Avoidance of pre-insolvency overcollateralisation?

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1. Overcollateralisation under Spanish legislation

(1) Our legislation prohibits (as unconscionable) clauses that, while not negotiated with consumers, require "collateral disproportionate to the risk assumed" (art. 88(1) of the Spanish Consumer and User Protection Act). Note that this rule has not been the subject of any case law development and that the clause that paradoxically could yield to art. 88(1) – namely, the punitive withholding of payments made by the buyer of property under a contract subsequently terminated by reason of the buyer's default – has been clearly (and recklessly) deemed lawful by the **Supreme Court's judgment of 15 April 2014**.

(2) It is worth noting that overcollateralisation, provided such has been effectively negotiated by the parties and are not pre-arranged standard terms introduced by either one of such parties, is not deemed unconscionable even in consumer contracts. At the very least, the same must apply to company contracts, where, moreover, collateral packages are ordinarily negotiated on a case-by-case basis and the different negotiated collateral does not, except in marginal cases, constitute the content of a provision included in advance within a contract's clauses. In other words, if you take, for instance, a pledge of receivables agreed in a separate contract, such pledge is not a "clause" of the debt master agreement providing for the granting of different collateral, including the aforementioned pledge.

2. Factual elements and the doctrine of the Supreme Court's judgment of 17 February 2015

(3) Although the factual elements in dispute ending up in the court of last resort are substantially complex – although unstated, there are relatively simulated transactional structures that offset each other – the **Supreme Court's judgment of 17 February 2015** (reporting judge: Sastre Papiol) is extremely interesting as it is the first time that overcollateralisation is questioned at a judicial venue, all the more significant when the debtor's insolvency administrators seek to base the claim for avoidance under art. 71 of the Spanish Insolvency Act (IA) on such overcollateralisation.

(4) The transaction under judgment at the Supreme Court is rather confusing due to the seemingly illogical situation that the bank discounting the promissory notes is, at the same time, the surety of the same, the assignee of the note and the pledgee of the discounted paper credit. Nonetheless, this matter will be left aside in this memo. The Supreme Court judgment was of the opinion that the pledge of the discount did not have a negative impact on the debtor's assets upon insolvency. The relevant part of the transaction, however, refers to the 1.8 million euros "withheld" from the bank and pledged as security for the interest that the loan should yield. Here again, the transaction is somewhat confusing. The bank chose to advance the amount of "discount" as a loan (6 million euros) because the discount transaction would entail an excessive cost for the debtor (discount interest is earned in one go). To

secure the interest under the transaction, 30% of the borrowed amount is pledged, and this is where the ghost of overcollateralisation appears.

(5) According to the judgment, this pledge of part of the money borrowed constitutes overcollateralisation and, in short, is prejudicial to the interests of the insolvency proceedings:

> "We are not saying that it is not possible to take collateral for a financing transaction, only not where such feeds itself entirely from the liquid amount of an advance payment transaction [...]. The end result was that a significant portion (30%) of the principal was made unavailable to the borrower, as if dealing with a discount transaction."

Further:

> "... Security over the total interest taken exclusively from the principal of the transaction is contrary to art. 1258 of the Civil Code [...]. It is contrary to the nature of the loan transaction that much of the amount should serve to secure the interest that may accrue from the transaction, essentially altering the risk-sharing arrangement under such type of transactions".

(6) The terms of the court's decision must be clear in our mind. It is not that the granting of overcollateralisation entails a detriment to the insolvent's assets within the meaning of art. 71 IA, but that granting a loan of a certain amount and withholding some or much (?) of the same by way of a pledge as security for the interest of said loan is contrary to good faith. Note that if the bank had taken a pledge of 1.8 million euros on deposit in *another account* other than the loan's account, the judgment's blame would not arise, because the transaction would not be inconsistent with the nature of a loan transaction. Note also that the "overcollateralisation prejudicial to the assets upon insolvency" [sic] occurs, in the opinion of the Supreme Court, for the reason already explained, and not because the bank loan was *generally* overcollateralised by having a pledge of money plus a pledge or endorsement of the "discounted" promissory notes.

