Pérez-Llorca

Alternative Lending
in the Spanish Real Estate Sector

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Introduction

In Pérez-Llorca, we advise international (and some local) lenders who are looking at the Spanish real estate sector. These lenders are not banks, and, therefore, they are known as "alternative lenders"[1]. They are funds, insurance companies and private equity firms that have taken over a segment of the market that banks, the traditional lenders in the real estate sector, have lately abandoned. This has given rise to the already widespread business of "shadow banking". This global trend began to consolidate in Spain in the years after the 2008 credit crunch (and the subsequent Euro crisis of 2012, which was even more traumatic to us here in Spain) as banks consistently reduced their exposure to real estate in Spain. The trend is known as "direct lending" and also as "alternative lending", although in this paper I will use the term "alternative lending", since I believe that it explains what this is all about much better, at least from the perspective of Spanish law. As a lawyer, I will try to summarise the main products and legal institutions used in "alternative lending" in the Spanish financial and real estate markets. I will try to be informative because this is not an academic or exhaustive memorandum (the format does not allow me to get into all the legal technicalities) and, it goes without saying, this article does not constitute any kind of formal advice or legal opinion. I will need to express myself through general ideas, and I will try to point out the most noteworthy exceptions and nuances (but not all of them) in the footnotes. I will start by explaining why I prefer to call this business "alternative lending" (although this article is actually about "direct" lending in the sense that I will always refer to situations where there is a lender lending directly to a borrower[2]) and I will then describe the main legal implications of this business in Spain, from a Spanish legal standpoint.

Alternative to what?

What is this lending "alternative" to, precisely?

"Alternative" to bank financing. Although some business divisions within merchant banks (the so-called "special situations" teams) are actually lending on more or less the same terms as "alternative lenders", the latter typically qualify as "non-banks" (i.e. companies without a banking licence or, in other words, lenders who do not take deposits from the public.) They do not meet the requirements of Law 2/2009, of 31 May, as they do not grant loans to consumers and, therefore, do not fall within the scope of that law (which I will discuss later in this paper.) Non-bank "alternative lenders" focus on sectors and assets that banks do not currently finance[3], or deals that risk committees in banks would not typically sign

1 In this paper, I will refer to these non-bank lenders as "alternative lenders". This definition is more accurate in terms of Spanish law than "direct lenders", since banks are also direct lenders, more often than not.

2 In referring to alternative or "direct" lending, I exclude other formulas such as "crowdfunding" platforms, "fintech" products, certain ways of contributing funds through joint accounts or "cuentas en participación", etc. I am merely focusing on non-bank lenders who structure their financings as loans or credits granted to real estate borrowers.

off on these days. At this point, after years of balance sheet cleaning, Spanish and international banks are still "brick-averse" and do not lend unless such "bricks and mortar" are income-producing or pre-sold (and in both cases, only up to 50% or 60% of the market value or acquisition price, which is known as "loan to value" or "loan to cost", respectively.) Other than by these strict criteria (which I have obviously over-simplified), banks do not lend. This opens a window of opportunity for alternative lenders to finance land purchases, developments at pre-sale / pre-licensing stages, acquisition financings or refinancings above the 50% or 60% "loan to value" or "loan to cost" limits. In addition to these basic examples, alternative lenders may fund acquisitions of shares in real estate companies ("share deals"), purchases of loans or other debt instruments ("loan-on-loan") and offer other creative products, which usually have a greater risk (and return) than those offered by banks to their diminishing number of clients in the real estate market.

"Alternative" to equity investments. Non-bank lenders have one key feature in common, which is their need to (i) invest funds and (ii) receive a high return on their investment. They refer to the former as "equity deployment", a term that describes the need to invest the funds that their investors have entrusted to them. They refer to the latter as the "cost of capital", meaning the "price" of the funds that they have available for investing, which is very high (higher, of course, than for any bank)[4], because their final investors require a high return on capital. Even though they are committed to making loans, they structure many of these loans as equity investments (ideally, their loans to players in the Spanish real estate market should be "equity-like", that is, similar to investments of limited partners who commit resources in a company, in search of a higher return than that sought by "standard" lenders.) In practice, it is capital (equity) granted in the form of loans or credits, the remuneration of which is expected to cover the high cost of capital of the investors, but which needs to be tailored with the protections and guarantees that traditional lenders would typically expect. The best of both worlds, and no minnows for lawyers.

