CLIFFORD CHANCE

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Shadow directors and facility agreements

There have been several recent cases in which financial institutions have been accused of acting as shadow directors of companies which have been declared insolvent.

The judgment handed down on 3 June 2014 by Madrid Commercial Court No. 5 (insolvency of Mag Import S.L.) helps to focus this debate.

Key issues

- The threat of shadow directorship
- Case law on shadow directors
- The treatment of shadow directorship in the Judgment of 3 June 2014
- Conclusion

The threat of shadow directorship

In several insolvency proceedings underway, lending entities have been accused of having acted as shadow directors of the insolvent company due to the influence they had on the company before its declaration of insolvency.

Often in the context of syndicated financing (whether relating to project financing, leveraged buy-outs, corporate financing, refinancing, etc.), a series of restrictions are set out in the contractual documentation by way of positive covenants, negative covenants, representations and warranties, etc. This contractual framework, of varying complexity, is a breeding ground for allegations of "shadow directorship" on the part of lenders. For a lender to be found to be a shadow director entails the significant consequence (explained below) of being classified in insolvency proceedings as a party having a special relationship with the debtor ("specially related persons").

The legal foundation for this subordination hypothesis is Article 92.5 in relation to the provisions of Article 93.2.2 of the Spanish Insolvency Law (*Ley Concursal*) ("LC").

Shadow directorship can result from either the insolvency receiver's report, by means of the subordination of the debt of the lender in question (which the lender is then forced to challenge), or a challenge by the debtor of the List of Creditors, so that whoever was considered an ordinary creditor by the insolvency receiver is reclassified as a subordinated creditor.

Shadow directorship has extremely serious consequences. Not only does it determine the subordination of the debt of the lender classified as a specially related person, but it also leads to the cancellation of security once this status is made final (Article 97.2 LC). It is also possible to attribute liability to the shadow director for causing or aggravating the insolvency, which in exceptional cases can involve being held liable for debts (Article 172 bis LC).

In view of this legal scenario, there is no doubt that the mere suggestion of shadow directorship can completely alter the insolvency situation. The debtor might see a possibility of cancelling security, converting its main creditors into ordinary liabilities, for the purpose of an arrangement. In turn, the creditors will see a risk emerge, with consequences which are difficult to predict, not only with regard to recovering their debts, but also because they could incur additional liability. In this sense, shadow directorship can be used by a debtor or by insolvency receivers as a mechanism for putting very great pressure on lenders, who almost always represent the debtor's main liability.

In many cases, it is the insolvent company itself which alleges the existence of shadow directorship. When this is the case, it is paradoxical that the party which has been following its creditors' instructions should later seek to alter this dynamic, thus calling into question its own conduct. In short, a third party can only take over the management when the formal administrator has relinquished its duties. This mechanism can even reach the extreme where a debtor, seeing insolvency on the horizon, baits the creditor in an attempt to pre-constitute proof in subsequent insolvency proceedings, in which the debtor will end up using this threat to force the creditor to negotiate.

In such cases there are parallels with claw back actions, where often it is the insolvent company itself (the same one which, some months earlier, freely and voluntarily signed a refinancing agreement or saw fit to grant security in favour of another company in the group) which suddenly becomes interested in weakening the position of its creditors, in flagrant contradiction of its previous conduct.

Case law on shadow directors

In summary, shadow directorship entails a transfer to third parties of the decision-making powers inherent to the management body.

Commercial law doctrine has always stressed that shadow directorship constitutes an anomaly, a "pathology" of corporate life. Case law has been gradually defining the requirements that must be met in order for shadow directorship to exist: in short, the taking of actions related to the company's administration and management by parties which are not part of the management body, in an autonomous and ongoing fashion.

Based on this case law construction, the successive reforms of commercial and insolvency law have assimilated the figure of the shadow director to the *de iure* director for liability purposes. What has been stated in case law until now, on assumptions which have not varied, has now been formally acknowledged.

In view of the case law issued until now on insolvency matters, we continue to have no doubt as to the exceptional nature of this legal concept, which the courts continue to apply with caution.

