Insolvency Reform of RD Act 4/2014 concerning the liability on insolvency for a shortfall (Art. 172 Bis IA)

Daniel Irigoyen Fujiwara
Consultant, Gómez- Acebo & Pombo
Barcelona Commercial Court Judge, on leave

Art. 172 IA determines the pronouncements the at-fault classification ruling must contain, judicial pronouncements that constitute true civil penalties.[1]

Thus, after classifying the insolvency proceedings as at-fault, the people affected by the classification and the accomplices, on whom the orders will fall, have to be determined. Then, arts. 172 and 172 bis IA establish that the judgment must order:

— the disqualification from managing other people's property,

— the loss of creditor rights,

— the return of property,

— damages,

— redress, in full or in part, of the shortfall (liability on insolvency).

What is the difference between the damages under art. 172(2)(3) IA and the liability on insolvency under 172 bis IA?

1. A minority view was that of the *Audiencia Provincial* of Barcelona no.15, which argued that the liability on insolvency under art.172 bis IA is a liability for intent and negligence which indeed shared the same compensatory nature of the liability under art. 172(2)(3) IA. In both cases the director who has knowingly or recklessly brought about or aggravated the insolvency will be found liable, and the extent of the compensation will be calculated in accordance with his degree of involvement or role (i.e., causality) in such insolvency.

2. To differentiate them and avoid the nonsensicality of the legislature doubly criminalising the same liability, the Court, resorting to a restrictive interpretation of the adverbial phrase "*as well as to compensate for any damage or loss caused*" under art. 172(2)(3) IA, in fine argued that this liability was linked to the case previously described in the precept: the order to return the property or rights wrongfully received out of the debtor's assets or pool of assets[2]. Consequently, another class of acts other than improperly obtaining property and causing damage and loss should be claimed through the channel of liability on insolvency under art. 172 bis IA.

3. The response of most other *Audiencias Provinciales* (AP of Madrid, Huesca, Leon,

[1] *Explanatory Note VIII to the IA states that "The effects of the classification are limited to the civil sphere, neither spreading to the sentence nor constituting a criminal matter for preliminary ruling in order to prosecute conduct that could constitute a an offence. The law clearly keeps unlawful civil and criminal acts apart in this matter".* In the same direction, art. 163 IA.

[2] Judgment of the AP of BCN no. 15 of 29 November 2007: "*The damages to be ordered from those found affected by the classification and/or accomplices is linked to the referred restitutionary order such as, for example, the devaluation on account of the use made and time elapsed in respect of the property or rights to be recovered or the impossibility of verifying said return inasmuch as the property has perished, gone to bona fide third parties or benefits from irreclaimability or registry protection*"

Pontevedra, Cordoba, Guipuzcoa, Caceres, Murcia, Granada, Balearic Islands...) differed, such courts considering that the liability on insolvency under art. 172 bis IA was a kind of objective liability - penalty, devoid of any inculpatory element in the production of the insolvency. Following this reasoning, if the conditions of art. 172 bis IA were met (opening of the liquidation stage, at-fault classification and existence of a shortfall), the director's conduct was sanctioned and ordered to meet all or part of the shortfall[3].

With this reasoning, the phrase "*as well as to compensate for any damage or loss caused*" of art. 172(2)(3) IA was given a broad and independent interpretation, without linking such to the prior order to return property wrongfully obtained. Such liability would always lie provided the causal relationship between any case of damage or loss and the conduct of the person affected by the at-fault classification or accomplice was proven.

4. In short, the difference between the two lines of reasoning rested on whether or not the court should order redress of the shortfall on insolvency.

5. At this point, the reform of Act 38/11 did not dispel doubts regarding the legal nature of the liability on insolvency and it was the Supreme Court (SC) which ended up shaping the case law on this matter[4], doctrine that RDL 4/2014 has challenged with the new wording of art. 172 bis IA.

The heretofore peaceful case law of the SC concerning liability on insolvency

6. The SC[5] has stated that:

   (i) By exclusion, the liability on insolvency for the shortfall under art. 172 bis IA is not conceptualised as a penalty.

   Therefore, the SC attributes to this source of liability a compensatory or reparatory nature with respect to "*the damage indirectly caused to the creditors (...) to an extent equivalent to the amount of the claims they do not receive in the liquidation of the pool of assets*"[6]. In short, this liability has a "role in protecting the interests of the company's creditors", not a sanctioning or punitive role.