"Alternative" to mortgage financing. In the real estate sector, financing has been traditionally mortgage-backed. In fact, both terms (real estate financing and mortgage-secured financing) have been used interchangeably. Anyone doing business in this sector immediately and almost instinctively connects, the existence of a loan to its corresponding mortgage. The activity of alternative lenders has caused this connection to be revisited: not all "alternative" real estate loans include a mortgage anymore. This is a radical change, to which the market needs to adapt. In Spain (I would say everywhere, but I haven't travelled that much) there is no legal mechanism that secures a debt against an asset like a mortgage does, reserving the value of the mortgaged asset to repay such debt and ensuring that the encumbrance "travels with the asset" even if it is transferred to a third party. However, creating mortgages in Spain is expensive (and I know that this is not always the case elsewhere), and such cost clearly dents the return that alternative lenders hope to obtain. Therefore, the mortgage may be ruled out in favour of other security that is less costly (although it would also be less effective as true security: let me stress that no security provides the same level of protection as

3 In this article, I focus on alternative lending in the Spanish real estate sector. It is important to stress this because "direct lending" or "alternative lending" does not necessarily have a real estate element. It also seeks to take advantage of the inefficiencies of the banking market to offer financing to companies (that is to say, "direct lending" can be a kind of corporate financing alternative to equity.) As a bibliographic reference, see one of the few books published on the subject (in fact, the only one I know of): "Private Debt, Opportunities in Corporate Direct Lending" by Stephen L. Nesbitt, published in 2019 by the Wiley Finance Series. This work summarises the financial, structural and legal foundations of alternative lending almost exclusively as a corporate subject, and does not address its obvious real estate variant. From an academic perspective, alternative and direct lending in the real estate sector remain largely unexplored.

4 According to the classic balance sheet of banks (although this is certainly changing or has already changed after the 2017 repeal of the famous Circular 4/2004, of the Bank of Spain and, in general, given the banking regulation conundrum), banks receive their funding fundamentally from depositories. These funds have a very low return, i.e., a very low "cost of capital", through the interbank market (which people in Spain instinctively but correctly equate with Euribor.) In addition, they receive capital contributed by their shareholders. Therefore, according to this classic scheme, the so-called "cost of capital" of banks is much lower than that of any private equity fund or firm (the alternative lenders that we are discussing here.)

mortgages do.) We will further discuss these alternative forms of security, as well as other protections in favour of lenders, which do not qualify as security (but rather as prohibitions and limitations, to which I would refer as "negative covenants" and "quasi-security items".)

Products offered by Alternative Lenders

What do these alternative lenders offer in the Spanish real estate market, and to whom? Well, they fill the spaces and market niches left behind by banks, and some new ones that banks do not wish to explore. In many ways, alternative lenders target clients that are being ignored by their traditional funders.

Bridge Financing

Presently, the most typical “alternative lending” product is land acquisition financing or "bridge financing" (the latter name reflects its provisional nature very well as it works as a "bridge" between the developer's own funds or “equity” and the much more affordable development financing that is expected to be offered by some bank at a later stage in the development phase when end-buyers have signed their off-plan agreements and licences are in place.) Thus, "Bridge financings" can be very easily explained. A real estate developer identifies a site that it wishes to acquire. However, no bank wants to finance the purchase, because banks expect (a) a minimum level of pre-sales and (b) that the planning risk has been allayed, that is to say, that the site or the development to be built on the site has a works licence in place, at the very least. Until that happens, alternative lenders offer "bridge" financing, so that the developer can buy the site and start the works. Both parties rely on such financing to be, indeed, "bridge" and short-term. Developers rely on this because “bridge loans” are expensive and need to be repaid as soon as possible; ideally with credit to the development financing that a bank will provide once the project is more mature. On the other hand, the alternative lender relies on this because it is taking a very high planning risk (it is financing the purchase of a “virgin” site) and, also, the marketing risk (in most cases pre-sales have not started.) This main feature of "bridge financing" (i.e., its short term) explains why lenders want to protect themselves financially from an early amortisation, which harms their profitability, through the “make whole” clause that is so typical in bridge loans, and why developers (borrowers) want to avoid costs if possible (including that of creating a mortgage.)

Mezzanine Financing

I mentioned before the prudence of banks (or rather, how their accounting rules and capital provisions act as deterrents) when it comes to financing real estate assets above a certain percentage of their appraised value or purchase price. Such percentage, expressed as a "loan to value" or "loan to cost" covenant, does

not usually exceed 50% or 60%. Above that level, there is room for extra indebtedness granted by alternative lenders in the form of "mezzanine" loans. As this term suggests, these loans act as a mezzanine floor between the bank's senior financing and the dear money invested by the developer or investor (or "equity".)

Mezzanine financing is less common in the Spanish real estate sector than bridge financing. However, a mezzanine market exists because leverage is key to achieving larger returns, and the leverage offered by banks is insufficient for the returns that some investors expect to obtain. Mezzanine financing is actually an invention of corporate finance (without mortgage security), but it has been implemented in the real estate sector as a formula to obtain additional leverage, either by resorting to *in rem* security (the so-called "second-lien mezzanine") or without it (even fully unsecured.) I will return to this point later when I discuss mortgages (or the lack thereof.)

Financing to purchase or refinance debt

The market has been offering distressed real estate debt for years. It is precisely the banks (and SAREB, the Spanish bad bank-like company, in which many banks have a stake) that offer this product, in the context of their painful process of deleveraging and balance sheet cleaning.) On the buy-side, there are many opportunistic investors that specialise in this type of product (non-performing loans or "NPLs" that have flown off the balance sheet of the banks and SAREB, mostly in the form of large portfolios.) Alternative lenders offer financing ("loan on loan") to buy these portfolios.

