RECOGNITION AND ENFORCEMENT IN SPANISH BANKRUPTCY PROCEEDINGS OF SUBORDINATION AGREEMENTS BETWEEN CREDITORS

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Abstract

The Consolidated text of the Spanish Insolvency Act (hereinafter, the Insolvency Act) has been amended to incorporate into Spanish law Directive (EU) 2019/1023 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt. In addition to incorporating the guidelines of the Directive in the pre-insolvency stage, Law 16/2022 amending the Insolvency Act introduces a rule not provided for in the aforementioned Directive: the new Art. 435.3 of the Insolvency Act provides that agreements between creditors remain valid including when the common debtor goes into insolvency proceedings. Moreover, it applies indistinctly whether the agreements between creditors have been adopted within procedures concerning restructuring or outside of these.

I. INTRODUCTION

Effective as of 26 September 2022, the recognition and enforcement of a subordination agreement between creditors in Spanish insolvency proceedings is a new feature of Law 16/2022 of 5 September[1] amending the Insolvency Act, approved by Royal Legislative Decree 1/2020 of 5 May, for the transposition of Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the

[1] *Boletín Oficial del Estado*, No. 214, 6 September 2022.

efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

Specifically, Art. 106 of Law 16/2022 indicates that a new paragraph 3 is added to Art. 435 Insolvency Act[2], which is worded as follows: "3. *Provided that it is not detrimental to third parties and the debtor is a party thereto, the subordination agreement between creditors will be recognised in insolvency proceedings and will be enforceable within such proceedings. The insolvency administrator shall make payments in accordance with the provisions of the clauses*".

The introduction of the new paragraph 3 of Art. 435 of the Insolvency Act is not a European rule. For its part, Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast)[3] does not impose on Member States the recognition in insolvency proceedings of subordination agreements between the creditors of the insolvent party.

Moreover, neither does the aforementioned Directive 2019/1023[4] mention the recognition of subordination agreements *within insolvency proceedings*. This omission is explained by the fact that it focuses on the *pre-insolvency stage*, within the framework of which it aims to provide common guidelines (suspension of individual enforcements, classes of creditors for the adoption of the restructuring plan or its judicial approval). By contrast[5], Directive 2019/1023 does not harmonise rules for the *insolvency stage* itself. The fact that the Directive remains silent on this point explains why, in Spain, the Draft Law[6] of 2022 of the Government reforming the Insolvency Act for its transposition (hereinafter, the Draft Law) did not establish the recognition *within insolvency proceedings* of the subordination agreement between creditors[7] either.

In fact, the origin of the new paragraph 3 of Art. 435 of the Insolvency Act is strictly Spanish. Specifically, it is the result of the parliamentary procedure concerning the Draft Law in the Congress of Deputies and the Senate. Its literal wording comes from compromise amendment number 9 proposed in the report of the Rapporteur for the Justice

[2] *Boletín Oficial del Estado*, No. 127, 7 May 2020.
[3] *Official Journal of the European Union*, L 141/19 of 5 June 2015.
[4] *Official Journal of the European Union*, L 172/18 of 26 June 2019.
[5] *Vid* European Commission Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, COM/2016/0723 final - 2016/0359 (COD), p. 3, available at https://bit.ly/3V7PjeI, accessed on 20 November 2022.
[6] *Boletín Oficial de las Cortes Generales*, Congreso de los Diputados, XIV Legislatura, Serie A, Proyectos de Ley, 14 January 2022, no. 84-1.
[7] Also NAVARRO FRÍAS, I.,"Los pactos de subordinación entre acreedores en la reforma del texto refundido de la Ley concursal", *Revista General de Insolvencias & Reestructuraciones*, no. 6, 2022, p.222.

Committee[8]. The compromise amendment accepted amendments no. 193 of the Plural Parliamentary Group and no. 415 of the Popular Parliamentary Group in the Congress of Deputies[9], which requested the inclusion of a rule in the Insolvency Act to recognise and enforce the subordination agreement within insolvency proceedings. This was incorporated, but not in the terms proposed by the Plural Parliamentary Group and the Popular Parliamentary Group: the compromise amendment added that the debtor should be a party to the agreement and imposed that the insolvency administrator should be responsible for making payments to the creditors party to the agreement.

The amendments of the Plural and Popular Parliamentary Groups in Congress did not include the debtor as a party to the agreement and envisaged that the insolvency administrator would pay the agent appointed by the creditors and that the agent would then redistribute the payment among the creditors, but this option was not accepted by the other Parliamentary Groups.

In the Senate, amendment no. 111 from the Popular Parliamentary Group in the Senate[10] to eliminate the requirement for the debtor to be party to the subordination agreement was not accepted.

II. GROUNDS FOR RECOGNITION AND ENFORCEMENT OF SUBORDINATION AGREEMENTS BETWEEN CREDITORS

1. Parliamentary reasons for the amendment

In order to understand the reason for the new paragraph 3 of Art. 435 of the Insolvency Act, it is useful to read the full justification of amendment no. 193 of the Plural Parliamentary Group in Congress, by Ferran Bel Accensi and Genís Boadella Esteve[11]. Due to its clarity in explaining the problem and the proposed legal solution, it is reproduced verbatim:

"The Draft suffers from a worrying pitfall in that it does not provide for the recognition of ranking agreements between creditors (technically known as "subordination agreements"). Through these agreements, investors are contractually

[8] *Boletín Oficial de las Cortes Generales*, Congreso de los Diputados, no. 84-4, 29 June 2022.
[9] The text of the amendments can be consulted in *Boletín Oficial de las Cortes Generales*, Congreso de los Diputados, 20 April 2022.
[10] *Boletín Oficial de las Cortes Generales*, Senado, no. 363, 13 July 2022.
[11] The Popular Parliamentary Group in Congress also proposed the same amendment, but limited its basis to "*technical improvement*".

stratified into classes of more or less preferential ranking ("senior" or "junior") according to the risk-reward trade-off of their respective debt or equity instruments. The Draft Law still does not give a legal status to these agreements, thus creating two parallel realities that are poorly reconciled: the reality of insolvency and contractual reality. The consequence of this is that, by ignoring these agreements, all Spanish insolvency instruments (in particular insolvency proceedings and the restructuring plan) cease to be effective for restructuring or liquidation, as they lead to iniquitous results where only the insolvency ranks are respected, but not the pre-existing contractual ranks (in contravention of the so-called "Butner principle").

