

Two comments on the duty of loyalty: the Unión Fenosa Gas case

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The Judgment of the Madrid ‘Audiencia Provincial’ (Twenty-eighth Chamber) of 3 March 2017 contains interesting thoughts on two issues related to the rules governing the duty of loyalty of directors of companies limited by shares. On the one hand, the appellate court asserts that purely declaratory claims in respect of such duties cannot succeed (insofar as they are purely instrumental in relation to other claims). On the other hand, it denies the standing of directors to claim from other directors, on their own behalf, fulfilment of the duties of loyalty inherent in their office.

1. Background information

Four directors of the company “Unión Fenosa Gas, SA” (UFG) sued five other directors and the company itself, petitioning (i) a series of adjudications (judicial declarations) in connection with the alleged breach by the latter of their duties of loyalty and (ii) an adjudication of invalidity of certain resolutions of UFG’s Board of Directors (in fact, as we will see below, these were “non-resolutions”) in the voting of which the defendant directors (allegedly breaching their duty to abstain) did not abstain.

The claimants had been appointed members of the governing body on the nomination of ENI SpA (ENI) while the defendants were so appointed on the nomination of GAS NATURAL SDG, SA (GN). These companies were the only two shareholders, with an equal stake, of UFG. The problem arose in connection with certain supply contracts (“relevant contracts”,

through which downstream gas was supplied) entered into by the latter company with certain gas suppliers (“Gas Natural Comercializadora”, “Nueva Generadora del Sur”, “Gas Natural Fenosa”) belonging to the group “Gas Natural Fenosa” (GNF) and with “Unión Fenosa Gas Comercializadora” (company in which UFG holds more than 99% of the shares). The claimant directors took the view that, in view of the problems caused by the reduction in gas supplies from Egypt (upstream supply), the “force majeure” clause in the relevant contracts should be activated with the consequent suspension of obligations by way of a resolution of UFG’s Board. The defendant directors were of the opposite opinion and considered that such contracts should be honoured.

When the issue was put to the Board of Directors (meeting of 20 March 2013), the latter members thereof (the defendants) took the view that they had no duty to abstain and voted against the resolution proposed by the chairman (a member also appointed on the nomination of ENI but who did not act as a claimant) to “*claim force majeure in the relevant contracts*”. As a result, the resolution could not be passed with a five-vote tie.

The Madrid Companies Court No. 3 gave the Judgment of 30 October 2013 [No. 246/2013; Id Cendoj: 28079470032013100003] which did not uphold the claim contesting the Board’s resolutions but upheld in part the claim against the directors appointed on the nomination of GN by: (i) holding that such directors were found to be involved in a conflict of interest with regard to the claim of force majeure in the relevant supply contracts and to have breached the duty to abstain from voting on resolutions or decisions of the Board of Directors at its meeting on 20 March 2013; and (ii) they were enjoined to abstain from any future voting within the UFG’s Board of Directors on a claim of force majeure in the contracts referred to above.

The first-instance ruling was appealed against by the defendant directors (note that the decision to not uphold the contest thus became final and conclusive). The appeal was determined by Judgment of the Madrid *Audiencia Provincial* (Twenty-eighth Chamber) of 3 March 2017 [No. 110/2017; Id Cendoj: 28079370282017100295], which upheld the appeal, reversing the first-instance determinations partly for the claimants.

The appellate court did not examine all the issues analysed in detail in the first-instance judgment (including the scope of the concept of conflict of interest in joint ventures or special purpose vehicle companies in which related-party transactions are an essential part of their activity) and focused, for what matters here, on two issues concerning the rules governing the duty of loyalty, both of which are linked to the standing of claimants (i.e., the possibility of success of petitioning to the courts mere adjudications regarding these duties of loyalty and the possibility of directors petitioning for an injunction against other directors to comply with these duties). Next, we will attempt to summarise this appellate court’s legal doctrine regarding these two issues.

2. On the purely “instrumental” nature of the adjudication that the directors had breached their duty to abstain and that they were involved in a conflict of interest

- (a) The defendant-appellant directors appealed, on the one hand, against the court’s finding that they had failed to comply with their duty to abstain from voting on resolutions of the UFG’s Board at its meeting of 20 March 2013.

