

**BANKRUPTCY AND A FRESH START:  
STIGMA ON FAILURE AND LEGAL  
CONSEQUENCES OF BANKRUPTCY**

**National Report Spain**

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# **Bankruptcy and a fresh start: stigma on failure and legal consequences of bankruptcy**

## **SPAIN**

### **TITLE 1. INTRODUCTION**

The Spanish legal regulation on insolvency currently in force has been almost unanimously criticised. The legal sources covering both the substantive and procedural aspects of the matter are spread among five different laws:

- (i) The Commercial Code 1829 covers a number of substantive matters of the bankruptcy procedure;
- (ii) The Civil Procedural Rules 1881 contain the main procedural rules governing the bankruptcy procedure;
- (iii) The Commercial Code 1885 lays down the legal regime of bankrupt debtors (thereby partially superseding and also complementing the one established by the Commercial Code 1829)
- (iv) The Civil Code 1889 regulates the two procedures applicable to the situations of civil debtors in temporary financial distress or terminal insolvency, respectively; and
- (v) The Suspension of Payments Act 1922 establishes the legal regulation of suspension of payments procedures.

In addition, as the social and economic environment at the time when all of the above-mentioned laws were enacted was completely different to the current organisation and forms of business activities (the Spanish economy was then largely dependent on the agricultural sector and most of the trading and industrial activities were conducted by individual entrepreneurs), the legal provisions therein contained have proved to be inadequate or insufficient. More specifically, certain personal restrictions imposed by the Commercial Code 1829 on bankrupt debtors (imprisonment, intervention of correspondence, etc) have been considered to be in contradiction with the Spanish Constitution 1978.

Consequently, there is almost no doubt in the Spanish legal literature and insolvency practitioners that our current system is unable neither (i) to encourage the survival of business under financial distress nor (ii) to guarantee a reasonable debt recovery rate for the creditors.

The general principles governing the Spanish law on insolvency can be outlined as follows:

- (i) The debtor is responsible of the payment of its liabilities with all its present and future wealth.<sup>1</sup> Should the debtor default its payment obligations, its creditors are entitled to bring individual legal actions against the debtor, in order to compel the latter for payment.
- (ii) As an exception, when the reasons why the debtor is unable to meet its payment obligations are (i) either temporary liquidity problems or (ii) the lack of sufficient assets to cover the amount of the liabilities, the law provides for certain insolvency procedures, the common features of which are the following:
  - These procedures are controlled and supervised by the judicial authority, either directly or by means of auxiliary persons appointed for that purpose;
  - The insolvency may be declared upon petition of the debtor or pursuant to a request by the creditors (under certain circumstances and provided that several requirements are met);
  - The opening and termination of the procedure (as well as other significant resolutions adopted in the course of the proceedings) are made known to the public, either by means of notification to public registries or by publishing notices in newspapers;
  - Creditors (at least, most of them) are barred from taking individual actions against the estate of the debtor;
  - A number of restrictions are imposed on the debtor's legal faculty to manage its goods, properties and business;
  - Depending on the specific nature of the insolvency procedure, its ultimate purpose is aimed either at reaching a composition between the creditors and the debtor or at the organized liquidation of the latter's estate;
  - When the insolvency is classified as a terminal one, the liability of the debtor is subject to examination by the judge in charge of the case;
  - Should the judge find that the debtor is liable for the terminal insolvency, this will aggravate the personal consequences suffered by the debtor;
  - Moreover, in the events of terminal insolvency, the law enables the creditors to take actions aimed at nullifying certain "suspect" transactions carried out by the debtor during the time immediately prior to the declaration of insolvency;
  - The law establishes a system of privileged and preferential credits;

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<sup>1</sup> Article 1911 Civil Code.

- Insolvency procedures will end either (i) with the full compliance by the debtor of the composition reached between the creditors and the debtor, or (ii) with the liquidation of the estate of the debtor;
  - In the events of terminal insolvency, the debtor may file a petition to be rehabilitated, provided that (i) the terminal insolvency was not classified as fraudulent and (ii) the debtor complied with the terms of the composition reached with the creditors or has satisfied all of the outstanding debts (either with the proceeds of its estate or by other means).
- (iii) There are four different applicable insolvency procedures, depending on whether the insolvent person or entity is a civil debtor or a trading person and also depending on whether the insolvency is of temporary or terminal nature.

The following chart shows the classification of the four procedures:

Status of the debtor	Type of insolvency	Applicable insolvency procedure
Civil debtor	Temporary	Moratorium ("Quita y espera")
	Terminal	Civil insolvency ("Concurso de acreedores")
Trading person	Temporary	Suspension of payments ("Suspensión de pagos")
	Terminal	Bankruptcy ("Quiebra")

The Spanish system, inspired in the social and political ideas of the liberalism of the nineteenth century, is presided by the principle that insolvency procedures should serve as a means to help the market identify and eliminate all those individual and entities who have failed in their business activities. Our insolvency law is founded on the belief that the market should be given tools to self-regulate and depurate. The priorities are therefore: (i) the protection of the safety of business transactions, (ii) the preservation of the debtor's estate, as a way to enable creditors to recover their receivable to the largest extent possible, and (iii) to ensure that all creditors are given equal treatment – pursuant to the rule known as *par conditio creditorum* (with the exception of the legal privileges and preferences).

Thus, it can be said that there is little or no concern in our legislation about eliminating restrictions for the insolvent debtor to resume its former business activities or to start new ones.

A clear distinction can be made, however, between the suspension of payments (temporary insolvency, in principle) and bankruptcy (terminal insolvency, in principle).

In suspension of payments procedures, the debtor is only subject to the approval and control of its activities by the supervising auditors appointed by the judge, so that every transaction involving payment of debts, collection of credits or the undertaking of obligations<sup>2</sup> must be approved by said supervising auditors. The above notwithstanding, the debtor maintains its legal right to manage and conduct the business (except when the insolvency is subsequently classified as a terminal one, then the judge may impose restrictions on the debtor's management faculties<sup>3</sup>).

On the other hand, in bankruptcy procedures, the declaration of bankruptcy entails, as an automatic consequence, the prohibition of the debtor to administer its assets.<sup>4</sup> The management faculties of the debtor are assumed by the receivers that will be appointed among the creditors<sup>5</sup>. The debtor may not be subsequently rehabilitated until the termination of the proceedings<sup>6</sup> (provided that certain circumstances are met), unless a composition with the creditors exceptionally allows him/her to resume business (this would only be applicable in the bankruptcy of companies<sup>7</sup>).

This difference between the personal consequences suffered by the debtor in suspension of payments and bankruptcy procedures results in practice in an overuse of the suspension of payments procedure for cases of terminal insolvency. Debtors try to benefit from the unclear legal limits between the objective definition of suspension of payments and bankruptcy cases. Thus, many of the petitions for suspension of payments correspond actually to cases of terminal insolvency.

According to the rules governing the suspension of payments procedure, when the judge declares (based on the report of the supervising auditors) that the debtor's insolvency must be considered as a terminal one,<sup>8</sup> some of the legal provisions governing bankruptcy cases become applicable to the suspension of payments<sup>9</sup> (possibility of taking nullifying actions against certain transactions prior to the petition for suspension of payments; examination of the debtor's liability for the terminal insolvency; possibility of imposing additional restrictions on the debtor's managing faculties). However, even in situations of terminal insolvency, the debtor in suspension of payments will not be disqualified for conducting business.

As a summary, the approach of the Spanish law on insolvency with respect to a fresh start in business activities by persons or entities previously involved in insolvency procedures can be considered to be opposite to eliminating obstacles and legal prohibitions. This conclusion is supported by the following:

- (i) The declaration of bankruptcy entails automatically the disqualification of the debtor for managing its business and assets<sup>10</sup> and for carrying out business activities, in general<sup>11</sup>.

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<sup>2</sup> Article 6 Suspension of Payments Act.

<sup>3</sup> Article 8 Suspension of Payments Act.

<sup>4</sup> Article 878 Commercial Code.

<sup>5</sup> Articles 1068 et seq. Commercial Code 1829.

<sup>6</sup> Articles 920 through 922 Commercial Code.  
Articles 1168 through 1175 Commercial Code 1829.

<sup>7</sup> Article 928 Commercial Code.

<sup>8</sup> Article 8 Suspension of Payments Act.

<sup>9</sup> Articles 20 and 21 Suspension of Payments Act.

<sup>10</sup> Article 878 Commercial Code.

In the event of bankrupt companies, the disqualification would affect the directors and managers of the company.<sup>12</sup>

- (ii) The bankrupt debtor (as well as the directors and managers of the bankrupt company) will be also disqualified for occupying the position of administrator of companies<sup>13</sup>, as long as he is not legally rehabilitated.
- (iii) The rehabilitation of the debtor may not be declared *ex officio* by the judge. It requires a prior petition by the debtor.
- (iv) The rehabilitation will be granted provided that the following requirements are met:
  - The separate procedure for the classification of the insolvency has ended and it has not been classified as fraudulent<sup>14</sup>.
  - The debtor shall be able to prove that it has complied with the composition agreement reached with the creditors or, when such composition was not reached, that it has paid all of the outstanding debts acknowledged at the bankruptcy procedure (either with the proceeds of the sale of its estate or otherwise<sup>15</sup>).

In Spain, the legal consequences of the bankruptcy on the person of the debtor can be considered to be a real stigma. Consequently, the rehabilitation of the debtor is intended to serve as a way to restore the *“personal prestige and reputation of the debtor”* and a proclamation that the debtor was not responsible for the insolvency and therefore he/she cannot be considered as *“socially dangerous”*<sup>16</sup>.

## **TITLE 2. DEFINITIONS AND TERMINOLOGY**

### **Chapter 2.1. Insolvency procedures**

- (i) Suspension of payments: “Suspensión de pagos”
- (ii) Bankruptcy: “Quiebra”.

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<sup>11</sup> Article 13. 2º Commercial Code.

<sup>12</sup> Preamble of the Commercial Code (section corresponding to Book IV) and also article 929 Commercial Code (impliedly). This position is confirmed by Jose Antonio RAMIREZ (*La Quiebra. Derecho Concursal Español*. Third Volume., page 542).

<sup>13</sup> Article 124 Companies Act and article 58.3 Limited Liability Companies Act.

<sup>14</sup> Article 920 Commercial Code. Article 1169 and 1170 Commercial Code 1829.

<sup>15</sup> Article 921 Commercial Code. Articles 1171 and 1172 Commercial Code 1829.

<sup>16</sup> Jose Antonio RAMIREZ (*La Quiebra. Derecho Concursal Español*. Third Volume, page 464).

## **Chapter 2.2. Main actors**

- (i) In suspension of payments:
  - Judge of the Court of First Instance (“Juez de Primera Instancia”): Judicial body legally in charge of hearing and conducting suspension of payments’ procedures.
  - Supervising auditors (“interventores”): Accounting experts appointed by the judge. Their main mission is to supervise and approve the debtor’s activities and prepare a report on the financial situation of the debtor’s business (in this report, the insolvency will be classified a temporary or terminal).
  - Public Prosecutor (“Fiscal”): Public official who represents the public interest before the courts. Must compulsorily be a party to the suspension of payments procedure.
  
- (ii) In bankruptcy procedures:
  - Commissioner (“Comisario”): Trading person appointed by the judge for carrying out supervising and control duties on behalf of the latter.
  - Depository (“Depositario”): Person appointed by the judge and whose purpose is to administer the estate of the bankrupt until the appointment of the receivers.
  - Receivers (“Síndicos”): Representative elected by the creditors and among them. Their mission is to arrange the organised liquidation of the estate of the bankrupt, under the supervision of the Commissioner and, ultimately, the judge.

## **Chapter 2.3. Legislation**

- (i) The Commercial Code 1829 (“Commercial Code 1829”).
- (ii) The Civil Procedural Rules 1881.
- (iii) The Commercial Code 1885 (“Commercial Code”).
- (iv) The Civil Code 1889 (“Civil Code”).
- (v) The Suspension of Payments Act 1922 (“Suspension of Payments Act”).

### TITLE 3. WARNING LIGHTS AND PREVENTION OF INSOLVENCY

There are no legal and compulsory procedures aiming at the prevention of insolvency. Therefore, companies are not compulsorily and systematically screened for this purpose.

In any case, debtors may have notice of their situations, by themselves, by means of the formulation of the company's annual accounts and, where mandatory, by the audit to which they are subject.

Creditors or future creditors, can check the insolvency situation of a debtor in the following ways in order to avoid the problems derived from it:

1. Obtain information regarding the future debtor:
  - a) Official information sources:
    - The Companies Registry, with which the annual accounts<sup>17</sup> of every company must be compulsorily filed in Spain (individual entrepreneurs may do so too). This information is public, so any third party may apply for a certificate including the financial information recorded at this administrative body.

Nevertheless, this information is quite limited and usually out-dated. There are also quite a number of companies, which do not comply with the annual accounts record obligation, being sanctioned with the closure of the Company's Page at the register until the accounts are deposited. This closure entails the impossibility of recording most part of the acts that affect the mercantile feature of the company. (This fact would be itself, indeed, very revealing). These details may also be accessed through the Internet in its web site.
    - The Property Registry is the administrative body that offers public information on the ownership, charges and encumbrances, if any, of real property assets in Spain. Dependant on this body is a Service that can be accessed through the Internet, which provides information on real properties in Spain registered in favour of any entity.
    - The Unpaid Acceptances Registry, dependent on the Bank of Spain ("*Registro de Aceptaciones Impugnadas*"-RAI) records all the unpaid bills that are formalised through banks, savings banks and credit institutions operating in Spain, indicating the amount of the bill and the name of the debtor.

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<sup>17</sup> Including the audit report, when appropriate.