This is also a resource for borrowers under NPL portfolios who want to refinance their legacy debt with banks or SAREB by resorting to alternative lenders (the product has a different name, these refinancings are commonly referred to as “DPOs” or “debt purchase opportunities”.)

Financing to purchase shares

Another rather typical product in alternative lending is financing for the purchase of shares (generally “*participaciones*”, as shares in Spanish limited companies are named) in companies which hold real estate assets. This form of acquisition financing entails practical difficulties and legal risks (among others, the risk of financial assistance, which prevents loans from being secured against the assets of the company whose shares are being acquired.) These inconveniences often discourage the structuring teams of banks (at least, Spanish banks.) Therefore, anyone willing to buy a real estate company should turn to more sophisticated international banks or to an agile and sophisticated alternative lender who understands and assumes these risks (and has access to high-end legal advice to cope with the legal issues.)

Other products

The examples above do not cover the entire spectrum of products offered by alternative lenders in the Spanish market. But in practice, everything ends up being a combination or a deviation in the risk curve of some of the previous scenarios. Some lenders offer "bridge financing" to purchase land, assuming the initial development risk and remain in the project until it is quite advanced and a bank agrees to enter the game with development financing once almost all of the units are pre-sold. The bank may be interested in a final tranche that allows it to place "retail" mortgages among end-buyers[5]. Alternative lenders are also offering mezzanine financing in the context of share purchases, in combination with the senior acquisition finance granted by another party. Think about any product or niche in the real estate sector that the risk committee of a bank would discard at first glance, and you will have a good understanding of the market currently covered by alternative lenders.

The Regulatory Framework of Alternative Financing

I will now address a topic that seems very sophisticated and profound, but in order to address it naturally, I will start with my proverbial simplistic approach to all things complicated and a heading: there is no regulatory framework for direct alternative financing. This heading is not too scientific, but I have already made clear that this article has no academic pretensions and is subject to a good number of exceptions, some more practical than legal, but it is a good start to this section if it really means to be informative.

Lending money is not, in itself, a regulated activity in Spain. Nor does it appear to be so in other countries. This explains in part (together with the excess of liquidity available to investors presently) the surge in alternative lending almost everywhere. A banking licence is not required to lend (here is another heading: a banking licence is only required to collect deposits from the public.) What are the legal and practical limitations that investors face when lending money in the Spanish real estate sector? There are essentially three:

1. **Consumer protection**. Alternative lenders are professional investors who target developers and real estate investors. It is a reliable rule of thumb: I am not aware of any alternative to banking in the Spanish market when it comes to financing purchases of assets by individuals. Alternative financing seeks to circumvent regulations, and lending to individuals is heavily regulated in the form of consumer protection laws, some of which are specific to mortgage financing (the latest milestone being the Real Estate Credit Law[6].) One of the most relevant measures under this Law (as recently confirmed by the Bank of Spain) is the mandatory registration with the Bank of Spain of lenders who grant credit to consumers (a process that may take several months.) Furthermore, recent case law (both European and local) has created

5 Lately, one can quite easily find alternative lending for the development of shopping malls and leisure parks, repurposing of office buildings and hotels ("CAPEX financing") and the purchase of conventional real estate to convert it into alternative uses such as "co-working", student residences, "co-living", etc.

6 Law 5/2019, of 15 March, on real estate credits.

a favourable climate for consumers of financial products in matters such as floor clauses, origination fees, abusive or even usurious interest rates. Thus, alternative lenders typically target companies and professionals acting within their scope of business to avoid the application of these rules and adverse case law. Even so, in non-consensual situations, alternative lenders find that their defaulted borrower may invoke the abusive nature of certain clauses in their loan agreements, and find protection in the courts, as some Spanish judges are consistently extending consumer protection to borrowers who, on paper, do not qualify as consumers.

2. **Creation of mortgages**. In general, and with exceptions, the most common clients of alternative lenders are small and medium-sized development companies or investors. This type of client ("SMEs") insulates lenders from the risk of becoming subject to the regulations and case law that increasingly protect financial consumers. But there is no clear border, especially when it comes to mortgages. Many Land Registries question whether SME borrowers actually qualify as a "business" and therefore apply protective regulations when authorising the registration of mortgages against their assets (i.e., by requiring that lenders prove that they are shortlisted with the Bank of Spain, as briefly explained above.) This shows how blurred the line may be between small businesses and financial consumers in Spain.

3. **Corporate tax withholdings**. Alternative lenders do not operate from Spain, which is due to a tax implication of lending from Spain (not to a legal or regulatory limitation to the free business of lending within the Spanish borders.) Simply put, a Spanish company (I am assuming that all lenders are companies, and I am forgetting here an immemorial Spanish tradition of individual lenders that has not yet disappeared) that lends to another Spanish company is subject to a 19% withholding on the payments it receives from the loan. This Spanish borrower's corporate tax withholding explains why alternative lenders operate from Luxembourg or Irish entities (or US companies domiciled in Delaware) to avoid this tax issue, which they see, obviously, as a "leakage" on their return.

