Companies Act Amendment (Corporate Governance) Bill

Abuse of rights by majority shareholders, conflicts of interest and violation of the right to information within the Bill

Ángel Carrasco Perera
Professor of Civil Law, Universidad de Castilla-La Mancha
Academic Counsel, Gómez- Acebo & Pombo

Although the abuse of rights is implicitly taken under consideration in other parts of the proposed changes, the Bill contains two express references to such tactics, one which restricts the reach of the right to information and another which extends the scope of application of annulments to company resolutions. A third reference is more remote, although it serves the same purpose.

I. Right to information and abuse of rights

1. Although nuances were far from clear, until now case law recognized a "final possibility" for companies to deny shareholders the information requested prior to or during the shareholders meeting. Even if the information had been requested by shareholders representing 25% or more of the share capital, the directors could still refuse to deliver or make available such information if they proved that possession of the same would be abused, such as by hindering the company's affairs with unnecessary documentation, reduplicating costly-to-produce information already held by the requester or, mainly, using it to obtain an advantage with a competitor. Even so, case law was not unanimous, with outcomes and principles depending on the peculiarities of each case.

2. Despite aiming to be (at least in appearance) more deferential than the current law to the requirements of the "principle of loyalty", the Bill incomprehensibly puts an end to the above possibility. In fact, art. 197(6) merely provides that in the event of an abusive or harmful use of this information, the shareholder shall be liable for the damage or loss caused to the company. This is an unnecessary rule, given that it simply repeats what is already in force under art. 7 of the Civil Code (CC). But now the company may only act *ex post* and may not refuse to provide the information, even if its mere provision and knowledge by the shareholder automatically "creates" an abusive situation, regardless of the subsequent "use" made of the same.

3. In other words, the rule, taken together with its precedents, implies that the company may not plead as an extrajudicial (at the shareholders meeting) or judicial (in the annulment trial) *defence* that the requested information and the subsequent challenge constituted an abuse of rights. This is an absurd rule. Case law will probably continue resorting to preventive rather than compensatory remedies, as still permitted by art. 7 CC.

II. Annulment of company resolutions owing to the abuse of rights by majority shareholders

4. There was a tendency for legal doctrine and, to a lesser degree, case law to consider that the content of what is now contained in art. 204(1)(II) of the Bill was already law. The temptation to include such content was strong, even though it has nothing to do with a corporate

governance reform; the simple fact was that this rule already appeared in other foreign pieces of legislation, which our corporate legislators are prone to copy. As until now, resolutions may be annulled when the majority has obtained (or obtained for a shareholder or third party) an advantage or benefit prejudicial to the interests of the company; this prejudice to the company's interests also occurs (and this is the new development) if the resolution "is imposed abusively where, without meeting a reasonable need of the company, it is approved by the majority for its own benefit to the unjustifiable detriment of remaining shareholders".

5. For those familiar with case law, this rule seems to have been purposely designed to invalidate majority share capital increase resolutions that are not genuinely necessary for the company's finances and lead (intentionally?) to a dilution of the minority shareholding. Until now, almost unanimous case law (correctly) dismissed actions for annulment of resolutions. We shall see what happens after this legal reform.

6. I do not believe this new rule will be applied, however, to *voluntary* winding-up resolutions instigated by the majority who, without the support of a minority, wish to invest company resources in other projects ("phoenix companies"). And it is not applicable because we cannot speak of a company having a *reasonable need* to remain in existence, as the company has no protectable claim of its own against the shareholders in respect of remaining in existence or being liquidated. Therefore, in this case the condition required by the Bill for the balancing of interests is absent.

7. The prohibition of abuse of rights set out in art. 7 CC, which governs all areas of law, has been historically applied without difficulty by courts in corporate disputes of this kind. Therefore, the Bill's rule is redundant, unless its intention is to go beyond the prohibition of abuse of rights and construct a kind of duty of loyalty amongst shareholders on the erroneous and disturbing basis that majority shareholders or shareholders with a relevant vote are subject to *fiduciary* obligations towards the minority, as if they were *de jure* or *de facto* directors. No duties of this type exist, as is apparent in comparison with the specific rule governing company directors (cf. art. 227(1)), which would otherwise be rendered meaningless.

8. In Spain, only two types of company exist meaningfully: close companies (whichever their form) and listed companies. It makes no sense to impose a "qualified duty of loyalty" in close companies. First, because intra-shareholder conflicts of interest are inherent to these structures; second, because in order to deduce "implicit obligations", it would be sufficient to interpret the existence of a corporate *contract* between the shareholders pursuant to art. 1258 CC (for example, many of the resolved cases where a minority shareholder was "removed" from all forms of company revenue); third, because in the event of this kind of dissent in matters that go beyond common corporate matters, the only reasonable resolution is to wind up the company or for the "losing" shareholders to exit. There is even less justification for imposing this type of duty in listed companies. In this type of company there is no special relationship between the shareholders that could justify the imposition of crossed loyalty duties. The shareholders of these companies are exclusively investors, not their co-investors' partners, and each one uses his votes to achieve the short or long-term strategy that most suits him. He is entitled to feel indifferent not only to the company but also to the other investors. Investments and the short-term resale of funds are probably not "meeting a reasonable need of the company". But this should not be judged by a non-shareholder third party from a neutral vantage point which in this world of opposing interests does not exist. Note that it is not practicable to control compliance with the implicit fiduciary duties of listed companies' relevant shareholders when the law permits both agents and indirect owners to diversify their votes at their whim thanks to holding a large number of proxies (cf. art. 524 of the Bill).

