SQUIRE PATTON BOGGS

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The Supreme Court Rates a Credit as Subordinated Because the Creditor Is a Company Belonging to the Insolvent Company's Group

Judgment of the Supreme Court, Chamber One, number 134/2016, 04 March

In this judgment the Supreme Court issued a decision on the determination of the concept "group of companies" in the arrangement of creditors of a real estate developer, by virtue of the appeal for annulment filed by a financial institution, Caixabank, S.A., whose credit against the insolvent company was classified as subordinated by the insolvency administration, upon considering the financial institution as a company of the insolvent party's group and, consequently, specially-related thereto.

In this case, and within the scope of the arrangement of creditors of a real estate developer, one of the creditors, the financial institution, filed an ordinary lawsuit before the Commercial Courts challenging the list of creditors issued by the insolvency administration, since its mortgage-backed credit was classified as a subordinated credit insofar as the financial creditor was a person specially-related to the debtor, because they formed part of the same group.

The claims of the financial institution were dismissed at first instance as well as in the Provincial Court, and the institution then filed a cassation appeal before the Supreme Court with the argument that the "group of companies" status in order to be deemed as a person specially-related to the debtor under insolvency law had been incorrectly applied.

The Supreme Court endeavoured to settle the precise moment to be considered for determining whether the creditor had the status of a company specially-related to the insolvent company, and the implications of this for rating the credit.

Both the Commercial Court and the Appeal Court maintained that, in accordance with the wording of the insolvency regulation and on the basis of a systematic interpretation thereof, the moment of the declaration of the arrangement with creditors (the relationship between creditor and debtor at the moment at which the insolvency was declared) should be considered in rating the credit as subordinated or privileged, and not the time of the origin of the credit; as well as that the deciding factor for credit subordination is the existence of that situation (that these are specially-related companies) at the time of the declaration of insolvency, which means a privileged situation since the creditor would have been able to access the financial information of the insolvent company and potentially use such information for the arrangement of creditors.

In this sense, at the time the arrangement with the creditors of the real estate developer was declared, the financial institution indirectly controlled 65% of the share capital of the insolvent company whereby, in accordance with the wording of the insolvency regulation, there is no doubt as to the control exercised by the creditor over the insolvent company and, consequently its credit should be subordinated by virtue of its status as a specially-related person with the debtor.

The Supreme Court dismissed the argument alleged by the appellant for the following reasons:

In the first place, because the appellant did not apply the relevant legislation when the arrangement with creditors was declared (prior to the insolvency reform), but rather the one currently in force and, at that time, the law considered that persons specially-related to the insolvent legal entity were "the shareholders that in accordance with the law are personally and unlimitedly liable for corporate debts and any others that, at the time of credit right origin, hold at least 5% of the share capital, if the company declared insolvent has securities traded on an official secondary market, or 10% if they do not" and "the companies that form part of the same group as the company declared insolvent and its shareholders (…)."

It also indicated that while prior to the enactment of our Insolvency Act there was no unitary concept of a group of companies in commercial legislation in our country, it is currently obvious that the notion of group in the Insolvency Act does not refer to a "decision-making unit", but to the control that one company exercises over another, whether directly or indirectly.

In the second place, the Supreme Court considered that the issue under debate was whether the status of company of the same group should occur at the moment of the declaration of insolvency or upon the origin of the credit to be subordinated. Thus, the Court explained that, strictly speaking, the precept of the Insolvency Act to which the Commercial Court and Provincial Appellate Court refer did not specify the given moment to be taken into consideration in determining whether the creditor company forms part of the same group as the insolvent company.

The High Court understood that it was reasonable to use the moment of the declaration of insolvency as the relevant moment insofar as it determined the formation of the debt pool with the insolvency credits existing at that time, but it disagreed with that argument and indicated that it was more appropriate to interpret the legislation by addressing the "ratio" that justifies the status of a person specially-related to the insolvent company.

Thus, the Supreme Court explained that the precept of the Insolvency Act that determines in which cases a party is deemed as specially-related to its debtor should be complemented with another two precepts of the same Act; that which sustains that those specially-related persons will have their credits rated as subordinated, and that which subjects all actions of disposal for consideration in favour of specially-related persons to the debtor two years before the declaration of insolvency to the *iuris tantum* presumption of damage, when the insolvency action for rescission is exercised.

Lastly, the Supreme Court concluded that a somewhat systematic interpretation, in keeping with the literal wording of the precepts raised, as well as a teleological interpretation should be made in the sense of addressing the objective sought in each case, and that such interpretation leads to granting the status of company of the same group as the insolvent company at the moment at which the devaluation involved in such relationship justifies credit subordination, or the suspected damage of an action of equity disposal. In other words, the determination of the status of specially-related person with the debtor required taking the moment at which the legal transaction whose insolvency relevance will be necessary (the subordination of the credit or the rescission of the action for disposal) as reference, since what devalues the credit (the relationship between creditor company and debtor company) should occur at the time of its origin.