- b) Private information sources: These have arisen due to the limitations of the Official information sources. There are few databases that give solvency information regarding entities and individual entrepreneurs as well as individuals. Private Investigator Agencies might also be taken into account in these regards.
2. Adopting some controls regarding the day-to-day operations of the company towards third parties.

It is advisable to adopt some internal measures in order to avoid having debtors with insolvency problems, some of which may be:

- a) The use of trade bills suitable to the operations, which maximize the chances of collection in the event of non-payment;
- b) For higher risk operations, these could be secured by real or personal guarantees (pledges, mortgages, deposits, etc).

#### **TITLE 4. LEGAL POSSIBILITIES TO CONTINUE ECONOMIC ACTIVITIES**

There is only one legal procedure under Spanish legislation which makes possible the survival of the entrepreneur<sup>18</sup> affected by what in principle would seem to be temporary financial or liquidity problems and that still has the possibility to avoid bankruptcy: the suspension of payments procedure<sup>19</sup>.

##### **Chapter 4.1. Suspension of Payments**

###### *§ 1. Comprehensive description of the regime as well as its underlying philosophy*

This procedure involves a compulsory moratorium on all the debtor's debts and aims at coming to a judicially controlled arrangement or composition between the business and its creditors by making changes in the terms and conditions governing the debts, so as to enable the business to restore its finances and return to a situation where it is able to pay its debts in time. It also aims at avoiding the damages that may be derived from the different actions that might be initiated individually by each of the creditors

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<sup>18</sup> The situations of temporary financial distress of civil debtors can be submitted to the procedure regulated by Articles 1130 through 1155 of the Civil Procedural Rules 1881 (this chapter of the Procedural Rules is still in force, until the enactment of the draft Insolvency Act currently in preparation).

<sup>19</sup> It must be noted, however, that the legal regulation of bankruptcy (article 929 Commercial Code) also foresees the possibility of a bankrupt company reaching a composition with its creditors for the continuation of its business.

against the debtor's assets and the inconvenient side-effects that ensue from a business' liquidation.

The mentioned composition between creditors and debtor must be consented by a sufficient majority of creditors and it usually implies a postponement in the payment ("*espera*"), a debt reduction ("*quita*") or a combination of both ("*quita y espera*")<sup>20</sup>. Nevertheless, although this procedure aims at reaching the mentioned composition, it might finally end up in liquidation of the company, as well as a bankruptcy procedure might end up with a composition with creditors, which enables the debtor to survive<sup>21</sup>.

The suspension of payments is regulated under Spanish law by the Suspension of Payments Act, dated 26<sup>th</sup> July 1922 and by Articles 870-873 of the Commercial Code 1885 in the wording given to them in the 1897 Act. As both regulations, however, do not always reflect the same criteria, the Suspension of Payments Act is to be considered a special law, which has a preferential applicability to the Commercial Code 1885.

The judge would only consider the suspension of payments' application when the debtor's insolvency is not "terminal" but "temporary", this is, the debtor has enough assets/net worth to cover all its debts/liabilities but it has not enough cash to pay them at their maturity dates<sup>22</sup>, which in fact reflects a "solvency" situation but without enough cash disposal. Should the debtor be under a pure insolvency situation, (this means the debtor's assets/net worth do not cover its debts/liabilities), it would have to face bankruptcy. Nevertheless, the legal procedure for suspension of payments has in practice also been considered as a first stage of bankruptcy and has priority in the procedure before the latter in order to facilitate a composition between the creditors and the debtor<sup>23</sup>.

Since the date when a petition for suspension of payments is filed, and as long as the procedure is in progress, no bankruptcy petition will be admitted against the debtor.<sup>24</sup>

The supervising auditors appointed by the judge will have to prepare a report on the financial situation of the debtor and classify the insolvency as "temporary" or "terminal". In the events of terminal insolvency, the suspension of payments

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<sup>20</sup> Although Article 872 of the Commercial Code, provides that the judge cannot conduct the suspension of payments' case if a reduction of the amounts of the debts is sought and it does not allow the postponement in the payments to be longer than 3 years, Article 14 of the Suspension of Payments Act recognises the possibility of filing a petition for suspension of payments where the composition proposal is not subject to the 3 years maximum postponement and of definitive insolvency cases, which need to be approved by a larger majority.

Therefore, any kind of composition is possible if it is subject to the Laws in force, the moral and the public order, (i.e. with postponement periods longer than 3 years, with debt reduction, with both postponement and reduction, with assignments of assets in favour of the creditors as the payment of the debts, etc.).

<sup>21</sup> See Title 5 below.

<sup>22</sup> As stated by Articles 870-871 Commercial Code.

<sup>23</sup> Judgments of the Supreme Court dated 3<sup>rd</sup> July 1933, 7<sup>th</sup> June 1968, 22<sup>nd</sup> April 1969, 5<sup>th</sup> July 1985 and 20<sup>th</sup> May 1993.

<sup>24</sup> Article 9 Suspension of Payments Act.

procedure becomes similar to a bankruptcy procedure<sup>25</sup> (possibility of taking reinstatement actions for nullifying transactions detrimental to the debtor's estate; possibility of examining the debtor's liability on the insolvency; the judge may impose additional restrictions on the debtor's faculties to manage the business, etc).

*§ 2. Classification of the procedure among branches of law, competent jurisdictions, overview of the procedure followed before these jurisdictions, implications of international private law*

- a) This procedure belongs to the Mercantile branch of Law. Therefore, all the related issues must be heard by Civil Courts in Spain. But it must also be taken into account that some issues may arise from insolvency, which may be heard by different Courts in Spain: i.e. labour matters, which will be heard by Labour Courts; Public enforcements, which will be heard by Contencious-Administrative Courts; criminal insolvencies, which will be heard by Criminal Courts; etc.

It is not a clear matter whether the suspension of payments' procedure is voluntary or contentious. Part of the legal literature<sup>26</sup> believes it is voluntary for the following reasons:

- The Suspension of Payments Act refers to this procedure stating that it is a file ("*expediente*"). Therefore, it is not a lawsuit ("*litigio*"), which would imply a contentious nature of the procedure.
- The Suspension of Payments Act also states that the debtor "may" file the petition. Therefore, it is not compulsory.
- The creditors' aim is the same as the one of the debtor's: avoiding bankruptcy; therefore, there are no opposite interests.

But in the case that the composition to be entered into between the creditors and the debtor is opposed by any creditor/s<sup>27</sup> or if the continuation of the file itself is opposed (in terminal insolvency cases), all further actions will be contentious.

Some others<sup>28</sup> hold it is a contentious procedure because:

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<sup>25</sup> Article 8 Suspension of Payments Act.

<sup>26</sup> Francisco de P. Rives Y Martí, Enrique Molina, Daniel Ferrer Martín, Guasp, Prieto Castro, Carnelutti, etc.

<sup>27</sup> Once the composition is passed at the Creditors' Meeting, (as mentioned in § 6.1 below), the creditors who may oppose such composition within 8 days after the Meeting are:

1. The creditors who did not attend the Meeting;
2. the creditors who attended the Meeting but voted against the approval of the composition;
3. the creditors who were eliminated from the Creditors' final list by the Judge.

<sup>28</sup> Joaquín Torres de Cruells, José María Sagrera Tizón, Jesús Sáez Jiménez, Epifanio Fernández de Gamboa, Plaza, Joaquín Garrigues.

- The creditors' and the debtor's aim is not the same: the creditors have the intention of being fully paid while the debtor wishes to renegotiate the outstanding debts (to obtain a postponement in the payment ("*espera*"), a reduction in the amounts owed ("*quita*") or a combination of both ("*quita y espera*").
- There are several parties with different interests (debtor, creditors and Public Prosecutor).
- When the suspension of payments proceedings do not reach a composition or when this has not been fulfilled, incidents towards bankruptcy may be exercised.

Case-law also considers this procedure to be contentious<sup>29</sup>.

- b) The procedure begins once the debtor files an application through its lawyers to the judge of the First Instance Court<sup>30</sup> at the place of residence<sup>31</sup> of the debtor<sup>32</sup>.

No tacit nor specific submission is possible nor the appointment of a special Judge<sup>33</sup>.

Our criminal legislation also provides for the case of suspension of payments maliciously caused or worsened by the debtor or whoever acts in its representation and for the case that the debtor presents false accounting information in order to irregularly obtain the suspension of payments declaration<sup>34</sup>. A previous civil declaration of the suspension is not required in order to action criminally. The action will be brought in these cases before a Criminal Court.

- c) The petition for suspension of payments must annex the documentation mentioned in point no. 3.1 below. The judge will accept the filing of the application if this has been properly drafted and if it is complemented by the mentioned documentation to be annexed. This application must be accepted or

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<sup>29</sup> Judgment of the 2<sup>nd</sup> Chamber of Civil Jurisdiction of the Territorial Audience of Barcelona dated 14<sup>th</sup> December 1955, judgment of the Audience of Gran Canaria dated 17<sup>th</sup> October 1957, judgments of the Audience of Barcelona dated 29<sup>th</sup> October 1974, 13<sup>th</sup> December 1975 and 29<sup>th</sup> May 1980.

<sup>30</sup> Civil Jurisdiction.

<sup>31</sup> It may be possible that the real residence does not coincide with the legal/registered office of the business (recorded at the Companies Registry in the case of companies). In such case, the real residence is the one to be attended, which is the "*centre of the effective administration and management of the business*", (Article 6 of the Companies' Act, passed by means of the Legislative Royal Decree 1564/1989 and Article 7 of the Limited Liability Companies' Act, no 2/1995, dated 23<sup>rd</sup> March 1995). In this sense: Judgments of the Supreme Court dated 13<sup>th</sup> January 1953, 2<sup>nd</sup> May 1952 and 30<sup>th</sup> December 1953 and Judgment of the Constitutional Court dated 8<sup>th</sup> November 1984.

<sup>32</sup> Article 870 Commercial Code.

<sup>33</sup> Judgment of the Constitutional Court dated 8<sup>th</sup> November 1984.

<sup>34</sup> Articles 260 and 261 Criminal Code, passed by means of the Organic Act no. 10/1995, dated 23<sup>rd</sup> November 1995.

rejected by the judge during the same day of filing of the application or, if not possible, the day after, and before any petition for bankruptcy has been filed.

Should the application be accepted, the judge will issue a resolution<sup>35</sup> admitting the application and all the Courts of the locations where the debtor has branches, agencies or representative offices will be notified of the application's<sup>36</sup> admittance for the purpose of such offices also being controlled. From this moment, any foreclosure procedure initiated against the debtor's assets must be immediately halted.

The Court will order by such resolution that the debtor's operations be controlled from that moment onwards. To this end, three (3) supervising auditors ("*interventores*") will be appointed by the judge, (two of them will be accounting experts<sup>37</sup> and the third one will be one of the creditors of those in the first third of the creditors' list by amount of the credit<sup>38</sup>). The supervising auditors will start performing their posts the same day of their appointment once they take the oath, otherwise, the judge will continue exercising the control until they do. The appointment of any of the supervising auditors may be appealed by the debtor or any of the creditors. If the judge admits the appeal, he/she will appoint another one.

The supervising auditors will have to prepare a report regarding the accuracy of: the balance filed by the debtor, its accountancy and the reason/s alleged by the debtor which have led to the suspension of payments situation. This report

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<sup>35</sup> The content of this resolution is:

- the declaration of the status of suspension of payments of the debtor;
- the notification of this judicial resolution to the Public Prosecutor, having him/her as part of the procedure;
- the appointment of the supervising auditors who will control the debtor's operations;
- the notification of this situation to the Salary and Wages Guarantee Fund if there were any salaries and wages credits;
- the order to the Court's Secretary to write down in the Accountancy Register Books of the debtor, with the supervising auditors' consent, any inaccuracy, and return those books to the debtor;
- the order of controlling all the debtor's operations;
- to register the suspension's application in a special Registry that is kept in every Court, as well as at the Companies Registry, the Property Registries where the real estate of the debtor might be recorded, if any, and the Civil Registry, if appropriate;
- the order to notify this situation to the Courts of the locations in which the debtor has branches, agencies and representative offices.
- the order of suspension of any judgment's execution as well as of any pending seizure or judicial administration against the debtor's non-mortgaged and non-pledged assets, being the latter substituted by the supervising auditors;
- the way in which the application will be published. It will be in the most convenient way, stating the date of admission of the application and the fact of being controlled the debtor's operations.

<sup>36</sup> The suspension of payments will not be judicially declared until the supervising auditors issue their report regarding the accuracy of: the balance filed by the debtor, its accountancy and the reason/s alleged by the debtor which have led to the suspension of payments' situation, (Articles 8.1 and 5 of the Suspension of Payments Act).

<sup>37</sup> According to the 4<sup>th</sup> Additional Disposition of the Audit of Accounts' Act, no. 19/1988, dated 12<sup>th</sup> July 1988, these two accounting experts must be certified public accountants.

<sup>38</sup> A sole supervising auditor may be appointed (among the creditors as explained) if the judge deems the suspension of payments is of a minor importance or if its nature makes it advisable.

will be prepared in the period established by the judge (20-60 days from their appointment)<sup>39</sup>.

After considering such report, which is not binding for the judge, he/she will declare the suspension of payments status by means of a decree<sup>40</sup>, which will also state the type of insolvency –temporary (if the assets exceed or are equal to the liabilities) or terminal (if the liabilities exceed the assets). If it were terminal, the debtor would have to deposit or otherwise guarantee in 15 days the amount by which the liabilities exceed the assets. If it fails to do so, a separate section will be opened within the main procedure in order to establish whether the debtor is liable for the terminal insolvency situation.

Should the insolvency be temporary or, being terminal, should the debtor deposit/guarantee the mentioned amount, the Creditors' Meeting would be afterwards convened for the purpose of approving a composition between them and the debtor, which would, after its fulfilment, settle all the debts. However, the debtor or a 40% of the creditors may seek the dismissal of the proceedings in order to institute bankruptcy proceedings instead.