(7) However, we cannot leave the matter here, because it is very likely that the concepts of "excessiveness" and "overcollateralisation" are not the same in the Supreme Court as those used at the first instance court ("excessive collateral") and by the *Audiencia Provincial* court ("excess of collateral").

3. What is overcollateralisation?

(8) Overcollateralisation can occur for any of three reasons:

a) Because for the security of claims a number of items of property are charged, be it as components of single collateral (e.g. extension of the mortgage to the property belongings), be it as objects of separate collateral, provided that the sum of the value of charged property *exceeds by far* the loan amount.

b) Because the value of the only property charged by the single security is disproportionately greater than the secured loan amount.

c) Because the parties have created as a penalty clause a second-degree obligation, which is in turn secured by way of a charge *in rem*, and the penalty clause is excessive when compared with the foreseeable damage.

Common to all three cases is the characteristic element of *excessive cover*. In the following paragraphs I will only consider the first hypothesis, being the most striking. The conclusions reached will apply equally to the second. The third is conditioned by the interpretation of art.1154 of the Civil Code (adjustment of excessive penalty clauses) and is unrelated to this analysis.

4. *Ex ante* and *ex post* overcollateralisation

(9) A claim may be overcollateralised *ex ante*, but cannot remain so when the security is eventually enforced. Clearly, the creditor may only recover from each item, at most, up to the amount of the claim. If the amount of liability of each set of collateral is less than the amount of claim, the creditor may proceed against each charged asset up to full recovery of the claim. Consequently, no preferential creditor is overcollateralised *ex post*, nor, therefore, is blamable for enriching himself at the expense of the insolvent's assets. It may be that, because of procedural or contractual rules, the creditor ends up awarding himself the property as repayment of the debt for an

amount (much) lower than the actual value of the asset; but this can occur with or without overcollateralisation and in any case would deserve separate insolvency treatment because for the purposes of art. 71 IA the enforcement of security may have led to unjust enrichment of the distrainer. Note that this danger is not present in the pledge of claims or security over cash accounts.

(10) But what provides *ex ante* overcollateralisation? First, the preferential creditor minimises his risk of a claim shortfall not covered by the security, for which he would join the class of junior unsecured creditors (art 90.3 IA); and will minimise it all the more the more numerous or more valuable the assets charged with the payment of the claim are. Second, the creditor obtains the additional advantage of being able to choose between one route and another to recover in the insolvency proceedings; he will choose, for example, the enforcement of a pledge of money, which lacks enforcement costs comparable to those of a mortgage and is not subject to the vexatious procedure under art. 155(4) IA. Or he will choose the enforcement of financial security under Royal Decree-Act 5/2005 when art. 5 bis (4) or art. 56 IA impose a payment deferral in respect of ordinary security.

(11) Let us now consider the provisions of art.155 IA. Despite the heading of the provision, this is not a special rule limited to payment in settlement of first-priority secured claims. Art. 155(2) is obviously a rule that presupposes a moment before liquidation. The same applies to sub-articles 3 and 4. In fact, art. 155 is the only rule governing the modus operandi of the insolvency administrators regarding charged assets. Let us assume now that the claim in question is covered by a number of security interests and the "collateral value" of each charged property is hypothetically sufficient to cover the claim plus post-insolvency interest. The powers and options of the insolvency administrators would not be compromised. If the repayment option under art. 155(2) is made use of and covers the claim, it is clear that all security will be canceled. The same applies if the property is disposed of in accordance with art. 1499(1)(3) or art. 155(4), as the package of security will expire when (and only if) the claim is paid in full.

(12) So far I think it cannot be disputed that neither the insolvency administrators nor the creditors payable on distribution upon insolvency have a legitimate claim that the preferential creditor's claim is *as little as possible secured "ex ante"*. Nor would the interest of someone in the value of the security being the smallest possible so as to drag the preferential creditor into the list of junior unsecured creditors be legitimate.

