Corporate governance and groups of companies: common doubts

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1. Introduction

The recent amendment to the Spanish Companies Act (abbrev. LSC) has significantly modified the rules governing directors' duties. On the one hand, in respect of the duty of care, by introducing the business judgment rule and protecting the strategic and business decisions that the directors make in an informed manner and in the best interest of the company. On the other hand, by clarifying and supplementing the content of the duty of loyalty and the causes of action that a breach of this duty can give rise to. These changes have important consequences for companies that form part of groups, and especially for those where there is a relevant (not single) shareholder. This briefing note focuses on some of the problems and doubts that arise in these cases.

2. The concept of interest of the company and its coexistence with the interest of the shareholders

The duty of loyalty is defined by the LSC as the duty of "*acting with the loyalty of a faithful representative, in good faith and in the best interest of the company*."

It is clear that directors owe loyalty to the directed company, regardless of who appoints or even pays them. As the Supreme Court states, the director "*once appointed, […] serves the interests of the company, not of those who appointed him or her*."

This approach, apparently clear and simple, nonetheless raises many doubts in its application.

It is common to see shareholders' agreements where each shareholder undertakes to give instructions to the directors that it appoints and where the directors personally undertake to follow them. This may determine the invalidity of the agreement as it neglects that the director must be independent from the interests of the person who pays or appoints him or her and thus cannot follow instructions from single shareholders. The same effect can be lawfully obtained if the General Meeting of Shareholders gives instructions to the directors, which the amendments expressly provide for.

At the General Meeting, the company interest is the interest expressed by the majority of the shareholders, except in those cases where the majority imposes an agreement for its own benefit that does not respond to a need of the company and causes unjustifiable prejudice to other shareholders.

In the Board of Directors, again, the interest of the company will be that expressed by most directors, provided that they comply with their duty of loyalty.

These aspects are particularly germane to transactions either between companies of the same group or with shareholders with relevant shareholdings. We must consider, first, that the

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interest of the group cannot be imposed on the group's affiliates if it does not respond to a need of those affiliates and harms other shareholders. Secondly, directors of affiliates must act and vote in the interest of that affiliate, being liable otherwise. This, at first glance, is at variance with the legitimate need of many groups of companies to organise the activities of their affiliates by areas of business, geographic markets or other criteria which, seen from the perspective of the affiliate, can be more difficult to justify. The Board of Directors of the affiliate, therefore, should ascertain that the decision that benefits the group does not harm the affiliate or, if it does, that the affiliate receives adequate compensation from the company or companies benefiting from the decision. The group must be able to explain that the benefits received by an affiliate from a particular decision affecting several companies are higher than any possible prejudice and, if they are not, the differences must be compensated. The procedure related to the provision of information and taking of the decision should be clearly documented in preparation for any possible action disputing these measures.

3. The duty of loyalty in groups of companies

As has been pointed out, the duty of loyalty is defined by law as a duty to act "*with the loyalty of a faithful representative, in good faith and in the best interest of the company*". The law states the basic obligations that flow from this duty, among which is adopting the necessary measures to avoid conflict of interest situations, and lists conducts that every director must refrain from.

Among the consequences of the duty of loyalty, this note focuses on the prohibition on directors competing with the directed company, transacting with it, disclosing non-public information and obtaining advantages or remuneration from companies other than the directed company.

3.1. *Can the director perform functions in other companies that engage in the same business?*

The Companies Act prohibits the director from engaging in "*business, for his or her own account or on account of another, which competes or may compete with the [directed] company*". It is not uncommon, however, for a relevant shareholder of a company to be a company engaging in business in the same sector, and this gives rise to the question of whether this prohibition is violated when that shareholder appoints one of its managers as the director of an affiliate.

If the shareholder and the directed affiliate are members of the same group of companies, they are not competitors, and therefore, the director who works, at the same time, for the shareholder or its group is not ineligible or disqualified from appointment in terms of competition and does not breach his duty of loyalty. Notwithstanding, several companies are including in their articles of association (bylaws) the provision that under no circumstances shall it be understood that the activities that the director carries out for group companies constitute a breach of the duty of loyalty. Such clarification is probably unnecessary, but its presence may avert a dispute in this regard.

In the event that the shareholder and the company do not belong to the same group, the director can neither provide services to nor be employed by competing companies without a dispensation from the General Meeting when no harm to the company is expected or if that which is expected will be offset by the benefits derived from the dispensation. Once again, as in the transactions that benefit the majority, the dispensation should be based on an analysis of the benefits and dangers or harm that said dispensation would bring to the company, and it is recommended that the decision-taking procedure is carefully documented.