"The proposed wording seeks to accommodate these subordination agreements within the Spanish legal system, as is already the case in other legal systems, such as those of the USA, the United Kingdom, France and the Netherlands. It should be noted that France and the Netherlands, like Spain, have had to transpose Directive 2019/1023. Both France and the Netherlands have expressly provided for the recognition in bankruptcy (both in insolvency proceedings and in restructuring plans) of subordination agreements. This proposed amendment is complementary to the proposed amendment of Article 435 of the Insolvency Act.

"Failure in Spain to follow the example of other jurisdictions such as the US, UK, France or the Netherlands could have serious effects on our economy: both on the granting of credit ex-ante (given the disincentive for investors to invest in a jurisdiction that does not recognise their contractual rankings), and on the effectiveness of ex-post tools (Spanish insolvency tools would need the subsequent complement of the civil courts for the application of subordination agreements, resulting in inefficiencies due to increased costs caused by lengthy legal procedures and the flight of investors to other jurisdictions given the insufficiency of Spanish jurisdiction).

"In any event, the proposed wording leaves the rights of third parties untouched, since the recognition of subordination agreements can only have effect between the parties and must therefore be neutral for third parties."

2. Legal certainty for the debtor's syndicated lenders and for the financial market in general.

The new section 3 of Art. 435 of the Insolvency Act does not create the associated institution, but rather it adjusts insolvency law to a type of agreement that is very common in commercial financial practice. A leading author on subordination agreements, Dee

Martin Calligar[12], pointed out in 1961 that in the two previous decades, the use of subordination agreements between creditors had seen an ostensible increase. In the 1980s, in Spain, the notary Martínez Sánchiz[13], in connection with Law 27/1984 of 26 July 1984 on Reconversion and Reindustrialisation, which laid the general grounds for the subordination of shareholder loans to joint creditors, emphasised the common use of general subordination clauses (in relation to all creditors) and particular subordination clauses (in relation to specific creditors) in notarised financial documents. He attributed this to the creditor's need to obtain a better position over others in cases of crisis, giving rise, by contract between the creditors themselves, to situations of "privilege or priority" and "anti-privilege or subordination" in their respective claims before the common debtor.

In this legal and economic context, in order to obtain a better credit position before the common debtor, the creditors involved in the financing, which are normally large ones, need the subordination agreements between them to be valid, *also in the event of insolvency of the common debtor*. Art. 435.3 of the Insolvency Act provides legal certainty not only for specific creditors, but also for the financial market in general.

Today, agreements between financial creditors with subordination of claims are, in fact, an essential part of large financing operations, such as in the case of company acquisitions, the financing of large-scale projects and the debt restructuring of struggling companies, where survival depends on obtaining new financing that provides corporate liquidity, among other things[14].

Banking prudence in not taking on major financing alone facilitates the formation of syndicated operations in which several credit institutions and other lenders share the amount to be financed among themselves, under the coordination of an agent bank[15] and formalised in a syndication agreement (mentioned in Art. 640 of the Insolvency Act). Although each of the lenders may be in the same position and on an equal footing (*pari passu* or *par conditio creditorum*) with respect to one or more others, the contracts or agreements they enter into commonly include "subordination agreements", whereby the

[12] CALLIGAR, D. M., "Subordination agreements", in *Yale Law Journal*, vol. 70 no. 3, 1961, p.376.

[13] MARTÍNEZ SANCHIZ, J. A., "Préstamos y créditos participativos y subordinados", *Anales de la Academia Matritense y del Notariado*, vol. 28, 1988, para.1.

[14] See NAVARRO FRÍAS, I., *El contrato entre acreedores*, Thomson Reuters Civitas, Madrid, 2016, pp.17 et seq.

[15] HOUSSIN, M., "La subordination de créance après l'ordonnance relative au droit des entreprises en difficulté (ordonnance n° 2021-1193 du 15 septembre 2021)", *Banque et Droit*, no. 202, 2022, p.9.

creditors contractually and voluntarily create privileged debt and subordinated debt[16]. This gives rise, to use the precise terminology, to senior debt and junior or subordinated debt. The term "mezzanine debt" is also used. This term is intended to convey the intermediate credit quality, between the first floor, which is occupied by the senior debt, with preferential collection, and the ground floor, which corresponds to the debtor's partners, who are positioned below the mezzanine creditor[17].

Senior debt holders are usually credit institutions that provide the majority of the financing and, through ad hoc clauses, hold advantages such as priority of payment and prioritised collateral[18]. In contrast, junior debt holders cover a smaller part of the syndicated transaction and voluntarily subordinate themselves to the senior debt. These are typically venture capital firms, investment funds and other entities willing to accept the higher risks inherent in this subordinated financing[19]. This is usually in exchange for higher returns, as the interest rates are higher to cover the higher risk and the longer principal repayment term.

For the debtor, subordination between creditors allows it to increase its financing, while also allowing it more time to repay the principal of the junior debt[20]. The debtor can first repay the financed capital to the senior creditor and then, upon completion of repayment, to the junior creditor. This allows for less financial burden and more liquidity at the start of the financing operation.

