Company directors' remuneration: legislative changes

Fernando Marin de la Bárcena
Reader (Associate Professor) of Commercial and Company Law, Universidad Complutense de Madrid
Academic Counsel, Gómez-Acebo & Pombo

1. Introduction

The new rules on directors' remuneration have attracted considerable interest as they deal with a subject that has traditionally posed problems regarding essential matters (legal nature of directorship) that spilled over to the fields of employment and tax (contractual relationship doctrine).

The Spanish Corporate Income Tax Act 27/2014 of 27 November now lays down that the remuneration of directors for the performance of senior management functions, or other functions under an employment contract with the entity, shall not be regarded as *ex gratia* payments (art. 15(3)(e), last sentence). This will mean a degree of relaxation on the part of operators as regards compliance with company regulations, since the true incentive rested on tax deductibility. Even so, we should proceed with caution, as the foregoing does not rule out *a priori* any tax contingency and, in many cases, one will not be able to assert that a director performs senior management functions or that he/she is in the employ of the company.

Below we will analyse corporate aspects of the new rules, starting off with what sets the different organisational systems of directorship (simple or complex structures) apart from each other. The most controversial issue refers to the remuneration of executive or managing directors which, in our opinion, must be resolved through a systematic interpretation of the general legal regime (arts. 217-219 and 249 of the Spanish Companies Act [abbrev. LSC]) and the special legal regime governing listed (quoted) companies (art. 529 *septdecies, octodecies* and *novodecies*). In this regard, I will put forward some thoughts on the new director's service agreement.

2. Simple structure systems

In essence, the basic rules on directors' remuneration have not changed when it comes to a sole director, joint and several directors, joint directors or a board of directors without delegation of powers or executive functions to one or more specific directors.

The rule that the position of director is non-remunerated, unless the company's articles of association (by-laws) state otherwise whilst determining the remuneration arrangements (art. 217(1) LSC) and setting out the component elements (items) of such remuneration, be they fixed, variable, per diems, compensation, etc. (art. 217(2) LSC), is kept.

The general meeting of shareholders must approve the maximum amount of annual remuneration payable to the directors as a whole, amount that shall remain in effect until a modification thereof is approved (e.g., variable remuneration at most twice or three times as much as fixed remuneration). The distribution among directors, when they are several, will be decided by agreement according to their respective functions, unless otherwise provided by the general meeting (art. 217(3) LSC). The specific rules on remuneration through profit-sharing pegged to company shares are also kept (arts. 218 and 219 LSC).

The main novelty lies, therefore, in the provision of a "programmatic" legal limit to remuneration according to the company's size and financial situation and the market standards of comparable companies (art. 271(4) LSC). Also notable, even if regulated among the duties of loyalty, is the express prohibition of earning *external remuneration*, i.e. the prohibition on obtaining advantages or remuneration from third parties other than those or that received from the company and its group for the discharge of duties, excepting small gifts and tokens of appreciation (art. 229(e) LSC).

It should be noted, lastly, that rules on directors' remuneration under the articles of association apply to the remuneration earned for the performance of functions specific to directorship. Remuneration earned for functions unrelated or ancillary to the company's directorship (e.g., engineering, project management, legal advice, etc. services) are excluded. The establishment or amendment of the terms of these service agreements requires the approval of the general meeting in a limited liability company (art. 220 LSC) and, in all legal forms of company, the duties of abstention in respect of directors involved in a conflict of interest (art. 229 LSC) must be observed.

3. The board of directors with delegation of functions

3.1 *System overview*

The regulation that poses most problems in practice is that affecting the board of directors where executive functions have been delegated or otherwise assigned to one or more directors (art. 249(1) LSC).

The remuneration of managing directors or directors to whom executive functions have otherwise been assigned (power of attorney within the meaning of mandate) must be specified in a director's service agreement signed with the company, which shall be drawn up in writing subject to prior approval by the board (two-thirds majority with the concerned director abstaining) and attached to the minutes as an annex thereto (art. 249(3) LSC).