5. Disposal of the asset with the lien subsisting

(13) However, it can be speculated with a problem when the secured asset (a secured asset) is sold to a third party with subsistence of the lien and subrogation to the debt (arts. 149(1)(3)(b) and 155(3) IA). Under the applicable rules, the claim would be excluded from the estate and would be left out of the insolvency proceedings. This subsisting security would not be extinguished by virtue of the order approving the auction referred to under art. 149(3). But what about the rest of the security charging assets that have not been left out (perhaps) from the insolvency proceedings? Will these respond as a sort of security for third-party debt? I do not think so. The issue must be resolved in simpler terms. The claim in question remains in the estate and it is the acquirer who responds as third-party holder or guarantor (perhaps too "*in personam*") for third-party debt. There is no real detriment to the insolvent estate, if the creditor chooses precisely to enforce the security that has been left out of the insolvency proceedings and such payment shall extinguish all the claim and, if the insolvency proceedings must face payment with the remaining security, he will have available an action for recovery against the acquirer if the internal assumption of debt (or assumption of fulfillment) has been agreed for the purpose of reducing the price. What does not make sense – to the extent of imposing on the creditor a "disproportionate sacrifice" – is to compel the creditor (who perhaps has not consented to the sale with subrogation) to be satisfied with the security that is perhaps worth least.

6. Overcollateralisation and insolvency prejudice

(14) Therefore there is no detriment to insolvent estate simply because a creditor in insolvency proceedings is overcollateralised. That is to say, overcollateralisation as such is no more harmful to the insolvency proceedings than

ordinary security. The prejudice can be found, however, in the conditions under which the security as a whole was granted or, as I said before, by an award in kind that is unbalanced in terms of comparative values. Let us imagine that we are faced with security that severely chains the debtor, which is not in a position to operate on any free and clear way. The situation is not specific to overcollateralisation. Even a single security interest in an asset that may be subject to insolvency proceedings (e.g., security over all of the debtor's accounts and deposits of money, with a prohibition on disposals) can succumb to art. 71 IA. Now let us imagine instead global security as absolute as a floating charge (similar example: art. 22 of the Chattel Mortgage and Pledge without Dispossession Act) where it has been agreed that the debtor may, however, dispose of assets and have others subrogate to them in the ordinary course of business; this pact would eliminate the perverse part of the transaction and would allow the debtor to enjoy a margin of transactional autonomy. This problem certainly requires very delicate treatment, but also reveals itself as an issue alien to the phenomenon of overcollateralisation, so we shall not delve any deeper therein.

7. Overcollateralisation and the "value of security"

(15) I move on to consider now whether the process and basis of the system for calculating the value of security, under art. 94(5) IA (latest version amended by Royal Decree-Act 1/2015), forces us to reconsider the proposed conclusion. According to the aforementioned rule, the report of the insolvency administrators will "express" the value of security. For its determination, from nine-tenths of the fair value of the charged property or right, the outstanding debts that enjoy security payable in priority over such property must be deducted, "but under no circumstances can the value of the security be less than zero or greater than the claim value or the value of the maximum of liability that has been agreed." The rule then determines which is the fair value based on each class of property and envisages security in favour of the same creditor resting on different property, in which case "the result of applying over each item of property the rule in the first sub-article of this article will be added, without the combined value of the security being able to exceed either the claim value of the relevant creditor."

(16) It is very likely that the final quoted text does not refer to the concurrence of independent security rights on various assets but to individual security rights that rest on different property, if the law does not impose a division of claims and, consequently, a split of the security. However, as the difference does not seem relevant here, I will work with the hypothesis that this provision also includes the concurrence of independent security rights over different assets.

(17) According to the considered rule, the values of each security shall be "added", but the "joint value" of these cannot exceed the value of the claim. If, for example, the amount of the secured claim is 100, the fair value (having deducted 1/10) of the charged property A is 110 and of the charged property B is (having deducted 1/10) 70, the "joint value of security" may not exceed 100, according to the text of the rule. But this is incorrect. Clearly, the joint value of collateral is 180, because that value is a fact that cannot be denied by any legislative fiction; however, the claim only appears on the list as payable in priority (preferential) for 100. This, moreover, is evident. No claim can be recognised as payable in priority by an amount greater than the amount of such claim.

