Briefing note

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LENDER AS A SHADOW DIRECTOR

In debt restructurings, the question frequently arises as to whether a lender can be considered a shadow director (*de facto* director) as a result of the latter's involvement in the rescue of the debtor.

The reason behind this concern is not due to a trend in case law in this regard. As we will see, the handful of rulings that have treated lenders as shadow directors were in response to exceptional circumstances that rarely arise in the context of debt restructurings. That said, there are several helpful rulings that have held that the monitoring of a debtor's business activities by a creditor, within the context of the terms agreed in a refinancing agreement, does not constitute shadow directorship.

To avoid being considered a shadow director, the creditor must limit its actions to supervising and monitoring and must not interfere in debtor's decision making procedures. Occasionally it can be difficult not to overstep this limit, particularly if the borrower seeks assistance from the lender and encourages and invites the lender to assist with the management of its affairs.

1. THE CONCEPT OF SHADOW DIRECTORSHIP

The existing case law on shadow directorship is quite consistent. A summary of the legal doctrine in this regard can be found in a recent ruling handed down by the Madrid Court of Appeal on 23 December 2016 (Aucosta insolvency proceedings), which cites a Spanish Supreme Court ruling dated 22 July 2015.

These rulings state that for shadow directorship to be considered to exist, certain prerequisites must be met - one negative one (not having been appointed director) and three positive ones: i) acquiring decision-making powers corresponding to the management body; ii) systematically and continuously performing significant actions; and iii) having autonomy (in the sense of autonomous decision-making powers).

In all cases, the consequence of a lender being considered a shadow director is the treatment of the lender's loans, which are then subordinated to other claims (this also brings about the cancellation of in rem guarantees). It can also result in liability for the lender, in the event of a subsequent insolvency which is attributed to the negligent actions of the directors.

2. THE STARTING POINT OF OUR ANALYSIS: THE EXCEPTIONAL NATURE OF SHADOW DIRECTORSHIP

From the case law we have discussed, we can draw an initial conclusion: shadow directorship is an anomalous phenomenon and, as such, it is exceptional in nature. Therefore, it should be interpreted in a restrictive manner (ruling of Madrid Commercial Court No. 5 dated 3 June 2014).

The Supreme Court ruling of 8 April 2016 points out that "*the legislative tendency is not to classify as subordinate the loans of those lenders that help to refinance debtors that are at risk of insolvency*". The ruling explains that the aim of the amendment of Article 93.2.2 of the Spanish Insolvency Act (Act 9/2015, of 25 May) was precisely to provide lenders with a degree of protection in the context of a restructuring against the risk of being considered a shadow director.

Although the legislator's intention was clear, the amendment of Article 93.2.2 was not entirely successful. Some commentators consider that the clarifications it introduced were unnecessary and only served to create more confusion. On the one hand, such Article refers to creditors that participate in a debt to equity swap in the context of a refinancing agreement foreseen in Article 71 bis or in the Fourth Additional Provision of the Insolvency Act. However, it goes without saying that the mere fact that a creditor becomes a shareholder does not carry any risk of shadow directorship, when the directors appointed by the shareholders act independently. On the other hand, the amendment states that creditors will not be considered shadow directors on account of the obligations associated with a viability plan. It is also clear that simply monitoring a debtor, does not, in any event, equate to participating in the decision making procedures of the debtor.

3. SHAREHOLDER STATUS CARRIES NO RISK OF SHADOW DIRECTORSHIP BEING CONSIDERED TO EXIST

If a creditor, in general-) acquires an equity stake in the debtor, this does not mean that they are automatically considered to be a shadow director. A different matter is whether or not the creditor would be subject to subordination as a result of its shareholder status (if its stake is greater than 5% or 10%, depending on the case). If the creditor is not a shareholder at the time of granting the loan, then its loans should not be subordinated.

Not even majority shareholder status can result in a scenario of shadow directorship, (A Coruña Court of Appeal ruling of 26 June 2009). The power to appoint directors (which is inherent to shareholder status) does not necessarily entail exercising control or influence over directors' decisions. As a general rule, the role of a shareholder and a director are not be considered to be one and the same. Anyone arguing otherwise would need to prove that the director is, in fact, simply being used by the shareholder to make the decisions (ruling of the Madrid Court of Appeal dated 23 December 2016).

