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ARTICLE

Subordination of Claims Held by Creditors that Belong to the Same Group of Companies as the Insolvent Debtor

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Synopsis

Judgment No. 134/2016 of the Spanish Supreme Court (First Chamber) of 4 March 2016 ruled on the eligibility of non-lending related claims (in this particular case, a claim for rent under a lease agreement between group companies) to be an exception to the general subordination rule contained in section 92(5) of the Spanish Insolvency Act.

Judgment No. 134/2016 of the Spanish Supreme Court (First Chamber dated March, 4 2016)

The case at hand concerns the eligibility of non-lending related claims (in this particular case, a claim for rent under a lease agreement) between group companies for the exception to the general subordination rule contained in section 92(5) of the Spanish Insolvency Act[1] ('LC').

Before delving into the case, it is worth spending some time analysing the text of the Articles of the LC that are at the heart of the dispute. As in many other areas of the LC, these articles lack the clarity and precision one would expect from a piece of legislation that deals with such a relevant matter as subordination in insolvency.

Article 92(5) LC subordinates in the insolvency of a debtor the 'claims held by any related party to the debtor as per the following section, with the exception of those established in Article 91.1 where the holder of the claim is a natural person' and also 'claims, other than for loans and transactions with an analogous purpose, held by the shareholders mentioned in paragraphs 1 and 3 of Article 93.2'.

This is the general rule of equitable subordination that lies at the heart of the dispute. So, in short, claims held by related parties, with two specific exceptions, shall be subordinated to the rest of the creditors of the insolvent debtor.

Paragraphs 1 and 3 of Article 93(2) of the LC define parties related to the insolvent debtor as:

i. *Paragraph 1*: shareholders that are either personally liable for the debts of the insolvent debtor or that, at the time of inception of the claim, hold, directly or indirectly, at least, 10% of the debtor's share capital (5% if the insolvent debtor was listed in an official secondary market or had issued any sort of instruments so listed).

ii. *Paragraph 3*: (i) companies that belong to the same group of companies as the insolvent debtor; and (ii) its common shareholders, provided that the latter meet the requirement established in paragraph 1.

As said before, the text quoted above is all but clear. However, we thought it was worth providing the reader with a free translation of the relevant parts of Article 92(5) to illustrate the origin of so much confusion surrounding these subordination rules.

For the benefit of the reader, let's try to dissect the aforementioned rules.

Pursuant to paragraphs 1 and 3 of Article 93(2) LC, the following persons shall qualify in the context of insolvency as parties related to the debtor:

i. Shareholders that are either personally liable for the debts of the insolvent debtor or that, at the time of inception of the claim, hold, directly or indirectly, a significant share interest in the debtor's share capital (i.e. 10% or 5% as mentioned above) [paragraph 1] (a 'Qualified Shareholder'); and

ii. Companies that belong to the same group of companies as the insolvent debtor and its common shareholders, provided that the latter meet the requirement established in paragraph 1 of the same article [paragraph 3].

Section 92(5) LC sets forth a general rule of subordination of all claims held by related parties of the insolvent debtor, but provides safe harbour from this subordination to:

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1 Law 22/2003, of 9 July.

i. Certain labour claims held by natural persons and social security claims in both cases up to a particular amount as contemplated in Article 91.1 LC; and

ii. Claims for loans and transactions with analogous purpose held by the shareholders of the insolvent debtor referred to in paragraphs 1 and 3 of Article 93(2) LC.

As the reader will easily recognise, paragraph ii. above does not expressly include non-lending claims held by group companies among the beneficiaries of the exception to the subordination rule set forth in Article 92(5) LC. It only refers to non-lending claims held by Qualified Shareholders. But the issue is, could group companies not fall in the definition of Qualified Shareholders? What's more, is there any reason why sister companies within the same group of companies (hence not formally falling in the definition of Qualified Shareholders) should not benefit from the same safe harbour as Qualified Shareholders?

The topic seemed to be contentious. Some legal writers[2] had interpreted that the safe harbour to the subordination rule was also applicable to claims held by companies belonging to the same group of companies as the insolvent debtor. This same criterion seems to have been maintained by some provincial and regional insolvency courts.[3] Other legal writers however had expressed very firm reservations on this topic.[4]

It was required that this apparently unclear topic was decided upon by the Spanish Supreme Court.

So finally, the Spanish Supreme Court was presented with a case of a company (Company A) that held some claims for rent under a lease agreement with another company (Company B) that belonged to the same group of companies as Company A.