It covers all kinds of remuneration (e.g., payments in kind, pension and saving schemes, compensation for loss of office, payment by virtue of post-contractual non-competition, etc.) for performance of senior management executive functions (i.e., at the highest level of the organogram and with full autonomy and authority). Remuneration not contained in the duly approved agreement shall be regarded as unlawfully earned and must be returned at the request of any person with a legitimate interest, although one can safely assume that, at least in internal relations, disputes that may arise will eventually be resolved in a manner similar to that before this legislative amendment (e.g., application of the doctrine of estoppel).

The most controversial issue is to determine if the items relating to such remuneration should be recorded in the articles of association and whether the overall annual maximum amount thereof must be approved by the general meeting or, conversely, must only be recorded in the director's service agreement duly approved by the board.

It is an issue which, in our opinion, must be resolved through the analysis of the doctrinal construction that served as justification for the proposed amendments, a construction that starts off by distinguishing two types of legal relations:

- The relationship that arises as a result of the appointment of directors by the general meeting is classified as "original" and recognises its corporate-contractual nature (relationship of directors "in such capacity"). This relationship would be governed by the Companies Act and the articles of association.

- The relationship established by the board itself as a result of the delegation or any manner of assignment of executive functions to one or more specific directors is classified as "derivative" and its legal nature varies on a case-by-case basis. From this point of view, it has been suggested that the relationship of executive directors could be regarded as one of senior management employment if the requirements for such apply (executive or managing directors). To support this idea, it will be contended (and, indeed, has already been contended) that the Workers' Statute

(art. 1(3)) excludes the nature of employment where the office of "mere director" is held and that a director who performs executive functions is not such. In this way, the argumentative circle will be squared and directors who act with autonomy defending the company's interests are turned into managers subject to mandatory instructions (as if not directors).

The idea that seems most widespread is that, pursuant to the new legislation, original relationships (those of directors "in such capacity") would be regulated by art. 217 LSC, so that only in respect of those relationships will the rules under articles of association govern the items of remuneration and fixing of the maximum amount of overall annual remuneration at a general meeting. Executive directors would not be affected by these rules because executive functions would not be included amongst the functions specific to directors "in such capacity". The board itself will determine the component elements of remuneration and fix the amounts thereof (art. 249(3) LSC).

The result is that, in the legal model, the shareholders of close (closely held) companies would have been left apart from any involvement in regards to the fixing of remuneration of their executive directors (including compensation for loss of office).

Though it may be paradoxical, this does not happen in listed companies because the special regulation contains a well thought out system of distribution of roles and responsibilities between the general meeting and the board of directors with regards to directors' remuneration that makes it possible to control the remuneration of executive directors.

The Act itself takes into account the remunerated nature of the position (art. 529 *sexdecies*) and lays down different rules for the remuneration of directors in such a capacity (art. 529 *septdecies* LSC) and directors who perform executive functions (art. 529 *octodocies* LSC).

The general meeting of listed companies will approve the directors' remuneration policy (for a maximum of three years), comprising: a) with respect to mere directors, "the maximum amount of annual remuneration to pay all directors in such a capacity" (art. 529 *septdecies*(1), the distribution thereof rests with the board); (b) with respect to executive directors, the determination of the "annual fixed remuneration and its variation in the period to which the policy relates", as well as the "parameters for fixation of variable components" and the "main terms of their contracts" (article 529 *octodecies*(1)).

3.2 *Critical considerations*

The exclusion of all shareholder responsibilities in non-listed companies with regards to a an incorporation issue, as is the remuneration of its executive directors, does not sit well with the elementary principles of all corporate organisations or with the legal system itself.

Article 217(1) LSC, which requires recording in the articles of association the remunerated nature of the *position of director*, does not distinguish between directors in such a capacity and executive directors and, however much one may try, it cannot be denied that an executive director is a director and acts in the holding of his/her office as a director.

The arguments supporting the derivative and variable contractual nature of the relationship arising out of the resolution to delegate powers or assign executive functions are not sufficiently accepted by Spanish legal scholars or case law to consider that the amendments should be interpreted in this manner (cf. the Code of Commerce Proposal). Moreover, if it were so, the consequences would go far beyond remuneration (effect of delegation in joint and several liability, exonerating effect of instructions, etc.).

