

HOW THE INSOLVENCY AND PRE-INSOLVENCY SYSTEM WORKS IN SPAIN

This box reviews the main features and shortcomings of insolvency procedures in Spain. These procedures generally play an important role in the development of business activity, since they allow insolvent but viable firms, whose debt needs to be restructured, to be distinguished from unviable firms that need to be liquidated. International evidence¹ shows that the existence of an efficient insolvency system helps to raise aggregate productivity, the rate of innovation and business investment. In addition, soundly functioning insolvency mechanisms support the intermediation activity of banks as they make it easier for them to recover part of their unpaid loans. Finally, the correct functioning of bankruptcy procedures for individuals encourages entrepreneurship: sole proprietors will be less concerned about the possibility of failure, since part of their debts can be discharged.

In Spain, pre-insolvency and insolvency procedures are governed by the Insolvency Law approved in 2003, which came into force on 1 September 2004.² However, the increase in insolvency proceedings as a result of the global financial crisis laid bare various malfunctions in the system, which led to six reforms of the Insolvency Law in the period 2009–2015. These procedures can also be used by consumers, although this box focuses on firms and the self-employed. Figure 1 shows the various pre-insolvency and insolvency procedures according to the type of firm involved.

The aim of insolvency proceedings is to resolve a situation of insolvency via one of two channels: a restructuring agreement or liquidation. A restructuring agreement is an agreement between creditors and the debtor company, which includes a debt restructuring seeking to ensure

that lenders recover the highest possible proportion of their claims and that the firm continues to operate. The agreement may envisage a reduction in the nominal amount of the debt, a deferral (postponement of the scheduled payments), a debt-equity swap and assignment of assets and rights in payment of debt. Such agreements must have the backing of the majority of unsecured credit. A liquidation involves the sale of a firm's assets to pay its creditors in accordance with a certain order of priority of claims.

In addition, there are two types of pre-insolvency arrangements, which aim to resolve insolvency problems that are detected early: out-of-court payment agreements for individuals and small firms; and refinancing agreements, which are used predominantly by firms of a certain size. The latter include a variant – court-approved refinancing agreements – that offers greater protection to the debtor firm.

Lastly, in the case of individuals, whether self-employed or owners of small businesses, there are two insolvency channels: immediate discharge of debt following liquidation of the debtor's assets; and the fresh-start mechanism, which consists of a five-year repayment plan ending with discharge of all other debts.

By international standards, very limited use has been made of insolvency proceedings in Spain, even during economic crises. This is mainly explained by the low use of these procedures by the self-employed and microfirms (firms that employ fewer than 10 persons), which make up the bulk of the productive system in Spain. In the case of the self-employed, in 2019 there were 2 insolvency proceedings for every 10,000 self-employed persons in

1 M. A. McGowan, D. Andrews and V. Millot (2017), "Insolvency regimes, zombie firms and capital reallocation", *OECD Economic Department Working Papers Eco No 31*. V. V. Acharya and K. Subramanian (2009), "Bankruptcy Codes and Innovation", *The Review of Financial Studies*, Volume 22, Issue 12, pp. 4949–4988. J. Ponticelli and S. Alencar (2016), "Court Enforcement, Bank Loans and Firm Investment: Evidence from a Bankruptcy Reform in Brazil" *Quarterly Journal of Economics*, 131 (3), pp. 1365–1413. R. La Porta, F. Lopez de Silanes, A. Shleifer and R. W. Vishny (1997): "Legal Determinants of External Finance", *Journal of Finance*, 53, pp. 1131–1150. M. Giannetti (2003), "Do Better Institutions Mitigate Agency Problems? Evidence from Corporate Finance Choices", *Journal of Financial and Quantitative Analysis*, 38(1), 185–212. J. Qian and P. Strahan (2007), "How Laws and Institutions Shape Financial Contracts: The Case of Bank Loans", *Journal of Finance*, 52(6), 2803–2834. G. Rodano, N. Serrano-Velarde and E. Tarantino (2016), "Bankruptcy Law and Bank Financing," *Journal of Financial Economics*, Volume 120, Issue 2, pp. 363–382. W. Fan and M. White (2003), "Personal bankruptcy and the level of entrepreneurial activity", 46:2, *Journal of Law and Economics*, 543–68. J. Armour and D. Cumming (2008), "Bankruptcy Law and Entrepreneurship", *American Law and Economics Review*, V10 N2, pp. 303–350.