- d) In the case of cross-border insolvencies, Spanish Private International Law has to be considered<sup>41</sup>.

Spanish Private International Law can be considered to be outdated and incomplete in this matter. From the *international judicial competence* point of view, in the case of debtors whose domicile is abroad but that have activities in Spain, Spanish case-law<sup>42</sup> has considered the Spanish Courts as the ones competent to hear the case<sup>43</sup>. This competence will have to be considered by the location of its agencies in Spain and, in the case of existing various, by the location of the principal one<sup>44</sup>.

From the *applicable law* point of view there are no specific regulations.

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<sup>39</sup> Article 8 Suspension of Payments Act. This report will include the definitive balance sheet and the creditors list if they were not filed previously, as well as a list of the credits stating their legal nature and mentioning which creditors have an abstention right (for this purpose, the supervising auditors may request the legal advise they deem appropriate). Should they fail to forward this report to the Judge in the term given to them, the accounting experts-certified public accountants would be sanctioned with their disablement for a period of 2 years and the creditor-supervising auditor would loose its credit, without prejudice of their criminal responsibilities. In this case, the judge will ask the Court's Secretary to draft a memorandum in the term of 15 days instead of the supervising auditors' report.

<sup>40</sup> The effects of the suspension of payments will be understood to have started in moment the debtor filed the application, if this is finally admitted, (Judgments of the Supreme Court dated 25<sup>th</sup> February 1983 and 31<sup>st</sup> October 1990).

<sup>41</sup> Spanish Private International Law provisions in this matter will only be applicable in all those cases which fall out of the scope of the EC Council Regulation 1346/2000, of 29<sup>th</sup> May 2000, on Insolvency Proceedings.

<sup>42</sup> There are very few judgments referred to this matter.

<sup>43</sup> Judgments of the Supreme Court dated 17<sup>th</sup> January 1912 and 6<sup>th</sup> July 1914.

<sup>44</sup> Judgment of the Supreme Court dated 10<sup>th</sup> February 1953.

From the *recognition of foreign judicial resolutions* point of view, all the bilateral treaties regarding the recognition of judicial resolutions exclude the insolvency issues from their material application scope<sup>45</sup> as well as does the Brussels Convention on jurisdiction and the enforcement of judgments in civil and commercial matters<sup>46</sup>.

§ 3. *Criteria to benefit from the regime (the origin of the criteria (legal, case-law, practice) must be specified)*

The requirements to be met in order to benefit for this regime are:

- The debtor has to be a trader or a mercantile company<sup>47</sup>.
- The debtor is under what in principle seems to be a temporary financial distress<sup>48</sup>.

Articles 870 and 871 of the Commercial Code also state 2 additional requirements, which are not established by the Suspension of Payments Act:

- The debtor foresees that it may not be able to pay its debts in their maturity dates or it has not attended a payment within the 48 hours after the debt's maturity date.
- The debtor's financial distress must be temporary, this implies that the value of the assets has to be higher than that of the liabilities/debts, without considering for these any debt reduction ("quita").

However, just a minor part of the legal literature still supports the validity of these two requirements. Most part of the scholars and case-law understand that both of them are not in force anymore, as they have been repealed by the Suspension of Payments Act 1922<sup>49</sup>.

In order to apply for the beginning of the procedure before the judge, the debtor (any kind of company, co-operative or individual entrepreneur) has to file an application through its lawyers and submit it to the judge of the First

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<sup>45</sup> Treaties entered into with France, Germany, Austria, Mexico, Israel, Brazil, China and Czechoslovakia.

<sup>46</sup> The Brussels Convention on jurisdiction and the enforcement of judgments in civil and commercial matters, concluded on 27 September 1968.

<sup>47</sup> As explained on Title 1, civil individuals and civil companies follow different insolvency procedures. For temporary insolvency the applicable civil procedure is the one named "moratorium" ("*quita y espera*"), aimed at obtaining a reduction of the amounts owed and a postponement of payments.

<sup>48</sup> Articles 870 and 871 Commercial Code 1885.

<sup>49</sup> José M<sup>a</sup> Sagrera Tizón. Judgments of the Supreme Court dated 29<sup>th</sup> December, 1927 and 3<sup>d</sup> July 1933.

Instance Court at its place of residence. This application must annex the following documents<sup>50</sup>:

- The latest financial statements, setting out the assets and liabilities and the titles which entail the property of real estate, if any, (should there be no titles available, a complete description of the real estate assets will be enough);
- a list of all the creditors with their complete names, addresses and the debt's amount, origin, date and maturity date. If there were more than 1,000 creditors or if the nature of the operations derived from the debts would make it difficult to set their amounts, it would be enough to state the approximate number of creditors, the name of the known ones and the total amount of their debts;
- a report stating the reason/s which have led to the suspension of payments and the means the debtor has in order to pay the debts;
- a composition's proposal for paying the pending debts;
- if the debtor is a mercantile company, the decision of filing the application before the judge has to be passed by its governing body so a certificate of such resolution has to be annexed to the application, as well as evidence proving that the General Shareholders Meeting has been called in order to ratify the governing body's decision<sup>51</sup>;
- a list of the branches, agencies or representative offices that the debtor may have, mentioning their location;
- the accountancy books, which must only be showed to the Court's Secretary who will stamp a seal, at the end of the last record made, mentioning that the company is under the legal situation of suspension of payments. After this, the books will be immediately returned to the debtor.

#### *§ 4. Specification of the possible initiators of the procedure*

Only the debtor (individual entrepreneurs, companies and co-operatives) has the right to file an application for suspension of payments<sup>52</sup>. Creditors have no right to do so nor may a Court order such suspension, even if the debtor has stopped or suspended payments.

It is so because the suspension of payments has been designed as a procedure aimed at protecting the debtor. Besides, the debtor is in most cases the only one who is in a position to foresee that it may not be able to attend the

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<sup>50</sup> Articles 2 and 3 Suspension of Payments Act.

<sup>51</sup> Should the General Shareholders' Meeting finally not be convened or, being convened, should it reject the decision of filing the suspension of payments' application, the procedure will come to an end. Should the decision be passed, the General Shareholders' Meeting will also have to decide the persons or bodies which will represent the debtor in the procedure.

<sup>52</sup> Articles 870 and 871 Commercial Code and Article 2 Suspension of Payments Act.

payments in due time. This is not in any way a fact that may be known externally by its creditors. Furthermore, the debtor is the one who is interested in avoiding the restrictions involved in a bankruptcy process, which may be initiated by creditors.

*§ 5. Administration of the procedure (who manages the assets of the individual or the company, the role of the different actors in the proceedings (creditors, debtor, State, appointed manager, court, etc)*

- a) During the procedure, the debtor will keep the management of its assets but now it will have to do it together with the supervising auditors and under their supervision. The debtor will require the approval of the supervising auditors for<sup>53</sup>:
- receiving any payment and any operation of acceptance, transferring or protesting drafts, bills of exchange or promissory notes;
  - contracting any kind of obligation;
  - entering into any contract or making any payment and
  - continuing with the ordinary activities of its business.

Should the debtor carry out any of the mentioned activities without the authorisation of the supervising auditors (or the judge's, in case the supervising auditors are pending appointment), the debtor will commit a criminal offence and the contracts will be null and have no effects. Should any of the supervising auditors disagree with the others, the opinion of the majority will prevail.

- b) The role of the different parties involved in this procedure are the following:
- Debtor: its purpose is to renegotiate the debts owed to the creditors with a view to obtain, if possible, a debt reduction (“*quita*”), a postponement in the payment (“*espera*”) or both of them (“*quita y espera*”).
  - Creditors: they intend to be successfully paid, with the least reduction or postponement. Most part of them will attend the Creditors’ Meeting (the ones that have the so-called abstention right usually do not attend, as their credits are privileged) in order to pass an agreement/composition that aims to the payment (whole or partial).
  - Judge: He/she has to supervise all the steps of the proceeding and declare the filing of the application, appoint the supervising auditors, declare the status of suspension, announce the approval of the repayment plan approved at the Creditors’ Meeting, decide on the objections raised against said repayment plan, the ending of the procedure, etc.

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<sup>53</sup> Article 6 Suspension of Payments Act.

- Supervising auditors: They have a number of obligations, being the most important ones to authorise the debtor's transactions<sup>54</sup>, to report to the judge any important issue regarding the debtor and its business, draft the creditors list, issue the report mentioned in §2.1.c) and inspect the debtors accountancy.
- Public Prosecutor: He/she must be a party to the procedure<sup>55</sup>. In practice, however, his intervention is only significant in the event of terminal insolvency, where he/she must prepare the writ judging the liability of the debtor for the insolvency situation<sup>56</sup>. Furthermore, the Public Prosecutor is entitled to request from the judge the necessary precautionary measures<sup>57</sup> that may guarantee the responsibilities of the debtor that might be determined in the statement of classification.

*§ 6. Restructuring plan (if applicable, who must file it, how, where, must it be voted by creditors, is there a court intervention, etc.)*

Ordinary creditors must attend a Meeting where the composition proposal attached by the debtor to its initial application will be reviewed in order to be approved. If there were to be more than 200 creditors attending, the Meeting may be substituted by a written procedure if the judge, at the request of the debtor/creditors, deems it appropriate.

The judge will call the Meeting and will chair it. The supervising auditors and the debtor<sup>58</sup> are obliged to attend. The creditors may attend personally or represented. It will be validly constituted if creditors representing at least 60% of the total liabilities attend the meeting (after deducting the amount of the debts of those creditors that, having an abstention right<sup>59</sup> have exercised it, (but should they attend the Meeting, their credit would no longer be privileged and the composition would be binding to them as to any other creditor))<sup>60</sup>. Once the session is declared opened, the final list of creditors will be read.

The debtor's initial proposal will be discussed, three creditors may give their opinion in favour and another three of them against it. The debtor and the supervising auditors may speak as many times as they wish. The creditors may modify the composition's proposal as far as the debtor agrees. Afterwards, the modified composition proposal will be voted and its approval will require the

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<sup>54</sup> See § 5.1.a) above.

<sup>55</sup> Article 23 Suspension of Payments Act.

<sup>56</sup> Article 20 Suspension of Payments Act.

<sup>57</sup> Article 20 Suspension of Payments Act.

<sup>58</sup> A lawyer may act in its name and on its behalf during the Meeting. It therefore, must attend personally or specifically represented. If not, the judge will dismiss the proceedings.

<sup>59</sup> These are the specially privileged, the privileged and the mortgage creditors, stated in Article 913.1, 2 and 3 of the Commercial Code as well as the ones established in articles 908-910 Commercial Code (see footnotes 47, 48, 49 and 50).

<sup>60</sup> If such quorum is not met the proceedings will be dismissed.

following majorities in value (in terms of value with respect to the total debts) and in a simple majority in number of those creditors attending:

- At least a 60% in value (excluded the amount of the credits which exercised their abstention right) if the proposal includes a postponement in the payment (“*espera*”) of less than three years;
- At least a 75% in value (excluded the amount of the credits which exercised their abstention right) if the proposed postponement (“*espera*”) is of more than three years and if the proposal is for a reduction in the payment (“*quita*”) or if it is a terminal insolvency. (Should the composition not be approved in this case, the judge would convene a second Meeting in which the proposal may be approved with the favourable vote of the 66% of the liabilities. If this majority is not in either way, the suspension of payments proceeding would be dismissed).

Once approved by the Meeting, the judge will last 8 days in announcing the approval of the composition after the date of the Meeting. This is the period of time within which certain creditors may oppose to the composition. These creditors may be:

- the ones that did not attend the Meeting;
- the ones that attended but did not vote in favour of the composition;
- the ones eliminated by the judge from the final list of creditors.

The opposition causes are limited<sup>61</sup>.

Should there be no opposition in the mentioned term of 8 days, the composition would be approved by the Judge, whose resolution would be recorded in the Registries mentioned in point §12.1 below. If there were any opposition/s, the Judge would settle them by means of a summary procedure. The judge’s resolution could be appealed.

*§ 7. The degree of protection of the actors implied in the procedure: public investors, creditors (secured and unsecured, preferential or not), shareholders, stakeholders,...), as well as the way to carry out this protection*

a) There are creditors with an abstention right, these are:

- (i) The specially privileged creditors<sup>62</sup>;

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<sup>61</sup> Article 16 Suspension of Payments Act.

<sup>62</sup>These are (Articles 15 Suspension of Payments Act, 913 Commercial Code, 1924 Civil Code and 26 and 32 of the Workers Statute, passed by means of the Royal Legislative Decree, no 1/1995, dated 24<sup>th</sup> March):

- (ii) The simply privileged creditors<sup>63</sup>;
- (iii) Creditors with a mortgage or pledge security<sup>64</sup>; and
- (iv) Creditors by virtue of ownership<sup>65</sup>.

These creditors have secured credits, this is the reason why they do not have to attend the creditors' Meeting. However, should they attend, they would lose their preferential rights and would be bound by the terms of the composition.

- b) The rest of the creditors are classified as ordinary creditors.

Should any of the first ones not be included as preferential/secured, they would have the right to oppose to the list in the term of 15 days before the date of the Creditors' Meeting, filing an application to the judge with the relevant documentation. The judge will decide in the term of 8 days and there is no further appeal to his/her decision.

