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ARTICLE

Treatment of Shareholders' Right of Separation in Insolvency Proceedings

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Synopsis

The judgment of Audiencia Provincial de A Coruña (Provincial Court of A Coruña, the 'Provincial Court') in its ruling number No. 12/2018 of 15 January 2018 (the 'January 2018 Judgment') resolved some of the most relevant issues related to the exercise of the right of separation by a company's shareholder pursuant to Article 348*bis* of the Spanish Capital Companies Act ('LSC'), including, among others, after what time a shareholder loses its status for the purpose of Article 92.5 of the Spanish Insolvency Act ('LC') (see below) and the status of the shareholder's claim arising from the exercise of the right of separation in the waterfall upon insolvency.

Introduction: the shareholder's right of separation

Article 348 of the LSC recognises the right of separation of a company's shareholder where (i) the general shareholders' meeting of that company did not pass a resolution to distribute at least one third of the legally distributable profits arising from the company's main business activities after the fifth year from the date of the company's registration on the Companies Register and (ii) such shareholder voted in favour of distributing the distributable profits as dividends.

The purpose of this provision is to protect minority shareholders from majority shareholders' abusing their power, recognising for the first time in the Spanish legal system the specific right of the shareholders to receive dividends from the companies in which they hold shares.

Before the introduction of Article 348*bis*, the LSC already recognised the right of shareholders to take part in the distribution of a company's profits (Article 93 of the LSC). However, as academic commentators point out, the latter provision creates an abstract right different from the specific right to claim the dividend of a specific year.

The right of separation in Article 348*bis* was incorporated into the LSC by means of Law 25/2011 of 1 August 2011 concerning the partial reform of the LSC which entered into force on 2 October 2011.

However, given the economic situation in which the country found itself in 2012, Article 348*bis* of the LSC was suspended shortly after its entry into force, on 24 June 2012, by Law 1/2012 of 22 June 2012 concerning the simplification of the obligations of information and documentation of mergers and divisions of corporations. The suspension was initially effective until 31 December 2014 but subsequently extended twice by Royal Decree: Law 11/2014 of 5 September 2014, concerning urgent measures in bankruptcy matters and Law 9/2015 of 25 May 2015, concerning urgent measures in bankruptcy matters, which suspended the application of Article 348*bis* of the LSC until 31 December 2016. Finally, on 1 January 2017, Article 348*bis* of the LSC entered into force again.

The following requirements must be met for the shareholder to rely on Article 348*bis* of the LSC:

a) The company has been registered for five years in the Companies Registry

It is necessary that five years have elapsed since the registration of the company in the Companies Registry. Pursuant to jurisprudence and grammatical interpretation, the fifth year is included. Accordingly, the provision is available in relation to the profits of the fifth year whose distribution would be proposed to be adopted in the annual general shareholders' meeting taking place in the sixth year.

b) The shareholder voted in favour of the distribution of dividends

Only shareholders who voted in favour of distribution of the profits or against reinvestment of the profits in the company (as appropriate) will be entitled to exercise the right of separation on the basis of failure to distribute dividends. Additionally, it is accepted that shareholders who have been illegally prevented from casting their vote are also entitled to exercise their right of separation.

Those shareholders who did not attend the general shareholders' meeting which adopted the resolution not to distribute dividends, shareholders who have not paid up their shares in full or in part, the shareholders who abstained from voting and the holders of social participations or non-voting shares are not entitled to use the right of separation.

c) The general shareholders' meeting fails to resolve that a dividend of at least one third of the profits of the business made in the previous year be distributed

The provision refers to 'profits from the exploitation of the corporate purpose'. This must be interpreted as profits that are derived directly from the ordinary activities of the company. Therefore, extraordinary and atypical profits, such as those derived from the sale of productive assets that were part of the company, are excluded.

d) The profits are legally distributable

There is no legal restriction on the basis of which the company can refuse to distribute profits such as the need to compensate for previous losses or provide legal or statutory reserves.

Classification of the claim resulting from the right of separation as subordinated

The January 2018 Judgment of the Provincial Court concerns a dispute commenced as early as October 2011 by a minority shareholder, the owner of the 14% of the share capital of a company, who had exercised the right of separation. Despite the company's objection, the minority shareholder's exercise of the right was recognised by the court on the basis that the company had failed to distribute dividends. In the same judgment, the company was ordered to pay to the claimant the fair value of the shares in consideration, which was determined to be EUR 1,263,654.70 by an external account auditor. The valuation was subsequently challenged by the company in ordinary judiciary proceedings which are pending at the time of writing.