There are other legal or tax specifics when providing alternative financing in Spain. But they are not conditions or impediments. The heading with which I started this section works as a general principle, and perhaps I can use another heading as a coda: it is not necessary to be a bank to lend money in Spain in an efficient manner, both legally and for tax purposes.

Alternative Financing Agreements

I am now going to focus on the main specifics of an “alternative” loan contract.

1. **Applicable law**. I will start by dealing with both the law applicable to the contract and its “form”. Commonly, international alternative lenders (or most of them) use, or are inclined to use, English law as the jurisdictional law applicable to the loan agreement, and a format known as"LMA standard". These "LMA standard"[7], English law contracts are not new or alien to the Spanish financial marketplace: they were commonly used to document large syndicated loans (they are still used, although the syndication market shut down in the aftermath of the 2008 credit crunch and is struggling to open up again.) But the users of "LMA standard" and English law in syndications were or are different: we are talking about large international banks and insurers lending multi-million dollar amounts to sophisticated corporations and listed companies. In today's Spanish real estate market, the use of "LMA standard" and English law is not so easily accepted, because deals are usually of less volume, borrowers are local developers, and financing conditions are simpler than those typically provided in the many pages of "covenants", "undertakings" and "representations and warranties" in “LMA standard” contracts. From a legal point of view, apart from the need to involve English lawyers to negotiate and draft the loan (and the fees, for both parties)[8] and other circumstances more political than legal (I refer to Brexit, which seems not only imminent but also “hard” as I write this article), loans may be made subject to English law, if the conditions required by international law (the Rome Convention) are met. It is also possible, from a strictly legal point of view, to use the format that the parties deem appropriate (regardless of whether that format is more or less manageable than others, and whether it more or less accurately reflects the terms and conditions of a given transaction.) So this is a commercial issue: lenders need to convince their borrowers to use this foreign law and this London format, and this is covered by the parties’ freedom of choice to engage in this kind of sophisticated agreement.

   There are, however, legal implications arising from the use of English law, in combination (invariably) with the "LMA standard" format. I will not elaborate too much on them, because they require and deserve a separate piece of legal scholarship, but I must warn against the most obvious ones:

   (i) The “LMA” concept of the security agent, other forms of "parallel debt" and other fiduciary formulas are, at present, incompatible with the regulation of security under Spanish law, since the accessory nature of security (principio de accesoriedad) requires that beneficiaries of security must necessarily be lenders as well

7 The acronym "LMA" refers to the Loan Market Association. This is an institution headquartered in London that, among other objectives, is in charge of homogenising the most common financing contracts, with the help of law firms that prepare and update these templates with a markedly pro-lender approach (because both the Loan Market Association itself and its collaborating lawyers work for lenders with bank status and others that do not.)

8 The English language can be a barrier, but there are Spanish versions of some of the "LMA standard" contracts

(at least one of them) and not a third party (the aforementioned security agent)[9].

(ii) Some Land Registries demand (and others will soon start demanding) a full Spanish version of the document that sets out the obligations secured by the mortgage. This means that the summary of the terms of the contract that lawyers normally prepare for the purpose of registering the security, summarising the key contractual terms and conditions, may no longer be a generally accepted practice by Registries. LMA Standard contracts drafted in English may need to be translated in full for registration purposes if this trend continues (it is, therefore, advisable to pre-empt this issue with the Land Registrar before drafting the documentation.)

(iii) There may be other problems when adapting LMA Standard documentation to Spanish standards, such as discrepancies in the jurisdiction in the case of loan contracts that are raised to public status (the contract is usually subject to the jurisdiction of the London courts but the mortgage is necessarily subject to the court of the place where the mortgaged property is located.) Moreover, lenders' expectations under English law as to the enforceability in Spain of certain "LMA standard" clauses may be frustrated because enforcement proceedings cannot be initiated based on certain covenant breaches, and Spanish legislation and case law do not admit certain effects that these contracts display under English law. By way of example, the LMA Standard contains a borrower's declaration of insolvency as an event of default-triggering acceleration –which is contrary to Article 61. 3º of Spanish Bankruptcy Act– or the application of measures against third parties, such as the very common substitution of a contractor or service provider in favour of the lender through "step-in rights" under English law, this is a concept which is totally alien to Spanish law.

It must be noted that mortgage enforcements in Spain are essentially based on clauses registered with the Land Registry, given that the borrower's options of defence are limited to those provided in the law (although this would be arguable these days.) The governing body of Spanish notaries and registrars has declared on several occasions that many of the "covenant breaches" provided in these type of contracts may not be recognised as causes for early acceleration because they lack substance (*eficacia real*) under Article 12 of the Mortgage Act. There are exceptions to this, such as failure to comply with the "loan to value" ratio. Under certain conditions, this covenant breach may trigger early acceleration, if drafted in a manner that complies with article 1129.3 of the Spanish Civil Code.

