice" provided banks with a chance to prove the economic sense of an out-of-court workout that could justify the detriment triggered by the legal presumptions of the SBA's fraudulent conveyance regime. The absence of the "legal shield" is not an insurmountable obstacle in the legal defense against an avoiding action.

[66] From the perspective of post-petition financing, other things being equal, banks do not have incentives to provide new money in light of the Bank of Spain's accounting regulation. They must register automatically the corresponding loss (at least, 25 percent of the claim). As prepetition claims, the loss cannot furthermore be compensated until the debtor has paid 25 percent of the claims participating in (and as amended by) the judicially approved composition, or after two years since the judicial approval, provided that there are no doubts about future recovery.

Second, transactional and litigation lawyers criticized the lack of flexibility in the appointment of an independent expert[67]. They asserted that certain commercial registrars are reluctant to designate the expert before the conclusion of the negotiations. The issue, of course, is that the outcome of the independent expert's report will most likely prompt amendments to the workout[68]. Significantly, the Act on Support of Entrepreneurs addressed this issue. The resulting article 71 *bis* of the SBA provided that the debtor might petition the appointment of an independent expert at any moment after the beginning of the negotiations. However, following the Royal Decree-law 4/2014, of March 7, the independent expert's report is not anymore a compulsory requirement for the purposes of earning claw-back protection[69]. Whilst the parties may decide to have the expert appointed (either at the debtor's or the creditors' request), the current plain language of article 71 bis.4 of the SBA has not reproduced the former amendment by the Act on Support of Entrepreneurs. Yet, it seems sensible that the appointment may still be made at any point of the negotiations.

Third, the interviewees complained about the lack of legal expertise of the majority of independent experts, who are economists or auditors. These experts are not required to be knowledgeable on insolvency law or even to team-up with a lawyer, and of course their knowledge is not evaluated before their appointment. Thus, while independent experts are qualified to issue an opinion on the short-term or medium-term economic viability of the business plan, they are not as familiar as they should, the interviewees said, with certain security interests, for instance. The proportionality of the resulting security interests according to current market conditions is indeed challenging for most lawyers, let alone economists. As a result, the outcome of their analysis is not as accurate as it should concerning the most significant legal issues. Most importantly, certain interviewees furthermore stressed that this lack of understanding and the independent expert's liability regime may distort and jeopardize the goals of the report. Because the independent expert needs to protect herself against eventual liability actions, her lack of training in insolvency law is likely to prompt the inclusion of more qualifications in the report.

Last but not least, litigators contended that the Legally Enhanced Workouts are not totally shielded against claw-back. The SBA's 2009 reform did not clarify what the effects of any qualification in the report from the independent expert would be[70]. It remained unclear whether or not a claw-back

[67] The commercial registrar appoints the independent expert within fifteen days from the debtor's request. The independent expert must accept then the appointment within five days and, thereafter, the corresponding report must been issued within a month.

[68] However, another lawyer, who is also a professor of commercial law, casted doubt on it. She asserted that it is feasible to have the independent expert appointed during the negotiations.

[69] It is nonetheless possible to have the expert appointed, which is moreover important for other purposes, such as the exemption to launch a takeover bid following a debt-for-equity swap or in order to ascertain the reasonability of such corporate decision for the financial viability of the company. See footnote 13.

[70] Perhaps a perverse and unintended effect of the huge amount of scholarly work produced by professors, lawyers, economists, and even judges may be the plain language's raised loopholes. It is remarkable that Spanish Supreme

action could be more likely to succeed on the merits in light of such qualifications, either because of actual concerns about the economic viability or because the expert's lack of understanding of certain security interests. Hence there could be room for litigation. Declaratory relief might seek to challenge any of the requirements of the legally enhanced regime in order to pursue claw-back subsequently. This raised reasonable doubts about the vulnerability of the "legal shield", making the Legally Enhanced Workouts more expensive in relative terms. According to some authors (bankruptcy judges)[71], the Royal Decree-lay 4/2014, of March 7, has confirmed the possibility of seeking declaratory relief prior to the filing of a claw-back action to avoid a Legally Enhanced Workout.

