Corporate & Commercial

Parties related to directors following Act 5/2021 of 12 April

Analysis of the amendment of Art. 231 of the Spanish Companies Act within the regulatory framework for directors' fiduciary duty of loyalty

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1. Introduction

The main purpose of the amendment of the Companies Act (LSC) by Act 5/2021 of 12 April was to incorporate into our legal system the rules on related-party transactions provided in Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement. The result can be found in Part VII *bis* ("Related-party transactions"), comprising Articles 529 *vicies* to 529 *tervicies* LSC, which set out the procedure to be followed in order to approve transactions between listed companies and parties related "to the company" (directors, relevant shareholders and other related parties according to accounting standards).

Chapter VII of the Explanatory Notes to Act 5/2021 explains that reasons of systematic coherence made it advisable to also amend Article 231 LSC, which provides the list of parties related "to the directors" within the regulatory framework of the duty of loyalty owed to the company. The amendment is also justified by the incomplete nature of the list, as it does not include clear cases of connection or association, just when the Supreme Court had acknowledged that it is a closed list, contrary to what could be considered the

majority opinion of legal scholars (cf. Judgment of the Supreme Court of 17 November 2020, Duro Felguera case).

The amendment therefore contains an extension of the list of related parties. The first line of Article 231(1)(d) assigns this status to entities or companies in which the director holds, directly or indirectly, a relevant number of shares that allows him or her to influence management, a much broader concept than that previously contained in that letter (companies controlled by the director within the meaning of Article 42(1) of the Code of Commerce). The second line of the same provision includes companies or entities in which the director holds a board or senior management position. Finally, within the framework of "horizontal" conflicts of interest, the shareholder "represented by the director on the governing body" is expressly characterised as a related party (Article 231(1)(e)).

Below, beyond the reasons given by the lawmaker to justify this extremely important amendment, we will analyse how it fits within and how it affects the set of rules on the duty of loyalty of directors of companies limited by shares, the subject of an interesting systematic review, at least by legal scholars.

2. Background to the amendment

2.1. *Situation prior to Act 31/2014 amending the LSC*

The concept of "related party" in the rules governing directors' duty of loyalty was originally developed on the basis of the idea of the "indirect" conflict of interest understood from a "subjective" point of view, i.e. arising from the involvement of a third party, related to the director, in contracts with the company.

The connection was conceived as the result of an express or tacit agreement between the director and the third party to carry out a transaction potentially harmful to the company for the benefit of the director, the third party or both or, simply, without the need for such an agreement, as the possibility that the third party could exercise a relevant influence on the director, nullifying the due autonomy and independence with which he or she should hold the position. Such a connection would be upstream when the director was legally bound by or simply promoted the interests of a third party with an interest in conflict with the company's best interest. The connection would be downstream when the conflicting interest lied with the director and the third party acted on account and in the interest of the director.

As anyone may want to benefit or simply let himself or herself be influenced by his or her relatives and it is obvious that a director can exercise his or her influence over a company he or she controls, for his or her own or the company's benefit, the list in Article 231 LSC was composed of relatives and companies controlled by the director.

Most noticeably, however, this list was conceived as an open-ended list comprising rebuttable presumptions of subjectively indirect conflict of interest and, for that reason, the status of related party could be assigned to other third parties if a connection was found that could undermine the director's autonomy and independence (e.g. a shareholding with relevant influence in a company).

2.2. *Role of the concept of related party following Act 31/2014*

The amendment of the rules on directors' duty of loyalty by Act 31/2014 of 3 December significantly affected the conceptual scheme as it was designed.

As regards the concept of indirect conflict of interest, the new regulation established the obligation to abstain from participating in the deliberation and voting on resolutions or decisions in which the director "or a related party" has a "direct or indirect" conflict of interest (Art. 228(c) LSC). In turn, the duty to disclose conflicts of interest would be triggered in situations of "direct or indirect" conflict of interest involving the director "or parties related" to the director (Art. 230(3) LSC).