   (ii) By exclusion, nor is it compensation for the damage resulting from knowingly or recklessly bringing about or aggravating the insolvency. This kind of liability must be claimed under article 172(2)(3) IA, providing evidence of the classic action/omission, damage (identified with the damage or loss from "bringing about or aggravating" the insolvency) and causation.

   (iii) The liability on insolvency for the shortfall under art. 172 bis is a liability for another person's debt. Strictly speaking, the debt is of the insolvent legal person

[3] In the same way as with the liability of the directors under the Spanish Companies Act (CA), this reasoning meant allowing certain nuances to adjust or even release from the liability on insolvency. Hence, an automatic imputation was not always imposed, requiring instead subjective imputation, a review of personal involvement to support the penalty and the proportion of liability.

[4] SC Judgments of 23 February, 12 September, 6 October, 17 November 2011, 21 March, 26 April, 21 May, 20 June, 16 and 19 July 2012, 28 February 2013.

[5] SC Judgment of 16 July 2012.

[6] SC Judgment of 6 October 2011.

and the person affected by the at-fault classification is required to take it on[7] in the event of opening of the liquidation stage[8] and non-satisfaction, in whole or in part, of the creditors' claims[9].

7. If these requirements are met, the Judge "*may*" order redress, in full or in part, of the shortfall.

   This "*may*" raised the question of which is the imputation criterion, which is not at all clear in the legal text and which the SC resolved by attributing to the Judge a wide discretionary freedom in the making of orders and determination of the quantum[10].

8. Because of the obligation to reason judgments (art. 120(3) of the Spanish Constitution), the SC required, in its exercise of discretionary powers, an "*added justification*" to make an order to meet the shortfall. That is, the reasons behind the determination should be clarified.

   The SC defined this "*added justification*" cryptically stating that "*the Judge must assess, in accordance with regulatory criteria and in order to substantiate the necessary reproval, the different objective and subjective elements of the conduct of each of the directors in relation to the acts that, attributed to the governing body with which they are identified or of which they form part, had determined the at-fault classification of the insolvency proceedings*"[11].

   In short, according to the case law of the SC, art. 172 bis IA did not require causation between the (wilful, negligent or without fault) conduct and the creation or aggravation of the insolvency of the company subject to insolvency proceedings[12].

9. The above doctrine is being applied and developed by the courts of law.

   For example , the AP no. 15 of Barcelona, with the strength of the convert, essentially states that the liability's reparatory role does not refer to direct damage but to something different, the "*damage that was indirectly caused to the creditors*"(...); "*one might say that this amounts to not requiring evidence, not even the existence of causation between the quantum of the penalty and the fact determining the declaration of at-fault insolvency proceedings.*" Said court recognises

---

[7] The affected persons may be "all or some of the directors, liquidators, de jure or de facto, or general attorneys-in-fact of the legal person subject to insolvency proceedings" and now also, by virtue of the reform of RDL 4/2014, "shareholders who have rejected without good cause the capitalisation of claims or issuance of securities or convertible instruments, thereby frustrating the attainment of a refinancing agreement under article 71 bis (1) or the fourth additional provision".

[8] There will be no liability for the defaulting insolvent company if the at-fault classification is made within insolvency proceedings concluded by a composition with creditors, even if such is extremely burdensome (art. 167(1) IA).

[9] Be they creditors in insolvency proceedings or against the pool of assets.

[10] SC Judgment of 16 July 2012: "The nature of the liability for another's debt is not obscured by the broad discretion that the rule attributes to the Judge in respect of making an order and determining the quantitative reach of such order – something unthinkable given the damage and loss all the accused must be held accountable for – which, however, raises the question as to what are the factors the Adjudicator should take into consideration (...) ".

[11] SC Judgment of 28 February 2013 and those it refers to.