3.5. The shortcoming of the 2009 urgent measures and the subsequent reform of 2011

The SBA's "announced" second reform was enacted in October 2011. The provisions that concerned the Legally Enhanced Workouts entered into force immediately. The question that follows is why this new reform, which further incentivized the negotiation and conclusion of the Legally Enhanced Workouts, brought about a decreasing use of this new "fancy" legal device. True, these provisions entered into force in October. However, the bankruptcy proceedings increased in 2011, while the Legally Enhanced Workouts decreased. Despite the short period of time the statistics are not consistent with the reforms.

In particular, the reader may wonder whether or not the 2011 SBA's reform helped to fix any of the issues noted above, particularly the consequences of the independent experts' qualifications regarding a claw-back action in subsequent bankruptcy. Unfortunately, the interviewees asserted, the 2011 reform failed to be clear in this respect. Under article 71.6 of the SBA, the parties had to assess the legal risk of the independent experts' qualifications. To make things worse, article 72.2's plain language raised concerns about whether or not the trustee might seek declaratory relief to challenge the requirements of the "shield" [72]. The Royal Decree-law 4/2014, of March 7, has not addressed this issue. Under article 71 bis.4 of the SBA, the parties still have to assess the qualifications if they choose to appoint an independent expert as to claw-back protection, whilst

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Court's Justice Ignacio SANCHO criticized the allegations about loopholes and inconsistencies in the SBA's plain language regarding the Legally Enhanced Workouts' protection against claw-back. He asserted that the SBA's intent could not be clearer. See SANCHO (2009, pages 16-25). See also the document of July 5, 2013 that contains the criteria of the commercial judges of Catalunya as per certain practical issues of the out-of-court workouts. On the other hand, other judges pointed to the feasibility of such way around to challenge the workout by means of former declaratory relief. See NIETO (2013, page 16).

[71] See YÁÑEZ & NIETO (2014, page 10).

[72] Whereas article 71.6 of the SBA stated that the Legally Enhanced Workouts were not subject to claw-back (with the caveat of the qualifications from the independent expert's report), article 72.2 indicated that only the bankruptcy trustee had standing to bring a SBA's claw-back or any other private law action against workouts. This inconsistency brought some authors to suggest seeking declaratory relief aimed at stating that one of the requirements failed and, subsequently, bringing a claw-back action against the "unsecured" workout as it did not qualify for the legally enhanced regime. See NIETO (2012). Notably, the author is a commercial judge.

article 72.2 indicates that the trustee may only ground a claw-back action on the absence of the requirements set forth under article 71 bis.1 & 2 of the SBA[73].

Litigators furthermore represented that they are increasingly concerned about claw-back as the economic crisis elapses over time. Companies are undergoing second or even third workouts[74]. Nobody expected in 2007 that the economic crisis would loom until 2014, at least. Hence, the interviewees pointed out, short-term or medium-term viable business plans might be thwarted rather more successfully now than in 2009. The shortage in the "legal shield" may thus explain as well why there are more "unprotected" workouts than expected.

To sum up, the SBA's 2009 and 2011 reforms, while well-aimed and well-intentioned, set initial positive but imperfect steps to reach their goals concerning out-of-court workouts. They consist of an overdue and imperfect reaction to social outcry and lobbying pressure. The Legally Enhanced Workouts have become more expensive than an "unprotected" out-of-court workout in relative terms.

3.6. Are the Legally Enhanced Workouts expected to "work out" in a profound and enlarged economic crisis?

The interviewees suggested that the prolongation of the economic crisis might also explain the decreasing use of the Legally Enhanced Workouts. Further empirical research may analyze the existence of an inverse relationship between the breadth and duration of the economic crisis and the number of Legally Enhanced Workouts[75].