In this system, the idea of an indirect conflict "in the subjective sense" could not be maintained because the law itself acknowledged that conflicts could be direct or indirect and, in this double possible configuration, they could fall on the directors or on parties related to them (cf. Arts. 228(c) and 229(3) LSC). The indirect conflict would be "for objective reasons" and would cover situations in which the director (or related party) would be indirectly (or, if preferred, collaterally) benefited or harmed by the decision to be adopted or the transaction to be negotiated.

With regard to the content and drafting of the regulation, following the 2014 amendment, directors would not only be prohibited from being engaged in business that involves a conflicts of interest (duties or not) (Arts. 228(e) and 229 LSC), as this prohibition would also extend to the performance of any acts or activities whose beneficiary is a party related to the director (Art. 229(2) LSC).

In this system, the concept of related party serves to identify those natural or legal persons who, because they belong to the same sphere of interests as the director, the director may have an interest in benefiting to the detriment of the company he or she directs, in breach of the duty of loyalty that binds him or her to the company within the framework of the directorship.

The Act treats directors and their related parties as a *unit of attachment* and therefore attaches to the former direct or indirect conflicts of interest that lie with these related parties, who are not bound by a duty of loyalty to the company within the framework of the directorship. The directors are thus obliged to behave "as if" the interest conflicting with that of the company rested in their own person.

The result is that a transaction between the company and a party related to the director is prohibited, as is a transaction with the director. In these cases, it is not sufficient to communicate and abstain from preparing, deliberating and deciding on the terms of such a transaction (Arts. 227, 228(c) and 230 LSC), but it is necessary to obtain the mandatory *ad hoc* dispensation in accordance with the procedure specifically laid down in Art. 230 LSC (independence, transparency, harmlessness) under penalty of voidness (unenforceability) of the transaction.

The application of this attachment cannot be done indiscriminately without undermining legal certainty, and that is

why the list in Art. 231 LSC must be considered a closed list. Once the idea of a subjectively indirect conflict of interest has been expelled from the system, it can no longer be considered a list of rebuttable presumptions of this type of conflict. If the autonomy and independence of a director is impaired by the involvement of third parties not included in the list, the director concerned must abstain in the formation of the will of the decision-making body (Art. 228(c) LSC), but it is not obligatory to activate the dispensation procedure of Art. 230(2) LSC. This view was enshrined in the Judgment of the Supreme Court of 17 November 2020.

3. The new list of related parties

The systematic classification of related parties in Article 231 LSC can be made by distinguishing between two categories of conflicts that may arise in the directorship of companies limited by shares: vertical conflicts of interest (director - company) and horizontal conflicts (between shareholders). The latter extend to the governing body when directors who represent the interests of certain shareholders or groups of shareholders and who may not align with each other sit on said body.

3.1. *Companies or entities related to the director (amendment of Art. 231(1)(d) LSC).*

In the sphere of vertical conflicts of interest (director - company), the new letter (d) of article 231(1) LSC classifies as related parties any companies or entities in which the director is in a position to exercise a certain "relevant influence" as a shareholder or participant, an influence that must be understood to refer to the entity's financial and operating policy decisions, as can be deduced from the accounting standards that inspire all this regulation.

Such capacity is presumed (subject to rebuttal) if the director holds, directly or indirectly, a number of shares equal to or greater than ten per cent of the capital or voting rights or if, de jure or de facto, he has been able to obtain a representative of his interests as a shareholder or participant in the governing body (e.g. through shareholders' agreements).

The mere holding of shares in the capital of a company is not sufficient to establish significant influence on the management and therefore does not qualify the investee as a related party. If the director owns shares or has an interest in the company harbouring the (direct or indirect) interests in conflict with the directed company, but lacks the possibility of influencing financial or corporate policy (e.g. syndicate voting), he/she is obliged to disclose his/her personal conflict (the shareholding or interests) and must abstain from participating in the deliberation and voting on decisions relating to the transaction with that entity (Arts. 228(c)) and 229(3) LSC), but it is not necessary to activate the dispensation procedure legally envisaged for transactions with related parties.

