Update on the question of the consideration of financial creditors as *de facto* directors of insolvent borrowers

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Financial institutions usually include provisions in their loan agreements which allow them to monitor the activity of their borrowers. As a scholar has put it, the *"bank is entitled to keep a close eye on what is done with its money, and to impose conditions on its support for the company".* However, the extent of the monitoring of and the influence on the borrower should be considered carefully as, in certain circumstances, lenders can be held *de facto* directors*.*

Being held a *de facto* director of an insolvent borrower may have serious consequences for the lender from a double perspective:

(i) On the one hand, the lender's claim will be subordinated and its collateral, if any, will be cancelled; and

(ii) On the other, the financial institution may be subject to the same regime as if it were a *de jure* director, which means that it: (a) may be disqualified to administer assets or businesses for a period of between two and fifteen years; (b) may lose its claim; and (c) in exceptional situations, may even be held responsible for the insolvent company's debts.

Spanish courts generally have adopted a restrictive approach when considering the application of the *de facto* directors' doctrine. And scholars have traditionally maintained that courts would rarely hold financial institutions liable when merely attempting to protect their loans. However, a number of decisions handed down in 2011 and 2012 by the Commercial Court of Malaga raised the alarm among legal practitioners (especially banks' in-house lawyers).

Indeed, the Commercial Court of Malaga found that some of the most important Spanish banks were to be regarded as *de facto* directors in the context of a major real estate company's insolvency and, accordingly, ruled that their respective claims had to be classified as subordinated.

Although the above referred decisions have been heavily criticised and even though they are not final –several appeals seem to be currently pending before the Malaga Court of Appeal–, it is important to highlight that the Court found that the financial institutions did not comply with the terms and conditions agreed in their respective loan agreements. That is to say: the financial institutions were held to be *de facto* directors not because of the agreements *per se,* but precisely because they deviated from what was initially agreed or exercised their control rights in an abusive manner.

As a matter of fact, the same Commercial Court of Malaga expressly declared in a further decision rendered in the context of a different insolvency, in which the lender had been granted the right to merely manage the funds related to some specific real estate projects of the borrower, that said agreement*, "no matter how wide its faculties are,* [did] *not allow to consider* [the lender] *as a* de facto *director*." Therefore, a careful analysis of the way in which the relationship between the lender and its borrower has actually happened is necessary in order to ascertain whether the lender may be held to be a *de facto* director.

According to the Commercial Court of Malaga, the following circumstances might lead to consider that a financial institution has behaved as a *de facto* director:

(i) The financial institution performs the functions of the borrower's board of directors.

(ii) The financial institution independently and autonomously adopts decisions that are imposed upon the formal directors and affect essential or strategic activities of the borrower.

(iii) The financial institution has changed its attitude vis-à-vis its debtor precisely when the situation of the latter has worsened, with a view to protect or secure its claim.

(iv) The decisions adopted by the financial institution are detrimental to the company's interests and beneficial to the former.

In view of above, it seems clear that a financial institution will be considered a *de facto* director when it adopts a role that goes beyond the mere control of its borrower, to the extent of interfering in the borrower's decision-makers regardless of what the loan agreement says.

The above is confirmed by a well-known judgement of the Commercial Court No. 5 of Madrid of 3 June 2014 in which the claimant (an insolvent company) argued that a given financial institution had become a *de facto* director because, inter alia, it had (i) decided when and in which order should the bills be paid and (ii) controlled the cash of the company.

The Court, after stating that subordination of claims as a result of being held a *de facto* director "*should be restrictively interpreted as it is an exception to the rules on classification of claims*", dismissed one by one the claimant's arguments, finding that the financial institution limited itself to complying with the loan agreement and its role was not to manage the insolvent company, "*but to supervise and enforce the fulfilment of the agreed financing terms according to its legitimate interest.*"

This approach has been followed by subsequent decisions of other courts:

(i) In a judgement of 3 December 2014 the Commercial Court of Oviedo held that a financial institution had not acted as a *de facto* director by merely enforcing the terms agreed in a loan agreement, even though such terms were significantly advantageous for the lender.

(ii) In a judgement of 23 April 2015 the Murcia Court of Appeal confirmed that the lender should not be considered a *de facto* director because its conduct "*fell within the framework of its condition as a financial institution and in accordance with business criteria.*"

(iii) In a decision of 10 December 2015 the Commercial Court of Teruel found that the fact that the financial institution had appointed a controller in order to monitor the activities of its borrower did not allow to conclude that the lender had acted as a *de facto* director, as the parties had expressly agreed that said controller was "*to carry out a rigorous monitoring of the insolvent company*".

Finally, it is worth mentioning that, probably inspired by the above referred case law, section 93.2.2 of the Spanish Insolvency Act, as amended in 2014 and 2015, now includes the following paragraph:

> *"Nor shall have the consideration of* de facto *directors creditors who have signed a refinancing agreement, an insolvency composition or an extrajudicial agreement to pay obligations undertaken by the debtor in relation to a viability plan, except if the existence of any circumstance that might justify that condition were to be proven".*

To sum up, it seems that Spanish courts and the lawmaker accept that contractual rights of control do not *per se* imply the consideration as *de facto* director, because financial lenders have the right to monitor the activity of their borrowers, provided that they do not unreasonably interfere in the company's own decision-making process. In our opinion, this approach is the right one. However, a close watch should be kept in the actual way in which the relationship between the lender and the borrower develops, in order to avoid being considered a *de facto* director.