When asked about the reasons for the decreasing use of the Legally Enhanced Workouts following the SBA's 2011 reform, certain interviewees contended that they are not that useful now. Turning to a Legally Enhanced Workout makes sense, and banks indeed require it as covenant to negotiate, they said, as long as there is new money or additional security interests to grant on account of antecedent or new debts. Certain corporations are undergoing their second or third out-of-court workout since the onset of the financial crisis. Hence, there may not be any more assets or equity free of liens and encumbrances to offer new security interests. In addition, banks are not willing to extend new money given their own capital needs and the subsequent general credit restriction. Finally, a transactional

[73] See footnote 13.

[74] After seeking unsuccessfully its fourth out-of-court workout since the onset of the financial crisis in 2007, *Reyal Urbis, S.A.*, a Spanish listed public real estate company, filed the bankruptcy petition in 2013. It is the second largest bankruptcy proceeding in Spanish history after *Martinsa-Fadesa, S.A.'s*.
http://www.expansion.com/2013/02/19/empresas/inmobiliario/1361257807.html.

[75] To be sure, the exploratory stage of this research work does not enable to draw any conclusion inferable to the research population, let alone the announcement of a causal relationship or its direction. However, perhaps others may build on these traces to ascertain whether or not such a causal relationship may exist, and why.

lawyer argued that banks will not be willing to extend new money to a company if they are obliged to register an accounting loss amounting at least to 25 percent of their total exposure to it. Hence, the absence of new security interests and prepetition new money would also make the Legally Enhanced Workouts more expensive than a "general" out-of-court workout in relative terms.

In short, the SBA's reform of 2011 linked the "fresh money privilege" to prepetition new money granted within the framework of Legally Enhanced Workouts. Paradoxically, therefore, the reform made it even more expensive to turn to a Legally Enhanced Workouts within the current economic context.

3.7. A first approach to the Royal Decree-law 4/2014, of March 7

These results may be useful in doing a first non empirical approach to the brand-new reform of the SBA carried out by the Royal Decree-law 4/2014, of March 7, which deprives the unprotected out-of-court workouts of any of the fostered legal incentives to remove insolvency through a negotiated solution. Indeed, the dichotomy between out-of-court workouts and bankruptcy is still at issue. The reform has addressed again the majority of the concerns akin to the Legally Enhanced Workouts.

First, it has eased the negotiation, conclusion, and protection of workouts concerning financial claims. A majority of 51 percent of the financial claims is enough to put in place an automatic stay concerning enforcement actions and to request a court-sanctioned bankruptcy-proof out-of-court workout, which might only be challenged by the trustee on merits of any of the more restraining rescission actions of the Spanish Civil Code. In addition, the holdout problem and certain assignees' greenmailing strategies are likely to disappear since the law refers to creditors holding financial claims instead of financial entities. The invulnerability of creditors holding secured financial claims has also come to an end. Sixty-five percent or 80 percent of the secured financial claims may agree to enter into a workout that may be crammed down over dissenting secured financial creditors[76]. Second, article 71 bis.2 of the SBA is concerned with out-of-court workouts that still earn claw-back protection even though the majority of article 71 bis.1 of the SBA (60 percent of the claims) cannot be reached. However, certain requisites set forth in article 71 bis.2 of the SBA ought to be clearer[77]. Third, article 93.2.2º of the SBA contemplates a rebuttable presumption according to which creditors entering into a Legally Enhanced Workout shall not be held *de facto* directors. Fourth, new money granted by creditors becoming shareholders as a result of a debt-for-equity swap as a result of a Legally Enhanced Workout shall not be subordinated. In addition, the reform grants a whole

[76] Unsecured creditors' financial claims may be also crammed down with a majority of 60 percent or 75 percent of the financial claims. See footnote 13.