In addition, companies or entities in which the director holds a position in the governing body or senior management, whether in the entity itself or in its controlling company, are expressly considered to be related parties (Art. 231(1)(d) second line). This is the so-called

"conflict of duties", which refers to the legal impossibility of defending two contradictory interests at the same time without compromising the independence and autonomy with which the position must be held. For this reason, there will be no conflict if it is a question of holding a board position to defend the interest of the directed company in an investee (the conflict will arise in the investee where he/she must abstain, but he/she will have no duty to abstain in his/her capacity as director of the company owning the shares).

Holding a "key position" in the management of a company with conflicting interests in the directed company is not the same as participating in the senior management or directorship of a company or entity. A director who holds a management position in a company in a situation of direct or indirect conflict of interest with the directed company must abstain from decision-making if, in the case at hand, such a situation entails a breach of his or her autonomy or independence, but the company or entity in the management of which he or she participates cannot be considered as a related party.

3.2. *Shareholders represented by the director (new Art. 231(1)(e) LSC)*

"Horizontal" conflicts of interest occur between the shareholders of a company and it is from this perspective that the inclusion in the list of parties related to the shareholder (or group of shareholders) *represented* by the director in the governing body makes sense (new Art. 231(1)(e)) and, before the amendment, Art. 529 *duodecies* para. 2).

In our opinion, the characterisation of the director as a "representative" of a shareholder (nominee director) cannot be derived solely from the fact that a director is nominated by a resolution of the general meeting of shareholders with a majority of votes consisting of a shareholder or group of shareholders, nor does the new regulation intend to subject all contracts between the majority shareholder who secured the appointment of the director and the company to the rules on authorisation or dispensation, in the manner of a regulation of related-party transactions between the majority shareholder - company for closely held companies.

The application of this rule presupposes the existence of a governing body composed of a plurality of members in which the 'connection' between a shareholder or group of shareholders and the (respective) office-holders is either inherent in the underlying economic reality of the company (group company or company with public shareholding) or is the result of the application of legal rules, by virtue of which all or some shareholders are entitled to appoint directors to represent their interests in the management of the company, in coordination with the representatives of other shareholders or groups of shareholders (directorship co-participation agreements or rules).

The insertion of this type of connection within the framework of horizontal conflicts or conflicts between shareholders makes it easier for the shareholders themselves to establish a contractual regulation to the contrary by means of shareholders' agreements or joint venture contracts, where they establish the rules of conduct they consider most appro-

priate to their interests (e.g. allowing the participation of directors nominated by the shareholders in decisions relating to contracts between the shareholders and the company, with the corresponding unblocking mechanisms).

3.3. *Economic nature of the list of related parties*

As we have pointed out in previous sections and as the Spanish Supreme Court has stated, there is no doubt that the list of related parties is closed-ended, but it does not follow that it should be interpreted in a restrictive manner or that it is of an exceptional nature.

The assignment of related party status must be made on the basis of the economic reality underlying the connection that justifies the legal assignment of related party status to certain persons or entities, and in such a way that the function and purpose of the rules on directors' duty of loyalty is duly safeguarded. This is also required by the accounting standards that have served as the basis for the re-drafting of the list in the latest amendment (IAS 24: "In considering each possible related party relationship, attention is directed to the substance of the relationship and not merely the legal form").

There is no doubt that the status of party related to the director should be extended to companies or entities in which a family member referred to in Art. 230(1) LSC is a shareholder for the non-corporate director (or for the non-corporate representative of the corporate director), given that the risk of harm to the corporate interest of such a transaction is the same as that which would arise if the transaction were carried out personally with the family member in question. For the purposes of the application of these rules, it is the same to contract with the relative as with the company in which the relative has an interest, unless the shareholding is insignificant. The same applies, for example, to a connection with another company in which the director exercises significant influence through a position equivalent to that of a shareholder, even if he or she does not formally have an interest in the capital (e.g. the director is a silent partner).

The prohibition of transactions with the company can obviously not be circumvented by the interposition of third parties acting on its account and interest (the "downstream" connection), but in order to preserve this prohibition it is not necessary to draw up a list. No one can do through a third party what he or she is forbidden to do personally. These types of cases must be dealt with by means of general techniques and principles of extension of attachment based on safeguarding the function and purpose of the mandatory rules on the duty of loyalty, without any detriment to legal certainty, but precisely with the aim of preventing the rules from being defrauded.