The treatment of shadow directors in the judgment of 3 June 2014

We know that facility agreements authorise lenders to take actions which undoubtedly affect the debtor’s power to manage and use its assets.

In fact, it is common for a debtor and its creditors to agree that certain actions by the debtor (including certain payments) are subject to the approval of the creditors. In this way, the parties ensure that the debtor uses available cash for the purposes set out in the facility agreement and, ultimately, to repay the debt. In this case, the debtor remains in a position to spend its money, even contrary to what has been agreed, but if it does so, it will commit a contractual breach.

When, in addition, security exists, such as a pledge on bank accounts, the power to dispose of assets is limited in itself, such that the debtor needs express authorisation from the creditors in order to make certain payments (sometimes disposal procedures are established according to amounts or designated uses). These blocking mechanisms are ancillary to the security, which would otherwise not be effective.

Until several years ago, no one would have thought that the powers conferred on lenders by facility agreements could give rise to shadow directorship. The first alarms began to sound during the insolvency of Aifos, where the Malaga Commercial Court understood just the opposite (judgment of 7 April 2011). Leaving aside the legal grounds of this quite questionable judgment, it suffices to read it to note that the facts declared proven do not correspond to what is usually considered normal in these cases.

As we have already mentioned, a number of recent insolvencies in which lenders have been considered to be shadow directors have brought this issue to the fore once again. In times such as these, many companies need the support of their creditors in order to survive, either because they are complying with the provisions of refinancing agreements that are already in place, or because they are negotiating refinancings. In this context, lenders are in a difficult position. The same debtor which is now seeking their support and offering its cooperation in order to ensure the fulfilment of the agreements, may reappear a few months later claiming that the lenders unlawfully interfered in its administration and management. The question is clear: *Just how far can a lender go in this case?.*

The answer depends on the specific case at hand. However, some very interesting conclusions can be drawn from the judgment handed down by Madrid Commercial Court No. 5 on 3 June 2014.

No matter how well-known, the Judge wished to recall the Spanish Supreme Court's case law relating to the general premises of this legal concept. In this regard, he noted that the lenders were merely "supervising and demanding fulfilment of the facility agreement, in defence of their legitimate interests". In other words, the lenders had limited themselves to exercising their contractual rights.

In this case, the lenders had been mainly accused of using the existing balance in current accounts and deciding on making payments on behalf of the company. In light of these accusations, the Judge reminds us that shadow directorship requires proving the habitual execution of administrative, management or organisational acts. Regardless of whatever influence the lenders may have had on the decisions of the insolvent party, the lenders did not have decision-making autonomy. What is more, these entities lacked the ability to make decisions, which continued to belong to the debtor ("*an order from the insolvent party is required in order for payment to be made*").

In short, the Judge concluded that the lenders had merely supervised to ensure that certain expenditure did not affect the repayment of the loan originally granted.

Conclusion

In an environment in which the allegation of shadow directorship constitutes a very powerful weapon in the hands of debtors and insolvency receivers, the judgment handed down on 3 June 2014 by Madrid Commercial Court No. 5 reinforces the premises of this legal concept and stresses that the exercise by lenders of the powers granted to them in facility agreements is in no way whatsoever anomalous.

Obviously, shadow directorship should be analysed on a case-by-case basis, taking individual circumstances into account. Since the temptation of subordination exists, which can be very attractive as a negotiating tool, lenders cannot afford to let their guard down. In this regard, there are two aspects of the case discussed to be kept in mind: i) the ability to use assets should belong to the debtor – lenders can only verify if payments comply (or not) with the provisions agreed, and ii) the exercise by lenders of their powers should strictly reflect what has been agreed. To reduce the risk, it is very important that lenders respect these limits, in terms of both their substance as well as their form, paying special attention to communications with the debtor.

This case is particularly welcome because it contributes to legal certainty at a time when Spanish companies are seeking financing and Spain's legislator is focusing on avoiding insolvencies at all costs. The risk of subordination by shadow directors should be restricted to those parties which have truly exceeded the limits. If normal cases are included in the same legal regime which applies to a pathological situation, this could cause irreversible damage to the market, since lenders would ultimately prefer their debtors to be declared insolvent than assume the risks of a refinancing which may eventually work against them.

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