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Reform of the Spanish Companies Act and new legal framework for corporate governance

Introduction

On 4 December 2014, the Spanish Official State Gazette published *Ley 31/2014, de 3 de diciembre, por la que se modifica la Ley de Sociedades de Capital para la mejora del gobierno corporativo* (the "**LSC Reform Act**") which amends the Spanish Companies Act ("**LSC**") with the aim of improving corporate governance. The LSC Reform Act entered into force on 24 December 2014, as stipulated in final provision four thereof.

The LSC Reform Act is the direct descendent of the work of the Expert Committee on Corporate Governance (the "**Expert Committee**") and, more specifically, of the Study on proposed regulatory amendments (*Estudio sobre propuestas de modificaciones normativas*) issued by said Committee on 14 October 2013 (the "**Study by the Expert Committee**"). The Expert Committee was created pursuant to a Decision of the Council of Ministers dated 10 May 2013 (Order ECC/895/2013, dated 21 May), "with the aim –in the terms of said decision- of improving efficiency and responsibility in the management of Spanish companies while, at the same time, raising domestic standards to the highest level of compliance compared with international criteria and principles on Good Governance".

In accordance with the recommendations of the Study by the Expert Committee which the LSC Reform Act has incorporated virtually in its entirety, the changes to the LSC refer –as is to be expected in the case of a reform concentrating on the improvement of corporate governance- to the two bodies that comprise the corporate structure of companies ("*sociedades de capital*"):

- some amendments affect the *shareholders' general meeting* and *shareholders' rights*, with the recurrent aim –as stated in the preamble to the LSC Reform Act- of "strengthening their role and providing means for promoting shareholder participation";
- other amendments affect the *management body* and, to be more precise, in the case of listed companies, the *board of directors*, due to the need to "regulate certain aspects –as the preamble of the LSC Reform Act puts it – which have been acquiring increasing relevance, such as, for example, the transparency of governing bodies, fair treatment of shareholders, risk management or the independence, participation and professionalisation of directors".

Some of the amendments to the LSC come from the Proposed Mercantile Code of June 2013, drafted by the Commercial Law department of the General Code Committee (the "**Proposed Mercantile Code**"). And many others have consisted of raising to legal status what until now were mere voluntary recommendations in the Unified Code of good governance for listed companies, approved in 2006 and updated in June 2013 (the "**Unified Code**"). Despite this, the Expert Committee, and by extension the LSC Reform Act, have considered that the voluntary nature of the codes of good governance and the correlative principle of "comply and explain" continue to be a useful system for addressing a large part of the corporate governance system. Nevertheless, the conversion of some of these recommendations into mandatory rules is justified by the growing recognition of some aspects of corporate governance as basic and essential when until recently they were not considered imperative, as well as by the organisational deficiencies which the recent financial crisis has laid bare in several entities.

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1. The new powers of the general meeting and its intervention in management affairs

Key aspects:

- The general meetings of joint stock companies ("*sociedades anónimas*") are now able to intervene in management affairs, giving instructions to the management body or rendering said body's decisions or resolutions on certain matters subject to approval
- The general meeting is given a new exclusive power, consisting of decision-making regarding the acquisition, transfer or contribution of essential assets
- In listed companies, the general meeting will also be exclusively responsible for transfers of essential activities performed by the company to dependent entities, even if the former maintains full ownership of the same ("*subsidiarisation*")
- An asset/activity is considered essential when the transaction represents more than 25% of the value of the assets appearing on the last balance sheet approved

The possible intervention of the general meeting in management affairs

The LSC Reform Act addresses a traditional aspect of Spanish corporate legislation, consisting of the absence of a clear differentiation between the powers of the general meeting (supreme, sovereign body) and those of the management body (the body that manages and represents the company). The reform, moreover, forms part of an increasing trend in comparative law –the most significant point of reference of which is the famous "*Holz-Müller*" doctrine under German law – consisting of increasing the participation by the general meeting in corporate affairs, in order to *promote shareholder participation in the decisions of greatest relevance for the company* and guarantee control over the actions of the administrators.

The Unified Code recommended that listed companies submit certain transactions that could involve a structural modification of the company to the approval of the general meeting "even if not expressly required by commercial law". The approval of the Structural Modifications Act ("*Ley de Modificaciones Estructurales*") also represented important progress in this regard, with the amendment of Articles 160 and 161 LSC representing the consolidation of this trend.

In its new wording, Article 161 LSC reproduces the content that it had previously, with regard to *empowering the general meeting to "give instructions to the management body or to submit the adoption of decisions or resolutions on certain management affairs to the general meeting's authorisation"*, albeit provided the by-laws do not state otherwise. But while this power was previously envisaged only in the case of limited liability companies ("*sociedades limitadas*"), the new wording expressly extends it to the general meetings of "Spanish companies" ("*sociedades de capital*").

