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# The Spanish Supreme Court interprets the rules on company directors' remuneration after the 2014 amendment (Judgment of 26 February 2018)

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## I. Introduction

The amendment to the Spanish Companies Act ('LSC') with regard to directors' remuneration was interpreted by most as meaning that the application of its rules depended on whether the structure of the governing body was simple or complex. If the former (sole director, several directors or joint and several directors), the rules provided in articles 217 to 219 LSC would apply, requiring the company's articles of association (bylaws) to state the items (component elements) of remuneration and the company's general meeting (of shareholders) to approve the maximum amount of remuneration to be earned by all directors.

Where a board of directors had delegated executive powers or assigned executive functions to one or more directors, a distinction would have to be made between the remuneration to be earned as a result of holding the office of a "mere director" (directors "as such") and the remuneration to be earned for performing the executive functions delegated or assigned in any way to one or more "executive" directors. The remuneration to be earned for discharging the duties of a mere director (essentially, supervisory duties) would be subject to the requirements of recording in the articles of association the item of remuneration and approval of the maximum amount of director remuneration by resolution of the general meeting, as provided in art. 217 LSC. On the other hand, the remuneration of executive directors would be governed by the provisions of art. 249(3) and (4) LSC, whereby the approval by the board of directors of each director's service contract attached to the minutes of the meeting would suffice, without the need to record it in the articles of association or the general meeting's resolution.

From the outset, there were many voices denouncing that this interpretation of the rules, even if in line with what the experts who planned the amendment had in mind, was not in conformity with the legal system interpreted as a whole (art. 217(1) LSC does not distinguish between executive and non-executive directors) and also produced an effect contrary to what the rule itself sought to achieve, that is, to foster corporate governance by strengthening the role of the general meeting as a control body over directors. Luis Fernández del Pozo's work on this subject is well known and worth reading since it showed how inappropriate it is to maintain this interpretation in respect of closely-held companies.

Notwithstanding, the Directorate General for Registers and Notaries ('DGRN') and a large part of scholarly writings accepted without reservation the view first set out above and declared the full autonomy of the remuneration to be earned by executive directors for the performance of their executive functions with respect to the legal system provided in paras. 1 to 3 of art. 217 LSC for the other directors. We have already pointed out that accepting such a reasoning could affect the characterisation of the very nature of the delegation or assignment of executive functions as a power of self-organization of the board, the characterisation of the relationship between the executive director and the company and even the application of the rules on joint and several liability of directors of companies limited by shares.

The Judgment of the Supreme Court of 26 February 2018 (Reporting judge: Sarazá Jimena) resolves the appeal lodged by the Company Registrar Luis Fernández del Pozo against the Judgment of the Barcelona Provincial Court (Fifteenth Chamber) of 30 June 2017 in proceedings concerning the revocation of the Registrar's rejection of an article in articles of association drafted after the 2014 amendment. Such article provided that the position of director of a private limited company was unremunerated and that the remuneration of its executive directors would be subject to the approval of their contracts by the board of directors under the terms set out in art. 249(3) and (4) LSC without the intervention of the general meeting. The Registrar considered this to be contradictory because the position of director cannot be unremunerated and remunerated at the same time and, although this is a matter to be analysed more carefully and separately, the authority to decide on the maximum amount of remuneration to be earned by all directors cannot be taken away from the shareholders in general meeting.

The Court thus had to decide on the meaning and scope of the 2014 amendment to the LSC with regard to directors' remuneration and, in particular, on the controversy over the rules applicable to executive directors' remuneration.

## II. The Supreme Court's response (in summary).

1. The Court does not share the legal doctrine laid down by the DGRN in its decision of 17 June 2016 on the scope of the amendment to the LSC regarding directors' remuneration or, consequently, the interpretation of the legal system by the Barcelona Provincial Court

of 30 June 2017, which it sets aside.

2. Art. 217 LSC applies to "directors' remuneration" and the "position of director" and is therefore applicable to the remuneration of all directors irrespective of whether they are directors performing executive or supervisory functions. As a result, the remunerated nature of the position of director and the items of remuneration to be earned must be stated in the articles of association in respect of all directorships, and not exclusively in respect of a category of directors (as can be deduced too from the Explanatory Notes).

3. The distinction between directors "as such" and "executive" directors is not acceptable, at least as far as the interpretation of this set of rules is concerned. The system for organising the governance of Spanish companies limited by shares is monist and, therefore, it is not possible to distinguish between a supervisory body (or position) and another executive body (or position) as is the case in dualist systems. The board may delegate executive functions to one or more directors or committees (or attorneys-in-fact) precisely because these are functions appertaining to the delegating directors (*nemo dat quod non habet*).

