# Is a company or new transferee shareholder estopped by the conduct of the transferor single shareholder? A problem related to the remuneration of company directors

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## 1. The assignation to the articles of association in respect of directors' remuneration

Under the rule of art. 130 of the Public Limited Companies Act (abbrev. LSA/1989) [art. 217 of the Companies Act, abbrev. LSC], the courts established as legal doctrine that, under any circumstances, the remuneration of company directors should be fixed in the company's articles of association, and that this requirement for the protection of independent shareholders (mostly minority shareholders) could not be circumvented by concluding with a director a senior management "employment" contract or a freelance "work for hire" agreement under which the board of directors and the "engaged" director had free rein to agree amongst themselves the latter's salary and benefits.

The above case law reached its climax in two famous judgments of the Supreme Court (Judicial Review Division) of 13 November 2008 (RJ 2009, 59 and 453), where the established legal doctrine of the Supreme Court's civil and employment divisions was collected and applied to a matter concerning the tax deductibility of remuneration paid by a company.

These rulings revolved around two fundamental postulates. On the one hand, a strict interpretation of art. 130 LSA/1989 in respect of what was meant by the articles of association's determination of the office's remunerative nature and the system of remuneration for directors. On the other hand, the acknowledgement of the cited "corporate approach" created by the Employment Division and developed by the Civil Division of the Supreme Court, according to which a director - company relationship and an employee (or worker, through consultancy work for hire) - company relationship for the performance of the same executive and management functions are not compatible, with the latter (employment or work for hire) ultimately being absorbed by the former (directorship).

Nuances, however, could not be avoided. The judgment of the Supreme Court (Civil Division) of 31 October 2007 involved a single shareholder company. The Supreme Court concludes that reliance on art. 130 LSA to deny payment of the remuneration stated in the directors' service contract constitutes conduct contrary to good faith. As there is no difference between the company and the (single) shareholder, it makes no sense to invalidate a payment obligation that cannot be unrelated to the single shareholder, as material owner of the company. Art. 130 LSA cannot apply when the rule's circumstances for protection are absent, namely, independent shareholders uninvolved in decisions concerning directors' remuneration, particularly in relation to compensation for loss of office, which affects the principle of at-will revocability.

The judgment of the Supreme Court (Civil Division) of 24 April 2007 deals with a case where the director's service contract, which included a 'compensation for loss of office' clause that had not been provided for in the company's articles of association, had been authorised by the Board of Directors made up by *ex dominio* (i.e., by reason of ownership) directors appointed by all the shareholders (several companies and public administrations). The Court held that the objective of art. 130 LSA is to "*protect the shareholders from* *the possibility of directors changing of their own accord the remuneration*", adding though that the Board's authorization "*lacks the necessary univocal meaning*" as "*conclusive acts expressing the actual agreement of all the shareholders*" concerning the right to collect compensation. Presumably, if statutory representatives of the shareholders had participated in that Board, the court decision would have been altogether different.

This brings us to the case decided by the judgment of the Supreme Court of 17 December 2015. The sole director of a single shareholder public limited company for years had in effect a "senior management contract" with the company, which provided for, in addition to other remuneration, the payment of compensation for unjustified loss of office. This compensation contradicted the company's articles of association which, since 2006, provided that the position of director would be remunerated by a fixed annual amount, *per diem* for attendance at board meetings and reimbursements of traveling expenses, but said nothing about compensation for loss of office.

In October 2008 the single shareholder (who had signed the senior management "employment" contract) changed and the new shareholder, acquiring one hundred per cent of the shares, decided to remove the sole director, but refused to pay the compensation provided for in the contract, claiming that such compensation was not included in the articles of association as required by art. 130 LSA / 217 LSC.

The director brought an action to an employment court, claiming payment of the compensation under the senior management contract. The claim, however, was disallowed for lack of jurisdiction by applying the 'corporate approach' ("The remuneration set forth in the senior management contract remunerated the functions performed by the claimant as director"). The director then filed suit in a civil court that allowed the claim, subsequently affirmed on appeal.