2 Law 22/2003 of 9 July 2003. Owing to the numerous amendments to the original text, the Consolidated Text of the Insolvency Law came into force on 1 September 2020. See Royal Legislative Decree 1/2020 of 5 May 2020, approving the consolidated text of the Insolvency Law.

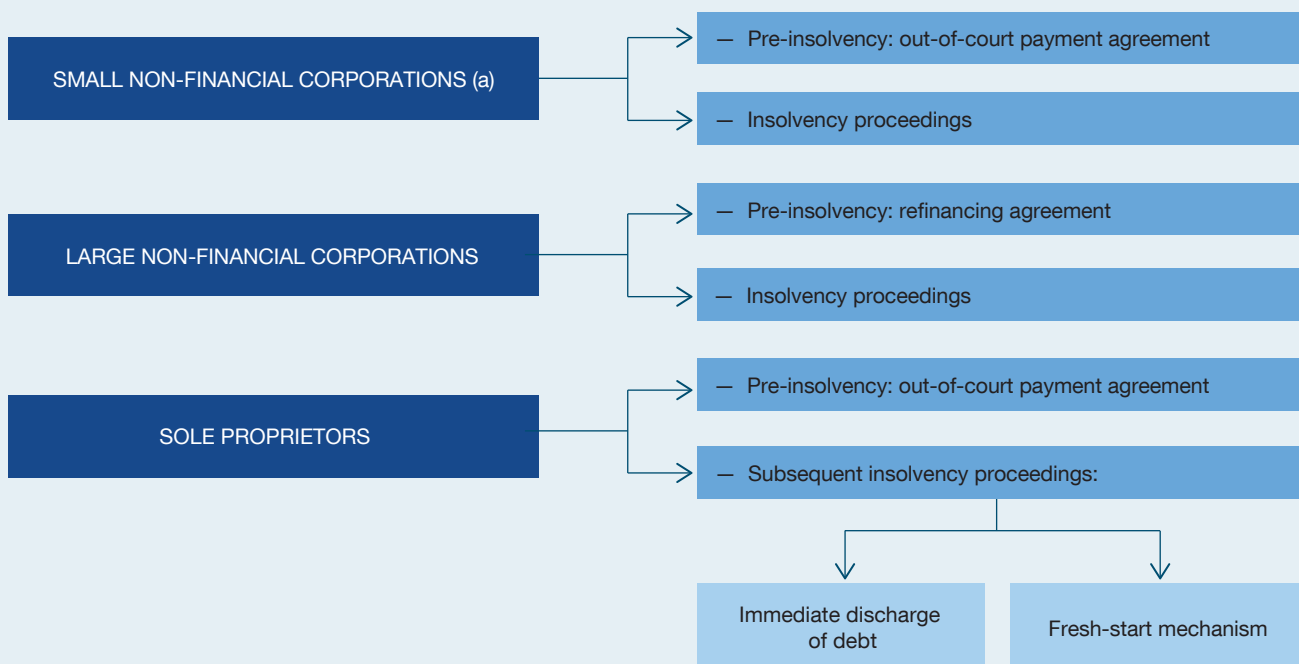
HOW THE INSOLVENCY AND PRE-INSOLVENCY SYSTEM WORKS IN SPAIN (cont'd)

Spain, as against 32 in France and 74 in England and Wales. As regards microfirms, in 2019 there were 9.5 insolvency proceedings for every 10,000 Spanish microfirms, as against 105 in France.³