4. MONITORING COMPLIANCE WITH A FACILITY AGREEMENT DOES NOT TRIGGER AN INSTANCE OF SHADOW DIRECTORSHIP

A good example of the issue being analysed here can be found in the case decided by the judgment handed down by Madrid Commercial Court No. 5 dated 3 June 2014 (Mag Import insolvency proceedings).

The case involved the provision of syndicated financing to a debtor, which ended up in insolvency proceedings. The creditors had monitored the debtor's activities, exercising the powers conferred upon them under the facility agreement. In the proceedings, the Insolvency Receivers deemed that the creditors had acted as shadow directors. But the Court held otherwise. In short, it considered that the creditors had not been involved in "*managing and executing the business activities*", but instead had only been "*monitoring and demanding compliance with the facility agreement, in defence of their legitimate interests*".

The Court analysed the actions that the Receivers had presented in their argument: the payment of invoices required an order from the debtor, and the creditors had merely been able to indicate that certain payments made by the debtor were in breach of what was agreed. Essentially, the creditors had only been "*monitoring compliance with the loan agreement*". There was no proof that they had been involved in "*acts of managing, directing and executing the insolvent party's business activities*". Nor did the Court observe "*a decisive influence on the decisions related to the insolvent party's activities*".

This opinion is supported by the judgment handed down by the Supreme Court on 8 April 2016. Although it refers to the supervisory activities of the Spanish State's industrial holding company (SEPI), its reasoning is equally applicable to the case of a lender: "*the SEPI's activities consist of establishing guidelines for viability and ensuring that they are met*".

5. SIGNIFICANT INTERFERENCE

There are very few rulings that have attributed shadow director status to a lender. Two of them were handed down by the same court (Malaga Commercial Court) in the same insolvency proceedings (Aifos), namely: the judgments of 7 April and 26 May 2011. The exceptional nature of the facts they deal with confirms our analysis – the lenders were considered shadow directors because: i) they modified and cancelled loans and contractual relationships between the debtor with third parties; ii) they extended guarantees; iii) they decided which works would be completed and which would not, in their own interest; and iv) they decided which debts to suppliers would be paid. Ultimately, the Judge concluded that there had been continuous interference by the creditor in the decision-making power that corresponded to the management body.

A cause of greater concern is the case decided by Madrid Commercial Court No. 4 in its judgment of 10 March 2016 (Chamartín La Grela insolvency proceedings), which is still pending appeal. In this case, the Receivers had treated the creditor's loans as subordinated claims. The Court sets out the proven facts in a single paragraph, as follows:

"*In the case in question, the Insolvency Receivers and the co-defendant allege and prove that the plaintiff entity fully has shadow director status, because the insolvent party was obliged to provide it with all kinds of information regarding the economic and financial performance of the business, all amounts received by the insolvent party were deposited to a pledged account, and so on*".

Later on in its judgment, although this statement is not reflected whatsoever in the facts declared proven, the Court also stated that the creditor "*controlled and decided how these amounts were allocated to pay taxes, salaries and social security, etc.; that is, the ordinary payments of its corporate activities. In other words, controlling income and payments implies having essential control over the company and obviously having exhaustive knowledge of its economic and financial situation*".

6. CONCLUSION

As we see, except for this latest court decision (which is still subject to an appeal), and which seems to confuse control and the decision-making capacity of the debtor, there are very few cases in which a lender has been considered to be a shadow director. Those cases have been in response to exceptional circumstances, in which the creditor not only controlled but also participated in the decisions taken by the debtor.

When the creditor controls the activities of the debtor in exercising the powers attributed to it in the facility agreement, no shadow directorship exists. The anomaly is that decision-making power is transferred to the creditor, and the creditor must take a reactive, and not an active, stance.

Shadow directorship will not even be considered to exist if the creditor has the power, because it has become a shareholder, to appoint directors, provided that the director it appoints is not a mere instrument, only executing the instructions of the creditor-shareholder. When creditors appoint an observer to the management body (with the right to speak but not to vote, at the most), the risk of shadow directorship being considered to exist will be even lower.

Even though there may be no legal basis to do so, there is no doubt that in an insolvency, treating the main lenders' loans as being subordinated to other claims may be a strategy which an Insolvency Receiver adopts to force creditors to negotiate, or to increase the likelihood of collecting the remaining debts. Thus, lenders must be extremely wary of the relationship they have with their borrowers, especially in distressed situations. The communications exchanged between the parties (which tend to be the main evidence in these cases), must show that the borrower is the one making the decisions and that the lenders are only monitoring the borrower's actions, to the extent permitted under the facility agreement.

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