3.2. *Can the appointment of a director affect transactions within a group?*

Even if the non-competition obligation has been dispensed with, or no competition has been found to exist, directors should refrain from transacting with the directed company, be it on their own account or on account of another. This prohibition also extends to transactions where the beneficiary is a person related to the director. If the director is a natural person that controls the directed company or if

the director is a legal person, the entire group of the director becomes a related person and is affected by the prohibition to transact.

There is, therefore, an argument against the director of an affiliate company being a natural person in control of group companies, a legal person shareholder or other group companies: transactions between companies and their shareholders are hindered or hampered. It is also doubtful, where the director is an individual related to the controlling shareholder by virtue of a contract of employment or a business agreement, whether the relationship affects transactions between the directed company and the shareholder. It seems that the shareholder who appoints the natural person director is not considered a related person, according to art. 231 LSC, but the director could be deemed to be indirectly involved in a conflict of interest inasmuch as acting on account of the shareholder.

Although the scope of this prohibition could be considered excessive, since it does not seem reasonable to prohibit any transaction with a group company when many such transactions could be necessary or convenient, and when the existence of synergies may be the very reason for the existence of the group, the fact is that the law does not lay down a special rule on duties of loyalty in the case of groups of companies. The solution proposed by the law (dispensation by the Board of Directors or the General Meeting, as appropriate, with the director or shareholder concerned abstaining from voting on such dispensation) can create situations in which the decision-taking procedure is remarkably difficult and even where minority shareholders or shareholders outside the group can veto certain decisions without justification, thus preventing the majority shareholder from properly managing the activities of the companies of its group.

3.3. *Can a director inform the shareholder of the content of Board meetings?*

It is usual business practice for the director appointed by a shareholder to inform such shareholder of the content of the Board of Directors' meetings and even provide copies of the information distributed to the board members. Such conduct may constitute a breach of the duty of loyalty of the director, which includes a duty of secrecy. The Board of Directors' exchange of information between the Board of Directors and the shareholders is lawful and desirable, provided all shareholders are on an equal footing. Although a dispensation of the duty of secrecy is not provided for in the law, in those cases where all shareholders are represented in the Board of Directors I see no obstacle to the General Meeting authorising information from the Board of Directors to the shareholders to flow through the directors appointed by such shareholders.

Special care should be taken in those cases where information is shared with shareholders that are competitors or that have companies in their group which compete with the directed company. Such disclosures should be analysed from the perspective of competition law as the sharing of information may be forbidden in these circumstances.

3.4. *Can the shareholder pay the director of its affiliate?*

The LSC forbids a director from obtaining advantages or remuneration other than those received from the directed company for the discharge of his or her duties as director. Doubts arise in cases where a company employee or manager has as one of his or her functions to sit in the Board of Directors of that company's affiliates.

Firstly, if the affiliate is part of the group of the paying company, the prohibition does not apply. If it is not, the prohibition only includes remuneration related to the performance of his or her duties as director. Therefore, if the position of director is just one more of the employee's functions and this position does not affect his or her remuneration, there is no violation of the prohibition. In other cases - such as those where having a seat in the Board of Directors leads to additional remuneration

and such is paid by a company other than the one under his or her directorship, or when the dedication of the employee of the shareholder (but not controlling) company to director duties is very relevant - it would be advisable to obtain a dispensation from the General Meeting of the affiliate.

4. Conclusions

The recent changes made to the Companies Act make it advisable not only to review the companies' articles of association, but also their governance structures, their shareholders' agreements and their decision-taking and documenting procedures. In particular:

a) Shareholders' agreements should be reviewed and the review should ensure, in any case, that instructions are only given to the directors by the General Meeting and not by individual shareholders, and that instructions for dispensations by the General Meeting or the Board of Directors and the exchange of information with shareholders are contained in said agreements.

b) Groups of companies should review their director appointment policies to prevent the duty of loyalty of directors from creating an obstacle to the operations of and operations with their affiliates.

c) It is advisable to carefully follow and document the decision-making procedure in all debates of the governing bodies, particularly in transactions involving or affecting several related companies, directors and/or persons related to them. In addition to being essential to prepare against possible actions contesting the validity of resolutions, it is a requisite to rely on the protection of the business judgment rule.