Subordinated Credits under the Spanish Insolvency Act

Banking and Capital Markets Department

1. Introduction

The Spanish Insolvency Act ("**SIA**") classifies credits into three main groups: privileged credits, ordinary credits and subordinated credits.

This note is aimed at discussing certain aspects related to subordinated credits, with special emphasize placed on those granted by insiders of the insolvent company (parties "specially related" to the debtor according to the SIA) and credits held by parties acting in bad faith.

2. Subordinated credits

The following credits will be considered subordinated according to the SIA (Section 92 of the SIA):

1) Credits included in the list of creditors made by the receivers but which were submitted late by the relevant creditor[1]. This is one of the measures contained in the SIA to encourage creditors to meet the deadlines contained in the law; indeed, late communication has as its primary consequence full subordination of the credit that was not communicated on time.

2) Credits characterised as subordinated to all other credits of the debtor according to the contractual arrangements agreed by the parties;

3) Credits for interest of any kind, including late interest, except for those secured by an *in rem* security up to the sum covered by the security;

4) Credits for fines and other monetary penalties;

5) Credits held by any of the parties "specially related" to the debtor (insiders);

6) Credits arising as a result of revocation actions, when the Court has declared that the counterparty of the debtor acted in bad faith;

7) Credits arising from contracts with reciprocal obligations which are kept in force or reinstated after the declaration of bankruptcy, if it is determined that the creditor has repeatedly hindered fulfilment of the contract against the insolvency interests.

2.1. Insiders

The SIA introduced the concept of "insider" (person or entity "specially related to the debtor" according to the SIA) to the Spanish insolvency regulations in order to identify entities or individuals who have a privileged position in terms of information about the debtor or influence on the decisions made by the debtor.

[1] Except for credits whose existence arises from the documentation of the debtor or any in any other manner recorded in the insolvency procedures, in which case subordination is not applicable.

The SIA defines the insiders according to two categories depending on whether the insolvent company is a natural person or a corporation.

The first group (when the debtor is a natural person) is based on family links: the debtor's spouse, relatives (ascendants, descendants and siblings) and the in-laws (spouses of those relatives previously mentioned).

Regarding the second group (cases in which the debtor is a company or corporation), the following qualify as insiders and therefore their credits will be considered subordinated in accordance with the SIA:

a) Shareholders who are liable for the company debts and shareholders who were holders, when the credit was granted, of at least 5% of the share capital of the debtor (in the case of listed companies) or 10% of the share capital (for non-listed companies).

   The above stakes in the company will determine subordination of the debt against the debtor only if the relevant stake was held from the beginning (when the credit was granted), not affecting those creditors who reached such level of participation at a later stage. However, it is important to note that if the company that acquires the trigger stake after granting the credit has performed administrative duties (either by appointing directors, by having "shadow" directors, or by falling into any of the circumstances foreseen in section b) below), the credit will be subordinated;

b) Directors (legally appointed or *de facto)*, liquidators and representatives with general powers of the debtor (as well as those who have acted as such during the 2 years preceding the declaration of insolvency).

c) Companies forming part of the same group as the insolvent company and their "common shareholders" (provided that the latter fulfil the requirements of section a) above). Reference of the SIA to the "common shareholders" (introduced in an amendment to the SIA published in 2011) is not totally clear and can be open to different interpretations. It would be reasonable to construe that the law intends to subordinate credits held by persons or entities that have a stake of 5% or 10% in all the companies belonging to the group except for the insolvent company. But a literal interpretation of the law would also accept cases such as companies having a 5% or 10% stake in at least 2 of the companies belonging to the group of the debtor.

In addition, assignees or awardees of credits held by persons or entities that are considered insiders according to the above rules are presumed to be insiders if the acquisition of the credit has been effected within the 2-year period prior to declaration of bankruptcy. In other words, the acquisition of credits from an insider will imply subordination even if the new creditor does not fall within the circumstances contemplated above. The SIA leaves an open window to challenge the subordination by stating that the presumption of insider admits evidence to the contrary. The discussion in this case is whether such evidence to the contrary can really amount to challenging the *ratio legis* (for instance, if the assignee did not have a privileged position that justifies the consideration of "insider") or if the challenge would only be limited to the qualification of the assignor as an insider or the compliance with the 2-year hardening period.