[12] In numerous judgments, the SC denies the plea of respondents ordered to meet the shortfall on insolvency that the Audiencia (which applied the sanctioning reasoning) should have justified or reasoned the causation between the behaviour of the director and the creation or aggravation of the insolvency. The Judgment of the SC of 19 July 2012 states in a case where it applied a presumption of art. 164(2) IA (accounting irregularities) that: "We have stated in the above situations that, given the relationship between the provision of article 172(3) and those serving as precedent, conditioning the order against the director on the concurrence of a requirement that is not needed for the class of offence leading to the at-fault classification of the insolvency proceedings does not conform either to the necessary respect to judicial discretion the aforementioned provision recognises or to the systematic canon or hermeneutical integrity imposed by the mutual illumination of the concerned provisions."

that it is the judge who in each case specifies the sum and at the same time indicates the criterion of imputation he must serve himself of: as art. 172 bis IA is a rule of distribution or allocation of risks – just as corporate liability for company debts under art. 367 CA - "*There is objective imputation between the behaviour determining the at-fault classification and non-payment of company debts*". However, the court recognises that facts may be ascertained that make it possible to exclude or reduce said objective imputation. Therefore, the judgment determining the quantum must take into account all the facts and circumstances relevant in each case to impute the aggravation of the insolvency and not just, in causation terms, the behaviour in relation to the at-fault creation/aggravation of the insolvency. The court specifies that *"it involves judging to what extent the shortfall is attributable to the directors, for which all the facts associated to the at-fault insolvency proceedings declaration must be taken into account, both jointly and individually"*[13].

Elsewhere (Oviedo), a distinction is drawn between the criminalised acts according to their abstract, not specific, gravity. For example, keeping a double set of books, serious inaccuracy or misrepresentation in the documentary evidence submitted in the insolvency proceedings, asset stripping, acts which delay, hinder or impede the levying of an execution against property, fraudulent trading or sham transaction, the penalty should be set between 75% and 100% of the shortfall. In a second group of conduct, such as a material breach of the book-keeping obligation, relevant accounting irregularity, opening of the liquidation stage due to a breach of the composition with creditors or breach of duties related to the annual accounts, the redress ordered would be between 30% and 75%. Finally, the penalty would not exceed 30% of the shortfall, in cases of breach of duty to petition for the opening of insolvency proceedings, breach of duty to cooperate and inform and non-attendance at the meeting of creditors.

10. With this doctrine consisting in not limiting judicial discretion in ordering the redress of the shortfall to causation between the conduct of the person found guilty and the creation or aggravation of insolvency has caused considerable legal uncertainty and concern for litigants, who do not know for sure what to expect in order to avoid such costly and serious liability.

The reform in this area operated by RD Act 4/2014

11. Now, amongst the profound reforms made to the Insolvency Act with the enactment of RD Act 4/2014, there is one that merits special attention because of the enormous practical importance it will have for the liability of persons affected by the at-fault classification of liquidating insolvency proceedings and with an outcome where the creditors' claims have not been fully satisfied (shortfall on insolvency).

    Leaving aside the novelty that those "who have rejected without good cause the capitalisation of claims or issuance of securities or convertible instruments, thereby frustrating the attainment of a refinancing agreement under article 71 bis (1) or the fourth additional provision" (art. 165(4), art. 172 bis and art. 172(2)(1) IA) will be persons affected by the at-fault declaration, RD Act 4/2014 has given a new wording to art. 172 bis (1) that has introduced a parameter to determine the liability for a shortfall on insolvency. Now the penalty ordering full or partial redress of the shortfall must be *"to the extent that the conduct that determined the at-fault classification created or aggravated the insolvency"*.

    With this guideline, in order to avoid legal uncertainty , the legislator reacts against the SC's case law on this matter and rejects judicial discretion where ordering or not redress, prescribing that the judgment of liability must proceed in accordance with the terms expressed by the dissenting judge in the SC Judgment of 21 May 2012: "the criterion for imputation of liability would be determined by the influence that the conduct of the administrator or liquidator, deserving of the at-fault classification of the insolvency proceedings, has had in bringing about or aggravating the insolvency. Depending on the greater or lesser extent he has contributed to this creation or aggravation

[13] Judgment of the AP of BCN no. 15 of 23 April 2012.

of the insolvency, such should be the extent to which he should be held accountable, which ordinarily will be reflected in the order to pay a percentage of the shortfall on insolvency: if fully responsible for bringing about the insolvency, he shall be liable to pay all the shortfall on insolvency; if responsible for having contributed to the creation or aggravation of the insolvency, such influence should be estimated."

For any queries on the above please contact any of the following members of Gómez-Acebo & Pombo:

Verónica Romaní Sancho
Partner, Madrid
Tel.: (34) 91 582 91 00
vromani@gomezacebo-pombo.com

María José Paz-Ares Rodríguez
Partner, Madrid
Tel.: (34) 91 582 91 00
mjpazares@gomezacebo-pombo.com