### *§ 8. Termination of the procedure*

The approval of the composition entered into between the debtor and the creditors is the wished termination of the procedure. But there are other events of termination. The dismissal of the proceedings may take place when:

- the General Shareholders' Meeting of the company which applied for the suspension was not held for ratifying the governing body's decision or, should it be held, it did not ratify the decision of its governing body;

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- Salaries and wages' credits (salaries and wages of the last 30 days in the maximum quantum of twice the minimum average salary and wages), which are absolutely preferential to any other credit; the rest of the salaries and wages' credits are preferential to others except with respect to:
    - (i) those credits with a real guarantee and
    - (ii) to those in favour of the State and/or insurers up to the amount of the triple of the minimum average salary and wages multiplied by the number of days of salaries and wages pending payment;
    - (iii) this same preference is held by dismissal compensations up to the amount of the minimum legal quantum calculated upon a basis lower than the triple of the minimum average salary);
  - Social Security's credits of the last year;
  - Tax Authorities' credits, (Article 71 of the General Taxation Act, no. 230/1963, dated 28<sup>th</sup> December 1962;
  - Credits granted in public deed or the ones stated in a final judgment;
  - The ones derived from the management of the suspension of payments;
  - Funeral disbursements and
  - Alimony creditors (the ones that have paid alimony allowances to the debtor).

<sup>63</sup>These are the ones affected to a specific asset and have the right to be repaid with the value of such good (articles 913.2 Commercial Code and 1922 Civil Code).

<sup>64</sup>Article 913.3 Commercial Code and article 1923 Civil Code.

<sup>65</sup>Articles 908-910 Commercial Code: Creditors by virtue of ownership are all those creditors who own assets which are in the possession of the debtor but that have not been transferred to the latter by means of an irrevocable title. The debtor is not the owner of these assets, therefore, they must be put aside from the rest of the debtor's estate.

- the insolvency is declared to be terminal by the judge and the debtor or the 40% of the total value of the liabilities apply for the termination of the procedure. They may also apply for bankruptcy in this case;
- the debtor does not attend the Creditors' Meeting by itself or duly represented;
- the Creditors' Meeting was not attended by creditors whose rights represent the 60% of the total debt once deducted the amounts of the credits with an abstention right that has been exercised.
- the required majorities are not obtained in the voting of the composition;
- the debtor does not comply with the approved composition. In this case any of the creditors may apply for the termination of the composition and seek a bankruptcy declaration from the judge who heard the suspension procedure.

In any of these cases, the creditors' rights are restored in relation to the part of liabilities that remain unpaid and they are free to exercise their individual rights.

Should the proceeding be terminated upon the conclusion of the terms of the composition, the debtor's liabilities will be considered fully settled and the debtor will no be pursued for any shortfall.

The suspension of payments situation will be legally considered to continue as long as all the terms of the composition are not fully complied with by the debtor.

*§ 9. Degree of information on the development of the procedure towards creditors (e.g. access to (court) files, etc.)*

Creditors may have limited access to accountancy data of the debtor by means of the supervising auditors. This information is needed by them in order to exercise their rights of applying for credits' inclusions and exclusions in the final list of creditors. The supervising auditors are obliged to provide them with the information regarding the Register Books and documents of the debtor they may ask for.

Until the day of the Creditors' Meeting, the Court's Secretary will make available to the creditors the supervising auditors' opinion, the memorandum, the balance sheet, the list of credits with abstention right and the debtor's composition proposal.

*§ 10. Costs related to the procedure, if applicable (e.g. fees trustee, receiver, etc)*

- a) The supervising auditors will be paid for exercising their posts. The regulation, however, only stipulates that the judge will state in the resolution which, among others, appoints the supervising auditors, the amount they will receive for performing their duties, which will not exceed the total amount of 100.-Pesetas (0.60.-Euros) per day.

This amount, obviously outdated, is currently fixed by the judge considering the importance and the volume of the debtor's assets and the difficulty of the works to be performed by the supervising auditors. It could be calculated either as a fixed amount or as an allowance per day or as a mixture of the former two.

If, once performed their duties, these turned to be more complex than initially thought, the judge may increase their remuneration.

The debtor will pay such remuneration from the amount of the assets, being such credit preferential from all the rest.

- b) Another related costs are the fees of the procurator who represents the debtor and the fees of the lawyer/s who defends the debtor.

The lawyers' fees are calculated on the basis of the amount of liabilities of the debtor (from the balance passed by the supervising auditors). As an illustration, their fees could amount to approximately 86,700.-euros for a debtor with an amount of liabilities of 2,700,000.-euros in accordance to the Lawyers' Bar Associations recommended professional fees.

The procurator's fees are always calculated upon their schedule of legal fees and for the mentioned amount of liabilities their fees would amount to 3,590.-Euros.

#### *§ 11. Competence, knowledge and functioning of insolvency (bankruptcy) courts*

At the present time, there are no special Courts in Spain in charge of this kind of procedures.

Therefore, as mentioned in § 2.1 above, Civil Courts are the ones who hear suspension of payment cases. However, as the situation of insolvency does usually have consequences in various aspects of the debtor's activity (employment matters, foreclosure actions or litigation initiated against or by the Public Administration, criminal responsibility of the debtor, etc), judges of the labour, Contentious-Administrative and Criminal jurisdiction may open separate files for judging these specific aspects.

The judges of the Courts of First Instance (Civil Branch) do not receive specialised education neither on business law, in general, nor in insolvency matters, in particular. Thus, the average qualification of these judges in

suspension of payment matters is sometimes unsatisfactory. It must be noted that the handling of this type of procedures requires a minimum background on accounting and business management issues, which are alien to most of these judges.

Due to this, judges tend to entrust in practice the handling of the procedure to the supervising auditors they appoint. Moreover, the most significant decisions adopted by the judge do usually rely on the opinion or report previously issued by these supervising auditors. Although the Suspension of Payments Act requires in a number of occasions that the opinion or report of the supervising auditors be heard before the judge takes certain decisions, it is completely unusual that the decision of the judge differs from the opinion previously expressed by the supervising auditors.

One of the most serious problems criticised by the Spanish insolvency practitioners is the fact that the supervising auditors are selected by judges from a reduced circle of accounting experts (there is no regulation limiting the number of cases where the same accounting expert may be appointed as supervising auditor by the same judge). This situation, apart from questioning the independence and objectivity of the supervising auditors, results in a restriction of the possibilities of enhancing the qualification of the persons acting as supervising auditors.

The performance of the First Instance Courts in suspension of payment cases can be considered as defective. The average time consumed in completing the procedure (up to the approval of the composition, without considering the postponement of payments agreed) ranges from one to three years<sup>66</sup>.

It is a general impression among the creditors affected by the insolvency of one of their debtors that the quality of the information received from the Court is not satisfactory. Besides, the costs that the creditor has to face if it wishes to be notified of all the resolutions handed down by the judge and therefore have a chance to play a more active role in the procedure (by appearing formally as a party to the file) are too high (fees of the lawyer and of the procurador).

#### *§ 12. Publicity conditions, if applicable (e.g. newspaper, official gazette)*

The judge gives notice of the resolution whereby he/she admits the application of the suspension of payments, which is not only recorded at a special Register in the Court but also registered with the Companies Registry<sup>67</sup> and the Property Registries<sup>68</sup> where the debtor may have recorded any real estate.

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<sup>66</sup> Alvaro ESPINA, “*La reforma del Derecho concursal y la eficiencia económica.*” Pág. 288. Madrid, 1999.

<sup>67</sup> Article 320 Companies Registry Regulation, passed by means of the Royal Decree 1784/1996. Should the sole trader/individual entrepreneur not be registered with the Companies Registry, prior to the recording of the application of suspension of payments it will be necessary to register the trader by means of a judicial order.

<sup>68</sup> Articles 42.4 and 42.5 Mortgage Act and article 142 Mortgage Regulation.

The judge also gives notice of the filing of the application by notifying the Courts in the locations where the debtor has located branches, agencies and representative offices so that no pending judgments would be executed against the debtor nor a necessary bankruptcy action may be filed.

The judge has also the freedom to give the necessary publicity to this situation for its general knowledge, taking into account the importance of the suspension (considering the number of creditors and the extension of the debtor's business). This further publicity is usually accomplished through the Court's notice board and by means of the Province's or the Autonomous Community's Official Gazette. In cases of greater importance, it may be published in the State Official Gazette.

The mentioned resolution will also be recorded at the Civil Registry<sup>69</sup>. This is not a personal disability but a disposal system conditioned to the measures that may have deemed fit in order to save the creditors' patrimonial interests.

It may also be published in one of the major daily newspapers in the province of the business if the Judge deems it fit.

Any act that may affect the application of suspension of payments will also be filed at the mentioned Registries, (i.e. the suspension's declaration, the classification of the insolvency as terminal, if appropriate, the announcement of the approval of the composition entered into between the creditors and the debtor passed, the judge's declaration that brings to the end the procedure because the minimum number of creditors have not attended the meeting, any declaration that limits the debtor's patrimonial capacity, etc.).

## **TITLE 5. LEGAL CONSEQUENCES OF BANKRUPTCY AND POSSIBILITIES FOR A FRESH START**

### **Chapter 5.1. Bankruptcy procedure**

#### *§ 1. Description and types of bankruptcy*

##### 1.1. Description

The bankruptcy is a judicial procedure that aims principally to the organised distribution of the bankrupt's assets amongst its creditors, due to his total insolvency.

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<sup>69</sup> Articles 1.5 and 46 Civil Registry Act, dated 8<sup>th</sup> June 1957 and article 178 Civil Registry Regulation, passed by Decree dated 14<sup>th</sup> November 1958.

The bankruptcy declaration and proceedings are mainly regulated by the Spanish Commercial Code of 1885, the Civil Procedural Rules of 1881 and articles 1001 through 1177 of the former Commercial Code of 30 May 1829 which remains in force for the specific provisions on bankruptcy.

## 1.2. Qualification of the bankruptcy

According to the different reasons which led to the bankruptcy, there are three different types of bankruptcy:

- a) The bankruptcy can be qualified as fortuitous, whereby all or part of the debtor's debts cannot be satisfied due to misfortune<sup>70</sup>.
- b) The bankruptcy will be qualified as tortious if the bankrupt appeared to be negligent in complying with basic commercial rules and lacked diligence in the administration of its business<sup>71</sup>. As such, the bankruptcy is considered to be tortious, without possibility of proof to the contrary, if any of the following circumstances takes place:
  - excessive expenses,
  - losses in games, bets, sales or purchases in excess of what a normal diligent person would do,
  - transactions for the purpose of avoiding or delaying bankruptcy,
  - resale of unpaid goods below the normal price in the last six months preceding the bankruptcy declaration,
  - if it can be proved that, at any time since the last inventory until the declaration of bankruptcy, the amount of the debtor's debts was double of the value of its assets, according to the inventory.<sup>72</sup>

In addition, unless proof to the contrary, the Commercial Code presumes tort when the bankrupt did not keep the company's accounting records properly or kept these with errors to the detriment of third parties, or when the bankrupt did not appear in person during the bankruptcy proceedings in the absence of legitimate impediments<sup>73</sup>.

- c) The bankruptcy will be considered to be fraudulent, without possibility of proof to the contrary, when the loss of capital is due to illegal manoeuvres by the debtor, including the following acts:
  - concealment of all or part of its assets,
  - not keeping the company's accounting records<sup>74</sup> or keeping them with irregularities<sup>75</sup> or modifications to the detriment of third parties,
  - keeping double accountancy,
  - simulation of disposal of assets,
  - abuse of confidence to the detriment of third parties,
  - advanced payments to non-privileged or false creditors,

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<sup>70</sup> Article 887 Commercial Code; STS 2 April 1964, RJ 1964, 1737.

<sup>71</sup> STS 15 October 1974, RJ 1974, 3752.

<sup>72</sup> Article 888 Commercial Code.

<sup>73</sup> Article 889 Commercial Code.

<sup>74</sup> STS 20 December 1969, RJ 1969, 5975.

<sup>75</sup> STS 2 February 1976, RJ 1976, 315.

- purchases on behalf of a third party to the detriment of the creditors,
- charging of bills after the last balance prior to the bankruptcy declaration to persons who do not have funds nor credits,
- when, after the bankruptcy declaration, the bankrupt perceives assets of the bankruptcy estate using these for personal purposes, or withdraws assets from the bankruptcy estate<sup>76</sup>.

The bankruptcy of a trading person whose actual financial situation cannot be inferred from its accounting records is also presumed to be fraudulent unless proof to the contrary<sup>77</sup>. In the event the bankrupt is a company, the absence of keeping the company's records, or the presence of irregularities in these must be due to the persons with managing functions or faculties further to the law or to the company's By-Laws, or to the shareholders who participated in the performance of these infringements<sup>78</sup>.

The bankruptcy of commercial agents will be considered fraudulent when it is proven that they performed a transaction for their own account<sup>79</sup>.

The qualification of the bankruptcy as either tortious or fraudulent will essentially depend on whether the acts were performed intentionally or not.

The Commercial Code only qualifies the different types of bankruptcy, whereas the criminal punishment is established autonomously by the Criminal Code. The qualification of the bankruptcy has a number of implications for the bankrupt, which are further developed in section 5.3.

## *§ 2. The bankruptcy declaration*

### 2.1. Criteria in order to file a bankruptcy declaration

In order for the petition to qualify for filing the bankruptcy declaration, the debtor has to have the quality of "trading person" and has to encounter himself in a generalized stay of payments.

a) The quality of "trading person" of the debtor<sup>80</sup>

Bankruptcy is a situation applicable only to trading persons, either individuals or companies, except for general or limited partnerships, where the bankruptcy can be extended to the collective partners, trading persons or not<sup>81</sup>, as well as in case of civil companies with commercial form<sup>82</sup>.

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<sup>76</sup> Article 890 Commercial Code.

<sup>77</sup> Article 891 Commercial Code, STS 19 November 1977, RJ 1977, 4225.

<sup>78</sup> STS 19 February 1981, RJ 1981, 752.

<sup>79</sup> Article 892 Commercial Code.

<sup>80</sup> Specific rules apply in case the debtor in bankruptcy is the Railway Company or other Public Works.

<sup>81</sup> Article 923 Commercial Code.

<sup>82</sup> Article 1670 Civil Code.

The status of trading person for the purpose of the bankruptcy declaration, is a question of facts and law, subject to the appreciation of the courts.