[77] See footnote 13. The Royal Decree-law 4/2014 was confirmed by the Spanish legislature on March 20, 2014. Besides, this reform is going to give rise to a new law, which may introduce some amendments on the current draft. Hopefully these amendments may clarify some points of the reform. In any event, the interviewees did not take account of this reform.

administrative expense preference to the new money stemming from a Legally Enhanced Workout for two years (until March 7, 2016), notwithstanding whether the lender is a debtor's especially related person. Fifth, the reform sort of acknowledges that insolvency might prompt that unsecured creditors become the new residual claimants or, at least, the holders of the residual decision rights[78]. Directors and shareholders are incentivized to foster a debt-for-equity swap stemming from a Legally Enhanced Workout if an independent expert considers it to be reasonable to handle financial distress[79]. Lastly, article 172 bis of the SBA eases the liability for the impaired claims by establishing a more demanding adequate causation requirement.

Concerning inconveniences, public claims are not bound by the automatic stay (unlike suppliers —see article 5 bis of the SBA—). Nor are the commercial and the public claims affected by the cramdown provisions of the additional section fourth of the SBA. In addition, the automatic stay does not embrace setoff or certain declaratory relief. Most importantly, the reform has concentrated even more the legal incentives on the Legally Enhanced Workouts. First, debtors negotiating an unprotected out-of-court workout may not file a communication to suspend their duty to petition bankruptcy and to forestall non-voluntary petitions for four months. The law seems to take for granted that no sensible stakeholder would turn to an unprotected workout, regardless of whether or not it may be as efficient as a Legally Enhanced Workout in order to handle corporate insolvency. Second, protection against claw-back and the prepetition new money incentives also remain within the realm of the Legally Enhanced Workouts. It is hard to tell the economic grounds that may explain why certain new money is better than other. Third, the safe harbor provision under article 93.2.2 of the SBA regarding lender liability akin to *de facto* direction does not apply to creditors entering into an unprotected out-of-court workout. All in all, this safe harbor provision only confirms that anyone seeking creditors to be held *de facto* directors bears the corresponding burden of proof. Fourth, the promotion of the debt-for-equity swaps should not depend upon the conclusion of a Legally Enhanced Workout or an unprotected out-of-court workout. Last but not least, the reform fosters the cramdown of out-of-court workouts far beyond the scope of a composition agreement in bankruptcy (particularly as to the treatment of secured claims).

Be that as it may, the goal of the reform seems to consist of promoting negotiated out-of-court alternatives as the main solution to remove corporate insolvency, characterizing bankruptcy as a residual venue for liquidation (preferably through the sale of the business unit as a going-concern).

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[78] See footnote 22.

[79] Otherwise the directors and even the shareholders may be charged with a rebuttable presumption of willfully or grossly negligently generating or aggravating insolvency (see article 165.4º of the SBA), which may wind-up in liability for the impaired claims if bankruptcy is classified as guilty (see article 172 bis of the SBA).

4. *Conclusions*

Bankruptcy is still compulsory to handle corporate insolvency under Spanish law. In fact, however, it is the residual option for the majority of going-concern companies, which draw on "unprotected" out-of-court workouts increasingly at the expense of the legal incentives of the Legally Enhanced Workouts. The interviews conducted with practitioners have offered certain hints to explain this phenomenon. The absence of new security interests or "fresh money" would make the Legally Enhanced Workouts more expensive than "unprotected" out-of-court workouts in relative terms. The concerns about the "legal shield" and the case law's shift towards the "unjustified estate's prejudice" doctrine may also contribute to understanding the loss of the Legally Enhanced Workouts' comparative advantage. All in all, the Legally Enhanced Workouts still seem to be "a must" from a qualitative point of view. In addition, the suspicion that may loom over "unsecured" out-of-court workouts in light of the remaining accounting incentives that might lead to banks' strategic behavior could also increase their appeal. Further empirical research work should analyze the evolution of the statistics once the SBA's brand-new reforms of 2013 and 2014 have settled among the legal actors.

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