Regarding this claim and the problem of existence (or absence) of the standing to sue, the Court discussed the possibility of success of purely declaratory claims from the point of view of the presence of a legitimate interest in obtaining the petitioned judicial remedy. It recalled in this regard that when an injunction is sought against a defendant the need for a remedy is implicit in the claim itself. However, the situation has different aspects when the claim is merely declaratory (as it was, in this case, for adjudication that a particular duty had been breached). In such cases, the claimant must specify the interest it holds (which will generally correspond to the need for adjudication of a right or a certain legal situation as a means of preventing harm in its own legal sphere).

Based on this idea, the Judgment now discussed understands that there is no obstacle to identifying as suitable for some directors to petition for an adjudication that other members of the governing body breached their statutory duties with regard to their voting on the formation of a certain agreement “*when such breach is indicated as cause of action for holding the agreement in question null and void*”. However, it must be borne in mind that if, in the end, such contesting claim is not upheld, the declaratory claim which served as a basis for the same is manifestly without interest and cannot stand on its own merits (the appellate court finds support for this conclusion in the Judgment of the Supreme Court of 4 November 2011 [RJ 2012/1249], which also characterised as instrumental the relationship between the adjudication of a breach of directors’ duties and making such directors liable for said breach).

In sum, according to the appellate court, a ruling that merely holds that certain directors breached their duty to abstain (currently provided in art. 228(c) LSC and, until 2014, in art. 229(1) LSC) cannot succeed. And this is so because such an adjudication is “merely instrumental” in relation to the petition for an adjudication of invalidity of board resolutions passed in breach of the duty to abstain. Thus, once the decision to not uphold the contesting claim has become final and conclusive, there is no genuine and proper interest supporting an action for the aforementioned adjudication.

- (b) For the same reasons, the appellate court took the view that the petition for adjudication that the defendant directors were involved in a conflict of interest in connection with the issues relating to the “relevant contracts” could not be satisfied. In fact, the appellate court pointed out that it was an adjudication that merely functioned as a requirement for the petition for an adjudication of invalidity of company resolutions. As a result, given its *instrumental* nature, once the contesting claim on which it was based had not been

upheld, the latter adjudication was deprived of utility and interest and therefore could not succeed.

3. The impossibility of directors petitioning for an injunction against other directors to abstain from any future voting within the board

The appellants also objected to the claimant's standing to petition for an injunction against them to abstain from any future voting on the "relevant contracts" within the UFG's board of directors.

In this regard, the appellate court pointed out (backed by authoritative scholarly writings) that the petition for an injunction against the defendants to abstain from any future voting on the "relevant contracts" can only be understood as an action for compliance with the duties of loyalty incumbent on directors of companies limited by shares (and, in particular, as an action for compliance with the duty imposed on directors involved in a conflict of interest to abstain from voting on resolutions or decisions concerning the transaction to which the conflict refers). These duties are originated and developed within the framework of the existing contractual relationship between the directed company and its directors. A relationship that, according to the appellate court, must be characterised as a "director's service contract" (species of so-called management relations) and from which certain fiduciary duties derive and, among them, that of loyalty (which is expressed in the "*primacy of the principal's interests in the event of a conflict of interest between the manager and the person who has entrusted himself to him, in such a way that it requires the superordination of the interests of said person over those of the manager*": Judgment of the Supreme Court of 4 October 2011 [RJ 2012/759]).

Therefore, and given that the claimant directors are outside the director's service contract binding the company and the defendant directors, the former do not have standing to claim from the latter compliance with said contract and, in particular, with the fiduciary duties arising from it. In other words: in the absence of a special rule providing otherwise, the petitioned remedy (injunction to comply with the duty of loyalty, of a contractual nature) can only be made by the obligee party to the contractual relationship, i.e., by the directed company.

The so-called "usability" or "reliability" of the content of a contract by a third party does not preclude this conclusion, since it cannot provide justification for a non-party to the contract to claim from one of the contracting parties the fulfilment of his contractual obligations (the true purpose of said mechanism is to allow a third party to base on a third-party transaction a personal and differentiated claim against one of the parties to such transaction). Nor does art. 237 LSC constitute a decisive objection because, although it is true that safeguarding the legality of the board of directors is inherent in the duty of care incumbent on directors, this cannot become a source of standing to petition for something that only concerns the company.