G A _ P

Gómez-Acebo & Pombo

Subordination of intragroup claims

(Supreme Court Judgement, 15th March 2017)

Fermín Garbayo Renouard
Partner, GA_P

Article 92 of the Spanish Insolvency Act[1] (**SIA**) sets forth that claims held by related parties shall qualify as subordinated in the event of insolvency of the debtor.

Furthermore, article 93(2)(3) SIA includes in the list of a debtor's related parties, and therefore taints with subordination claims held by, among others: (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 of the same article[2].

Judgement no. 190/2017 has shed some light on the debate as regards the scope of (i) above (i.e. what is required for the subordination trigger in respect of group companies.)

A group of companies in the context of insolvency proceedings is defined under additional provision no. 6 SIA by reference to the definition of "group" contained in article 42(1) of the Spanish Code of Commerce:

[1] Ley 22/2003, as from the 9th of July

[2] Those 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).

"Article 42(1)

Controlling companies of corporate groups must draw up consolidated annual accounts and directors' reports in the manner provided in this section.

A group exists when a company has, or may have, directly or indirectly, control over one or several others. In particular, control will be presumed when a company, the controlling company, is in any of the following situations with respect to another company, the controlled company:

(a) It holds the majority of the voting rights;

(b) It has the power to appoint or remove the majority of the members of the governing body;

(c) It may dispose, by virtue of agreements entered into with third parties, of the majority of the voting rights;

(d) It has used its votes to appoint the majority of the members of the governing body who hold office at the moment when the consolidated accounts must be drawn up and during the two financial years immediately preceding. In particular, this will be presumed when the majority of the members of the governing body of the controlled company are members of the governing body or top management of the controlling company, or of another company controlled by it. In that event, consolidation will not arise if the company whose directors have been appointed is bound to another in any of the cases provided in the first two letters of this section."

For the purposes of this section, the voting rights of the controlling company shall be added to those it holds through other dependent companies, or through persons acting in their own name, but on account of the controlling company, or other dependent ones, or those with which it has made arrangements through any other person.

In the case at hand, company A held a claim against company B (insolvent). Both, Company A and Company B, were wholly owned subsidiaries of two companies under the control of the same individual.

Court of First Instance

In what is relevant for the purposes of this analysis, the Companies Court no. 3 of Barcelona, in charge of the insolvency proceedings of company B, had ruled that both Company A and Company B belonged to the same group of companies and therefore the claim of the former should rank as subordinated in the insolvency proceedings of the latter. The court contended that no other conclusion could be reached on the grounds that (i) the same individual held 65% and 79% of the companies holding 100% of the shares of the debtor and creditor, respectively, and consequently had all corporate means to pass any kind of resolution in both companies, that (ii) both companies

shared the same sole director and that (iii) the main officers of each of these companies had been given powers of attorney that allowed them to act indistinctly for and on behalf of one and the other.

All these factors persuaded the court that since there was unity of direction and clear control by the same ultimate shareholder, the subordination rule established in article 92(5) SIA by reference to 93(2)(3) was to apply. The court held that in order to predicate the subordination attached to intercompany claims as per the above there is no requirement that both companies are under a relationship of control among themselves. To the contrary, such a subordination rule should be used also in respect of companies under the same direct or indirect control (i.e. sister companies).

Court of Appeal

The Court of Appeal[3] overturned the decision of the court of first instance on grounds that the definition of *group of companies* contained in art. 42(1) of the Spanish Code of Commerce had been amended in 2007 to eliminate any and all references to the feature of *coordinated direction*. The court contended that the definition of *group of companies* contained in article 42(1) of the Spanish Code of Commerce had shifted in 2007 from the broader definition based on unity of direction to another one based on corporate control, meaning companies that have - or are in a position to have - control over others.

In fact, in 2007, all references contained in article 42(1) of the Spanish Code of Commerce to the requirement of *same or coordinated direction* had been eliminated from the definition of *group*.

The rule of subordination required, in the views of the Court of Appeal, the existence of a number of companies subject to the consolidation obligation provided for in article 42(1) of the Spanish Code of Commerce and could not be used in a case where such control is in the hands of a natural person who is not bound by the said consolidation obligation. Since additional provision no. 6 SIA referred to the definition of "group" contained in article 42(1) of the Spanish Code of Commerce, companies that were not under the consolidation obligation provided therein could not be affected by the subordination rule set forth in article 93(2)(3) SIA. This meant that horizontal groups or groups by coordination would be exempted from this subordination rule.

