Insolvency – the key moment to determine whether or not bankruptcy should be declared in Spain

Bosco de Gispert
Grupo Gispert, Barcelona
bosco.gispert@grupogispert.com

The Provincial Court of Barcelona has ruled recently on a decision where dismissing the judgment made by a Court of First Instance states basic rules regarding bankruptcy declaration in Spain, indicating (1) when the insolvency situation should be determined in a bankruptcy proceeding; (2) settles uncertainties related to multiple creditor requirements; and (3) rules on debt subrogation made in bad faith.

On 28 December 2020, Barcelona Provincial Court No. 15 revoked entirely the judgement made by the Court of First Instance (Barcelona Commercial Court No 6), which dismisses a bankruptcy proceeding as consequence result of the fact that a third party paid the debts of the insolvent company, except to one creditor, under such circumstances the court considered that the bankruptcy could not proceed in view of the lack of multiple creditors.

Before analysing the legal grounds of the Provincial Court's decision (*Auto 200/2020*), we shall summarise the background of the case.

Background

In May 2018, a bankruptcy proceeding was filed by a creditor (the Creditor), against the insolvent company (the Company). In the same application, it was apparent from the latest reported accounts of the Company that there were other creditors who had already initiated executions against the debtor.

After corresponding formalities, the first instance court declared the bankruptcy proceedings as the Company had not formally opposed the application. A bankruptcy manager was appointed, who took office and began the functions of his position.

A provisional report was submitted by the insolvency administration in which the assets have been valued and where the multiple creditors were identified. When the bankruptcy manager had filed reinstatement actions, criminal actions were pending against the Company's manager and the execution in payment of the property subject to special privilege. The Company filed an extraordinary motion for the nullity of the proceedings due to defects in the summons to the company.

After the corresponding formalities, by the decision of the court, the bankruptcy declaration order was annulled, allowing the Company to file a statement of opposition to the bankruptcy application. The court upheld the grounds for opposition: the Company's bankruptcy was not declared as it was considered proven that the Company had satisfied all outstanding claims, with the exception of the claims held by the Creditor. The Court's decision considered that the Company was not insolvent as it had only one creditor enforcing its guarantees.

In light of the above, the Creditor appealed the Court's decision, claiming the following grounds:

- erroneous assessment of the evidence, inasmuch as the Company's insolvency would be accredited given that the payments it has made to creditors are all subsequent to the declaration of bankruptcy;
- infringement of Article 19 of the Spanish Insolvency Act, then in force, in that the amount owed had not been deposited before the Court;
- infringement of Article 18.2 of the Spanish Insolvency Act in that the burden of proving the debtor's solvency had been reverse;
- erroneous assessment of the evidence regarding the existence of multiple creditors; and
- erroneous assessment of the evidence regarding the award of costs at the time of the insolvency proceedings.

After seeing the background of this particular case, having in the first place recognised the bankruptcy situation of the Company and in the second place annulled it, Barcelona's Provincial Court analysed the filed appeal as follows.

Legal grounds

The assessment of the insolvency situation must be made at the time of the bankruptcy application

Many previous court decisions have held that the moment in which the application for bankruptcy is filed is crucial in order to declare whether we are facing an insolvency situation or not. For instance, a decision from 5 February 2018 (AP Barcelona Auto No. 317/2018) clearly shows that intention:

> 'The material aspect of this initial control on the justification of the application obviously does not translate into the requirement for the applicant for bankruptcy to provide full proof of the debtor's insolvency, or of the revealing fact consisting of the generalised failure to make payments, in such a way that the judge is convinced, on the basis of the application and the accompanying documentation, that the objective prerequisite for bankruptcy is actually met (except in the case of Art. 15.1 from the Insolvency Act).
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> 'On a material level, it is a question of the applicant providing suitable data and elements of justification so that the judge can form a provisional and indicative hearing, to a degree of well-founded probability, that the objective prerequisite for bankruptcy has been met with regard to the specific debtor, and not a simple possibility or hypothesis that will be cleared up or confirmed in the contradictory procedure. This a priori material control, when ruling on the application for bankruptcy, is coherent with the transcendence of this procedural act, since, if it is admitted for processing and proves to be unfounded, it may cause damages to the debtor, and hence the provision for compensation in Article 20.1 from the Insolvency Act in fine if the declaration of bankruptcy is rejected.'