III. RECOGNITION OF SUBORDINATION AGREEMENTS IN SPANISH BANKRUPTCY PROCEEDINGS

1. Jurisdiction of the insolvency bodies.

Article 435.3 of the Insolvency Act states that "*subordination agreements between creditors shall be recognised in insolvency proceedings and shall be enforceable therein*", but it does not identify who is responsible for deciding on the recognition of the

[16] PÉREZ MARTÍN, E., "El contrato entre acreedores", in MANZANARES SECADES, A. (Coord.), *Estudios sobre financiaciones sindicadas*, Clifford Chance Thomson Reuters Aranzadi, 2017, pp.259-260.
[17] SERRANO ACITORES, A., *El sistema contractual de las adquisiciones apalancadas de empresas por operaciones de capital riesgo*, doctoral thesis, Universidad Juan Carlos I, 2012, p.207.
[18] BUIL ALDANA, I., *Subordinación contractual relativa y marcos de reestructuración preventiva*, doctoral thesis, Universidad Complutense de Madrid, 2021, p.13; PÉREZ MARTÍN, E, "El contrato…, *Ibid.*, pp. 259-260; and, SERRANO ACITORES, A., *El sistema*…, *Ibid.*. 206.
[19] NAVARRO FRÍAS, I, *Los pactos…*, *Ibid.*, p. 201.
[20] SERRANO ACITORES, A., *El sistema*…, *Ibid.*. p. 208.

subordination agreement between the senior and junior credits of the insolvent party. It adds that "*The insolvency administrator shall make payments in accordance with the provisions of the agreements*".

In view of this provision, the insolvency judge and administrator, as the insolvency bodies, are competent to recognise and enforce subordination agreements between creditors in insolvency proceedings. However, we believe that the initial decision must be interpreted as corresponding to the insolvency administrator. This is, of course, without prejudice to the supervision of the insolvency judge (Art. 82 of the Insolvency Act) when the insolvency administrator's report is challenged through ancillary proceedings (Art. 300.1).

2. Recognition of senior and junior debt in the list of creditors under the terms of the subordination agreement.

The Insolvency Act does not establish a specific procedure for the recognition in court of subordination agreements. In fact, we consider that the object of the recognition is the senior and junior credits involved in such agreements, rather than the agreements themselves.

The creditor informs the insolvency administrator of its claim and, in exercise of the constitutional right to effective judicial protection, may use all appropriate means of proof to assert its rights (Art. 24.2 of the Spanish Constitution). It is up to the insolvency administrator to assess the evidence provided, so that it may recognise and declare the existence of a right under the terms of the subordination agreement. After this is done, the rights of each claim will be recognised in the insolvency proceedings and each claimant will be able to participate in the vote in the event of a creditors' agreement or in the liquidation, which is the essential effect of the recognition of claims[21]. However, in recognising such rights, it is imperative that the insolvency administrator take into account the proven and valid subordination agreement.

Otherwise, in the absence of Art. 435.3 of the Insolvency Act, the insolvency administrator could also recognise the claim in the insolvency proceedings, but without regard to the debt subordination agreements between creditors. This would have very

[21] SACRISTÁN BERGIA, F, "Comentario al art. 259", in PULGAR EZQUERRA, J. (Dir.), *Comentarios a la Ley Concursal. Texto Refundido de la Ley Concursal*, vol. I, Wolters Kluwer, Madrid, p.1300; M. L. SÁNCHEZ PAREDES, M. L. y FLORES SEGURA, M., "La masa pasiva del concurso", in MENÉNDEZ, A. and ROJO, Á. (Dirs.), *Lecciones de Derecho mercantil*, vol. II, 20th ed., Civitas Thomson Reuters, Madrid, 2022, p. 524.

negative effects for any creditor of the insolvent party who has a private agreement with other creditors to grant its claim priority of payment. Despite the existence of an agreement with the other creditors, the insolvency administrator would not recognise such priority of collection.

Therefore, the moment when subordination agreements between creditors are normally recognised is when the creditors inform the insolvency administrator of *the existence of the claims* that they request to be recognised in the list of creditors of the insolvent party (Art. 255 of the Insolvency Act). The existence of the claims must be accredited, and the subordination agreement between creditors, to which the debtor itself is a party, constitutes proof of existence, enforceability and other conditions.

3. Monetary quantification of each claim in the list of creditors

The senior and junior claims may, by virtue of the subordination agreement between creditors, be included or excluded by the insolvency administrator in the list of creditors (Art. 259). If the insolvency administrator decides to include in the list of creditors the claims covered by the subordination agreement between them, the monetary value of each claim will be calculated and expressed in legal tender (Art. 267.1).

If the subordination agreement between creditors is recognised, each senior and junior claim must be quantified by the insolvency administrator in accordance with the provisions of the agreement.

4. The contractual subordination of a claim does not imply prejudgement of its classification in insolvency proceedings. Erroneous placement of claims classified as subordinated for the purposes of insolvency proceedings.

The agreement between creditors does not imply prejudgement of the bankruptcy classification of each claim concerned[22]. Each one can be classified by the insolvency administrator as a claim with special privilege, a claim with general privilege, an ordinary claim or a subordinated claim, and the classification of one senior or junior claim may be different from another senior or junior claim, even if they are all part of the subordination agreement between creditors.

In relation to the classification of each claim, the insertion of the new paragraph 3 of Art. 435 of the Insolvency Act presents a drawback of legislative technique. This relates to

[22] MARTÍN BAUSMEISTER, B., *El contrato de financiación sindicada*, Civitas Thomson Reuters, Cizur Menor, 2013, pp.89-90.

the payment of "subordinated claims", but the claims included in the subordination agreement between creditors are not necessarily subordinated. For example, a venture capital firm may agree to subordinate the repayment of the loan capital to the full repayment of the capital lent by a credit institution. However, this in no way implies any commitment or waiver by the venture capital firm of its collection rights against the insolvent party's creditors as a whole, which is the normal consequence of subordinated claims.