It is possible to declare bankrupt a trading person who already ceased his/her commercial activity, in the event the outstanding debts derive from the former fiscal year, so that the debtor will not be able to avoid the consequences of bankruptcy. Companies can also be declared bankrupt after being dissolved, during the period of winding-up<sup>83</sup>.

b) Generalized stay of payments<sup>84</sup>

The generalized stay of payments is a broad concept, which is to be applied by the judge in each specific case, taking into account the information included in the petition for bankruptcy and whose appreciation leads to the acceptance or rejection of the bankruptcy declaration. Such appreciation can be subject to review by the Courts.

Normally, the stay of payments corresponds to an economic imbalance, whereby liabilities exceed the assets of the debtor without however implying that terminal insolvency is a prerequisite in order to file a bankruptcy declaration. Case Law indicates that the bankruptcy declaration may take place because of the existence of a general stay of payments, without verifying whether in the case at hand there is a terminal economic insolvency. For this reason, the debtor may oppose to the bankruptcy declaration proving that he did settle his payments, notwithstanding his economic insolvency<sup>85</sup>.

It is not relevant whether the outstanding debts are of civil or commercial nature. In addition, the payment of a single debt would not avoid the situation of a general stay of payments, as the stay does not have to concern all payments<sup>86</sup>.

## 2.2. Types of bankruptcy declaration

There are two types of bankruptcy declaration:

- a) The bankruptcy declaration is deemed to be voluntary when it is the debtor who notifies the judge of the Court of First Instance of the legal district where he resides or has its registered office, that he is unable to settle payments and therefore seeks a declaration of bankruptcy<sup>87</sup>. In order for the debtor to file a request for bankruptcy declaration, he has to present his request and file all relevant documents, including the balance sheet and report indicating the direct and immediate causes of the bankruptcy<sup>88</sup>. All documents have to be signed by the bankrupt or by a duly empowered representative.

The voluntary filing of a bankruptcy declaration is not frequently used in practice, given that a trading person may trust that his business will redress at some

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<sup>83</sup> Article 928 Commercial Code, article 281 Companies' Act and article 124 Limited Liability Companies' Act.

<sup>84</sup> Article 874 - 876 Commercial Code.

<sup>85</sup> See point 2.4.

<sup>86</sup> SAP Valencia 26 April 1996, AC 1996, 818.

<sup>87</sup> Article 63, 8ª Civil Procedural Rules 1881.

<sup>88</sup> Article 1017-1022 Commercial Code 1829 and article 1324 Civil Procedural Rules 1881.

moment in the future. In addition, a bankruptcy implies that the debtor will be prohibited from continue trading and can only be rehabilitated at the end of the bankruptcy proceedings, upon satisfaction of all obligations towards the body of creditors, unless a composition is reached with the body of creditors. Consequently, a debtor will rather seek to file a petition for suspension of payments, a procedure that grants the debtor certain protection measures and which does not entail the disadvantages of the bankruptcy proceedings.

However, filing a petition for bankruptcy by the debtor is also a legal obligation. Article 1017 Commercial Code 1829 provides that any trading person in situation of bankruptcy is obliged to notify the judge of his residence about this situation within three days following the stay of payments of his debts. This provision refers, in turn, to article 871.2 of the Commercial Code, stating that the debtor is obliged to present his petition for bankruptcy the day following a delay of 48 hours after the aforementioned period of three days. In the event the debtor did not comply with this obligation, the bankruptcy will be deemed to be tortious. Notwithstanding the fact that this provision was abolished<sup>89</sup>, the Supreme Court confirmed the obligation to file a bankruptcy declaration by the debtor, because a debtor in bankruptcy may not delay the corresponding bankruptcy declaration to the detriment of his creditors without being punished for that. Thus, a trading person who ceases his normal payments and does not satisfy his obligations, has to present himself in suspension of payments or bankruptcy, depending on the nature of its financial distress.

When the debtor is a company, the bankruptcy declaration is to be requested by its governing body, subject to approval by the shareholders adopted at a shareholders' meeting. In principle, the bankruptcy of the company does not entail that of its shareholders, although the paying up of the shareholder's participation may be requested (should there be shares not paid up)<sup>90</sup>. The bankruptcy declaration can be extended to the shareholders if there is confusion of assets and liabilities between the company and the shareholders.

In case of limited liability companies which are being wound-up, the receivers are bound to request the bankruptcy declaration within ten days as from the moment such situation appears<sup>91</sup>. When the debtor is a collective company, the bankruptcy declaration will have to be filed by all members residing at the registered office of the collective company at the time of the request<sup>92</sup>.

- b) When the bankruptcy is declared upon petition of a creditor, the bankruptcy will be considered as compulsory. Any legitimate creditor may request the declaration of bankruptcy. The competent judge will be any among those who are dealing with the individual foreclosure actions pending against the debtor, or in its absence, in front of the judge of the domicile of the debtor<sup>93</sup>. Any creditor, whether ordinary or preferential, with conditional debts or with a debt payable on installments, whether its credit is due and payable or not, can request the

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<sup>89</sup> Article 871 Commercial Code, abolished by the Law of 10 June 1897.

<sup>90</sup> Article 925 Commercial Code.

<sup>91</sup> Article 281 Companies' Act, article 124 Limited Liability Companies' Act.

<sup>92</sup> Article 1022 Commercial Code 1829.

<sup>93</sup> Article 63, 9° Civil Procedural Rules 1881, STS 12 January 1987, RJ 1987, 222.

declaration as long as he is a legitimate creditor with a title accrediting the debt pending on the bankrupt debtor<sup>94</sup>.

The debtor or creditor will have to provide evidence of one of the following facts in order for their petition for bankruptcy declaration to be filed:

- Unsuccessful seizure of assets in an individual execution by a creditor<sup>95</sup>.
- Payments have been generally suspended or delayed (although failure to make a single payment will be sufficient if it indicates that the business is insolvent)<sup>96</sup>.
- The debtor disappeared, and no other person is appointed to represent its business<sup>97</sup>. In such case, the Court of First Instance may take, on its own initiative, the necessary measures for conserving the premises of the bankrupt<sup>98</sup>.
- A general or limited partnership declares itself bankrupt because of the bankruptcy of its general partners.
- In the event a suspension of payments fails to provide solution<sup>99</sup>.
- Non-compliance by the debtor of the convention reached within the procedure of suspension of payments<sup>100</sup>, or failure of the debtor to agree with the convention of the creditors within the suspension of payments<sup>101</sup>.

Upon evidence of one of these circumstances, the judge will proceed to the bankruptcy declaration.

The right of the creditor to request a bankruptcy declaration belongs to the public order for the purpose of protecting not only the interests of that specific creditor, but also those of all other creditors as well as the public, so that creditors cannot renounce contractually to such right.

### 2.3. Judicial declaration of bankruptcy

The judicial declaration is a prerequisite for the existence of the legal situation of bankruptcy, which is effective as from the moment of declaration. The declaration consists of a judicial resolution by the court of first instance, which changes an economic and factual situation into a legal situation. The declaration of bankruptcy takes place without notifying nor hearing the bankrupt. Such declaration *inaudita parte* has been disputed, given its serious consequences for the debtor, in particular its

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<sup>94</sup> Article 876 Commercial Code and article 1325 Civil Procedural Rules 1881.

<sup>95</sup> Article 876.1 Commercial Code.

<sup>96</sup> Article 876.2 Commercial Code.

<sup>97</sup> Article 877 Commercial Code.

<sup>98</sup> Article 877 Commercial Code.

<sup>99</sup> Article 17.1 Civil Procedural Rules 1881.

<sup>100</sup> Article 17 Suspension of Payments Act.

<sup>101</sup> Article 876.2 Commercial Code.

incapacitation, and given the relative easy access for creditors to request and obtain a bankruptcy declaration. Although in practice such declaration may indeed be used by creditors as a way of putting pressure on the debtor, it is also true that such unilateral declaration is deemed to be necessary, in order to prevent the debtor from disappearing or concealing goods or documents<sup>102</sup>.

In the event the suspension of payments and the bankruptcy declaration are requested at the same time, the suspension of payments will have priority, given the principle of “favor debitoris”. This is ultimately a means to facilitate the composition between creditors and debtor, avoiding the demerit, depreciation and ruin of the capital that the bankruptcy usually entails<sup>103</sup>.

#### 2.4. Opposition to the declaration

The debtor declared bankrupt, as well as any other interested third party (for example shareholders of the bankrupt company, or companies in which the bankrupt has a stake) and creditors who did not file the petition, may formulate an opposition to the declaration of bankruptcy as from its publication<sup>104</sup>. In case the bankrupt is a company, such opposition may be carried out by its directors<sup>105</sup>.

The opposition will be subject to a contradictory debate in separate section within the bankruptcy procedure<sup>106</sup>. In such separate section, the debtor will either attempt to prove that he does not have the quality of trading person, that he complied with his payments or that the facts on which the bankruptcy declaration is based, are false or insufficient. Should the debtor succeed, the decision of bankruptcy declaration will be overruled and the goods, documents and rights of the debtor will be restituted<sup>107</sup>. In addition, the debtor would be entitled to sue the creditor who filed the bankruptcy declaration for damages, should the latter have acted with manifest injustice, misrepresentation or maliciousness<sup>108</sup> and in the event such intentional factor can be proven by the debtor. Only when the resolution revoking the bankruptcy declaration confirms the existence of such wrongful intention, the bankrupt is allowed to sue the person who filed the bankruptcy declaration.

This situation is strongly criticised by legal authors for being disproportionate, given that the filing of a bankruptcy declaration is facilitated to creditors without requesting the constitution of any guarantee, whereas the debtor declared bankrupt can only in limited conditions sue for the damages caused as a consequence of an unjustified bankruptcy declaration. For these reasons, the proof of a mere “reckless” handling<sup>109</sup> as intentional factor in the filing of the bankruptcy declaration by the creditor, is deemed to be sufficient in order for the debtor to sue for damages.

#### 2.5. Actors in the bankruptcy proceedings

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<sup>102</sup> SAP Granada 11 October 1989, RGD 1990, 8228.

<sup>103</sup> STS 5 July 1985, RJ 1985, 3641.

<sup>104</sup> Articles 1170, 1319 and 1326 Civil Procedural Rules 1881; STS 9 January 1984, RJ 1984, 342; STC 27 April 1989, RJ 1989, 3266.

<sup>105</sup> STS 14 March 1984, RJ 1984, 1242.

<sup>106</sup> AAT Barcelona 10 February 1989, RGD 1989, 4059; STS 10 November 1983, RJ 1983, 6074.

<sup>107</sup> Article 1331 and 1667 Civil Procedural Rules 1881.

<sup>108</sup> Article 885 Commercial Code, 1034 Commercial Code 1829 and 1332 Civil Procedural Rules 1881.

<sup>109</sup> In accordance with articles 1101 and 1902 Civil Code.

- a) Jurisdictional body: The competent court is the Court of First Instance, which will deal with all proceedings running against the bankrupt. The judge within the Court of First Instance takes all decisions affecting the bankruptcy procedures, starting with the bankruptcy declaration.
- b) Managing body: The Depository is responsible for the recovery and possession of the bankrupt's assets and is appointed by the Judge in the bankruptcy declaration.
- c) Supervision and inspection body: the Commissioner acts as a delegate of the court and supervises the functions of the Receivers. He is appointed by the judge at the moment of the bankruptcy declaration<sup>110</sup>. The Commissioner prepares a report to determine whether the bankruptcy may be considered as fraudulent or non-fraudulent.
- d) Consultative body: The Creditor's Meeting has the function to vote on any of the proposals submitted by the debtor, approve the classification and ranking of debts and appoint the Receivers. Their vote is required concerning the acknowledgment of the balance and report presented by the debtor, the appointment of the Receivers, the investigation and acknowledgment of debts, the approval of the report of the Receivers, and, if appropriate, the discussion and approval of the composition agreement. The Creditors' Meetings are called by the Commissioner, who will also preside the meeting, and are to be approved by the Judge.
- e) Representative body: The Receivers represent the body of creditors and are responsible for the organised liquidation of the bankruptcy estate during the bankruptcy proceedings<sup>111</sup>. The Receivers have to be creditors and are appointed in the first Creditors' Meeting<sup>112</sup>. Their faculties are broad, they have to administer and preserve the value of the assets of the bankruptcy as a good trader, and prepare the necessary transactions in order to dispose of the goods and distribute the proceeds of the sales amongst the creditors. In this function, it is more important to preserve the economic value of the goods, rather than liquidating them at a low price, given that their value will have to satisfy the requests of the body of creditors.

## 2.6. Formation of the bankruptcy estate

The bankruptcy estate includes the assets of the debtor at the moment of the bankruptcy declaration, as well as the goods he may subsequently acquire during the bankruptcy proceedings. This estate can however be increased by means of the reintegration of some goods, or reduced because of the withdrawal of a good in favour of, for example, a preferential creditor.

### a) Reintegration of the bankruptcy estate

The bankruptcy declaration prohibits the debtor from carrying out acts of ownership and management.

The bankruptcy declaration can also have retroactive effects, in which case the Judge fixes the date as from which all acts of the debtor are deemed to be null and void<sup>113</sup>. The date will be fixed taking into account the moment on which the insolvency of the debtor became manifest, as well as any acts by which the debtor intentionally

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<sup>110</sup> Article 1044 Commercial Code 1829 and article 1333 Civil Procedural Rules 1881.

<sup>111</sup> Article 1218, 1319 and 1366 Civil Procedural Rules 1881.

<sup>112</sup> Article 1346 Civil Procedural Rules 1881.