The judgment of the Madrid *Audiencia* of 17 July 2013 stated that the estoppel generated initially by the company, when it belonged to the former single shareholder, by the signing of the senior management contract with the 'compensation for loss of office' clause, "*spreads in its effects to that from whence it derives, as it is a characteristic effect of a derivative transfer. This despite the fact that it would be more appropriate to link the estoppel to the company itself, the legal personality of which has not changed or been affected by the transfer of its shares*".

The new single shareholder could not be regarded as a *bona fide* third party protected by the absence in the Register of Companies of this item of remuneration for the outgoing director: "*Because it impinges on the confusion between the company under an obligation to pay and the company acquiring the former's share capital. The latter, upon acquisition of the shares in full, goes on to run a company with independent legal personality, separate from that of its shareholder, so that there is no fracture (or even succession) in obligations contracted with third parties or people incorporated in the same by the acquired company*."

## 2. Estoppel and the assignation to the articles of association by art. 217 LSC

The legal doctrine of estoppel has been developed since the mid-nineteenth century by constant case law that has wound up redirecting the same to the principle of good faith under art. 7 of the Civil Code (abbrev., CC). For the purposes below, suffice to say that it is a doctrine lying midway between the bond directly arising from the contract and the legitimate expectation based on appearance.

Here the judgment of the *Audiencia* stuck to the doctrine of estoppel, inasmuch as "*the estoppel generated initially by the company would spread its effects with the transfer of shares to a new single shareholder*". It concluded, therefore, that the company (underlying which is now only the transferee single shareholder) should be regarded as "estopped" by the transferor single shareholder, who, years ago, contracted with the director claimant the senior management contract that included the aforementioned compensation.

According to the judgment of the Supreme Court, however, "*estoppel can only be relied on against whoever conducted himself in a manner that is deemed binding (...) since it involves an individually personal conduct, and in this case the estopping conduct is not so much that of the company (indeed, if such were the case and a senior management contract should exist, the absence of reflection in the articles of association could never be used as an obstacle to the validity of the remuneration, and art. 130 LSA would be rendered meaningless) as it is of the shareholder* *who, aware of the remuneration agreement with the director, cannot subsequently seek the remedy provided in art. 130 TRLSA*".

In our view, the doctrine of the *Audiencia*, as presented, is beyond reproach, provided the estoppel has been *generated by the company*. But never do things occur exactly like that, because the generation of the estoppel – later attached to the company, or not – can only have come about in the person of the single shareholder or in the person of the director. That is, the company's estopping conduct must first and foremost be an individual's estopping conduct that is subsequently attachable to the company under a company or contract law rule.

In the text of the judgment of the Supreme Court and in that of the *Audiencia*, four separate conceptual pairs are addressed somewhat confusingly. First, the *director's* (signer's) estopping conduct, attached to the *company* as statutory representative of the same (LSC 234). Second, the *transferor single shareholder's* estopping conduct that may be attached to the *company*. Third, the *company as such's* estopping conduct. Finally, the *transferor single shareholder's* estopping conduct that may be attached to the *transferee single shareholder*.

Clearly, all other things remaining equal, the estopping conduct of the *shareholder*, even if owner of the entire share capital, cannot be attached to the single shareholder company. Similarly, the *company's* estopping conduct, as estopping conduct of the director that is attached to the former, cannot be attached to the *single shareholder* as estopping conduct of the same, even if the single shareholder also turns out to be the sole director of the company.

It is also clear that the *company's* estopping conduct (necessarily by way of a natural person representing it) estops the company itself according to the ordinary terms of the doctrine of estoppel developed by case law pursuant to art. 7 CC. Therefore, contrary to the opinion of the Supreme Court, the estopping conduct to which the rule of good faith refers is not "individually personal" because, if so, a company would never be estopped by its "own" conduct.

In our opinion, the shareholder's or company's estopping conduct could only be attached "up and down the corporate veil", if the conditions to apply the doctrine of piercing the corporate veil were met. Indeed, it makes no sense under these conditions that liability can be attached behind the corporate veil but conduct within the meaning of the case law relating to art. 7 CC could not. We will not go into the conditions to apply this 'veil-piercing' doctrine.