This is the difference between the subordination of Art. 435.3 of the Insolvency Act, which exists voluntarily before one or more claims, and the absolute subordination of Art. 280.1.2 of the Insolvency Act, by which a claim is qualified for insolvency purposes as "subordinated" to all the claims of a non-preferential creditor[23], so that it cannot be paid until all the other claims of the common debtor have been paid in full (Art. 435.1 of the Insolvency Act). Absolute subordination can be voluntary or legally imposed. An example of legally imposed subordination is shareholder loans, mentioned in the same Art. 280.1.2 of the Insolvency Act. Furthermore, Art. 20 of Royal Decree-Law 7/1996 of 7 June on urgent fiscal measures and measures to promote and liberalise economic activity establishes the subordination of shareholder loans to non-preferential loans[24].

In view of the above, the new paragraph 3 of Art. 435 of the Insolvency Act would have been better placed elsewhere. As it is a common agreement to give preference or reciprocal preterition between creditors, its natural place is not in Art. 435 of the Insolvency Act, which is reserved for subordinated claims. Insofar as it deals with the conventional subordination of claims, which constitutes an important legislative novelty, it deserves a more precise location, for example by creating a new Art. 429 bis to the Insolvency Act, thus establishing the validity of the conventional subordination of claims between creditors before the rules for payment of insolvency claims in accordance with the legal criterion. The use of the term "subordination" (of one claim before another), we believe, has wrongly led to their being placed among "subordinated claims" (insolvency classification).

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[23] ALEMANY EGUIDAZU, J. M., "Subordinación contractual y subordinación concursal" *Diario La Ley*, n. 6004, 26 April 2004, para. VI.3; GOLDENBERG SERRANO, J. L., *La subordinación voluntaria de créditos*, Civitas Thomson Reuters, Madrid, p. 27; CASTRESANA OLIVER, J., "Pactos de subordinación y acuerdos entre acreedores", *Revista General de Insolvencias & Reestructuraciones*, no. 5, 2022, p. 350; NAVARRO FRÍAS, I., *Los pactos…*, *Ibid.*, pp. 206-208; VILLORIA RIVERA, Í., "Refinanciación y concurso en una financiación sindicada", in MANZANARES SECADES, A. (Coord.), *Estudios sobre financiaciones sindicadas*, Clifford Chance Thomson Reuters Aranzadi, Cizur Menor, 2017, p. 491.

[24] For example, see judgements of the Provincial Courts of Barcelona of 7 June 2022 (LA LEY 146552/2022) and of Málaga of 22 September 2021 (LA LEY 233984/2021).

5. Recognition in insolvency proceedings of subordination clauses in intercreditor agreements.

Art. 435.3 of the Insolvency Act correctly uses the term "subordination agreement between creditors" and not the broader term of "intercreditor agreement". It seems to us to be appropriate for the commercial finance market, where subordination agreements are generally part of broader and more complex intercreditor agreements, also known by the acronym of ICAs[25]. The essential clauses of the agreement are all those that create priority and privilege for senior claims, while subordinating and downgrading junior claims, as a voluntary and contractually agreed anti-privilege. These agreements, if the legal conditions are met, must be recognised by the insolvency administrator and payments must be made in accordance with them.

6. The remainder of the intercreditor agreement cannot be recognised in insolvency proceedings.

By not admitting the recognition of intercreditor agreements, the legislator has excluded from insolvency proceedings all other clauses other than subordination agreements between creditors.

The insolvency administrator is only obliged to recognise and enforce subordination clauses between creditors when making payments. The other content of intercreditor agreements[26], such as the senior creditor being granted representation of junior creditors, the assignment of voting rights or the possibility of receiving payments on behalf of other creditors, among other content commonly included in such agreements[27], cannot be recognised in insolvency proceedings. There is no rule that obliges the insolvency administrator to recognise these clauses between insolvency creditors and, on the other hand, the rights and obligations of each insolvency creditor are provided for imperatively in the Insolvency Act, without any contractual derogation or prior waiver of the same.

This contrasts with the recognition of the other content of syndication agreements within the framework of preventive restructuring *in the pre-bankruptcy stage* (Art. 640 of the Insolvency Act).

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[25] CASTRESANA OLIVER, J., "Pactos…, *Ibid.*, p. 356; PÉREZ MARTÍN, E., "El contrato…, *Ibid.*, p. 86; MORRI, G. and MAZZA, A., *Property finance. An International approach*, Wiley, 2014, para. 7.4.

[26] NAVARRO FRÍAS, I., *El pacto…*, *Ibid..*, p. 213.

[27] MARTÍN BAUSMEISTER, B., *El contrato…*, *Ibid.*, pp. 89-90; PÉREZ MARTÍN, E., "El contrato…, *Ibid.*, p. 265.

IV. LEGAL CONDITIONS FOR RECOGNITION WITHIN INSOLVENCY PROCEEDINGS

1. It must not be detrimental to third parties

A subordination agreement between creditors may be recognised in Spanish insolvency proceedings "*provided that it is not detrimental to third parties* (...)" (Art. 435.3 of the Insolvency Act).

The reason why a subordination agreement between creditors cannot be recognised in insolvency proceedings if it is detrimental to third parties is its *inter partes* effectiveness. This is the general rule, according to which every contract is a matter arranged between certain parties (*res inter alios acta*) and must not have any effect on the legal sphere of third parties: neither to their benefit nor to their detriment (*nec prodest nec nocet*)[28].