Shareholders may revoke the appointment of directors *ad nutum* (as an indirect control measure over management) and yet they are faced with the obligation of paying them the compensation for loss of office provided in agreements signed by the board itself, without the articles of association or general meeting having any say on this

matter. Furthermore, operators wonder, and rightly so, about the compatibility of an article in the articles of association providing for the non-remunerated nature of the position of director with the fixing of remuneration in the agreements approved by the board in accordance with art. 249 *bis* LSC.

The above lends reasonability to the proposal for an interpretation of these rules that is consistent with basic principles and the purported objectives of the amendments, supposedly aimed at improving (not worsening) the corporate governance of all companies.

A joint interpretation of both sets of rules could lead to the conclusion that the reference in the general part to the remuneration of directors *in such a capacity* contained in articles 217(2) and (3) LSC for all directorship systems serves as a warning that those provisions apply only to the remuneration earned for the performance of roles and responsibilities specific to the position and not to that earned for the performance of functions ancillary to the company's directorship. This distinction often appears unnecessarily in articles of association, as noted sometimes by the Spanish Directorate-General for Registers and Notaries upon encountering difficulties related to company praxis.

The expression used would at the same time make it possible to integrate the general regime with the special rules on the remuneration of directors of listed companies. As a rule-exception system has not been used, it would have been necessary to systematically note, in the general part, that only the compensation of directors with supervisory functions in listed companies (directors in such a capacity as defined by art. 529 *septdecies*) must be provided for in articles of association and that the maximum amount thereof for each financial year must be approved by the general meeting. There is no such systematic need in the general part where the holding of the office is characterised – as a general rule – as non-remunerated and the categories of executive and non-executive directors are not legally distinguished (art. 529 *duodecies*).

The board's authority in the fixing of the terms of the executive directors' service agreements (in the "derivative" relationship) for all companies does not of itself imply the exclusion of any involvement on the part of shareholders in this very important aspect of the director's relationship with the company. These are different issues. Leaving to the board the arm's length negotiation and fixing of the terms of directors' service agreements (as is done with senior managers) is logical and not incompatible with the idea of reserving for shareholders the responsibility of approving the maximum amount payable to directors as a whole and that the manner of doing so should be provided for by the shareholders in the articles of association (e.g., if variable remuneration according to business objectives is possible, which will result in more or less risky management and in the promotion or non-promotion of short-term profitability). The explanatory notes to the amendment act expressly stressed the need of recording in the articles of association the items of remuneration of directors with executive functions.

In my opinion, both interpretations are possible within the wording of the act of parliament. Thus, it seems advisable, in the absence of a comprehensive set of rules on the distribution of roles and responsibilities for close companies, that the interpretation and application of these rules should be done in the manner most consistent with corporate governance. This requires not skirting the involvement of shareholders in a momentous matter.

3.3. *The director's service agreement*

The obligation of formalising in writing directors' service agreements - which are not filed or registered with the Register of Companies - is a positive aspect of the amendments. It is a widespread practice in the legal systems of neighbouring countries and brings a good dose of legal certainty, regardless of the structure chosen for the organisational systems of directorship.

In my opinion, this agreement is of the nature of a service agreement and is

joined to corporate relationships under functional subordination (it is ancillary to and functionally dependent on the same).

The agreement can be used to determine: the legal situation prior to signature of the agreement (when employment should be regarded as suspended or terminated); exclusivity or retention clauses; liquidated damages clauses in the event of breaching non-competition or duties of loyalty; a more precise definition or contractual configuration of directors' duties of confidentiality; the prohibition of post-contractual competition; the use of company property; change of control clauses; the contractual treatment of a temporary disability or termination due to death; good cause for termination or unilateral withdrawal; the company's undertaking to take out D&O insurance policies, etc.

Finally, it should be noted that, pursuant to the general rules on transitional law (second transitory provision of the Civil Code), it seems possible to assert that, at least in the internal relationship, pre-established agreements should not be affected and conformity with the new legal regime will only be necessary upon modification or termination. However, as the legislature has pronounced itself in such strict terms regarding the unlawfulness of remuneration that does not appear in the agreement and given that agreements signed prior to the amendments do not met in many cases the requirements imposed by the earlier regulation, it seems advisable to review and adapt such agreements to the new regulations.