This limited use of insolvency proceedings in Spain is essentially for two reasons: (i) the inefficiency of the insolvency system, reflected in how slow the proceedings are (with an average duration of 3-4 years),⁴ which is a result, at least in part, of congestion in the commercial courts; and (ii) the lack of appeal that the system has for individuals, considering how difficult it is to obtain a discharge of debts. In particular, public claims (essentially

taxes and social security contributions) cannot be discharged and usually make up a significant part of the debt of microfirms and the self-employed. Also, some experts stress that the repayment plan of the fresh-start mechanism is excessively long (five years), although the transposition of the EU Insolvency Directive⁵ should reduce the duration of the repayment plan to a maximum of three years. Lastly, a further deterrent is the fact that the cost of the proceedings (legal costs, remuneration for insolvency administrators and lawyers) is high and largely fixed or not sufficiently dependent on the amount of the firm's debt or assets. In consequence, and given the stigma that may result from using pre-insolvency and

Figure 1
PRE-INSOLVENCY ARRANGEMENTS AND INSOLVENCY PROCEEDINGS FOR NON-FINANCIAL CORPORATIONS AND SOLE PROPRIETORS



SOURCE: M. García-Posada (2020), "Analysis of insolvency proceedings in Spain against the backdrop of the COVID-19 crisis: insolvency proceedings, pre-insolvency arrangements and the insolvency moratoriums", *Occasional Papers*, No. 2029, Banco de España.

a Fewer than 50 creditors, estimated liabilities of no more than €5 million, assets of no more than €5 million.

3 M. García-Posada (2020), "Analysis of insolvency proceedings in Spain against the backdrop of the COVID-19 crisis: insolvency proceedings, pre-insolvency arrangements and the insolvency moratoriums", *Occasional Papers*, No. 2029, Banco de España.

4 M. García-Posada and R. Vegas (2018), "Bankruptcy reforms in the midst of the Great Recession: the Spanish Experience", *International Review of Law and Economics*, Volume 55, September 2018, pp 71–95.

5 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132.

HOW THE INSOLVENCY AND PRE-INSOLVENCY SYSTEM WORKS IN SPAIN (cont'd)

insolvency procedures,⁶ firms generally use insolvency proceedings only as a last resort. This means that the great majority of proceedings end in liquidation,⁷ because when firms file for insolvency their financial situation is already extremely vulnerable.

Finally, as regards pre-insolvency arrangements, refinancing agreements seem to be performing their function of providing an alternative mechanism to insolvency proceedings for firms of a certain size. Conversely, the limited use of out-of-court payment agreements shows that they are not attractive for the self-employed and owners of small businesses.⁸ According to some experts,⁹ there are two reasons for this. First, negotiation of the debt with public creditors is beyond the scope of out-of-court payment agreements.

Second, the economic incentives for possible mediators to recommend an out-of-court payment agreement to potential beneficiaries are generally limited since the remuneration is usually very low, and consequently most do not recommend them and do not inform debtors of the existence of this procedure. In this context, some analysts¹⁰ have proposed various ways of promoting the participation and performance of the professionals involved in pre-insolvency and insolvency procedures, by for example increasing the remuneration of insolvency mediators entrusted with managing and negotiating out-of-court payment agreements, guaranteeing the remuneration of insolvency administrators and broadening the scope of application of justice provided free of charge (the *turno de oficio* system) to the area of insolvency.

6 M. A. McGowan and D. Andrews, (2018): "Design of insolvency regimes across countries"; *OECD Economics Department Working Papers* No. 1504.

7 93% according to M. García-Posada and R. Vegas (2018), "Bankruptcy reforms in the midst of the Great Recession: the Spanish Experience", *International Review of Law and Economics*, Volume 55, September 2018, pp 71–95.

8 According to Van Hemmen (2020a), between 1 March 2015 and 31 March 2020 only 93 out-of-court payment agreements were initiated. E. Van Hemmen (2020a), *Estadística concursal. Anuario 2019*, Colegio de Registradores de la Propiedad y de lo Mercantil de España, Madrid.

9 S. Van Hemmen (2020b), "Acompañando la segunda oportunidad", *Anuario de Derecho Concursal*, No 50.

10 M. Celentani and F. Gómez Pomar (2020). "Concursos y pre-concursos de personas físicas, autónomos y microempresas: déjà vu all over again", *InDret* 3/2020.