The insolvency administrator is obliged to assess and, where appropriate, refuse to recognise the subordination agreement between creditors if, in its opinion, it is detrimental to third parties. This decision may be challenged before the insolvency judge through ancillary proceedings (Arts. 298.2 and 300.1 of the Insolvency Act).

The "third party" who cannot be adversely affected in any way by the subordination agreement between creditors is anyone who is not a party to the agreement, such as other insolvency creditors, creditors against the estate, or partners or employees of the insolvent company.

Clear examples of detrimental and therefore non-recognisable agreements are those that violate the priority of payment of a claim outside the intercreditor agreement or those that reinforce the security interests of the senior creditors and adversely affect creditors who are not party to the intercreditor agreement[29].

In our opinion, there is nothing to prevent the partial recognition of subordination agreements between creditors. The insolvency administrator may recognise some of the clauses and disregard others if they are detrimental to third parties.

2. The debtor must be a party to the intercreditor agreement

[28] DIEZ-PICAZO Y PONCE DE LEÓN, L., *Fundamentos de Derecho civil patrimonial I Introducción. Teoría del contrato*, Civitas, Madrid, 1996, p. 424.

[29] Judgement of the Commercial Judge of A Coruña, 4 July 2011 (LA LEY 195707/2011).

A subordination agreement between creditors may be recognised in Spanish insolvency proceedings "*provided that (...) the debtor is a party thereto (...*)" (Art. 435.3 of the Insolvency Act).

It is the responsibility of the insolvency administrator to verify that the debtor has consented to and is a contracting party to the subordination agreement between creditors. It does not normally pose a practical problem that the debtor is a contracting party, as it is the first party interested in obtaining the financing under the syndicated transaction. To this end, creditors require the debtor to contractually bind itself to comply with the terms and conditions of the financing by having it sign whatever contractual and financial documents are necessary to ensure compliance with the loan or credit agreement.

In practice, "subordination agreements between creditors" take the form of a series of clauses included in broader contractual documents, such as the aforementioned intercreditor agreement, which in turn accompanies, as a separate document, the loan or credit agreement that the group of creditors sign with the common debtor to establish the rights and obligations of the parties.[30]

Despite the fact that it is referred to as an agreement "between creditors", the debtor usually also signs the intercreditor agreement. This is evidenced by most authors[31] and judicial practice. For example, in Spanish case law, in the insolvency proceedings of the construction company Martinsa Fadesa[32], the judgment of the Commercial Court of A Coruña of 4 July 2011, which recognised the *inter partes* validity of the intercreditor agreement, stated that the debtor was a contracting party thereto. The signature of an intercreditor agreement can also be seen in the judgments of the Provincial Court of Donostia-San Sebastian of 9 March 2017[33], and of Commercial Court No. 11 of Madrid of 22 July 2016[34], among others.

In UK case law, examples of the signing of agreements between creditors and the common debtor can be found, for example, in the judgment of the High Court of Justice

[30] For example, judgement of the Commercial Judge of Madrid, no. 60, 28 April 2022 (Cendoj 28079420602022100001).
[31] PÉREZ MARTÍN, E., "El contrato…, *Ibid.*, pp. 281-282 and HOUSSIN, M., "La subordination…, *Ibid.*, p. 9. Against, SERRANO ACITORES, A., *El sistema*…, *Ibid.* p. 516.
[32] LA LEY 195707/2011.
[33] Cendoj 20069370032017100115.
[34] LA LEY 229098/2016.

of 26 October 2020[35] and in the opinion of a Lord before a Scottish court of 21 May 2021[36], as well as in the English High Court judgment of 16 April 2014[37], among others. However, on other occasions, this is not the case, as in the judgment of the High Court of Justice of 5 February[38]. This agreement not signed by the debtor could not be recognised in Spanish insolvency proceedings in accordance with Art. 435.3 of the Insolvency Act.

Therefore, the insolvency administrator must deem this requirement to be fulfilled if it verifies that the debtor is a party to the intercreditor agreement that contains the subordination clauses between creditors. Additional signatures against the clauses for the subordination of claims are not necessary.

However, there are other ways of expressing consent. It is essential that the debtor is a party to the subordination agreements between creditors, but there is no single, specific formality. For example, if the subordination agreements are framed within preventive restructuring processes, the restructuring plan must be approved by the debtor (Art. 640 of the Insolvency Act) and it is up to the insolvency administrator to determine whether or not this implies that the debtor is a party to the subordination agreements. Notwithstanding, such plans are usually accompanied by the documents accrediting the syndicated commercial loan and the intercreditor agreement[39].

Furthermore, it would even be possible for the insolvent party to subsequently adhere to and become a party to the subordination agreement. However, this requirement gives it what could be considered a veto right over the recognition and adds more formalities, going against the idea of flexibility that Law 16/2022 intends to promote.

On the other hand, if the partners of the insolvent company, which provide personal guarantee against the financial syndicate, are parties to the subordination agreements, this does not replace the consent of the insolvent company[40]. Art. 435.3 of the Insolvency Act places the focus on the debtor, not on its partners.

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[35] Aries GNH (Operations) Limited and Robson Asset Management Manco Limited [2020] EWHC 2880 (Ch).

[36] Opinion of Lord Tyre in the cause HCC International Insurance Company PLC v. The Scottish Ministers [2021] CSOH 53.

[37] U.S. Bank Trustees Limited v Titan Europe 2007-1 (NHP) Limited, Anchorage Illiquid Opportunities Offshore Master III, L.P., an unnamed class A noteholder and Bank of America, N.A. [2014] EWHC 1189 (Ch).

[38] The Bank of New York Mellon (London Branch and Truvo N.V., Deutsche Bank AG (London Branch), Millar Investments S.A. R.L. [2013] EWHC 136 (Comm).

[39] For example, see judgement of the Commercial Judge of Madrid, no. 11, 22 July 2016 (Cendoj 28079470112016100002).