9. Apart from the above, the rule creates highly dangerous judicial incentives if it allows the definition of abuse of rights to be

pushed beyond its traditional limits. Bear in mind that an independent arbitrator has to first judge whether the resolution is borne out of a "reasonable need" of the company and then whether it is an "unjustifiable detriment" to the other shareholders. The rule at issue does not create the relevant standard of review, making it necessary to either resort to consolidated standards (such as those on ordinary abuse of rights) or fall into judicial arbitrariness, which would be more disastrous for all involved.

10. As a result, although for different reasons, the two express references to abuse of rights should be deleted from the Bill, because they either do not get the nature of the conflict right or act unwisely by creating new incentives at the cost of litigation.

III. Shareholder's vote in conflict of interest situations

11. The Bill extends the prohibition on voting in conflict of interest situations - up to now applicable only to limited liability companies- to shareholders of stock companies (art. 190 CA). However, not only does it extend the rule, as would have been appropriate, to close stock companies, but it also intends for it to be applied to listed companies. This extension is highly dangerous and unjustified, a weapon for extortion in the hands of the majority or the minority, as proved by a number of unedifying quarrels in the Bilbao courts between Iberdrola and ACS. With a rule of this kind, mistakenly justified by some as a necessary outcome of the duty of loyalty between shareholders, shareholders of all classes end up being equated to *de facto* or *de jure* directors, obligated to avoid or circumvent conflicts of interest with the company, even at their own expense [cf. arts. 228(c) and (e), 229(d) and (f), 230 II and III of the Bill].

12. Lawmakers have taken advantage of this equalization of regimes between the two types of company to introduce legislative changes. As before, the prohibition is on exercising voting rights ("when a resolution is to be adopted"), not on exercising all other shareholder rights (such as the right to challenge) or the simple exercise of business as a competitor or the sale or purchase of shares by the conflicted shareholder. Voting is prohibited only in the conflict situations exclusively listed in the precept (i.e., authorization to transfer restricted shares, expel the shareholder from the company, free him from an obligation or grant him a right, provide him with financial assistance, release him from the obligations arising from the duty of loyalty under art. 230), but there will be no other prohibitions in respect of any other kind of resolution, particularly when the resolution deals with the general interests of the company and does not single out the shareholder in question. For example, a resolution to lift a restriction on transfers of shares by *all the shareholders,* which is different to a resolution authorizing the shareholder in question to transfer his shares; a resolution to provide *general* financial assistance, not singling out one shareholder. Although in fact the conflict situation can remain, concentrated in certain shareholders, the only ones who actually benefit from the general resolution.

13. The rule introduces a restriction on this type of residual application where, in spite of everything, there is still a conflict of interests. When the vote(s) of the shareholder(s) affected by the conflict was decisive for the approval of the resolution, it is up to the company and, as the case may be, the affected shareholder (if he takes part as a defendant), to prove that approval of the resolution is in the company's best interest, while the challenging shareholder must prove (only) the conflict of interest. In these cases the vote has already been cast and calculated for the resolution. In other words, there must be a resolution; the rule does not apply (against the shareholder) when the deadlock vote prevented the approval of the resolution since there is no resolution to annul.

14. There are many ways for a vote to be decisive. It could be that a vote is marginal in proportion but decisive in achieving the majority in question; it could be an individual vote with a sufficient percentage to constitute a majority, or the sum of votes of the "syndicated" shareholders, achieving the majority by accumulation of votes. Are any of these cases included or does it have to be a "relevant" vote?

In my opinion, a resolution in which an "interested" but not relevant shareholder (not relevant on his own or together with the rest of the "interested" shareholders) has taken part "decisively" cannot be affected by the burden of proof rule, as it is hypothetically impossible for there to have been an adequate cause and effect relationship between the resolution and the promotion of the individual interest affected by the conflict.

15. The "exception to the exception" once again presents a problem. The exceptional rule regarding the burden of proof is not applied in cases of resolutions "in which the conflict of interest refers exclusively to the *position* held by the shareholder in the company", as occurs in cases of appointment to and removal from governing bodies, derivative actions and other similar circumstances. In these cases, the contestants must prove that the resolution is prejudicial the interests of the company. It is difficult to figure out both the basis for such an analogous application of the rule and the non-positional circumstances. In my opinion, the rule is intended to refer to the existence and the promotion (or not) of extra-corporate interests. When a vote gives a particular advantage to an extra-corporate interest, the special rule regarding the burden of proof once again comes into play. For example, entering into certain contracts with third parties in whose profits the shareholder has an interest. But the shareholder will not carry the burden of proof that the resolution is in the company's interest when, for example, he votes in favour of a successful resolution to not distribute dividends or to wind up the company or to increase the share capital without waiving pre-emption rights, ora winding-up in which he is particularly interested; because these resolutions affect the shareholder's position in the company. If the rule is approved, we can surely await a spate of lawsuits, because the "positional" criterion is fraught with uncertainty.