9 In relation to this interesting issue of "parallel debt", I recommend the article by my colleague Antonio Garcia, "Los problemas del law shopping en las operaciones de financiación". Diario La Ley, no. 9127, January 26, 2018. Wolters Kluwer.

2. **Standard clauses**. I will now set out three typical clauses in "alternative" loan contracts:

(i) Calculation of interest. Alternative lending is expensive, as lenders face risk as well. Lenders' return is calculated based on the interest charged[10]. Interest rates may be fixed (most commonly) or variable (less common, since the funds loaned by these lenders do not have a variable element as the banks do when it comes to the interbank market.) Along with this rate of interest that is accruable and payable over the term of the loan, lenders often apply alternative formulas, such as PIK ("payment in kind") that reflect a higher fixed or variable remuneration that accrues over the term of the loan but is capitalised and paid at the end, on the agreed maturity date.

(ii) Amortisation. Amortisation schedules are not common, especially when the financed products (a piece of land, an ongoing development) do not generate income to cover periodic instalments. Payment of the principal (and the fairly common PIK interest) takes place on the maturity date. This total payment of the principal (together with interest accrued) at the end of the loan is commonly referred to as a "bullet repayment" and is certainly the most typical one. Sometimes, there are payments on account, according to an amortisation schedule that ensures a minimum repayment of the principal, so that most of it remains outstanding by the maturity date, at which point the outstanding balance is amortised by a "balloon repayment".

(iii) Make whole. Capital deployed by alternative lenders (again, according to the concept of "equity deployment") requires a multiple of the return that results from applying a given interest rate (fixed or variable, PIK or not.) I would not know how to put it in financial terms, but let's say that interest provides a return, except that it does not achieve the multiple of the capital if there is a short-term amortisation. I have already tried to explain that clients of alternative lenders try to repay as soon as possible; as soon as they get cheaper financing. Therefore, the loan agreement seeks to guarantee a multiple (the "equity multiple") by forcing the borrower to repay the lender the same amount of money that would have accrued if the loan had been repaid on maturity. The imported term is "make whole", and it is deployed in contracts as an exit fee, a break cost, or a similar item.

(iv) Equity-like. This type of "ambitious" capital provider expects a variable remuneration related to the success of the financed project. This is the great paradox of alternative lending: it is structured and documented as a loan, to benefit from the typical

10 In fact, some of the "covenants", such as ICR are aimed at ensuring that the activity of the debtor -or the underlying property- generates periodic income that does not fall below a certain multiple of the interest payable during the same period. Failure to comply with a covenant such as this, for example, would not be recognised as a cause for early acceleration, as it has no "substance" (*eficacia real*) under the Spanish Mortgage Act.

certainty and security of loan contracts and its guarantees. It seeks to avoid the uncertainty of qualifying as "equity" in a project, but at the same time, it aspires to the same profitability as equity. In alternative loan contracts, it is therefore common to agree on extraordinary types of return, such as variable interest (on top of the interest, fixed or variable, which I have already addressed) or some other item that is equivalent to the "equity kicker", the "penny warrant" or the "profit-sharing" in other markets. These three names refer to extraordinary forms of return, not entirely identical, through which a lender receives its share of the profits of the project it finances as if it were contributing to the equity or the capital of the vehicle company developing the project ("equity-like".)

The Security Package

Alternative lending in the real estate sector is secured (or that is the idea) because alternative lenders are concerned with recovering their debt through quick and effective enforcement of security, conscious of their role as lenders and of the risk that they assume in return for the remuneration they expect to receive. The ideal security package is essentially composed of a mortgage and pledges[11]. But sometimes one or the other is not possible, and that is when alternative lenders have to look for exactly that: alternatives. Let's see what those are.

1. **Why mortgage-less?** The alternative real estate financing is mortgage-secured. That is what alternative lenders wish for, but sometimes this is not possible. Why is that?

   (i) Because creating mortgages in Spain triggers notary and Land Registry fees and, much more importantly, the payment of a non-recoverable tax, the so-called Tax on Documented Legal Acts or “AJD” in Spanish (Spanish Stamp Duty.) Leaving aside the issue of who is responsible for paying this tax (since 2018 the legal obligation is on the lender), let's say that it makes the deal more expensive for both parties, which often makes the financial models non-viable;

   (ii) Because alternative lending is often so short-term that, for both borrowers and lenders, it is simply "not worth it". If we are talking about a bridge loan or "bridge financing" to buy an ongoing development that a bank is expected to refinance in a matter of weeks or a few months, why create a mortgage? It is interesting to note that lenders may sometimes accept temporary "windows" in which their real estate financing is not mortgage-backed;

   (iii) Because the bank financing that serves to repay the alternative lender's bridge loan often does not repay it in full, and, therefore,