[40] See judgement of the Spanish National Audience, Administrative Chamber, section 8, of 4 May 2021 (Cendoj 28079230082021100239).

3. The subordination agreement between creditors must be valid under the governing law, whether Spanish or foreign.

Pursuant to Article 7.1 of Regulation (EU) 2015/848, the law applicable to insolvency proceedings and their effects is that of the Member State within the territory of which such proceedings are opened. This means that, for the purposes of recognising subordination agreements in Spanish insolvency proceedings, the Insolvency Act is imperatively applicable, in particular Art. 435.3.

The insolvency administrator must apply the requirements of Art. 435.3 of the Insolvency Act, regardless of the law governing the subordination agreement. It is not a *sine quanon* condition for recognition in Spanish insolvency proceedings that the subordination agreement between creditors be subject to Spanish law, as the recognition of agreements subject to foreign law is also envisaged in Spanish insolvency proceedings.

In any case, the insolvency administrator may not recognise in Spanish insolvency proceedings any agreement between creditors that is null and void or ineffective under the national law governing it. The governing law is normally chosen in the agreement itself. Agreements between creditors drawn up based on standard templates provide for a governing law clause, which resolves the question in advance and avoids the application of conflict rules that would be applicable to select the national law governing the agreement.

3.1. Recognition of a subordination agreement between creditors subject to Spanish law

If the intercreditor agreement is governed by Spanish law, it is an atypical agreement in Spanish law, but valid as an expression of the free will to negotiate[41] (Arts. 1255 of the Spanish Civil Code and 57 of the Spanish Commercial Code).

Contractual freedom is conditional, since it requires compliance with the requirements of the agreement: the consent of the contracting parties; a certain object that is the subject matter of the agreement; and the purpose of the obligation that is established (Art. 1261 of the Spanish Civil Code).

In addition, the external format of the agreement can also be considered as a requirement[42]. In Spanish law, if the agreement includes clauses relating to the creation

[41] NAVARRO FRÍAS, E., *Los pactos…*, *Ibid.*, p.204.
[42] DIEZ-PICAZO Y PONCE DE LEÓN, L., *Fundamentos…, Ibid.,* p. 144.

of security interests in real estate, it must be notarised as a public document (Art. 1280.1 of the Spanish Civil Code). Likewise, if the subordination agreements between creditors form part of a restructuring plan, the latter must be notarised as a public deed by the signing parties (Art. 634.1 of the Insolvency Act).

Notwithstanding, notarisation is already the general rule for the formalisation of financial documents and intercreditor agreements in syndicated financing operations[43].

3.2. Recognition in Spanish bankruptcy proceedings of intercreditor agreements subject to foreign law.

The insolvency administrator must verify that the clause regarding subordination between creditors is valid under the law governing the intercreditor agreement.

The specific foreign law governs the conditions of validity and effectiveness of contracts in general and intercreditor agreements in particular. The content and validity of the specific foreign law must be proven in court, and the court may use whatever means of enquiry it deems necessary for its application (Art. 281.1.2 Law 1/2000 of 7 January on Civil Procedure[44]). In addition, the interested parties in the recognition and enforcement may provide the appropriate documents on the content and validity of the foreign law. However, Article 33.4 of Law 29/2015 of 30 July on international legal cooperation in civil matters[45] is clear in reserving the exclusive jurisdictional function of the court, since "*no report or opinion, national or international, on foreign law, shall be binding on the Spanish courts*"[46].

3.3. Analysis of US, English and French law

For information purposes, US, English and French law have been analysed to determine whether subordination agreements may be subject to recognition and enforcement in insolvency proceedings under the respective jurisdictions.

In the United States, the intercreditor agreement is valid and, moreover, is enforceable in insolvency proceedings. The Bankruptcy Code § 510(a) provides that a subordination

[43] For example, see judgements of the Provincial Court of Donostia-San Sebastian, section 3, of 9 March 2017 (Cendoj 20069370032017100115) and of the Commercial Judge of Barcelona, no. 2, of 22 October 2018 (Cendoj 08019470022018200001).

[44] *Boletín Oficial del Estado*, no. 7, 8 January 2000.

[45] *Boletín Oficial del Estado*, no. 182, 31 July 2015.

[46] J. C. Fernández Rozas, "El TS se pronuncia sobre la determinación de la jurisdicción competente, la alegación y prueba del Derecho extranjero y la validez del pacto de elección de la ley aplicable (High Court Judejement Civ 1, 27 July 2021)","in his Blog entry of 20 August 2021, at https://bit.ly/3GnqCXw, consulted on 10 December 2022.

agreement is enforceable in bankruptcy in the same manner as it is enforceable under the applicable non-bankruptcy law. This provision allows a contractual subordination agreement to be enforced in bankruptcy in order to respect the terms of the ranking or priority established in the intercreditor agreement[47].

In England, the Insolvency Act 1986 does not include a rule of positive law similar to US law, but several court precedents suggest that the intercreditor agreement is valid and, furthermore, recognisable in English insolvency proceedings, according to case law. The High Court[48] noted that contractual subordination agreements remain valid in the event of the insolvency of the debtor.

The Court of Appeal[49] reiterated the validity of such an agreement in insolvency, as it is commercially important that if a group of companies enters into a credit subordination agreement while the common debtor is solvent, such an agreement also be respected when the debtor becomes insolvent.

The same solution was applied by the High Court afterwards[50]. This cited the criteria for the validity in insolvency of the subordination agreement and added that the Insolvency Act in no way prevented the recognition of contractual subordination agreements in insolvency.