Company A contended, among other arguments, that the safe harbour to the general rule of subordination regarding non-lending claims should apply to the claims held by group companies. Company A argued that the same rationale for preserving the claims held by Qualifying Shareholders from the general rule of subordination when it came to contracts whose purpose was not providing any sort of financing to the insolvent debtor was also present in claims held by group companies.[5] It claimed that while it may be true that there was no specific reference to group companies' claims in the text dealing with the exception to the subordination rule, it was the spirit of the law that should prevail in the determination of the ranking of claims as opposed to the strict literality of Article 92(5). In short it claimed that Article 92(5) LC should apply by analogy to the claims held by group companies regardless of the fact of these claims not being expressly contemplated thereunder.

The Spanish Supreme Court concluded that the allegations of Company A that claims held by group companies deserved no better or no worse treatment than those held by Qualifying Shareholders should not be upheld.

In the views of the court, an analogous application of Article 92(5) to the claims of group companies required the conditions under section 4.1. of the Spanish Civil Code for such analogous application to be met, namely: (a) the existence of a loophole in the law; and (b) legal equivalence of the circumstances expressly contemplated in a specific regulation and those not expressly established. According to section 4.1. of the Spanish Civil Code, both circumstances should 'share the same rationale'.[6] So the Supreme Court undertakes the exercise of discovering the reasons for the milder treatment used in Section 92(5) LC as regards Qualified Shareholders.

In connection with the existence of a loophole in the LC, the court understands that there is no such loophole as the law clearly subordinates all claims of related parties to the debtor (including those held by Qualified Shareholders and group companies) and sets forth a very clear exception to this rule (i.e. claims by a very specific list of creditors arising from on non-lending transactions) that, in the view of the court, does not capture claims held by group companies.

In reaching this conclusion, the court analysed the evolution of the subordination rule contained in Article 92(5) LC. At the time of enactment of the LC in 2004, subordination would affect all claims held by related parties to the debtor other than those held by natural persons and social security claims in both cases up to a particular amount. The broad reach of this subordination rule was severely criticised by legal writers and practitioners, and a number of moderating elements were introduced over time. Among such moderating elements, the following should be highlighted: (i) the need for Qualified Shareholders to hold the relevant

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2 Daniel Rodríguez Ruiz de Villa, *Anuario de derecho concursal* 30 (September – December 2013), pp. 346, 347 and 348.

3 Judgement No. 12/2015 dated 16 January and 129/2015 of the Provincial Court of Madrid (chamber 28ª), and Judgement No. 233/2015 dated 7 October of the Provincial Court of Barcelona (chamber 15ª).

4 Jiménez Sánchez and Díaz Moreno (eds.), 'La masa pasiva. Los créditos concursales. Los créditos contra la masa', *Derecho mercantil. derecho concursal*, vol. 10 (Marcial Pons, Madrid, 2014,), p. 374.

5 The court explains that among the claims that would fall within the realms of the subordination rule would be all those arising from contracts with the goal of providing financing to the debtor, including not only those which are primarily financial such as loans, credit facilities, discount arrangements and financial leases but also *others which, despite not being a lending transaction by nature, would conceal the providing of financing to the debtor*.

6 Identidad de razón.

interest in the debtor at the time *of entering into the contract from under which their claim is derived* (March 2009); and (ii) the exception to the general subordination rule relating to the non-lending claims held by Qualified Shareholders (October 2011). Thus, the court seems to conclude that none of the moderating elements introduced over time on the general rule of subordination related to claims held by group companies.

With regard to (b), the court contends that while some common ground exists to subordinate the claims held by related parties such as Qualified Shareholders and group companies (access to information and influence over a company), there are also important differences that may justify treating the former differently than the latter.

In the opinion of the Supreme Court, while it is absolutely legitimate to run a business by means of incorporating a number of corporate vehicles that constitute a group of companies (as opposed to operating through one single company with different departments), the law had determined that group companies should not stand on equal terms with the rest of 'external creditors' in the insolvency of a debtor, including the right to seek recovery of its claims in equal terms as those external creditors.

To some extent, the court disregards for the purposes of insolvency the legal personality of the companies that belong to the same group of companies as the insolvent debtor by declaring that 'confronted with the situation of the impossibility for the insolvent debtor to regularly honour the claims of all creditors, the law allocates a lesser value to the claims of companies belonging to the same group of companies'.

The court seems to maintain that as a group of companies constitutes one single economic unit with a number of incorporated vehicles, honouring the claims of creditors that belong to the same group of companies as the insolvent debtor to some extent implies an indirect benefit to the debtor itself. In the court's views, transactions entered into by and between group companies under which the to-be-insolvent company may incur debts may not only serve the interests of the company itself but also those of the group as a whole. Therefore, the claims and interest of external creditors should take precedence and prevail over the rights of said group companies.

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