

THE REFORM OF *LEY CONCURSAL* IN SPAIN – FOR BETTER OR WORSE?

AGUSTÍN BOU
SOCIO. DEPARTAMENTO DE DERECHO CONCURSAL
JAUSAS

Background

The reform of the Spanish Insolvency Act (*Ley Concursal* – hereinafter referred to as LC) carried out in September 2003 was a very relevant change because it finished off a legal system which had finally become obsolete. The modification of credit categories and its preferences was one of the most important elements of this reform. Subordinated credits, particularly, those held by individuals or legal entities specially related to debtor¹ appeared.

Likewise, when referred to graduation of credits, LC stipulated the character to be given to those granted with security from third party and it specially stated that those credits were to be qualified with “the qualification the least aggressive to the insolvency estate...”². The main purpose of this Article was to prevent credits related to debtor from avoiding subordinated qualification.

From the very beginning, the problem was set up in connection with guaranteed bank credits. From literal wording of Article 87.6 of LC it was deduced that all credits granted with guarantees from individuals or legal entities related to debtor were supposed to be qualified as subordinated credits, regardless of the execution of the security. Financial sector was really concern about this, given that it was supposed that credits granted by financial entities to companies involved in insolvency proceedings, in the event of securities from third related persons, were supposed to be qualified as subordinated credits putting the reliability of the financial system in serious risk.

The solution initially adopted

The main purpose of subordinating credits of specially related persons is to protect ordinary creditors. In fact, it involves application of German doctrine to Spanish law, as it considers that shareholders of a company under financial difficulties must contribute the necessary funds in order to achieve the normal business running of the company or proceed to its liquidation.

This Article makes sense insofar as shareholders of a company with financial difficulties, directly or indirectly, do grant loans instead of contributing these funds as these contributions should be considered as own resources as in the

¹ Article 92-5 LC in connection with Article 93 of LC

² Article 87.6 LC

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event of participative loans, given that shareholders and related persons do have a privileged knowledge on the status of the company and they may try to be covered from potential risks by means of putting the money through guaranteed loans, which are, in fact, hiding contributions that should be effectuated as share capital. Deep down, it is a way of trying to equalize to capital all those contributions coming from the environment of the debtor.

It is all construed under the principle stating that while ordinary creditors have a passive participation in the evolution and development of the crisis of the company, specially related persons do contribute directly to it; hence, they are expected to support a much higher risk.

The legislator did not take into consideration that several times financing granted to a company is not granted by its shareholders but by financial entities, which are completely unaware of the business running of the company as it occurs with any other third creditor.

The reviewed interpretation of Article 87.6 LC

The so-called “reviewed interpretation” of Article 87.6 LC was developed at this stage, because of the obvious impact that this rule might have on financial sector (limitation of credit and increase of interest rates). This interpretation has been reflected by several Court decisions during the last years.

On the basis of this analysis, subordination is only applied to those cases in which guarantors are subrogated in the position of main creditors. The modification of the qualification of the credit is delayed to the moment of the effective execution of the guarantee. We can find a relevant sample of this thesis in the judgment rendered by Section 15 of Provincial High Court of Barcelona, dated June 16th, 2006.

This Judgement states that the purpose of this Article is to prevent application of rules concerning qualification of credits from being avoided, under the protection of oblique means, as well as specially prevent guarantor as a related person to debtor from avoiding the qualification of his credit as subordinated, when subrogated in payment to main creditor.

Judgment of Commercial Court n. 4 of Barcelona, dated June 22nd, 2007

This reviewed interpretation was accepted so unanimously by Courts until nowadays. However, in the last months, some Court decisions have been rendered in the sense of the literal interpretation of Article 87.6 LC.

Two judgement of Commercial Court n. 4 of Barcelona, dated June 22nd and 25th, 2007 should be stressed at this point. Likewise, other Courts in Barcelona currently deal with some incidental questions on this matter which are still pending to be solved at this time as some receivers seem to be following the same point of view.

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The main criteria alleged by these judgments are the following:

- (i) Although funds contributed come from a third party, the effects are indeed the same as if they were funds contributed by the shareholder. In view of a lack of resources, the shareholder contributes third party's resources instead of contributing his own funds as he was duly expected to do.
- (ii) Crisis is unduly financed because of contribution of third party's resources instead of that of own funds, which causes a serious damage to creditors.
- (iii) Money is provided by a bank; however, given that it is guaranteed, it is like if it was contributed by guarantor.

- (iv) Actually, the Bank is financing the guarantor, given that, because of the guarantee requested, it is from the own guarantor that expects to recover the credit.
- (v) Bank is aware of privileged information because it has had the opportunity to check company's accounts. This fact has led the Bank to distrust and that is why it asks for a guarantee. Provided that the Bank gives financing to the company without any trust, it only extends the crisis and transfers all its consequences to ordinary creditors.
- (vi) Financial creditor, who, although having doubts on the company's solvency, has decided to borrow some money, should not be considered as an ordinary creditor, who does not know anything about the crisis of the company. A liability quotation in creating the crisis is directly assigned to the bank.
- (vii) If the bank wanted to be considered like the other ordinary creditors should have given the loan in equal conditions, it means, without the guarantee.

Judge interpretation in these cases is truly surprising, provided that it means in the practice requiring financial entities to be guardians of the solvency of companies and assigning them the liability of companies' crisis.

In the event that this criterion is followed from now on, the concept of "noisy withdrawal" that is required to advisors and auditors by the new rules of surveillance appeared after the Enron scandal, would be extended to financial entities, which, insofar when they have doubts on a company's solvency, they would be forced to refuse to grant the credit in order to prevent from the future negative consequences that might for them. It is really easy to think at this point that companies whose credits have been denied will not wait so much time to suit and claim against financial entities alleging that they are also liable of their crisis because of the refusal to grant them the credit needed.

Even more, reasoning of judgment involves assuming that, insofar as a bank requests a guarantee, it perfectly knows that the applying company is facing a crisis and actually the loan is granted in favour of the guarantor but not in favour

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of the company³. Indeed, the Judge considers that there is a fake business -the financing of the company- and a subjacent real one – the financing to the guarantor- and, consequently, the bank must pay the consequences of its bad business behaviour.

The judgment in practice is even more surprising, given that it considers that a company with financial difficulties should only be financed by means of its own resources; financing through third party's resources being assumed as a bad business practice.

It is foreseen and desirable for financial system's safety that this Court decision is entirely revoked in appeal and, at last, Courts' position before ordinary transactions of financial entities is set forth in accordance to real economic situation not transferring the mismanagement from Directors to banks.

³ Legal Ground 23: "...Thirdly, lender actually finances the guarantor..."