Right of separation of minority shareholders and insolvency proceedings

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Litigation, Spain

Introduction

The A Coruna Court of Appeals recently addressed two key issues relating to a shareholders' right of separation regulated under Article 348*bis* of the Companies Act – namely:

- when a separation is effective; and
- what happens when the credit right for reimbursement leads the company to insolvency.**(1)**

Article 348*bis* of the Companies Act (1/2010), which came into effect on January 1 2017, recognises the right of separation of minority shareholders of non-listed companies in the case of non-distribution of dividends. In particular, this provision addresses one of the most common abuses by majority shareholders: rejecting the distribution of dividends even if the company is in the black year after year. In this scenario, the majority shareholders of a company prevent the minority shareholders from benefiting from the company's revenues, while – as insiders – such majority shareholders profit from remuneration as directors or other contractual agreements from which the minority shareholders are excluded.

Article 348*bis* is important for regulating the relationship between majority and minority shareholders. However, although the provision was included in the Companies Act in 2011, its application was suspended until January 1 2017. Due to the constant delays in the provision's effective implementation, there is little case law on the matter and a lack of harmonised criteria for interpreting the provision and applying the right recognised therein.

Thus, the decision rendered by the A Coruna Court of Appeals on January 15 2018 is significant, particularly because it analyses the following questions which are likely to arise from the application of Article 348*bis*:

- What happens when the exercise of the right of separation generates a reimbursement obligation regarding the minority shareholder that leads the company to insolvency?
- How should this credit right for reimbursement be recognised in the framework of insolvency proceedings?

Facts

Due to the lack of distribution of dividends, a minority shareholder exercised its right of separation under Article 348*bis*. The company opposed this act and the dispute was decided by a court, which recognised the shareholder's separation right and ordered the company to reimburse the reasonable value of the shares.

The shares were appraised by the Commercial Registry at €1.2 million. Although the company challenged such appraisal, the order to reimburse the amount to the minority shareholder led the company to insolvency.

Within the insolvency proceedings, the minority shareholder requested that its credit right for reimbursement be recognised and ranked as a potential credit right that would become an ordinary credit right when the challenge of the appraisal was decided. However, the insolvency administrator recognised the credit right and ranked it as a potential credit right that would become a subordinated (and not ordinary) credit right, as it considered that the minority shareholder was specially connected to the insolvent company. The decision addresses the shareholder's challenge of the ranking which was recognised by the insolvency administrator.

Decision

Under Spanish law, credit rights are ranked according to their nature and the creditor. This ranking will determine the payment in the framework of the insolvency proceedings. Having a credit right ranked as ordinary or subordinated has a direct impact on the chances of recovery: subordinated credit rights are repaid after all privileged and ordinary creditors have been fully satisfied.

The decision, contrary to the position adopted in the appealed first-instance ruling, considered that the credit right for reimbursement should be ranked as ordinary for several reasons.

First, the right of separation cannot be likened to a company's dissolution or liquidation.The first-instance ruling considered that the reimbursement right is an early exercise of the division of common property and that the rules for the dissolution of companies should thus apply. In a dissolution scenario, the shareholder can obtain its share of the remaining estate after all creditors have been paid. Applying this rationale to the insolvency, the first-instance ruling considered that the reimbursement credit right must be ranked as a subordinated credit right which is paid only after all other creditors have been paid.

The decision considers that the right of separation cannot be likened to a company's dissolution or liquidation. A dissolution entails the winding up of all of a company's assets and the extinction of said company on completion of the liquidation process. Conversely, the separation of a shareholder does not entail the extinction of the company even if its assets are reduced because the company must pay the shareholder the value of its shares.

Although the decision acknowledged that this payment obligation could reduce the recovery expectations of other creditors, a reimbursement does not, according to the Companies Act, depend on the prior liquidation of existing debts.

Second, a shareholder which exercises its right of separation before an insolvency declaration cannot be considered a specially connected party. The credit rights of creditors that are specially connected to an insolvent company (ie, shareholders) are subordinated, unless certain requirements are met. Therefore, it is important to determine the moment when the shareholder exercising the separation is no longer considered a shareholder.

There are different positions in this regard. However, the A Coruna Court of Appeals fortunately adopted the most reasonable solution in the case at hand by holding that the separation under Article 348*bis* will be effective when the company has been notified, even if the separation is challenged. The right of separation is a personal and optional right and takes effect immediately, so subsequent events (eg, the company's opposition) cannot undermine it.

Therefore, if the right of separation is exercised before an insolvency declaration, the former shareholder would not be a connected party for the purposes of ranking its credit right. In this particular case, the dispute regarding the value of the shares could not present an obstacle to the separation and the effectiveness thereof.

Finally, the reimbursement credit right cannot be likened to financing transactions. The decision also highlights that, even if the shareholder was considered specially connected to the insolvent company, the requirements for subordinating the credit right had not been met. Under Spanish law, the subordination of creditors specially connected to a debtor is limited to those credits deriving from a loan or similar financing transactions. However, the payment obligation (ie, the reimbursement) arising from the right of separation can never be considered a financing transaction.

Comment

This decision sheds light on the legal nature of the right of separation and, in particular, how the payment obligation regarding a minority shareholder must be regulated in the event of insolvency. The decision is clear in establishing that if a separation right is exercised before an insolvency declaration, there are no solid grounds for subordinating the credit right for reimbursement arising from the separation.

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Endnotes

(1) Appeal Proceedings 640/2017.

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