As the company had insufficient liquidity to pay the consideration to the separated shareholder as ordered by the court, the company submitted a petition for the commencement of insolvency proceedings, which was granted by an order dated 14 November 2016. The designated insolvency administrator included the claim resulting from the minority shareholder's exercise of the right of separation in the list of creditors. The claim was classified as subordinated and contingent on the basis that a dispute concerning the valuation of the claim was still to be determined in separate judicial proceedings.

This classification was challenged by the minority shareholder who requested the claim to be classified as ordinary (unsecured) and contingent. However, Mercantile Court no. 1 of A Coruña (the 'Mercantile Court') in its judgement of 31 July 2017 dismissed the challenge entirely and upheld the insolvency administrator's classification.

In its judgment, the Mercantile Court held that the right of separation implied an advance distribution of the shareholder's right to share in the shareholders' equity pursuant to Article 93 of the LSC. In other words, the right of separation is equivalent to the right of the shareholder to take part in the residual equity in a liquidation which is anticipated in time and involves liquidation of only the share of the shareholder, not the whole company. On this basis, the Mercantile Court considered that the right of a shareholder to take part in the residual equity in a liquidation is subordinated to all other creditors' claims being satisfied. Therefore, a claim resulting from a shareholder's exercising the right of separation is to be classified as a subordinated and contingent claim.

Classification as an ordinary claim

The insolvency administrator's analysis, which was upheld by the Mercantile Court as the first instance court, was recently rejected by the Provincial Court. In its January 2018 Judgment, the Provincial Court (as a court of appeal) ruled that a claim resulting from the exercise of the right of separation must be classified as ordinary (unsecured) and contingent. In reaching this conclusion, the Provincial Court resolved different relevant issues related to the exercise of the right of separation in the context of insolvency proceedings, such as: a) no application of liquidation rules applicable to companies in instances where the right of separation is exercised; b) the time period after which the shareholder loses its status as shareholder; and c) the classification of the claim as a loan or analogous act.

a) No application of liquidation rules applicable to companies in instances where the right of separation is exercised

As mentioned above, the Mercantile Court considered that the right of separation implied an advance distribution of shareholders' equity. Consequently, the shareholder's right to take part in the residual equity in a liquidation is subordinated to all other creditors' claims being satisfied. However, the Provincial Court stated that an exercise of the right of separation could not be compared to the liquidation and dissolution of a

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company, as, in a liquidation, all of the shareholders' equity is liquidated and the procedure concludes with the dissolution of the company. By contrast, in the case of a shareholder separation, the company remains intact, despite the inevitable loss in value as a result the separation.

b) Loss of shareholder status

The Provincial Court subsequently dealt with the controversial issue concerning the time at which the shareholder loses its status as shareholder. Article 92.5 of the LC states that claims against the insolvent debtor by its shareholders are subordinated, as shareholders are persons with a special relationship with the debtor in accordance with Article 93 of the LC. Therefore, it is especially relevant to establish at which point in time a shareholder loses its status as shareholder for these purposes. This issue is not regulated by statute and academic commentators are divided on it.

There are three different views: (1) The first view considers that the shareholder loses its status for the purpose Article 92.5 of the LC when the exercise of the right of separation is notified to the company; (2) the second view considers that the status is lost when a court recognises the shareholder's right to separate; and (3) the third view considers that the status is lost only when the company pays the consideration due on separation to the shareholder.

The Provincial Court adopted the first view and stated that the exercise of the right of separation is a statement of intent effective from the moment the shareholder notifies the company of its exercise, even though a challenge of the claim's valuation was pending. The Provincial Court referred to Tribunal Supermo case law, in particular to judgement number 32/2006 of 23 January 2006, in which the Tribunal Supermo stated that the right of separation is a subjective and facultative right which is immediately effective and cannot be undermined by subsequent events such as the shareholder's own acts or acts of the company.

c) Classification of the claim resulting from the right of separation as a loan or transaction for the same purpose

Lastly, the Provincial Court ruled, in the alternative, that it would not be possible to subordinate the claim pursuant to the Articles 92 and 93 of the LC, even if the shareholder were considered a person with a special relationship with the debtor. This is on the basis that Article 92.5 states that claims other than loans or transactions for the same purpose of financing the company shall not be subordinate.

In the Provincial Court's view, a claim resulting from the exercise of the right of separation is not equivalent to a loan or transaction for the same purpose, as it cannot be considered a transaction in which the company received a fungible asset or money for use on condition of repayment and which is of the kind and terms as required by Article 1740 of the Spanish civil code, which regulates loan contracts.

In conclusion, the Provincial Court, in its January 2018 Judgment, ruled that a claim resulting from the exercise of the right of separation is to be classified as a contingent and ordinary (unsecured) claim and resolved the aforementioned relevant issues related to the exercise of the right of separation.

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