   Therefore, with the expression directors "as such" the legislator refers to directors whilst holding office and refers to any director (including executive directors who perform executive functions also in their capacity as directors). The term "as such" is used to separate the remuneration earned by directors for the performance of the duties and powers of a director from that which they may earn, if so agreed with the company, for services rendered in connection with functions ancillary to those that are strictly directorial, as referred to in art. 220 LSC for private limited companies (e.g., engineering, legal advice and other contracts, which do not fall within the functions of a director).

4. The legislator has not sought to distinguish between remuneration to be included in the articles of association and that which is not, nor has it sought to take away from the general meeting the authority to fix the maximum remuneration that all directors may earn. The general system for directors'' remuneration (art. 217 LSC) must be supplemented by the rules on the remuneration of directors performing executive functions (art. 249 LSC) and must not be replaced or applied in the alternative.

   Proof of the foregoing is that some of the items of remuneration included in art. 217(2) LSC (variable remuneration) and which are later developed in arts. 218 and 219 LSC (remuneration based on a share in profits or shares in the company, respectively) are specifically related to the remuneration of directors with executive functions. The view that arts. 218 and 219 LSC do not apply to executive directors is not acceptable because it is precisely this type of remuneration that is "typical" of executive directors.

5. Art. 249*bis*(i) LSC itself states that "decisions relating to directors' remuneration may not be delegated, *within the framework of the articles of association* and, where applicable,

of the remuneration policy approved by the general meeting" (emphasis added). This statement is worded so because it is assumed that the remuneration of all directors (including executive directors) will at least be provided for in the articles of association governing the life of the company.

6. The reference to the different functions and responsibilities assigned to each director, referred to in art. 217(3) LSC as a criterion for distributing the total remuneration approved by the general meeting among the different directors, is only understood if the provision applies to directors with executive functions (at least in non-listed companies). If the provision only applies to directors for their attendance at board meetings, the "functions" and "responsibilities" of each director would be limited to holding a position within the body itself (e.g., the chairmanship), which would not justify, in principle, earning a different or higher remuneration than that of the other board members.

7. The conclusion is that the remuneration of executive directors (to be determined in the contracts) is remuneration for holding office and, therefore, must be framed within the company's articles on remuneration (article 217(2) LSC) and within the maximum amount of the annual remuneration of all directors approved by the general meeting (art. 217(3) LSC). The article stating that the position of director is unremunerated and, at the same time, providing that the remuneration of executive directors shall be fixed by the board in the contracts cannot be recorded in the Register of Companies because it is contradictory (the position cannot be unremunerated and remunerated at the same time) and because the items of remuneration to be earned by all directors (including executive directors) must be recorded in the articles of association and within the maximum amount approved for all directors by the general meeting.

## III. The regulatory system for the remuneration of directors of unlisted companies

With rare clarity, the Court explains that the legal system for directors' remuneration (in unlisted companies) is divided into three levels:

1. Level one: The articles of association must determine the unremunerated or remunerated nature of the position and, in the latter case, set out the items of remuneration to be earned by all directors (*obiter dicta*, the Court states that it should not be as rigorous as it has been up to now with regard to the details required of the articles of association).

2. Level two: The general meeting must provide the maximum amount of the annual remuneration to be earned by all directors, notwithstanding the fact that it may also pass a resolution on remuneration policy similar to that of listed companies (art. 529 *novodecies* LSC) and necessary intervention of the same if items of remuneration developed in arts. 218 and 219 LSC (share in profits, remuneration pegged to share value) are established.

This is without prejudice to the additional possibility of issuing instructions or submitting to its authorization matters related to the remuneration of executive directors (inasmuch as considered specific management matters subject to art. 161 LSC).

3. Level three: Directors' powers with regard to their remuneration consist of: (i) distributing the remuneration fixed for the whole of the different directors according to their functions and responsibilities, unless already distributed by the general meeting (art. 217(3) LSC) and (ii) approving and signing contracts with executive directors under the terms of art. 249(3) and (4) LSC, which supplement the regulation provided in arts. 217 to 219 LSC and are fully applicable to executive directors.

## IV. Consequences in practice.

The practical conclusions that can be drawn from this interpretation of the legal system, apart from tax considerations and other special considerations that are usually raised in each specific case, are as follow:

1. The articles of association must be revised in order to check whether they conform to the legal system as interpreted by the Supreme Court and, where not, instigate their alteration.

2. The service contracts of directors with executive functions must be revised in order to check whether they comply with the company's articles of association.

3. The procedure for approving directors' service contracts should be revised and, if they have not been approved by the shareholders in general meeting, they should be laid before them.

4. It is necessary to check whether the impact of the general meeting not approving the maximum remuneration to be earned by all directors or the remuneration agreed in directors' service contracts being higher than that approved by the general meeting may have on the validity of such contracts is provided for in the same (termination of contract, bona fide negotiation obligations, etc.).