Finally, it is important to note that if the creditor classified as an insider does not challenge such ranking in a timely and correct manner, the Insolvency Court shall declare the guarantees of any kind granted in favor of such creditor extinguished.

2.2. Insolvency revocation and creditors acting in bad faith

Sections 71 to 73 of the SIA contemplate cases in which acts carried out by the debtor can be rescinded through the insolvency procedure. As a general rule, acts carried out by the debtor within the 2 years prior to the declaration of insolvency can be rescinded if they are detrimental to the assets of the bankruptcy. The SIA further states that a fraudulent intention is not required for the act to be subject to revocation.

If an act or business carried out by the debtor is rescinded within the insolvency procedure, the immediate consequence is that the act is declared ineffective, and the parties (the insolvent company and its counterparty) will be liable for restoring the contributions effected. Therefore, in certain circumstances, this might imply that the debtor is compelled to restore third parties to the price paid for the acquisition of certain assets whose transfer has been rescinded, thus giving rise to a credit in favour of such third party.

In view of the above, as a cautionary procedure to protect the insolvent company and, particularly the rest of the creditors of the insolvency, the SIA states that credits borne in a revocation action, but in favour of creditors who acted in bad faith, are subordinated to the rest of the creditors of the insolvency.

Bad faith is not presumed, but must be declared in the relevant judicial ruling. However, the concept of bad faith is not defined in the SIA and consideration of the same is ultimately left up to the discretion of the courts. According to case law, certain circumstances such as knowledge by the creditor of the economic difficulties of the debtor, or trying to take advantage of such information against the interests of the rest of the creditors, are key considerations when evaluating bad faith being concurrent on the creditor.

Finally, it is important to point out that, in addition to the subordination consequences, the party acting in bad faith shall be responsible for paying the insolvent company. an indemnification for the losses and damages caused to the assets of the insolvency.

3. Other consequences of the subordination

The are other consequences applicable to subordinated credits under the SIA, such as the following:

— Holders of subordinated credits can request a declaration of insolvency of the debtor before the Spanish Court, but will not benefit from the privilege contained in Section 91.7 of the Insolvency Law[2].

— Holders of subordinated credits cannot be appointed as insolvency administrators. However, if a creditor holds both subordinated and unsubordinated credits, he can be appointed as the insolvency administrator.

— Subordinated creditors shall not be entitled to vote at the creditors meeting, but the composition with creditors (*convenio)* will be fully binding for them.

— Subordinated creditors shall be affected by the same reductions of debt and waiting periods applicable to ordinary creditors according to the composition with creditors. But the waiting periods of the subordinated debt will only be counted starting from the date on which the composition with ordinary creditors has been totally fulfilled.

However, it is important to mention that Section 100.1 of the SIA states that proposals for composition with creditors cannot include, for ordinary credits, reduction of debts over 50% or waiting periods longer than 5 years. These limits are only established for ordinary credits; therefore, notwithstanding the above paragraph, it should be understood that the composition for creditors can contain proposals for subordinated debts which are beyond these limits.

The above does not affect the possibility that the subordinated creditors have to accept alternative proposals for conversion of their credits into shares or stakes in the insolvent company, or in participation loans *(créditos participativos)*, if the proposal for composition with creditors has offered such alternative.

— If the insolvency ends up in a winding-up, Section 158 of the SIA states that payment

[2] According to the SIA, a quarter of the credit held by the entity that has requested in Court declaration of insolvency of the debtor is considered privileged (therefore payable with priority to ordinary credits). However, if the creditor that filed for declaration of bankruptcy is considered as a subordinated creditor, this privilege will not be applicable to such creditor.

of the subordinated credits shall not be performed until the ordinary credits have been fully settled (including unsecured ordinary credits, secured credits and privileged credits). Therefore, subordinated credits rank below all other credits of the insolvent company but have seniority with respect to equity. Payment shall be made in the order established in Section 92 (see list contained in section 1 above) and, when appropriate, proportionally within each group.

— According to the SIA, if the directors (legally appointed or *de facto)* are liable for the insolvency, the judgement imposed on such directors (either individuals or corporations) can include total or partial coverage of the deficit of the insolvency (assets vs. debts). This implies that subordinated creditors could eventually benefit from such a sentence if the judgement includes responsibility by directors for the deficit required to cover subordinated debts. Therefore, in those cases where the directors have acted negligently, subordinated creditors will have important incentives to obtain such a sentence in the insolvency procedure.

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