11 There are other ancillary documents, such as "duty of care agreements" or "subordination deeds" (in our opinion, of little effect in Spanish law), and also irrevocable powers of attorney granted in favour of the lender so that it (or the security agent, acting on its behalf) can carry out certain powers established in its favour in the main guarantees (the mortgage and/or the pledges)

it remains partially outstanding (because the utilisation that the bank allows is not enough, or for other reasons.) Regardless of that, the re-financing bank will request the total cancellation of the mortgage in favour of the alternative lender, so the latter may need to give in and have its outstanding debt unsecured until it can be fully repaid;

(iv) Because in cases of "mezzanine" debt there is a first-ranking mortgage creditor bank that may not tolerate the existence of a second-ranking mortgage in favour of a third-party alternative lender with a reputation as "vulture fund". This implies that the transfer of the so-called "second-lien mezzanine" to the Spanish real estate and mortgage markets cannot be taken for granted. When it comes to mortgages, the first-ranking mortgage holder (typically a bank) may simply not tolerate second liens, even if these are lower-ranking security[12];

(v) Because it may involve financial assistance, in cases where the alternative lender finances the acquisition of shares in the company that owns the mortgaged property[13].

2. **Pledge over shares or quotae of the borrower**. The standard security package includes a pledge on the capital of the borrower, which is usually represented by "*participaciones*" (as the typical borrower is a limited company or "S.L.".) This collateral is necessary and makes the mortgage more robust. There are three peculiar features regarding this security in the context of direct alternative lending:

(i) This pledge of equity is often incomplete if it covers only the shares of the borrower company. The holders of the equity do not always contribute it only as "hard equity". This contribution is likely to include shareholder loans, joint accounts ("*cuentas en participación*") and/or similar items. All of these must be pledged in order to achieve true security over the entire equity. To continue with the jargon of this business, the pledge required by the alternative lender must cover hard equity and any other items that are "equity-like";

(ii) Alternative lenders, especially international lenders, are concerned with the specifics of enforcement in Spain. This applies to foreclosure in any of its forms (even the most efficient of them all; the special mortgage enforcement proceedings, which can be interrupted for up to one year in the event of a declaration of bankruptcy by the borrower.) But it also applies to the enforcement of share pledges, since these require the holding of an auction. When they receive this legal advice, alternative lenders long for the much swifter foreclosure procedures that

12 In other jurisdictions, "inter-creditor" contracts that regulate the relations between holders of secured debt of different ranks are common. In Spain, they are also common, but in the context of structured financing, and not so much in simpler mortgage loans. Such "intercreditor" contracts would serve to regulate the effects of a default on the payment of the subordinated debt (that of the alternative lender holding the second mortgage) and the rights of the first-ranking mortgage lender for remedying such default in order to avoid the foreclosure of the second mortgage, etc. In general, banks that finance with first mortgages reject this type of agreement with third-party second or subsequent mortgage lenders.

13 The prohibition on financial assistance is a feature of leveraged transactions in Spain and many other jurisdictions. This is a topic that the case law has dealt with very extensively and which I will not address in-depth in this article.

they are used to in other jurisdictions (e.g., the "receivership" or the foreclosure "by appropriation" of share pledges.) This has opened the door to lawyers' creativity, which has blossomed in two initiatives to achieve enforcement by appropriation: the so-called "double LuxCo" structure and the attempt to apply the enforcement procedure by direct adjudication provided for in Royal Decree 5/2005. The latter does not apply to pledges over (non-listed) shares, as these are not considered tradable securities or financial instruments[14]. Note that any methods of direct appropriation (other than those permitted by law) need to be interpreted restrictively since they are an exception to the general principle of prohibition of *lex commissoria* under Spanish law[15].

3. **Double LuxCo**. The law of the Grand Duchy of Luxembourg allows enforcement by the appropriation of pledges (or equivalent security) over shares of companies incorporated in said jurisdiction. This advantage over the sluggish enforcement of pledges in Spain has aroused a great deal of interest, starting with the debt crisis of 2008 and the "distressed" market that resulted from it. Some well-known funds implemented this structure in the years immediately after the "credit crunch" and investment funds and the venture capital industry welcomed it with enthusiasm. The structure consists of two Luxembourg companies, (the "TopCo", as the sole partner of the second one called "HoldCo", to which the loan is granted.) Both serve as the head of an underlying business, domiciled in Spain. The lender takes two pledges governed by the law of Luxembourg, over TopCo's and HoldCo's shares. In the event of default, the enforcement of these pledges happens "overnight", by appropriation. The appropriation of HoldCo's shares allows the lender to control the underlying business of its borrower immediately (the underlying property or development in Spain, or the Spanish subsidiary of both Luxembourg companies that owns that property or development.) The simultaneous award of TopCo's shares has a substantial upside for lenders in a "distressed" market: insolvency remoteness. Controlling TopCo allows the lender to prevent its client from applying for the insolvency proceedings of TopCo (the sole partner of HoldCo, from whom the loan is being claimed), thus avoiding the negative effects of the insolvency declaration (including the interruption of such swift enforcement proceedings, at TopCo's request.)