In principle, there is no reason why a company director may not be a beneficiary of the application of the doctrine of estoppel, thus neutralizing any possible adverse effects of art. 217 LSC. Suffice to say in this regard that there is no objection to the director being able to legitimately expect that the single shareholder's estopping conduct is attached to the company or vice versa. However, below we explain how in this case it is not necessary to resort to such a hypothesis.

Will the company director's estopping conduct be attached to the company? Here we must make distinctions. It seems clear that against third parties unrelated to the company, the company director's estopping conduct is always attached to the company if such conduct occurs in the performance (within the bounds) of the functions and powers of the office in his capacity as statutory representative (art. 234 LSC). Indeed it would be nonsensical if the director's estopping conduct could not be attached to the company, when the director's contractual intention, pre-contractual liability, moral turpitude, negligence and civil or criminal intent, etc., can be ordinarily attached to the company.

But the *director's* estopping conduct cannot be attached against the company and in favour of the director himself as beneficiary of the expectation generated by his own conduct. This would be a circular case where the necessary protection of the expectation would not be generated. This is why the company holds, among other things, the right to file corporate liability claims, without the director being able to eventually plead *in pari delicto* as a defence (on the lines that the director's capacity as statutory representative served to "infect" the company itself with the same virus (of liability) incurred by the director). For the same reason, the company can always request reimbursement of overpayments made by the director to himself on the basis of a director's service contract concluded by and between himself, on his own behalf and on behalf of the company (self-employment issues aside).

However, in our case at hand it is not the doctrine of estoppel which the claimant (former sole director) might want to attach to the defendant company. What it might contend is that legal doctrine itself excludes, from the rule of assignation to the articles of association under art. 217 LSC, contracts entered into by the single shareholder company with the director because, in these cases, the rule requiring reflection in the articles of association loses its protective purpose. It is not then a question of attaching the shareholder's or director's estopping conduct to the company, but rather that the company is bound by the director's service *contract* and must pay the compensation because, in the present case, according to the abovementioned legal doctrine, the rule of assignation to the articles of association under arts. 130 LSA / 217 LSC would not apply. The conflict resolved in this judgment, as well as in the judgment of 31 October 2007, is a conflict of contract law (of art. 1255 CC), not a conflict of simple protection of good faith in terms of the doctrine of estoppel.

And with this we arrive at the final conclusion.

If the director could assert against the company the validity of the remunerative contract, thanks to the inapplicability of the aforementioned assignation to the articles of association, then it can be asserted against the company *in any case*, regardless of whether at the time such assertion is relied on the single shareholder of the company is one or the other. The "conduct" in question (concluding the director's service contract without basis in the articles of association) was already attached to the company by virtue of the (valid) director's service contract itself. The company was "obligated", not by the shareholder's or director's estopping conduct, eventually attached to the company, but by its valid contractual conduct. And in this the decision of the *Audiencia* is correct when it states that "*it would be more appropriate to link the estoppel to the company itself, the legal personality of which has not changed or been affected by the transfer of its shares*".

It even matters little whether the new shareholder (transferee) knew or not of the existence of that contract and the circumstances under which it had been entered into, or whether the transferee obligated itself or not with the transferor shareholder to waive any claims for conduct relating to the management of the company that was prior to the purchase of the shares.

Outside the doctrine of estoppel, there is another aspect considered by the judgment of the Supreme Court that also deserves some attention. The judgment admits as obvious that the company cannot apply for the annulment of the contract and/or recovery of the amounts against the sole director because the transferee waived any claims for conduct relating to the management of the company that was prior to the transfer. But, why is it obvious that an undertaking between the parties to a share sale and purchase agreement can somehow bind or be attached to the company? A share sale and purchase agreement can contain a stipulation in favour of the company, but an undertaking of this type between a purchaser and a seller is not valid against (*in peius*) the company, and yet the judgment under review ultimately regards it as valid. Self-validity of this kind could only have been justified if the judgment had argued – which it did not - that the *transferee shareholder's* estopping conduct is attached to the company thanks to the doctrine of *piercing the corporate veil*.