In France, the validity of the subordination agreement between creditors is implied by recognising its effectiveness in the pre-bankruptcy phase. This is an effect of the transposition of Directive 2019/1023, by which the *Ordonnance relative au droit des entreprises en difficulté*[51] has amended the *Code du Commerce*. Article L. 626-30-III, 2° of the *Code* provides that the distribution of creditors into classes within the framework of a *procédure de sauvegarde* must respect the subordination agreements concluded prior to the opening of such proceedings. This means that the submission of the subordination agreement under French law is valid and effective and could also be recognised in Spanish insolvency proceedings. Less certain is whether this same subordination agreement could be recognised in French insolvency proceedings, as the rule gives the French *liquidateur* no indication that it must respect

[47] WILLIAMS, R. E., "Proof of Equitable Subordination Under 11 U.S.C.A. § 510(c)", in *American Jurisprudence Proof of Facts 3d*, Thomson Reuters, 2022, p.223; MURPHY, P. A. et al, "§ 5:26", *Creditors' Rights in Bankruptcy*, 2nd ed., Thomson Reuters, October 2022, updated; , NAVARRO FRÍAS, I., *El contrato…*, *Ibid* p. 213.

[48] In Maxwell Communications Corp., Re (No. 2) [1993] 1WLR 1402.

[49] In re SSSL Realisations (2002) Ltd and Another; Squires and others v AIG Europe (UK) Ltd and Another [2006] EWCA Civ 7.

[50] In Re Lehman Brothers International (Europe) (in Administration), [2014] EWHC 704 (Ch).

[51] Ordonnance n° 2021-1193 du 15 septembre 2021.

the subordination agreements[52], as is the case in Spain pursuant to Art. 435.3 of the Insolvency Act or in the United States under Bankruptcy Code § 510(a).

V. ENFORCEMENT AND PAYMENT OF CLAIMS IN ACCORDANCE WITH THE PROVISIONS OF SUBORDINATION AGREEMENTS BETWEEN CREDITORS

1. Meaning of the procedural enforcement of the subordination agreement

Art. 435.3 of the Insolvency Act provides that the subordination agreement "*shall be enforceable within the same* (...). *The insolvency administrator shall make the payments in accordance with the provisions of the agreements*".

Through the process of enforcement of previously recognised subordination agreements between creditors, the insolvency administrator must carry out such actions as are necessary to satisfy the senior and junior creditors.

Whatever the classification of the senior and junior credits *for the purposes of insolvency proceedings*, the payments must be made in accordance with the provisions of the subordination agreements between creditors (Art. 435.3 of the Insolvency Act).

Compliance with subordination agreements is mandatory, even if it contravenes the mandatory rules of legal priority of payments (Arts. 429 to 440 of the Insolvency Act). In fact, Art. 435.3 of the Insolvency Act, supporting the free will of the creditors of the insolvent debtor, is also a rule that is imperative for the insolvency administrator.

2. Priority of payment in favour of senior creditors and subordination of the payment of the principal of the junior claim until full repayment of the senior claim

The full repayment of senior debt is a common requirement in subordination agreements[53]. In particular, one of the standard clauses of intercreditor agreement templates provides that the debtor must make payments on the senior debt within the periods envisaged. On the other hand, the debtor may only pay off the interest on the

[52] HOUSSIN, M., "La subordination…,*Ibid*, p.9.
[53] MARTÍN BAUSMEISTER, B., *El contrato…*, *Ibid.*, p. 95 and NAVARRO FRÍAS, I., *Los pactos*…, *Ibid.*, p. 200.

principal borrowed, fees and expenses of the junior debt or, *provided that the senior debt has been fully repaid*, any other amount due and payable[54].

This means that, irrespective of the insolvency classification of each senior and junior claim, the insolvency administrator must make the payment of the principal of the junior claim conditional on the assumption that the entire senior claim has been paid in full. To do otherwise would be contrary to the terms of the enforcement of subordination agreements recognised in court.

The legal nature of the voluntary subordination of claims by junior creditors is something that is disputed. The most widely accepted option is that it is an expression of the right to waive available rights[55]. It is up to the insolvency administrator to ensure that this waiver is not contrary to public interest or public policy or detrimental to third parties (Art. 6.2 of the Spanish Civil Code).

The contractual waiver of junior claims on a parity with senior claims has a lawful cause (§ 1275 of the Spanish Civil Code). The subordination in payment and the longer repayment period of the principal, because the debtor must first repay the principal of the senior claims, is contractually compensated by a higher interest rate in favour of the junior creditors[56]. In addition, there may be other equally legitimate incentives or advantages, such as the junior creditor taking a share in the financed company (debt-for-equity swap)[57], something that is common in venture capital firms.

Finally, it should be noted that, within senior and junior creditors, there may be different tranches, in the form of a hierarchical table. The insolvency administrator will make the payment of the principal of each junior claim conditional on the full repayment of all senior claims positioned above it[58].

3. Treatment of the payment of interest accrued on senior and junior debt

Since both senior and junior claims are generally financial credits, it is essential to determine whether they receive interest despite the insolvency proceedings.

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[54] See clause 9.1 of an *intercreditors agreement*, reproduced literally by the UK High Court Saltri III Ltd v MD Mezzanine SA SICAR (t/a Mezzanine Facility Agent), [2012] EWHC 3025 (Comm).

[55] NAVARRO FRÍAS, I., *El contrato…*, *Ibid.*, pp. 62-63.

[56] NAVARRO FRÍAS, I., *El contrato…*, *Ibid.*, pp. 82-83; SERRANO ACITORES, A., *El sistema…*, *Ibid*. 207; and, MARTÍN BAUSMEISTER, B., *El contrato…*, *Ibid*., p. 97.

[57] NAVARRO FRÍAS, I., *Los pactos…*, *Ibid*, p.200.

[58] For example, see Deutsche Trustee Company Ltd v Fleet Street Finance Three Plc and Another [2011] EWHC 2117 (Ch).