"Double LuxCo" structures have been "flavour of the month", a "must-have" and the subject matter of many a conversation in the marketplace, although they have been used much less in practice. However, they have been used and continue to be used, despite the growing reluctance of Spanish clients, who normally do not have any structure of this type in Luxembourg on day one and who are asked

14 Royal Decree-Law 5/2005, of 11 March, on urgent reforms to boost productivity and improve public procurement.

15 Article 1859 of the Civil Code.

to implement it for the sole purposes of receiving financing. The tax advisors (both in Spain and Luxembourg) must ensure that these structures comply with applicable regulations and that they are not challengeable based on the generic argument (which I now simplify as I have done with so many others) that the Spanish company that sets up this structure to get the financing obtains no benefit in Spain. The legal merits of "double LuxCos" in terms of immediate and unopposed enforcement are tested. However, the market is increasingly reluctant to use this scheme (there are less and less "double LuxCos") despite their merits, for commercial reasons (it is only worth it, as often said, in large financings that justify the cost of the structure.) As happens with all creative and alternative solutions, "double LuxCos" generate legal doubts in some aspects beyond their proven effectiveness in terms of enforcement (doubts regarding jurisdiction and competence of the courts, compatibility with the enforcement of other guarantees, etc.) In any case, I think I can conclude by saying that its recent loss of appeal is due to commercial and operational reasons (rather than legal).

4. **5/2005**. Alternative lenders are interested in having their share pledges governed by this Royal Decree-Law, which allows enforcement by the appropriation of shares and other securities that are represented by book-entries. In some term sheets, I have seen an obligation of the sponsor to turn its limited company ("S.L.") into a corporation ("S.A.") in order to subject the pledge to the "5/2005" regime. I don't know if this idea has ever been successful in any financing, or whether these types of pledges have been taken. It seems that law firms do not have a clear opinion on this point, and the concerns about turning an S.L. into an S.A. for its shares to be subject to this Royal Decree-Law are more than justified. My interpretation is very restrictive, insofar as the Royal Decree-Law also appears to be restrictive and it refers to shares of listed companies that may be held on deposit by third parties (which in practice refers to listed shares and not the shares of any S.A.[16]) But

16 For those readers interested in learning more about the merits of 5/2005 share pledges, what follows is a summary of the most common interpretation as of today.

It seems broadly accepted that any lender (not only banks or securitisation funds) would be eligible as a beneficiary of a 5/2005 share pledge (the only condition being that such lender is domiciled in the EU), and also that any shares in a Spanish public company or SA can be the subject matter of a 5/2005 share pledge (irrespective of whether the SA is listed or not, or whether the shares are nominative shares (*acciones nominativas*), bearer shares (*acciones al portador*) or shares represented by book entries (*acciones representadas mediante anotaciones en cuenta*)).

Indeed, Article 5 of Royal Decree-Law 5/2005 refers to banks and securitisation funds as immediate beneficiaries of the "*financial security*" governed by this piece of legislation, together with "*other financial entities*" as defined by EU Directive 2006/48 (later amended in 2013). The definition of "*other financial entities*" in this EU Directive captures "*companies other than banks whose businesses are listed in points 2 to 12 of Annex I*"; point 2 in that Annex refers to "*loans, including consumer loans, mortgage loans, factoring and commercial financings*". Therefore, an EU non-bank lender should be perfectly eligible as a pledgee of a 5/2005 share pledge. On the other hand, the most common legal opinion among Spanish finance lawyers and scholars is to consider any shares in a Spanish SA as eligible also for a 5/2005 share pledge, irrespective of how these shares are represented and whether they are listed or not.

efforts to apply this form of enforcement do not seem to have ended: in a recent financing in which the borrower was already a corporation (without any prior conversion) its lawyers managed to waive the obligation by their client in the term sheet to create a share pledge under Royal Decree 5/2005.

5. **More alternatives**. Alternative lending continues to seek routes different from traditional security (mortgage and share pledges.) Apart from the fact that the security package can be supplemented with other guarantees (pledges over lease contracts, bank accounts or insurance contracts) the two issues that alternative lenders have when it comes to mortgages and pledges remain present in every new financing: creating a mortgage is expensive, not always possible or well-received. Enforcing a mortgage may be subject to substantial delays (which worsen in the event that the mortgagor files for bankruptcy.) Enforcing share pledges requires an auction and liquidity is not guaranteed (you cannot take for granted that an investor will show up and pay a price for the shares.) In addition, allotment to the lender takes too long to prevent

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However, the flipside of 5/2005 share pledges, which is the possibility of enforcement by way of appropriation, may not necessarily apply to all of them. If the pledgee is a bank (or a securitisation fund) and the shares are listed, then the bank (or securitisation fund) can act as a bookkeeper of the shares and, upon a default by the borrower, enforce the pledge and repossess the shares immediately (shares of listed companies are necessarily represented as book entries, and banks and securitisation funds can act as depositaries of this kind of shares, so the combination is perfect for a bank to take a 5/2005 share pledge and act as a depositary or bookkeeper at the same time; in the event of a default, the shares are already with the bank, so repossession happens immediately).