Similarly, the Court stated in its decision from 8 March 2019 (AP Barcelona Auto No. 721/2019):

> 'The Barcelona Provincial Court considers that the declaration of bankruptcy seemed unquestionable at the time the Creditor filed the application for the Company's bankruptcy, as the creditors had not been satisfied and, furthermore, the company could have carried out some action aimed at diverting the company's funds to third parties, which actually was intended.'

In order for bankruptcy proceeding be declared, it is necessary for there to be multiple creditors

This matter has been controversial for a long time. Until the latest amendment of the Spanish Insolvency Act, the requirement of multiple creditors in order to start a bankruptcy proceeding was not explicit in the previous regulation. There was only mention of it in Article 2.1. of the Insolvency Act: 'the declaration of bankruptcy shall be made in the event of the insolvency of the common debtor.'

Much case law interpreted this provision as a requirement for the existence of several creditors in order to initiate bankruptcy proceedings. If there is a 'common debtor', it means that there is a plurality of creditors that concur against the debtor's assets, each with the legitimate claim to see their respective credits satisfied. If there were only one creditor, there would not be a 'common' debtor, but rather a 'debtor'. Therefore, there could be no concurrence and consequently no bankruptcy (AP Baleares Auto from 06 March 2008). This was not a unanimous position, however, as there were rulings and administrative decisions by the General Directorate of Registry and Notaries (DGRN) that considered that plurality of creditors was not essential.

However, the Consolidated Text of the Insolvency Act, 1/2020, which entered into force on 1 September 2020, states in Article 465 that the bankruptcy proceeding shall be dismissed when the definitive list of creditors proves that there is only one creditor. The wording of this provision seems to settle the discussion regarding the need of a plurality of creditors for the declaration of bankruptcy.

The Provincial Court states in its decision to this matter that it appears to be established that it was a third party who capriciously satisfied part of the outstanding debts, a circumstance which would determine that, at the date of the bankruptcy application, the plurality of creditors would be established. Even after the bankruptcy application, that plurality would be maintained since the third party who made the payment is subrogated to the position of those creditors – subrogation which is unrelated to the nature of those payments and their possible examination in bankruptcy proceedings.

The paying third party is subrogated to the position of the creditors

The only ground that the Company alleged for the nullity of the bankruptcy proceeding was the wrongful consideration that there was only one creditor left, as a third party paid the rest of the credits.

Although in accordance with the above Provincial Court's basis, the proceedings should not have been annulled as there was a plurality of creditors at the moment of filing the application of bankruptcy. The court additionally remarked that there were still multiple creditors even after the third party paid the other credits, as the paying third party subrogated the position of those.

This is fundamental in order to ensure legal certainty, and to avoid situations in which third parties (even companies of the same corporate group) pay debts, except to the creditor with the highest credit, for the sole purpose of avoiding bankruptcy proceedings. This was the situation in this case, in which the Creditor represented 99.71 per cent of the debt.

Conclusion

The decision of the Provincial Court establishes three clear principles. Firstly, that the moment of filing for bankruptcy should be the key moment to identify whether or not bankruptcy is possible. Secondly, it sets an end to the discussion as to whether or not a plurality of creditors is essential in order to be able to initiate bankruptcy proceedings in accordance with the new consolidated text of the Insolvency Act. Lastly, it rules out the possibility of a fictitious situation arising in order to avoid bankruptcy by means of the payment of almost all debts by a third party, but failing to pay the creditor with the highest outstanding debt.

Bosco de Gispert is one of the partners of Grupo Gispert, where he leads the Litigation and Arbitration Department. He has experience in complex insolvency procedures and has acted on behalf of clients and as a receiver appointed by the courts. He has experience in director's liability issues related to bankruptcy procedures and has helped clients in restructuring procedures and negotiations with creditors. The Insolvency and Restructuring department of the firm has been ranked by Chambers and Partners and Legal 500 for ten consecutive years.