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Avoidance of security perfected in compliance with previous undertakings (promise to grant security)

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It is known to everyone operating in the Spanish restructuring market that taking security to secure pre-existing indebtedness of a particular borrower is not a risk-free matter.

The risk associated with security arrangements for a debtor's pre-existing indebtedness stems from art. 71(3)(2) of the Spanish Insolvency Act (abbrev. LC) that presumes that these kinds of arrangements are detrimental to the insolvent's estate and therefore, unless evidence is provided to the contrary, will be avoided by the insolvency practitioner if concluded in the two-year period preceding the opening of insolvency proceedings[1].

This avoidance or clawback rule is solely based on detriment and disregards the intention of the parties to the particular transaction.

It is precisely this presumption that has generated some unrest among lenders that are beneficiaries of undertakings of the borrower to grant security subject to certain conditions (i.e. achievement of minimum financial ratios, occurrence of events of default, commissioning of assets built or acquired with the proceeds of loans, entering into certain contracts not yet executed at the time the loan is made).

The definition of "detriment" has been the subject of a number of interpretations, some more restrictive than others. The prevailing interpretation current among Spanish insolvency courts is that not only a reduction of the insolvent's assets should be analysed against the rules on detriment (restrictive interpretation), but also any unjustified action for the benefit of a creditor that diminishes the likelihood of satisfaction of third-party claims (broad interpretation). This broad interpretation seeks to ensure that all creditors are treated equally in the event of insolvency (*par condition creditorum*).

Obviously, without further examination of the context, any kind of security created *ex novo* for the benefit of a particular creditor, regardless of whether such security was firmly committed to under some promissory arrangement at the time the loan was made, could easily fall under the above-mentioned broad definition of detriment and be subjected to the avoidance action (and presumption of detriment) set out in art. 71 LC.

Avoidance of a contract under art. 71 LC determines the recovery of the consideration given and received by both parties to the transaction. As a general rule, in the absence of bad faith, the avoidance claim of the counterparty to the transaction would be pre-deductible from the assets available for distribution (arts. 73(3) and 84(8) LC) and satisfaction of this claim shall take place simultaneously (and subject) to the recovery of the consideration received by such counterparty

[1] Art. 71(3) LC reads as follows:

"*3. In the absence of evidence to the contrary, detriment shall be presumed in the following cases:*

[…]

…2 Granting of security to secure either pre-existing obligations or new obligations undertaken in lieu of these [pre-existing obligations].

(art. 73(3)). Pursuant to this, the clawback of a loan made to an insolvent debtor would require reimbursement to the lender of the amounts drawn on by the borrower.

As an exception to this rule, the LC provides for subordination of a contractual counterparty to avoidance if the insolvency court finds that such counterparty acted in bad faith. The Spanish Supreme court has clarified in several judgements – among others, those dated 16.09.2010, 27.10.2010 and 26.10.2012 – that "bad faith" does not require "fraudulent intent" but only (i) awareness of the debtor's financial distress and of the fact that by entering into said transaction the interests of the remaining creditors would be jeopardized, together with (ii) morally reprehensible conduct on the part of the affected creditor.

Some judgments, such as that of the Valencia Companies Court of 14.07.2014, have introduced some additional disturbing elements for financial institutions in the context of the determination of bad faith that may trigger the subordination described above, holding that *"it cannot be denied that it is precisely the lender bank who is best informed of its clients' state of affairs"*.

Now, given this legal backdrop, it is not surprising that financing structures based on promises to grant security are looked on with utmost distrust and suspicion. Creditors should carefully consider the effective perfection of security previously committed to under specific undertakings of finance documents, specially in those cases where the debtor (promisor of the security) may be undergoing financial difficulties or precisely in circumstances where the trigger events for the perfection of the security so promised are the symptom of such financial distress.

In the case under review, the Murcia Court of First Instance had initially avoided a mortgage perfected in favour of BBVA. The court was of the opinion that a clawback should apply on the basis that the mortgage had been executed after the granting of the (secured) loan and therefore the presumption of the mortgage being detrimental to the insolvent's estate applied.

On appeal, the Murcia High Court of Justice reversed the aforementioned judgment, stating as follows:

1. **Firstly, in connection with the application of the presumption of detriment to a promise to grant security**

   The above presumption of detriment to the insolvent's estate is supposed to address situations of security arrangements autonomous or independent of the loan secured thereunder so that the security *"implies a sudden improvement of the pre-existing loan with respect to remaining creditors, as opposed to contextual security arrangements* [security perfected simultaneously to the granting of the loan] *where the loan is linked to the security and is granted on the basis of* [as consideration for] *such security*", without a sudden improvement of ranking occurring. In other words, if contextual security arrangements are onerous (the loan is made on the basis of the security being perfected) and therefore are not presumed to be detrimental to the insolvent's estate, non-contextual - non-simultaneous - security is presumed gratuitous (and therefore detrimental), unless other circumstances concur that imply an improvement of the borrower's position.

   In the case at hand, the court finds that the above reasoning cannot be automatically used as forcefully in cases where the security is just the consummation of a previous undertaking and that this structure responds (as is contended by some scholars) to a conditional security rather than a new or *ex novo* security. The court *ad quem* argues that the above is the reason why some scholars have stated that security perfected on the basis of a promise to perfect such security is in reality a contextual (simultaneous) security and therefore should not be encompassed by the above-mentioned presumption of detriment. The security is said to be directly connected with the granting of the loan at the outset of the transaction.

2. **Secondly, with respect to the existence of detriment**

   Even if the above reasoning is not conclusive, the presumption of detriment contained in article 71(3) LC admits evidence to the contrary (it is a rebuttable presumption): *"and there is one concurring circumstance that we understand destroys said presumption of detriment, such as*

the mortgage perfected in March 2013 being a due act [an obligation assumed by the borrower] *deriving from a transaction under which the borrower obtained financing and entered into on a date relatively remote from the date of opening of insolvency proceedings [...], without there being sufficient evidence that the bank was aware of such situation at the time of perfection"*.

3. **Thirdly, in respect of the effect of the avoidance and the potential subordination of the beneficiary of the security**

   The appellate court rejects the petition that the secured lender be subordinated on grounds of bad faith. The court refers to settled doctrine of the Spanish Supreme Court on this subject matter whereby the effects of termination of security arrangements are merely the cancellation of the security and not the mutual or reciprocal reimbursement of consideration between the lender and borrower. The court further states that it is hard to predicate bad faith [required to subordinate the secured lender] where the security is granted in compliance with a promise to perfect such security and that it would not even be sufficient to attempt such subordination that the secured lender was aware of the company's situation of distress.

The text enclosed in square brackets is ours.

It is obvious that the decision of certain lenders to not take security at the time of granting a loan has in many cases been to the advantage of the sponsors of projects by averting unnecessary tax bills associated with the perfection of mortgages on real estate assets. In many others, this process is the only way forward in connection with security to be taken on assets (infrastructures, receivables under contracts etc…) that did not exist at the time the loan was made or more specifically that required proceeds from the loan to exist. In any event, treating these cases exactly the same as others where there is a clear intention of a lender to gain unjustified priority over certain assets of a debtor in distress is completely unfair.

Although this matter is not yet definitively settled, we hope that this ruling will be used in the future as a benchmark to separate the wheat from the chaff when it comes to security granted after the making of a loan or will at least introduce some common sense in a topic that has so far generated great unrest among practitioners when dealing with promises to grant security in general and in particular when dealing with the perfection of security promised by debtors in distress.