On judgment no. 134/2016 of the Spanish Supreme Court (First Chamber) of 4 March 2016

The relevant time for the subordination of claims held by creditors that belong to the same group of companies as the insolvent debtor

Fermín Garbayo Renouard
Partner, Gómez-Acebo & Pombo

Article 93(2)(3) of the Spanish Insolvency Act[1] (abbrev. LC) states that companies that belong to the same group of companies as the insolvent debtor shall be regarded as parties related to such debtor.

Article 92(5) LC provides that in insolvency proceedings, the claims held by parties related to the insolvent debtor who is a legal entity for loans or credit facilities in general shall be regarded as subordinated claims. This article in combination with the one referred to above determines the subordination of the claims between companies belonging to the same group for loans, credit facilities and other instruments with an analogous purpose to that of a loan.

However, Article 93(2)(3) LC does not specify when a creditor has to belong to the same group of companies as the insolvent debtor in order to be regarded as a related party to such legal entity and therefore merit the subordination under article 92(5) LC. This issue has been debated for some time and has generated some unrest among practitioners dealing with company debt restructuring.

In essence, two different positions have been defended regarding the "relevant time" for the purposes of the subordination referred to in article 92(5) LC, namely:

a. The two companies, insolvent debtor and creditor, must have belonged to the same group of companies at the time the insolvency proceedings were opened, or

b. The two companies, insolvent debtor and creditor, must have belonged to the same group of companies at the time the latter's claim against the former came into existence.

The difference between one and the other approach and the potential hazards for creditors are obvious. Loan structures with security packages comprising debtor company share pledges would, if the pledge is enforced and the shares appropriated by the secured lenders prior to the opening of insolvency proceedings, automatically trigger the subordination described in article 93(2)(3) if the relevant time is construed as per a. above.

Similarly, the option depicted in a. has generated a great deal of legal uncertainty in situations, such as the one being judged in the proceedings that culminated with this judgement of the Spanish Supreme Court, where a lender, after making a loan to the insolvent debtor, merges with or absorbs another external entity with indirect control over the debtor (such debtor becoming a group company of the lender as a consequence of the merger/absorption).

In the current version of the LC, the relevant time for the purposes of other grounds of subordination such as with regard to direct and indirect shareholders[2],

[1] Ley 22/2003, de 9 de julio.

[2] Article 93(2)(1) LC pursuant to Royal Decree Law 3/2009 of 27 March, only considers as a related party for the purposes of subordination "*The shareholders that* […] at the time their claim [against the insolvent debtor] *arose, directly or indirectly held at least 5% of the insolvent debtor's share capital where the latter had issued securities admitted to trading on a regulated ('official') secondary market, or 10% if it had not* [issued such securities]."

is clearly set at the time the claim arose. In this respect, article 93(2) provides that the subordination tainting direct and indirect shareholders only applies to those holding, directly or indirectly, some specific percentage in the share capital of the insolvent debtor at the time their claim came into existence. This clarification was only introduced in the amendments to the LC made in 2009, but for some reason it was restricted to the rule of subordination based on direct and indirect shareholdings and did not capture the subordination asserted in connection with companies belonging to the same group of companies as the insolvent debtor.

The main argument used by those supporting option a. was, in the words of the judgement of the regional court whose judgement was overturned by this judgement of the Spanish Supreme Court, that "*what is decisive for the subordination of a claim, as per the literality of article 93(2)(3) of the Insolvency Act, is the existence of this situation* [both companies belonging to the same group of companies] *at the time of the opening of insolvency proceedings, as this constitutes a privileged situation that allows access to financial information on the insolvent debtor and the potential use of that information in the context of the insolvency proceedings*".

Against the criteria used by the Regional Insolvency Court, the Supreme Court concludes that the relevant time to be considered while using the subordination rule contained in article 93(2)(3) LC should be the same as the one used in article 93(2)(1), i.e. the circumstances prevailing at the time the transaction under review is entered into. What taints the creditor's claim with the subordination provided in article 93(2)(3) is the condition of the creditor as an insider of the debtor at the time the contract is entered into and not the circumstances concurring with the opening of the insolvency proceedings.

The Supreme Court contends that this subordination rule is ancillary to other insolvency provisions such as that contained in article 71(3) LC and therefore the same relevant time ought to be used. Article 71(3) provides a presumption that all transactions for consideration entered into by the insolvent debtor with related parties within the two-year period preceding the opening of insolvency proceedings are detrimental to the insolvent estate[3]. The Supreme Court rightfully concludes that the same rationale is embedded in both provisions. In this case, the presumption that a particular transaction entered into with a related party is detrimental to the insolvent estate stems from the links between the parties to the transaction at the time the contract is entered into, without regard to what may subsequently occur. Similarly, in the case of companies that belong to the same group of companies, these circumstances may trigger the subordination under article 93(2)(3) LC if they apply at the time the contract, under which the claim arises, is entered into. Whether or not this situation persists when the debtor enters insolvency proceedings should be irrelevant for these purposes.

[3] Article 71(3) provides that "unless evidence to the contrary is provided, detriment to the insolvent estate shall be presumed in the following cases: 1) acts of disposal for consideration with related parties […]"