<sup>113</sup> Article 878 Commercial Code, 1024 Commercial Code 1829; STS 12 March 1993, RJ 1993, 1793.

withdrew goods to the detriment of the body of creditors<sup>114</sup>. The Receivers may also take action for restitution of assets belonging to the bankruptcy estate in the following situations:

- any payments made within the 15 days prior to the bankruptcy declaration in respect of debts with maturity date subsequent to the declaration of bankruptcy<sup>115</sup>;
- contracts made within 30 days prior to the date on which the bankruptcy takes effect, provided these contracts call for the transfer of the bankrupt's assets or setting up of a mortgage security<sup>116</sup>.

Furthermore, subject to the proof of fraud, all contracts, obligations and commercial transactions made by the bankrupt within the 10 days prior to the declaration of bankruptcy, can be declared null. The same is applicable to the remunerated disposal of immovable property, endowment of goods or any transfer of goods for free (if these were performed during the month prior to the bankruptcy declaration) and to the endowment or the acknowledgment of assets in favour of the spouse of the debtor, as well as to acknowledgement of receipt of money or bills as loan, when made during six months prior to the bankruptcy declaration<sup>117</sup>.

Finally, any donation or contract concluded during the 2 years preceding the bankruptcy declaration, can be requested to be revoked on behalf of the creditors, if they can prove simulation or surmise in fraud<sup>118</sup>.

The absolute nullity of the acts due to the retroactive effect of the bankruptcy declaration has been criticized in case law, when affecting third parties who acted in good faith with the debtor<sup>119</sup>, although the legal uncertainty created by the nullity *ipso iure* has not been considered unconstitutional by the Supreme Court<sup>120</sup>.

#### b) Reductions in the bankruptcy estate

The Commercial Code provides a right to sellers and other contracting parties to claim the refund of the goods sold to the bankrupt under certain circumstances, such as goods sold to the bankrupt but not yet paid in part or in total by the latter, goods not yet delivered or in transit at the moment of bankruptcy declaration<sup>121</sup>.

Secured creditors with rights on specific assets may continue to enforce their security separately<sup>122</sup>. Such creditors have however the choice to either surrender their security in return for full payment by the Receivers or exercise the power of sale in addition to making a claim for the shortfall in the sale proceeds. Ordinary mortgagees, who have initiated the enforcement of the mortgage before the declaration of bankruptcy, also benefit of such right of separation<sup>123</sup>.

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<sup>114</sup> STS 23 February 1990, RJ 1990, 712.

<sup>115</sup> Article 879 Commercial Code and article 1366 Civil Procedural Rules 1881.

<sup>116</sup> Article 880 Commercial Code.

<sup>117</sup> Article 881 Commercial Code.

<sup>118</sup> Article 882 Commercial Code.

<sup>119</sup> STS 12 March 1993, RJ 1993, 1793.

<sup>120</sup> STS 17 March 1988, RJ 1988, 2210.

<sup>121</sup> Articles 908, 909, 910 Commercial Code.

<sup>122</sup> Article 918 Commercial Code.

<sup>123</sup> Article 39, 127, 132 Law on Naval Mortgages and article 1187, 1003 Civil Procedural Rules 1881.

Some creditors benefit from a relative right of separation<sup>124</sup> and enjoy a preferential right for the collection of debts within the bankruptcy estate<sup>125</sup>.

## 2.7. Liquidation of the bankruptcy estate

### a) Sale of the assets included in the bankruptcy estate

The Receivers are free to decide the moment on which to proceed to the sale of the goods of the bankruptcy estate<sup>126</sup>, provided they act diligently and within the interest of the bankruptcy. They are however obliged to submit each proposed sale to the Commissioner, who will in turn, determine whether the transaction should take place or not, fixing in its case the minimum price. Furthermore, the disposal of the assets has to be preceded by an appraisal of the value of the goods concerned<sup>127</sup>. Although legal provisions establish that the sale, according to the type of goods, is to be carried out by means of a public auction<sup>128</sup>, preference is currently given to the most advantageous way of sale, guaranteeing the most advantageous economic results<sup>129</sup>. In this sense, it is also admitted to sell the undertaking as an economic whole, instead of fragmented disposals.

### b) Ranking of the debts

The Judge establishes the period within which the creditors have to present the titles justifying their claims to the Receivers, as well as the date for holding the Creditors' Meeting examining and acknowledging these debts. To this purpose, the Receivers must draft an individual report on each of the debts and establish a general list of the debts affected by the bankruptcy. These reports are transmitted to the Commissioner and read at the Creditors' Meeting.

The Creditors' Meeting will decide whether to approve each of the debts by majority of the votes, whereby creditors representing at least 3/5 of the total amount of debts have to attend. This procedure leaves however unaffected the right of the creditors and the bankrupt, to proceed in Court against the resolution of the Creditors' Meeting for being damaged by it, within a period of 30 days<sup>130</sup>. The creditors whose debt has not been acknowledged, may however not participate in the votings in the bankruptcy proceedings<sup>131</sup>.

The acknowledged debts are subsequently ranked in accordance with the priority of their satisfaction by the Creditors' Meeting called for this purpose<sup>132</sup>. This ranking is established in two sections<sup>133</sup>: the debts to be satisfied with the proceeds of movable

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<sup>124</sup> An "absolute right of separation" consists in the right to withdraw a specific good from the bankruptcy estate, by means of which the secured creditor satisfies its debt without taking part in the bankruptcy proceedings, whereas a creditor with a "relative right of separation" benefits of a preferential payment of its debt within the bankruptcy proceedings.

<sup>125</sup> Article 912-914 Commercial Code.

<sup>126</sup> Article 1084 Commercial Code 1829.

<sup>127</sup> Article 1086, 1087 Commercial Code 1829.

<sup>128</sup> Article 1085-1088 Commercial Code 1829.

<sup>129</sup> SAP Madrid 27 June 1992, AC 1992, 851.

<sup>130</sup> Article 1380 Civil Procedural Rules 1881.

<sup>131</sup> Article 1105 Commercial Code 1829.

<sup>132</sup> Article 1286 Civil Procedural Rules 1881.

<sup>133</sup> Article 912-914 Commercial Code.

property within the bankruptcy, on the one hand, and those to be paid with the proceeds of immovable property, on the other hand.

c) Payment of the creditors

The payment of the creditors is the last transaction within the bankruptcy proceeding and constitutes its principal objective. The payment is made with the proceeds of the sale of the goods within the bankruptcy estate, and following the ranking formerly established<sup>134</sup>, once the appropriate deductions have been made<sup>135</sup>. The mortgagees will be satisfied in accordance with the date of inscription of their title, and creditors whose credit was constituted by public deed will be paid according to the date their credit was constituted. In order to proceed to the payment, it is not necessary to await for the total sale of the assets, as long as all creditors belonging to the same category within the ranking are entirely satisfied at once<sup>136</sup>. The payment of the creditors ends the bankruptcy proceeding, as soon as the Receivers have reported on their management.

Creditors whose debts are not entirely paid with the proceeds of the sale of the goods within the bankruptcy estate and who did not waive their rights within the bankruptcy proceedings, keep their rights against the bankrupt for the outstanding part, and may execute them on its eventual future goods.

The proceedings may also be terminated in case the application for bankruptcy is dismissed, because, for example, the creditor has few or no assets and the creditors do not take further action, or when there are no creditors, or when a composition or agreement is reached between the debtor and creditors which establishes the termination of the bankruptcy, provided it has not been classified as fraudulent.

c) Composition agreement

Given the time and costs involved in the process of ranking of the debts, sale of the assets and payment of the creditors, as well as the loss of value of the assets due to the compulsory liquidation, these transactions can be replaced by a composition agreement concluded within the bankruptcy proceedings between the bankrupt and its creditors, except when the bankruptcy is fraudulent. It must be noted that the creditor who would conclude an individual agreement with the bankrupt will lose his rights in the bankruptcy and could be considered as accomplice to the fraudulent bankruptcy, whereas the bankrupt will be considered tortious or fraudulent<sup>137</sup>.

The composition agreement aims to satisfy either totally or partially the body of creditors in respect of the principle of equal treatment to creditors. At any moment of the proceedings, once finalized the acknowledgement of the debts and the qualification of the bankruptcy, the bankrupt and the body of creditors may conclude any agreements they deem appropriate<sup>138</sup>.

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<sup>134</sup> Article 916 Commercial Code.

<sup>135</sup> According to articles 908 through 911 Commercial Code, creditors who own goods or assets which are in the possession of the debtor, but that have not been transferred to the latter by means of a legal and non-revokable title, are authorised to regain possession of said assets, provided that they are acknowledged as creditors.

<sup>136</sup> Article 917 Commercial Code.

<sup>137</sup> Articles 893 and 899 Commercial Code.

<sup>138</sup> Article 929 Commercial Code.

The agreement proposed by a bankrupt company to its creditors may have as purpose either the continuity or the transfer of the business (except when the company is in liquidation)<sup>139</sup>. When the bankrupt is a company, it is not necessary to acknowledge the debts and qualify the bankruptcy prior to the proposal of a composition agreement<sup>140</sup>. However, it is not clear why such exception was made for companies by the legislator, given that a bankruptcy can equally be qualified as fraudulent or tortious in the event the bankrupt is a company.

In the case of collective companies, it is assumed that the proposal for a composition agreement can be made by all general partners. If, further to the agreement, the liability of the collective company is limited, the liability of the general partners will be limited to the same extent.

The composition agreement is judicial, concluded within the proceedings and compulsory for all creditors, except for the singularly preferential creditors who decide to abstain from taking part in the composition<sup>141</sup>.

The initiative to propose an agreement may be taken either by the creditor or the bankrupt, who have to request the Judge to call the Creditors' Meeting in order to deliberate on the composition agreement<sup>142</sup>.

The approval of the composition agreement by the Creditors' Meeting, requires simple majority provided that creditors representing at least 60% of the total amount of debts are present or represented (without including the credits of secured creditors and mortgagees who decided not to participate in the vote on the composition agreement)<sup>143</sup>. The agreement has to be approved by the Judge in order to become binding on the bankrupt and his creditors<sup>144</sup>.

Dissident creditors as well as those who did not attend the Meeting can oppose such approval for a limited number of reasons, such as formal defects in the calling or holding of the Meeting, lack of personality or representation in one of the participants to the meeting or fraud between the debtor and one or more creditors<sup>145</sup>. The opposition has to be presented to the Judge of the bankruptcy, whose decision can be reviewed<sup>146</sup>.

Composition agreements generally combine reduction and postponement in the payment of debts, although it can also consist in the conveyance of the assets of the bankruptcy estate in favour of the creditors, who will sell privately and satisfy their debts with the proceeds of these assets. Such waiver extinguishes further creditors' claims<sup>147</sup>.

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<sup>139</sup> Article 928 Commercial Code.

<sup>140</sup> Article 898 Commercial Code.

<sup>141</sup> Article 900, 904 Commercial Code.

<sup>142</sup> Article 1390 Commercial Code.

<sup>143</sup> Article 901 Commercial Code.

<sup>144</sup> Article 904 Commercial Code.

<sup>145</sup> Article 903 Commercial Code.

<sup>146</sup> Article 1394 - 1395 Civil Procedural Rules 1881.

<sup>147</sup> Article 905 Commercial Code.

From a procedural point of view, a composition agreement makes an end to the bankruptcy proceedings. Should the debtor fail to comply with the agreement, any of the creditors may request the Judge to cancel the agreement and to continue the bankruptcy proceedings<sup>148</sup>.

Once the bankruptcy proceedings are reinitiated, both the creditors subsequent to the agreement as well as the creditors prior to it will constitute the body of creditors within the bankruptcy. The creditors prior to the agreement will keep their claims for the outstanding debts.

## **Chapter 5.2. Legal effects of the initiation of bankruptcy procedures**

### *§ 1. Effects from a procedural point of view*

The decision of bankruptcy declaration by the judge implies the following:

- Appointment of the Depository and Commissioner.
- The rights of debt collection of all the creditors, except for those who are entitled to separate enforcement, are accumulated and no creditor may proceed with individual claims against the bankrupt. All proceedings against the debtor will thus be accumulated and be heard by the same Court of First Instance.
- Call the body of creditors at the first Creditors' Meeting.

### *§ 2. Effects from a substantive point of view*

#### 2.1. Consequences for the debtor

##### a) Consequences on the person of the debtor

The declaration of bankruptcy implies that the debtor is disabled *ipso iure* as from the date on which the bankruptcy declaration comes into force. As such he is barred from carrying on any type of business<sup>149</sup>, impeded to hold any function directly by holding the post of director or economically in commercial or industrial companies. The debtor may not be tutor nor guardian for the suit ("curador")<sup>150</sup>. He is prevented from entering in the Stock Exchange and the Brokers' Society<sup>151</sup>, and is obliged to have its correspondence at the disposal of the court<sup>152</sup>.

The procedural capacity of the bankrupt will also be limited, so that the latter can only intervene and act in the bankruptcy proceedings when admitted by law.

Consequently, any act of ownership or management will be null and void because of the bankrupt's lack of capacity. Such incapacitation does however not affect the civil

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<sup>148</sup> Article 906 Commercial Code.

<sup>149</sup> Article 878 Commercial Code.

<sup>150</sup> Article 244 and 291 Civil Code.

<sup>151</sup> Article 183 Regulation of Stock Exchange, article 94 Commercial Code.

<sup>152</sup> Article 1338 Civil Procedural Rules 1881.

capacity of the bankrupt regarding acts remaining outside the scope of the bankruptcy. The debtor may also be authorized by means of an agreement with the body of creditors, approved by the judicial authority, to continue at the head of his business, in which case the authorization is limited to the scope expressed in the agreement<sup>153</sup>.

The debtor may furthermore be placed under house arrest, subject to a prior motivated judicial resolution. Although legal provisions establish that the bankrupt will be automatically placed under house arrest if the latter sets up a guarantee, or imprisoned in default of such guarantee<sup>154</sup>, these measures are not applied anymore. Legal authors criticised these measures because they were based on a presumption of culpability of the bankrupt. The Constitutional Court approved such interpretation and declared that the arrest of the bankrupt infringes the principle of presumption of innocence established in article 24.2 of the Spanish Constitution<sup>155</sup>.