So, between the court of first instance and the Court of Appeal the controversy arose in connection with the fact that the ultimate controlling person of both companies involved in the insolvency proceedings (debtor and creditor) was a natural person as opposed to a legal person as seems to be required by the consolidation rule contained in article 42(1) of the Spanish Code of Commerce. In other words, whether company A and company B could be said to be part of the same group of companies and therefore be related parties for the purposes of the subordination rule contained in article 92(5) by reference to article 93(2)(3) SIA bearing in mind that the ultimate controlling shareholder was an individual.

[3] Provincial Insolvency Court of Barcelona (Fifteenth Chamber).

Conclusion reached by the Spanish Supreme Court

The Spanish Supreme Court has overturned the judgement of the Court of Appeal and has upheld the decision of the court of first instance by concluding that the subordination rule provided in article 92(5) by reference to article 93(2)(3) SIA should also be applied to the case at hand where a natural person is the indirect controlling shareholder of both the insolvent debtor and the creditor.

The conclusions reached by the Spanish Supreme Court are based on the following principles:

— Article 42(1) of the Spanish Code of Commerce contains a rule in respect of the obligation of legal persons to consolidate accounts with the companies with which they are in any of the situations depicted therein.

— The referral contained in Additional Provision no. 6 SIA to Article 42(1) of the Spanish Code of Commerce should be understood as a reference to the principle of control – be it current or potential, direct or indirect - embedded in the definition of *group* and "allows the exclusion, for insolvency purposes, of horizontal groups or groups by coordination, which before the amendment [of Article 42(1) of the Spanish Code of Commerce][4] also fell within the definition of corporate *group, for the purposes of* Article 42(1) of the Code of Commerce (and the subordination rule discussed herein).

— The emphasis now given in article 42(1) of the Spanish Code of Commerce to the principle of control does not require for the purposes of subordination in insolvency proceedings that the controlling company be directly involved in said proceedings. Two companies under the same control would be affected by the subordination rule irrespective of the fact that both are subsidiaries of another controlling company.

— In order to have a *group of companies* for insolvency purposes, the controlling person need not be a legal person with the legal obligation to draw up consolidated annual accounts and directors' reports. Article 42(1) of the Code of Commerce is located in a section devoted to accountancy and book record keeping obligations of legal persons and not in that relative to the rules applicable to legal persons in general and therefore there are parts of this article which (i) should only be considered in the context of the duties relative to the preparation of accounts and (ii) should be disregarded in the context of references made in other laws to this article to define what should qualify as a *group,* such as the one made in additional provision no. 6 SIA.

— As a consequence of the above, the first paragraph of Article 42(1) of the Code of Commerce only relates to the legal obligation of legal persons (controlling companies) that exercise control over a group of companies (controlled companies) to prepare consolidated annual accounts

[4] Carried out by means of Act 16/2007 dated 4 July 2007

and directors' reports. This obligation, as provided in article 42(1) of the Spanish Code of Commerce, does not apply to controlling persons that are natural persons even though these natural persons could choose to publish consolidated accounts (article 42(6) of the Spanish Commercial Code).

— It is only the second paragraph of Article 42(1) of the Code of Commerce that matters in respect of additional provision no. 6 SIA and henceforth the only one to be considered in the context of the subordination of claims in insolvency proceedings. If, the Spanish Supreme Court contends, there is control as defined in Article 42(1) of the Code of Commerce, it is irrelevant that in the apex of the *group* there is a legal person (under an obligation to consolidate accounts) or a natural person who is not under such an obligation.

— The protective goal of insolvency provisions, such as article 92(5) SIA, requires the application of the subordination rule contained therein not only in circumstances where the ultimate controlling shareholder is a legal person but also when it is a natural person. The possibility that (i) a creditor controlled by the same (legal or natural) person as its debtor having had access to inside information regarding the financial situation of the debtor, or having in some way influenced the debtor's business, or (ii) the financing made available to the said debtor attempting to alleviate the debtor's undercapitalization; exists also in the case at hand where a natural person indirectly controls both the creditor and debtor but there is no control relationship between one and the other.