(18) Note then that the legal provision does not itself lay down any rules on security, its value or its treatment in the insolvency proceedings. The rule is only interested in the rank of priority enjoyed by the claim because the rank will determine the voting power within the relevant class of preferential creditors and eventual immunity against agreements reached by the mass of ordinary creditors. The value of security will also serve to fix the amount of payment in the liquidation hypothesis under art. 149(1)(3)(a). This rule states that "if the price to be received falls below the value of the security, calculated as provided in art. 94, it will be necessary [...]". We are faced again with a *quid pro quo*, and what is meant is a hypothesis where the liquidation payment of a productive unit does not serve to cover the claim value that remains payable in priority under art. 94(5). It is not the value of the security that must be reached or not, but the value of the claim as a priority claim based on what was the value of the security.

(19) Consequently, the procedure and rules for calculating the value of security presently have limited effects. Namely, if the claim is recognised in full as payable in priority, it can no longer be recognised as *more preferential* despite the existence of additional security. But until the ceiling of 100% is reached, all security is added. Beyond the ceiling, the surplus value of security is, logically, irrelevant to the calculation of the priority. Note then that the overcollateralisation is effective in determining the value of the priority, at least when no security interest alone suffices to cover with priority all the claim.

(20) As provided in art. 94(5), things may have substantially changed between the report of the insolvency administrators and the relevant moment when the distribution must be voted on or carried out. If the insolvency administrators or the insolvency judge are of the opinion that - at the cost of the estate - a revaluation is appropriate, and if the ceiling value of the security has fallen below the claim´s ceiling value, in this case *the value of all available security would have to be added once again* to, where appropriate, reconstitute the priority to 100% of the claim. And the creditor would be entitled to apply for this recalculation, using the reserve fund of assets whereof the values have not been taken into account (because the "glass of priority" was already filled to the brim of 100%) in the first valuation.

(21) The existence of overcollateralisation is also irrelevant outside the contingencies for which the procedure of security value is operative. If the right holder enforces the security separately, under the terms of arts. 56 and 57 IA, and there is a shortfall, there can be no question that the balance can be paid over other security interest held until full satisfaction, if any, is achieved (cf. by analogy art. 161(1)).

(22) Different, due to the nature of the factual elements, is the hypothesis under art. 149.1(3)(a). The price obtained by the liquidation sale of a productive unit should be allocated to the priority payment of preferential creditors up to the amount of priority. The question is whether a creditor with first-priority security over an asset included in the productive unit must or not settle for the insolvency administrators allocating to him in payment less than the value of the priority amount, arguing that, being such creditor the holder of other security outside the productive unit, he may well cover the shortfall with such outside security and leave excess from the sale of the productive unit for payment of the other junior secured creditors. The question is not trivial. It was already raised and discussed in the *Ius Commune* with regard to the creditor who enjoyed both a priority general mortgage (along with several other creditors) and a special mortgage, and has been the subject of extensive literature in English *Equity* in respect of the institution known as *marshalling*. In both traditions it is held that our creditor has to find in his "special mortgage" redress of the shortfall generated in the procedure under art. 149(1)(3)(a). In my opinion, this proposal is not acceptable, not least because it runs counter to the interests of junior unsecured creditors and favours junior secured creditors regarding assets integrated in the productive unit. But be that as it may, the fact is that this reductive interpretation of the rule would not be specific to overcollateralisation and could arise in the context of different security rights the "values" of which together do not exceed (perhaps not even reach) the total claim.

8. Conclusion

(23) Consequently, overcollateralisation is not a special insolvency issue, neither under art. 94(5) nor for the purposes of avoidance under art. 71 IA. Another thing is how the debtor keeps a level of autonomy to dispose of assets that, at least in the composition with creditors stage, are attached to the continuity of the company. There is also the possibility (in respect of all security) of a challenge at insolvency proceedings against an award in kind that has in fact enriched the creditor above the value of his outstanding claim. Another thing, too, is whether the creditor may retain as a pledge a substantial part of the assets to be supplied to the debtor as available loan. The latter is to what the Supreme Court has given a reply in the negative. The question remains whether this is an absolute impossibility or is limited to a ceiling value of assets proven.