In certain circumstances, house arrest may however still be justified, provided it is proportional to the aim pursued, such as, for example, guaranteeing the presence of the bankrupt in the bankruptcy proceedings. The reasons for house arrest must be clearly motivated, in which case the bankruptcy will be presumed to be tortious or fraudulent. The duration of house arrest must be limited to the time necessary for attaining its objective.

In the case of bankruptcy of a company, legal authors sustain that the above mentioned measures may be imposed on the persons who legally represented and intervened in the management of the company during the period subject to the bankruptcy proceedings (directors, managing directors). These persons will be considered as the authors of the infringements in the case of tortious or fraudulent bankruptcy, save proof to the contrary.<sup>156</sup> In the case of partnerships, only those partners involved in the management of the company will be held liable.

Although article 221 Commercial Code provides that companies are dissolved further to their bankruptcy, it is to be understood that the bankruptcy may lead to the dissolution of the company upon the closing of the bankruptcy proceedings, but is however not a necessary consequence<sup>157</sup>.

The declaration of bankruptcy is to be published in newspapers of the province where the bankrupt is residing, as well as where he has its commercial premises. In addition, the bankruptcy is also published in the Official Gazette, when deemed convenient by the Judge. The bankruptcy declaration is also registered in the Civil, Commercial and Property Registry<sup>158</sup>.

Rehabilitation of the bankrupt, which will only be possible if the bankruptcy is not qualified as fraudulent, ceases all legal interdictions produced by the bankruptcy

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<sup>153</sup> Article 13.2 Commercial Code.

<sup>154</sup> Article 1044 Commercial Code 1829 and articles 1335, 1336 Civil Procedural Rules 1881.

<sup>155</sup> STC 178/1985, 19 December 1985, RTC 1985, 178.

<sup>156</sup> STS 3 May 1967, RJ 1967, 2215; STS 24 February 1984, RJ 1984, 1644.

<sup>157</sup> Rodrigo Uría, "Problemas y cuestiones sobre quiebra de las Sociedades", *Rev.Der.Merc.*, II, 1946, p33.

<sup>158</sup> Articles 83, 84, 86, 93 and 139 Companies' Registry Regulation, article 2 Mortgage Act, Civil Registry Act.

declaration and deletes the inscription of the bankruptcy in the Registries<sup>159</sup>. The debtor can obtain the rehabilitation by justifying the entire compliance with the composition agreed with his creditors. In the absence of composition, the debtor will have to prove that all obligations claimed by the creditors have been complied with. The judge will have to resolve on such request, further to the report of the Commissioner and the opinion of the Public Prosecutor.

b) Consequences on the assets of the debtor

Further to the bankruptcy declaration, the bankrupt is incapacitated to manage his own goods, in order to prevent him from reducing his assets<sup>160</sup>. He is dispossessed of all assets, correspondence and documents, as a direct and immediate effect of the bankruptcy declaration. Correspondence will be put at the disposal of the Court, although the bankrupt is to be summoned to the act of opening his correspondence, and will recover his personal correspondence<sup>161</sup>. All records and documents of the bankrupt are conferred to the Commissioner for investigation<sup>162</sup>: his assets will pass onto the Depository and the bankruptcy estate will be administered by the Receivers.

A company declared bankrupt will enter into the phase of liquidation for the purpose of distributing the assets of the bankruptcy estate to the body of creditors. This liquidation is mandatory and led by the depository and the receivers, who represent the body of creditors. The company will however continue to be represented by the governing body indicated by its Corporate By-Laws for the purpose of intervening within the bankruptcy proceedings<sup>163</sup>. In case of a collective company, the aforementioned measures are extended to all partners.

Although shops, warehouses and offices of the bankrupt are closed down upon the bankruptcy declaration<sup>164</sup>, such may not be extended to industrial plants, establishments for public shows (theatre, cinema), etc. Legal authors indeed sustain that these may continue running to the benefit of the bankruptcy estate, by the Receivers or the professionals empowered by the latter to this purpose. Consequently, bankruptcy does not always have to lead to the closing down of the bankrupt's premises.

Provided certain conditions are complied with, the bankrupt may be entitled to a maintenance allowance in order to provide his subsistence<sup>165</sup>.

The aforementioned consequences by the sole declaration of bankruptcy both on the person of the bankrupt and on his assets, imply serious legal obstacles for the bankrupt to undertake any further commercial activities. The bankruptcy declaration disables the bankrupt until the end of the bankruptcy proceedings, so that he cannot enter in any new business, either as manager, or financially. In addition, the bankrupt is dispossessed of his assets and may not manage them anymore, so that the bankrupt

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<sup>159</sup> Article 922 Commercial Code.

<sup>160</sup> Article 878 Commercial Code.

<sup>161</sup> Article 1044, 1058 Commercial Code 1829 and articles 1337-1339 Civil Procedural Rules 1881.

<sup>162</sup> Article 1333 and 1334 Civil Procedural Rules 1881 and 1044-1048 Commercial Code 1829.

<sup>163</sup> Article 929 Commercial Code.

<sup>164</sup> Article 1046 Commercial Code 1829.

<sup>165</sup> Article 1098 Commercial Code 1829.

will be virtually blocked in order to undertake any further economic activity. The bankruptcy declaration is published and filed with the Civil, Companies' and Property Registry, deterring any interested investors. This situation can be explained given the fact that the ultimate purpose of the bankruptcy proceeding is the settlement and satisfaction of the creditors of the bankrupt. The survival or rescuing of the undertaking, by means of economic aids and limiting the traditional rights of some preferential creditors is however not considered by law. Although there exist some isolated means in order to assist companies in crisis or to avoid their bankruptcy, such measures are not included in Spanish legislation on bankruptcy whose sole finality is the paying-off of the creditors.

## 2.2. Consequences on the creditors

### a) Equal treatment

The effects of the bankruptcy declaration on creditors derive from the principle “par conditio creditorum”, whereby all creditors lose the free exercise of individual actions which are accumulated to the bankruptcy proceedings<sup>166</sup>. The exercise of these actions is conferred to the Receivers<sup>167</sup>.

### b) Constitution of the body of creditors

The replacement of individual actions against the debtor by a joint or collective action can only be reached by gathering all creditors in a collectivity called “body of creditors”, who will appoint the Receivers as its representatives<sup>168</sup>. This body comprises all creditors who are affected by the decision of bankruptcy and its resolution, that is to say, all creditors who do not enjoy a preferential right on specific goods of the debtor. As such, do not form part of the body of creditors, those with a pledge constituted in a public deed, naval mortgagees, and ordinary mortgagees who filed the enforcement of their right prior to the declaration of bankruptcy<sup>169</sup>.

### c) Principle of division

All credits become subject to the “principle of division” (“ley de dividendo”), which means that all creditors will be paid with the proceeds of the bankruptcy estate in the same proportion. Consequently all creditors share the losses to the same extent.

### d) Suspension of interests

As from the date of bankruptcy declaration, all debts will cease to accrue interests, except for debts secured by mortgage or pledge, up to the value of the security<sup>170</sup>. However, in the event debts remain unpaid after the closing of the bankruptcy proceedings, these will accrue interests. In case the amount of the credit includes capital and interests, the credit will have to be reduced by the interests not yet due, which is however difficult to prove in practice.

### e) Expiry of deferred debts

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<sup>166</sup> Articles 1173, 1187 and 1319 Civil Procedural Rules 1881.

<sup>167</sup> Article 1218 Civil Procedural Rules 1881.

<sup>168</sup> Article 1366 Civil Procedural Rules 1881.

<sup>169</sup> Articles 172 and 132 Mortgage Act.

<sup>170</sup> Article 884 Commercial Code.

The bankruptcy declaration implies that the debts pending on the debtor become due<sup>171</sup>. In order to avoid that the creditors concerned are favoured by the anticipated payment, any payment before the date agreed by the parties, will be made with the corresponding rebate<sup>172</sup>.

f) Compensation between the creditor and the bankrupt

In the event the credit and debt derive from the same legal relationship, these may be compensated. No compensation may however take place when the reciprocal credit and debt derive from different legal relationships, in accordance with the principle of unavailability of assets of the bankrupt which does not allow payment to the detriment of the bankruptcy estate and the principle of equality of creditors.

g) Joint and several obligations

In case of bankruptcy of one or more joint and several debtors, the creditor can request the total amount of the debt in each of the bankruptcies, until its entire satisfaction<sup>173</sup>.

h) Termination of bilateral contracts in course of execution

In the case of non performance by both parties to the contract in course of execution, or by the debtor only and provided that the property of the goods sold is not yet transferred to the debtor, the creditor is entitled to terminate the contract and to withdraw the unpaid goods sold to the bankrupt from the bankruptcy estate<sup>174</sup>.

### **Chapter 5.3. Legal effects of bankruptcy as such**

#### *§ 1. Qualification of bankruptcy*

As stated in section 1.2, there are three different types of bankruptcy according to the bankrupt's conduct, with different legal implications. In this sense, the fortuitous bankruptcy is exempted from criminal liability, whereas the tortious and fraudulent bankruptcy may be punished from a criminal law point of view. The fortuitous and tortious bankruptcy further allow the bankrupt to reach agreements with his creditors.

The qualification of the bankruptcy will be made by the Judge, taking into account the facts, proofs and circumstances of each case, as stated in the reports of the Commissioner, Receivers and the Public Prosecutor<sup>175</sup>. The debtor can oppose such qualification and the corresponding resolution can be subject to review. Given the presumption of innocence, the qualification as fraudulent or tortious of the bankruptcy will only have civil law effects, whereas the criminal proceedings will determine the existence of a crime. Consequently, the civil resolution does not have binding effect on the criminal proceedings<sup>176</sup>.

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<sup>171</sup> Article 883 Commercial Code.

<sup>172</sup> Article 883 Commercial Code.

<sup>173</sup> Article 1144 Civil Code.

<sup>174</sup> Article 909 Commercial Code and article 1124 Civil Code.

<sup>175</sup> Articles 1382-1385 Civil Procedural Rules 1881 and 1138-1140 Commercial Code 1829; SAP Cuenca 14 November 1995, AC 1995, 2012.

<sup>176</sup> STS 5 December 1988, RJ 1988, 9366; article 260.4 Criminal Code.

## § 2. Criminal Sanctions

The Criminal Code provides a specific chapter on punishable insolvencies<sup>177</sup>. In principle, are punishable those insolvencies which are due to negligent conduct or tort, provoking, hiding or aggravating such insolvency. Prior to bankruptcy, concealment of assets or disposal of the same to the detriment of creditors, is punished with imprisonment of 1 to 4 years and fines from 12 to 24 months<sup>178</sup>.

Once the debtor is declared bankrupt, any act of disposal or conclusion of contracts by the latter, whereby he is bound to pay certain specific creditors to the detriment of other creditors, without judicial authorization or in the absence of legal provisions, is punished with imprisonment of 1 to 4 years and fines from 12 to 24 months<sup>179</sup>.

In the event the insolvency is caused or aggravated by fraudulent acts by the bankrupt or the person acting in its name, the same shall be punished with imprisonment of 2 to 6 years and fines from 8 to 24 months<sup>180</sup>.

These crimes can be prosecuted without awaiting the conclusion of the civil bankruptcy proceedings.

In addition, the person who consciously presents false information concerning the accounts of the debtor in order to obtain a bankruptcy declaration improperly, shall be punished with imprisonment of 1 to 2 years and fines from 6 to 12 months<sup>181</sup>.

When the bankrupt is a company, such criminal proceedings and penalties can be inflicted to the individuals representing or managing the company, in the event it can be proven that they are responsible for these fraudulent acts, which caused, either totally or in part, the insolvency<sup>182</sup>.

## § 3. Rehabilitation of the bankrupt

Only at the closing of the bankruptcy proceedings of fortuitous or tortious bankruptcy, the bankrupt may request its rehabilitation. When the bankruptcy is fraudulent, the bankrupt is not allowed to come to any arrangement with the creditors and he will be barred from engaging in any business in the future, even if all debts are paid<sup>183</sup>. The judicial declaration of rehabilitation ceases all legal prohibitions produced by the declaration of bankruptcy<sup>184</sup>. It is remarkable that the proceedings for rehabilitation is burdensome, given that it is not obtained *de officio* upon the termination of the bankruptcy proceedings, but has to be requested by the bankrupt and is conferred by

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<sup>177</sup> Articles 257 – 261 Criminal Code.

<sup>178</sup> Article 257 Criminal Code.

<sup>179</sup> Article 259 Criminal Code.

<sup>180</sup> Article 257 Criminal Code.

<sup>181</sup> Article 261 Criminal Code.

<sup>182</sup> STS 19 February 1981, RJ 1981.

<sup>183</sup> Article 898 Commercial Code.

<sup>184</sup> Article 921, 922 Commercial Code.

the civil judge by means of a judicial resolution upon full compliance of the obligations by the bankrupt to his creditors. In the event the bankrupt is also charged with criminal penalties, the rehabilitation cannot be obtained until this penalty is complied with<sup>185</sup>.

<b>Legal Consequences</b>	<b>Obstacle</b>	<b>Incentive</b>	<b>Neutral</b>
Rehabilitation of the bankrupt <sup>186</sup>	X		
Criminal sanctions	X		
Composition agreement		X	

#### **Chapter 5.4. ‘Excusability’ following bankruptcy**

The bankruptcy is qualified as fortuitous in the event it is produced by misfortune, which is to be considered as accidental within the regular and cautious order of a good commercial management.<sup>187</sup> The concept “fortuitous” is to be interpreted restrictively, so that only when it cannot be proven that the bankruptcy is to be considered as tortious or fraudulent, such bankruptcy will be deemed fortuitous.