Enforcement by appropriation is far less clear whenever (i) the pledgee is not a bank (or a securitisation fund) and cannot act as a bookkeeper or depositary of the book entries or (ii) the borrower is not a listed SA and its shares are not represented as book entries (although legally possible, non-listed SAs do not represent their shares as book entries except where there is an intention to float.)

If the pledgee is not a bank and the shares are nominative, then the 5/2005 share pledge would function (in terms of enforcement) as an ordinary share pledge under Spanish common law (the enforcement against nominative SA shares would need to be pursued before a Court of Justice or a Notary.)

If the pledgee is not a bank and the shares are bearer shares (*acciones al portador*), then the shares can be deposited with a Notary who, upon receipt of a notice of default, would hand them over to the pledgee on demand (which would be as close as it gets to enforcement by way of appropriation; however, KYC regulations in Spain and abroad have made bearer shares a total anomaly in today's corporate world and an impossibility in terms of sign-offs and approvals on the part of notaries, advisers, banks, authorities and supervisors (I have not seen them lately, but if they exist, bearer shares are a case study in KYC tutorials these days.)

Finally, if the pledgee is a non-bank and the shares are represented as book entries (*anotaciones en cuenta*), then the shares can be left in escrow with a bank or different authorised registered bookkeeper and, upon receipt of a notice of default, released to the pledgee on demand. This third option is uncharted territory in many ways, but still possible in theory; as of today's date there are 59 bookkeepers duly registered with the Spanish National Securities Market Commission (*CNMV*), all of them authorised to keep shares represented as book entries on their books; so a non-bank lender could, in principle, take a pledge over the shares of a non-listed *SA* if they were represented as book entries (uncommon, but still legally possible) and use a third-party bookkeeper as a depositary of the shares; upon notice of default, the bookkeeper would immediately, on demand, register the shares in the name of the non-bank pledgee.

However, this advice does not take into consideration the commercial and practical difficulties in advising a client to convert their *SL* into an *SA* (which implies higher share capital and more cumbersome corporate housekeeping going forward) and issue the shares of the new *SA* as book entries (which is legally possible but highly uncommon.)

the company's business and assets (which are beyond the lender's control until the foreclosure is completed) from losing value (or being stripped in the meantime.)

As a result, investors continue to ask for and offer alternatives. The well-known world of security interests is largely abandoned in favour of newer and rather unexplored solutions based on contractual limitations and restrictions, and registerable (or non-registerable) rights in favour of the lender, which are in fact translations into Spanish law of foreign concepts such as the "sales mandate", "negative pledges" and "quasi-security". Lenders and borrowers also draft sales mandates whereby they agree to put the asset for sale and repay the debt with the proceeds collected. The key is that this is not tailored as a unilateral right of the lender, although sometimes this undertaking may be reinforced by granting an irrevocable power in favour of an agent or broker to force the sale if the borrower does not voluntarily honour its commitment. This solution is similar to the so-called *pactum marcianum*, which the Supreme Court has historically favoured in its decisions of 1-3-1895 and 27-3-1926, among others. You can also find purchase options that allow the lender to buy the property at a symbolic price, instead of enforcing the security. Registering the purchase option in the Land Registry grants an additional layer of protection in case the borrower sells the asset (the option works as a charge or lien, and travels with the property like the mortgage.) But this figure may be deemed too similar to *lex commissoria*, which is generally prohibited under Spanish law.

The search for alternative formulas to security interests remains largely the day-to-day business of advisors to alternative lenders. The market has matured and competition in price and cost has increased. Veteran lawyers remember without nostalgia the banking market prior to 2008, in which banks competed in price and margins, but also in alternatives to security interests, using "springing" mortgages (which initially secure an amount lower than the principal of the loan, and provide a more or less automatic procedure to extend such mortgage liability upon the occurrence of certain milestones.) We, therefore, work in an increasingly competitive market, in which more and more special situations arise and legal risks need to be mitigated with more sophisticated solutions[17].

17 You can also find limitations in the by-laws to the sale of assets, the creation of liens in favour of the lender which, although are not in rem rights of security, create restrictions on the borrower's ability to dispose of the collateral to the loan.

Conclusion

The process of private deleveraging that developed economies have undergone in recent years, and in which fundamental players have been banks and families (and also SMEs), has been matched by the surge in unregulated lenders, who have shrewdly taken advantage of the inefficiencies of the market, in particular of the real estate market. By inefficiencies I mean circumstances, not necessarily attributable to any particular actor, that allow for "arbitrage". In the Spanish real estate sector, non-banking lenders have strengthened their position, given the banks' increasingly strict regulatory framework, and have made it possible for the sector to have access to credit (without which, as we all know in this business, there is no activity.) A specific way of lending, contracting and securing loans has been born, which is similar to the way these lenders work in other markets. The challenge for lawyers is to provide the best solutions, always according to the law, bearing in mind that each alternative lending deal is a new intellectual adventure.

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