As regards interest on junior claims accrued before the debtor declares insolvency, this may be included in the subordination agreement in addition to the principal. In this case, the rule of full payment of the interest on the senior claim before the interest on the junior claim applies.

However, it is quite a different matter for a finance company to allow a period for the repayment of the principal (until the senior capital is collected), and to delay the collection of interest on the loaned financing, as well as fees and other charges, until that time. The aforementioned standard clause of an intercreditor agreement does not provide for subordination other than the principal of the senior debt. In this case, if there is no subordination agreement regarding the interest and other claims, the insolvency administrator must recognise them and they must be paid in accordance with the legal regime of priority of claims. The interest due to senior creditors must also be recognised. In other words, if there is no contractual subordination for interest, the statutory priority of claims applies and the insolvency administrator will pay interest on senior and junior claims according to the general rules.

In relation to the interest generated after the declaration of insolvency, whether legal or contractual interest, the general rule is the suspension of accrual (Art. 152.1 of the Insolvency Act). An exception to this general rule is the case of secured claims, which continue to accrue the agreed remunerative interest up to the value of the security (Art. 152.2). The subordination agreement between creditors may affect this payment of interest after the insolvency proceedings, if a priority of payment in favour of senior creditors is provided for, so that junior creditors cannot collect until the senior creditors have been fully repaid.

4. Contractual subordination of security interests in the insolvent party's assets

In addition to the priority of collection, senior debt may be strengthened by first-ranking security interests in certain of the debtor's assets (secured senior debt).

In the case of senior and junior credits with special privileges in the form of security interests over the insolvent party's assets, the insolvency administrator must take into account that the recognised agreement usually contains priority of rank in favour of senior creditors. This means that the general principle of *prior in tempore, potior in iure*, set out in Art. 432 of the Insolvency Act, does not have to be applied, due to the preferential application of the subordination agreement recognised and enforceable within the insolvency proceedings (Art. 435.3).

5. Time of payment and party responsible

Given that in Spain insolvent parties are generally subject to liquidation rather than creditors' agreements[59], if there is sufficient money, the payments of the contractually prioritised and downgraded credits take place in the liquidation phase. Thus, it is the insolvency administrator that manages the payment, since from the opening of the liquidation it assumes powers over the administration and disposal of assets (Art. 413.1 of the Insolvency Act).

On the other hand, despite the wording of Art. 435.3 of the Insolvency Act, in the agreement phase, it is the insolvent party that is responsible for the payment of the prioritised or downgraded credits, as the insolvency administrator relinquishes its duties the moment the agreement enters into effect (Art. 395.1), which is the date of the judgement approving it (Art. 393.1).

In some special cases, the enforcement of the subordination agreement may allow the payment of certain creditors even in the first stage of the proceedings. Specifically, of the creditors with a special privilege recognised in the insolvency proceedings (Art. 270 of the Insolvency Act), only those who also have an enforceable instrument (*nulla executio sine titulo*) may separately enforce the asset or right affected and obtain priority collection of the proceeds obtained in the first stage, without the need to wait for the opening of the agreement or liquidation stages. In these cases, although the insolvent party maintains its powers of administration and disposal of assets, payment corresponds to the insolvency administrator, in accordance with Art. 435.3 of the Insolvency Act.

VI. CONCLUSIONS

1. It is in the essential interest of creditors participating in syndicated transactions that the subordination clauses between creditors also remain valid and effective when the common debtor enters into insolvency proceedings. These agreements already envisage systems for the redistribution of payments received by a creditor in insolvency to the other creditors in order to comply with the agreed subordination. However, as of 26 December 2022, the new paragraph 3 of Art. 435 of the Insolvency Act expressly establishes that subordination agreements will be recognised and enforced in Spanish insolvency

[59] According to para. 1 of the Preamble of Law 16/2022, insolvency proceedings are characterised by the fact that most of them end in liquidation, and not in an agreement. In particular, for legal persons, 90% of the successive stages are liquidation stages.

proceedings. The rest of the clauses of intercreditor agreements are not subject to recognition and enforcement in Spanish insolvency proceedings, for example, those regarding representation in insolvency proceedings, distribution of voting rights, majorities for the adoption of decisions, etc. Recognition in insolvency proceedings is strictly limited to the clauses regarding debt subordination between claims.

2. The insolvency administrator is obliged to recognise the subordination agreement between creditors, provided that it causes no damage to third parties and that the debtor is a party thereto, and must make payments in accordance with its provisions. The legal order of priority of credits is mandatory, although it is also imperative to respect the private free will of the creditor.

3. Standard subordination agreements may indicate that the junior debt holder can collect interest, fees and expenses derived from its credit, but will not collect the capital until all the prioritised creditors (senior debts) have been paid in full. However, there is contractual freedom as regards the specific clauses, and the terms of each agreement must be taken into account (Art. 57 of the Spanish Commercial Code).

4. In general, Art. 435.3 of the Insolvency Act represents an improvement in legal certainty for financial commercial transactions when a common debtor is declared insolvent. However, even those senior creditors with security interests in the debtor's assets are at risk of non-payment due to their devaluation. Creditors who have voluntarily subordinated their claims against other creditors are in an even worse credit situation.

5. In reality, in the interest of all, Art. 435.3 of the Insolvency Act should have a marginal application, and the debtor's crisis should be resolved beforehand in the pre-bankruptcy stage. This is the essential purpose of the reform to the Insolvency Act implemented by Law 16/2022, in transposition of Directive 2019/1023. In this regard, following the reform of the Insolvency Act, syndicated agreements are recognised in the restructuring plan on the procedure and exercise of voting rights (Art. 630). However, contractual subordination agreements are left out of the reform, as the legislator prefers the internal voting mechanisms themselves to be applied and externalised (section III of the preamble to Law 16/2022).