Although no fault resides with the bankrupt in such case, the latter will also be incapacitated during the bankruptcy proceedings. No criminal sanctions will however be inflicted and the bankrupt may conclude a composition agreement with the body of creditors.

#### **Chapter 5.5. Responsibility of the Company’s management in case of bankruptcy of a limited liability company**

The obligation to file a bankruptcy declaration when the bankrupt is a company, remains with the governing body. In the event such obligation is not complied with, the bankruptcy will be qualified as tortious and the governing body will be held liable.

Further to Case Law, the incapacitation of the bankrupt, and in its case, house arrest may be imposed on the representatives of the company during the period subject to the bankruptcy proceedings. These persons will be considered as the authors of the infringements in case of tortious or fraudulent bankruptcy.

In addition, criminal sanctions can be imposed on the representatives of the company, when these are responsible for the reasons causing the insolvency, or when they provided false information in the accounts of the company.

Consequently, in the event the tortious or fraudulent bankruptcy is caused by the director or managers of the bankrupt company, these may encounter difficulties in

<sup>185</sup> Article 1171 Commercial Code 1829.

<sup>186</sup> Only possible in the events of fortuitous or tortious bankruptcy.

<sup>187</sup> Article 887 Commercial Code.

order to start a new business, manage another company or start a new professional activity, given that the incapacity will persist during the bankruptcy proceedings and, in case the representative is inflicted with a criminal sanction, until compliance of such sanction.

## **TITLE 6. PROSPECTS AND RECOMMENDATIONS**

### **Chapter 6.1 Critical analysis of the Spanish legislation on insolvency**

The following is an overview of the most outstanding problems generated by the Spanish law on insolvency:

- (i) A debtor in Spain would only resort to file a petition for suspension of payments or bankruptcy as a last measure, when it is generally too late to take effective actions for restructuring the business. Thus, most of the insolvency cases in Spain (including both suspension of payments and bankruptcy proceedings) end up with the liquidation of the debtor's assets.
- (ii) The suspension of payments proceeding is theoretically intended to serve as the legal procedure for enabling debtors under temporary financial distress to reach an agreement with its creditors for the repayment of the outstanding debts.

However, the objective definition and limits of the situations which may give rise to suspension of payments or bankruptcy are unclear. The legal regulation of suspension of payments allows that a debtor in terminal insolvency may benefit from that regime, while the Commercial Code also provides that the bankrupt company may reach a composition with its creditors for the purpose of continuing the business. Many terminal debtors profit from this uncertain situation and file petitions for suspension of payments, with the ultimate purpose of avoiding the personal restrictions that they would suffer in the event of a declaration of bankruptcy.

- (iii) For all the above-mentioned reasons, the procedure of suspension of payments is overused in Spain and the underlying philosophy of our dual system (a preventative procedure for the cases of temporary insolvency, a liquidatory one for terminal insolvency) has proved to be ineffective in practice.

According to the statistics available,<sup>188</sup> 30% of the insolvency procedures in Spain are bankruptcy cases, while the remaining 70% are suspension of payments. On the other hand, the figures show that most of the business declared bankrupt are medium or small-sized companies.

- (iv) There are no legal provisions allowing or encouraging debtors or creditors to file a petition for some sort of preventative or protective measures of

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<sup>188</sup> Alvaro ESPINA. “*La Reforma del Derecho concursal y la eficiencia económica*”. Pág 166. Madrid 1999

temporary nature, with a view to allow the debtor to reorganise its business, thereby avoiding the terminal insolvency.

- (v) The current system of legal preferences and privileges, coupled with the usually poor financial situation of the debtors affected by insolvency proceedings, result in a very low debt recovery rate (only those creditors with secured or preferential credits are able to recover a significant portion of their rights). More often than not, when the collection of a part of the outstanding receivable takes place, it comes from the proceeds of the liquidation of the bankrupt business and not as a result of an approved repayment plan.
- (vi) In many cases, debtors under suspension of payments or even bankruptcy proceedings, manage to reach the majority of creditors' votes required for the approval of a repayment plan simply by using affiliated companies listed as creditors. Sometimes, the debtor even makes private and secret arrangements with one or several creditors who agree to accept hidden payments or to assign their receivable to a third person or entity ultimately controlled by the debtor (and who would replace the former creditor from that date on) for a consideration lower than the nominal value of the receivable. Although these secret payments and arrangements are illegal (and may amount even to a criminal offence<sup>189</sup>), they are relatively common in practice. As a consequence of this, the legal principle of equal treatment to all creditors (*par conditio creditorum*) is seriously infringed.
- (vii) There are no legal provisions organising the appointment of accounting experts as supervising auditors and receivers. Thus, each individual judge does usually appoint receivers and administrators among a reduced circle of accounting experts on which he / she relies. This situation represents a risk for irregular practices and is deterrent for the enhancement of the technical quality offered by the persons appointed as receivers and administrators.
- (viii) In the event of terminal insolvency, the law establishes a rigid and not well-defined system of nullification actions whereby a number of transactions carried out during a so-called suspect period (prior to the declaration of insolvency) could be declared to be null and void. This system generates uncertainty and sometimes gives rise to arbitrary decisions (either for the debtor or for the third party who takes part in the nullified contract).
- (ix) Since the law on insolvency affects all the areas covered by the business activity (company law, contracts, relationship with the authorities, employment and tax matters), several judicial cases may be simultaneously conducted by Judges of the relevant jurisdictions (civil, employment and judicial review).

As regards specifically the overall approach of the system with respect to the possibility of the insolvent debtor starting a new business once he/she is able to

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<sup>189</sup> Article 259 Criminal Code.

overcome the insolvency situation, it can be said that this concern is almost completely alien to the Spanish legislator.

The matter is only dealt with in three articles of the Commercial Code<sup>190</sup> (articles 920 through 922, under the heading “*the rehabilitation of the bankrupt debtor*”). The rehabilitation is conditioned to either (i) the full compliance by the debtor of the composition or repayment plan approved with the creditors, or (ii) (when no such composition or repayment plan exists) to the full repayment of the outstanding debts by the debtor (articles 921 and 922), either with the proceeds of the sale of its assets or otherwise. When the insolvency has been legally qualified as a fraudulent one, the debtor may not be rehabilitated (article 920).

As explained above, the system has failed to encourage effectively the resumption of the business activities by the debtor after the insolvency procedure. The legal procedure that should serve that purpose, the suspension of payments, is generally used in cases of terminal insolvency that result in the liquidation of the debtor’s assets (either because the repayment plan originally contemplates the liquidation or because the debtor’s failure to comply with the terms of the repayment plan results in the liquidation).

## **Chapter 6.2 The Spanish Draft Insolvency Act 2001**

After a number of unsuccessful attempts, it appears that the Spanish Government is actually determined to set into motion the long-expected reform of our legal insolvency system.

In September 2001, the Ministry of Justice published a Draft Insolvency Act, which is currently being reviewed by several consultation bodies (Council of the Judiciary, State Council). The main features of this Draft (which will still have to undergo the parliamentary process) can be summarized as follows:

- (i) All the substantive and procedural aspects of the insolvency will be regulated by one law.
- (ii) The reform envisages the creation of a new jurisdictional branch (*Commercial Jurisdiction*) that will deal with a number of litigation matters connected with business activities, including insolvency proceedings. The Judges of the new Commercial Jurisdiction will be competent for deciding on all the aspects of the insolvency (including employment matters and foreclosure actions to be taken by the Public Administration).
- (iii) The new system provides for one only insolvency procedure, instead of the four different ones currently existing. This procedure will be the only applicable one, both for temporary and terminal insolvency, both for civil debtors and trading persons.

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<sup>190</sup> Also in articles 1168 through 1175 of the Commercial Code 1829.

- (iv) The reform allows the debtor to file a petition to be declared insolvent, even when the insolvency is only *imminent* (i.e., the debtor does not have to be insolvent at the time the petition is filed).
- (v) The situations that could entitle a creditor to file a petition of insolvency of the debtor are more precisely and objectively defined.
- (vi) The possibility of the debtor making separate arrangements with independent creditors or profiting from the votes of related creditors are expressly prohibited.
- (vii) The Judge is legally compelled not to appoint the same accounting experts as receivers or judicial administrators in every insolvency procedure. As a general rule, there will be three judicial administrators: an accounting expert, a lawyer and a representative of the creditors.
- (viii) The system of legal privileges and preferences is simplified by eliminating or restricting many of them.
- (ix) The scope and consequences of the so-called *suspect period* are more restricted and better defined.
- (x) The Draft introduces an entire chapter with International Private law provisions, consistent with the ones of the EC Council Regulation 1346/2000 of 29 May 2000 on insolvency proceedings.

In general terms, the reforms aims at offering a unified and systematic law on insolvency, with legal provisions adapted to the requirements of a modern economy.

The political conflict between protection of creditors and preservation of the debtor's business has been resolved by the Spanish legislator in the following terms:

- (i) According to the preamble of the Draft, the new regulation is governed by the principle that the liquidation of the insolvent debtor should only be dealt with as a last resort. Consequently, there are a number of mechanisms that should enable the debtor to reach an agreement with the creditors on a prompt and straightforward manner:
  - The debtor is allowed, under certain circumstances, to attach to the initial petition of insolvency a composition proposal addressed to the creditors.
  - As indicated above, the debtor may appear before the Judge and ask to be declared insolvent, even when the insolvency situation is only imminent. The purpose of this provision is precisely to offer to economically viable businesses the opportunity to agree with its creditors on a realistic and effective restructuring plan, before it is too late.
  - When the terms of the proposed repayment plan include only a limited reduction and/or postponement of the payment of the outstanding debts, the majorities required for the approval of the plan are lower.

- The privileged creditors with guarantees on specific assets are prevented from starting foreclosure proceedings against said assets during the twelve months following the date of the declaration of insolvency (unless the Judge orders the liquidation of the debtor's assets before the end of said term). The purpose of this provision is clearly to avoid the debtor being deprived of assets required for continuing its business activities during the insolvency procedure.
- (ii) However, the interest in preserving the estate of the debtor is merely a consequence of what appears to be the leading principle of the Draft: trying to create the best possible conditions for the creditors to recover as much as possible from their outstanding credits. This leading principle is mentioned up to five times in the preamble of the Draft, where it can also be read that *'the purpose of the insolvency procedure is not the restructuring of business'*.<sup>191</sup>

This leading principle has other consequences throughout the new regulation:

- The Draft includes a provision whereby the creditor who filed the petition of insolvency (and provided that the petition was admitted and resulted in the declaration of insolvency) obtains a legal preference equal to 25% of its credit.
- Creditors are also protected by the above-mentioned provisions that prevent the debtor from using the votes of related creditors for obtaining the majorities required for the approval of the repayment plan.

As a summary, the current terms of the Spanish Draft Insolvency Act appear to be inspired by the purpose of ensuring that the creditors are paid. The Spanish legislator believes that this purpose is better served by preserving the debtor's assets and simplifying the requirements for the debtor reaching a composition with its creditors. Consequently, the liquidation is contemplated as the worst scenario, that must be avoided, unless the composition proves to be impossible.

On the other hand, a significant progress has been made in the approach of the Draft with respect to the legal consequences of the bankruptcy on the debtor:

- (i) The declaration of bankruptcy does not imply *ipso iure* the disqualification of the debtor for carrying out business or managing its assets.
- (ii) This disqualification could be declared by the judge only when the classification of the insolvency is required (this would happen (i) when the terms of the composition include a debt reduction of more than 33% of the total debt or a debt postponement for more than three years<sup>192</sup>, or (ii) when the insolvency procedure enters into the liquidation stage) and it the insolvency is finally classified as fraudulent.

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<sup>191</sup> Chapter VI of the preamble.

<sup>192</sup> Article 162.1 Draft Insolvency Act 2001.

Thus, the scope of the disqualification of the debtor, when appropriate, has been narrowed (the disqualification will not be automatic, general and for an indefinite period of time, as it is under the current legislation). The judge will have a considerable autonomy for establishing the specific consequences of the disqualification. On the other hand, the rehabilitation will not be linked to the full compliance by the debtor of the composition agreement or to the full payment of the outstanding debts. The debtor will be automatically rehabilitated once the disqualification term established in the relevant judgment has elapsed.

Some of the scholars that have studied the Draft<sup>193</sup> understand that, even if the composition involves a certain degree of debt reduction or postponement, it should not trigger the need to classify the insolvency (otherwise, this provision would act as a deterrent for terminating the insolvency procedure with a composition). On the other hand, the persons who could be affected by the disqualification should be better defined, in order to avoid uncertainties.

- (iii) The resolution of the judge establishing the disqualification of the insolvent debtor will establish the term during which the disqualification will be effective (from 5 to twenty years<sup>194</sup>). The disqualification will entail for the debtor the prohibition to manage assets, as well as to represent or manage other persons. This resolution will be notified to the competent public registries (Civil Registry and Companies Registry).
- (iv) The reform is also inspired by the principle of eliminating other repressive aspects of the former regulation. Thus, article 260 of the Criminal Code (that punishes all those who are responsible of producing or worsening the insolvency situation) will be eliminated.

The only crimes connected with insolvency procedures that shall remain in the Criminal Code will be the ones concerning illegal payments made to creditors during the insolvency procedure (article 259) or the presentation of false accounting information in the course of the judicial procedure (article 261).

## **TITLE 7. STATE OF KNOWLEDGE**

### **I. Legislation**

- Commercial Code
- Commercial Code 1829
- Suspension of Payments Act 1922
- Criminal Code
- Civil Procedural Rules 1881

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<sup>193</sup> Guillermo ALCOVER GARAU (“*Estudios sobre el Anteproyecto de Ley Concursal de 2001*”). Pág. 259. Madrid, 2002).

<sup>194</sup> Article 171.2.2º Draft Insolvency Act 2001.

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