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Company in Crisis: Refinancing and Insolvency Proceedings (B)

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As we saw in the previous note,[1] a company facing acute financial crisis but that is nonetheless committed to its own continuity may either pursue an out-of-court negotiation for an agreement with its creditors or it may act within the framework of Law 22/2003 of July 9, the Insolvency Act (Ley Concursal) Under the latter it has two options: a "preinsolvency" debt renegotiation with creditors (article 5a) or renegotiation under a voluntary arrangement with creditors administered by the commercial court.[2]

In turn, a formal insolvency proceeding can lead to one of two outcomes: continuity of the business under a debt restructuring agreement or business liquidation,[3] whereby the business's assets are sold off to settle as much of its debt as possible.

This note describes the process for refinancing with financial institutions. For the sake of simplicity, this guide is not written in terms of whether the company has opted to renegotiate within or outside the scope of article 5a of the Insolvency Act, though it refers to both scenarios.

The Refinancing Process: Steps

Although there is a great variety of refinancing arrangements, a number of steps occur during all processes in one way or another. The first step is a briefing with an initial proposal to the creditors. This is followed by the negotiation and conclusion of an agreement. The last step is monitoring of the implementation of the negotiated terms and conditions.

[1] See José Antonio Segarra and Héctor Sbert, "Crisis de empresa: refinanciación y concurso (A)" [Company in Crisis: Refinancing and Insolvency Proceedings (A)]," JN-34, IESE, February 2015. Spanish only.

[2] See José Antonio Segarra and Jordi Carrillo, "Crisis de empresa: la Ley Concursal y sus reformas" [Company in Crisis: The Insolvency Act and Its Reforms], JN-26, IESE, February 2012. Spanish only.

[3] See José Antonio Segarra, Miguel Castiella, and Héctor Sbert, "Crisis de empresa: el proceso de liquidación dentro del concurso de acreedores" [Company in Crisis: The Liquidation Process Within Insolvency Proceedings], JN-36, IESE, February 2015.

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Initial Briefing With the Financial Institutions

Once the company detects its problems and prepares a document describing its preferred solution, it will hold an initial briefing with the financial institutions. It is advisable to avoid further financial deterioration and to approach the refinancing process fully prepared, properly anticipating future problems and not focusing on present shortcomings in a rushed and panicked manner. A forward-looking approach and professionalism are essential for generating the necessary environment of trust.[4]

Briefings will ordinarily be held with financial institutions. Although a company may have different types of creditors, financial institutions usually assume the greatest risk and also have the necessary capacity and experience in managing such situations. For their part, government entities have their own specific debt restructuring mechanisms.[5] Moreover, if the company specifically decides to undertake refinancing through a para-proceeding arrangement under article 5a of the Insolvency Act, negotiations will be limited to creditors with claims to financial liabilities.

At this first meeting it is important to get the bank's commitment to continue financing the company for the duration of negotiations, which may last a few months. Otherwise, the refinancing process could get complicated. If one or several institutions decide to cut off the company's flow of working capital, the others would have to assume greater risk. Wary of the company's difficult situation, the latter creditors would grow very hesitant and the company's situation would be complicated even further. One bank's decision to jump ship can cause a domino effect, with dire consequences for the company.

This extended period (known as a "standstill") has a direct relationship with the company's business. In these times of crisis, it is vital for the company to focus all its efforts on managing the business, while keeping attention away from the constant "struggle" with the banks to retain its lines of credit.

The company may approach the banks as a collective or meet separately with each in a bilateral manner. The first option is advisable, since it carries greater clarity and transparency for all stakeholders (a requirement for arrangements under article 5a of the Insolvency Act). From their perspective, the creditors must know exactly what their position is, as well as be aware of the stance taken by the other participants. Where refinancing involves the concession of new guarantees and/or payment date extensions, it is vital that all parties affected know where they stand in relation to the rest. Moreover, to prevent the avoidance

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[4] See Jordi Carrillo and José Antonio Segarra, "Pymes y entidades financieras: decálogo de criterios para una correcta relación" [SMEs and Financial Institutions: Overview of Steps to a Successful Relationship], FN-576, IESE, February 2010. (Available from IESEP. Spanish only.)

[5] See Elisa Valle and José Antonio Segarra, "Financiación extraordinaria para situaciones extraordinarias (I): diferimiento de impuestos" [Special Financing Arrangements for Extraordinary Situations (I): Tax Deferrals], FN-577, IESE, March 2010. (Available from IESEP.) See also Elisa Valle and José Antonio Segarra, "Financiación extraordinaria para situaciones extraordinarias (II): diferimiento en el pago de las cuotas a la Seguridad" [Special Financing Arrangements for Extraordinary Situations (II): Social Security Payment Deferrals], FN-579, IESE, May 2010. (Available from IESEP. Spanish only.)

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action mechanism provided by the Insolvency Act,[6] an agreement must be approved by the majority of creditors and judicially endorsed.

Attaining unanimous agreement is a key aspect of bank refinancing. If a creditor opposes an arrangement it will compromise the others, whose risk stands to increase to compensate for the withdrawing creditors. This scenario occurs more frequently where financial institutions with residual risk positions in the company do not consider an arrangement of this type to be worthwhile. In other scenarios, the main creditors may offer to take on the positions of the others, thereby facilitating agreement by reducing the number of participants and without taking on much more risk.

In any case, collaboration between the financial institutions tends to prevail. Even if a creditor institution considers that an agreement is not in its best interest, as a matter of course it will refrain from instituting an action for breach against its client until an agreement has been reached. This is a logical strategy when we consider that a creditor that may have little risk in a particular case may be the most important creditor in another arrangement involving the same creditor banks.

For its part, the debtor must commit to refrain from pursuing action that might prejudice the creditors' positions. For example, it must not accept additional financing that may be offered to it, it must likewise refrain from providing guarantees for new operations not covered by the plan submitted to the banks, and so forth.

Only when a company is viable should refinancing be considered. Undertaking a complete renegotiation of the agreements just to postpone an inevitable outcome makes no sense for any party involved. Under that premise, the company must submit a viability plan with highly realistic sales forecasts. It is advisable to restructure as aggressively as possible while forecasting expected sales as conservatively as possible.

Negotiations between the parties must be conducted on the basis of transparency. The company must fully disclose its books to the financial institutions. Any bad debts or lines of business with negative margins must be explained clearly to the creditors. Covering up such situations with the aim of signing an agreement should be avoided. Moreover, any anticipated needs for additional capital must be set forth clearly, with justification for why such needs are set out. Requesting a reduced amount of additional funds just to facilitate agreement between the parties may require a second refinancing shortly after the first, which will lead to a negative impact on creditor trust.

Transparency should apply equally to the financial institutions. Such situations transform their role, whereby they go from being competing financing providers to becoming creditors sitting on the same side of the negotiating table. If one of them tries to improve its position bilaterally, distrust among the other banks can arise.

Debt restructuring should be accompanied by other measures to reduce capital requirements in some way. The company must adapt to its new situation, which is likely to require equity reduction, personnel downsizing, office closures or operational outsourcing, divestiture of nonproductive assets, and so forth.

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[6] See the "Judicial Endorsement" section in note JN-34, op. cit.