Thus, what was previously reserved for limited liability companies, due to their closed, personal nature, is extended by the reform to all Spanish companies, including listed companies. However, the extension of this power in the case of listed companies is unlikely to have great relevance in practical terms, not just due to the possibility of over-ruling it in the by-laws, but also because of the habitual inoperativeness of the general meeting as a decision-making body in this kind of companies.

On the regime for intervention of the general meeting

This new provision has nothing to do with any interest by the legislator in restricting the autonomy of the management body in general terms. The intervention of the general meeting must be restricted to "certain management affairs". And it is reasonable to think that such affairs must be of an extraordinary nature, in the sense that due to their exceptional nature or effects, they represent a departure from ordinary matters and could end up affecting the position of the shareholders.

Moreover, unlike new Articles 160 and 511 *bis* LSC, which make it obligatory for certain matters to be approved by the general meeting, Article 161 LSC merely recognises the *possibility for the general meeting to give instructions to the management body* motu propio *on*

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management affairs, or subject certain decisions to authorisation. As such, this is purely an option or possibility that the general meeting may or may not use.

The LSC is indeed imprecise in relation to the matters that should be submitted to the general meeting for approval or on which it can give instructions.

With regard to the first question, if we consider that the legislator has reserved the exclusive power for the general meeting to deliberate and decide on certain matters (Articles 160 and 511 *bis* LSC), it is reasonable to think that the management matters that could be submitted for the approval of the general meeting are precisely those that do not correspond to said matters. In this regard, and according to common practice in shareholder agreements, it would be possible to establish certain areas of management in which approval by the general meeting is obligatory, either in general terms or when certain quantitative thresholds are surpassed.

With regard to the instructions, here things seem to be even more imprecise due to the need to determine whether or not, if given, they are binding on the management body, in the sense that it is obliged to comply with them in order to avoid incurring liability.

Of course, as indicated in the final reference in Article 160 LSC to Article 234 on the scope of the power of representation of administrators, it must be understood that a failure by the latter to comply with the instructions received from the general meeting, will not, in principle, affect the validity of the acts they perform. The administrators have the fullest powers of representation of the company, with any restriction on the same being ineffective vis-à-vis third parties even when their acts go beyond the remit of the corporate object. The potential liability to which administrators could be exposed is a different issue, although any action in this regard would require, in addition to a breach of the instructions received, that the action would have resulted in financial harm for the company.

This right for the general meeting to intervene in management affairs, moreover, *can be over-ruled by means of an express provision in the by-laws*. This possibility would clearly be justified in the case of companies with a particular corporate structure and a greater centralisation of the management function, such as in the case of listed companies.

The new powers of the general meeting: the acquisition or transfer of essential assets

In line with what we have explained above, with a view to involving the general meeting more actively in management affairs that affect the company in a structural sense, Article 160 LSC includes as *new matters reserved for approval by the general meeting* "*the acquisition, transfer or contribution to another company of essential assets* ", assuming "the essential nature of the asset when *the amount of the transaction exceeds twenty-five per cent of the value of the assets appearing on the latest balance sheet approved*". As in so many other areas, the LSC Reform Act has given legal status to something that until now was just a recommendation of the Unified Code (recommendation 3).

The aim here is to reserve for the general meeting the approval of certain corporate transactions which, due to their financial significance, can have *similar effects to those of a structural modification*, even though technically speaking they do not constitute this kind of transaction. In this way, in contrast to the situation existing to date, the situation where the board of directors decides independently on the possible acquisition, transfer and contribution of essential assets, without any kind of restriction in terms of the value of the same, is avoided due to the significant effects that such transactions can have on the company and, by extension, on the position of the shareholders.

Moreover, unlike the Unified Code, which does not establish any quantitative criterion and merely assumes that the acquisition or transfer is essential when the transaction "involves an effective modification of the corporate object", the new Article 160 LSC –as we have seen- establishes an *objective criterion*: assets will be considered essential when their transfer, acquisition or contribution represents a value in excess of 25% of the value of the company's assets according to the latest balance sheet approved. In this regard, we can understand that it will be necessary to take into consideration the net book value –not the market value – of both the essential assets and the total company assets appearing on the said balance sheet. The balance sheet used will be the latest one approved by the general meeting, without express need for it to be audited in those cases in which it is not obligatory.

The reference to the amount of the "transaction" means that, when it encompasses the transfer of a series of assets that are not classed as "essential" separately, but are considered as such taken together, it must be approved by the general meeting. At the same time, doubts may arise when the same financial transaction involving the acquisition or transfer of "essential" assets takes place

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in legal form via a series of deals that while formally independent, only exceed the above-mentioned quantitative threshold when considered as a whole.

Nevertheless, the aspect of this new regime that will foreseeably prove most delicate refers to the *consequences of a breach*, when the administrators decide or carry out any of these transactions without having obtained prior approval from the general meeting. In these cases, the rules on the formation of the corporate will clash with the need to protect legal relations and, more specifically, the irrevocable content of the powers of representation of administrators (Article 234.1 LSC), which cannot, in principle, be restricted vis-à-vis third parties.

Meanwhile, the major significance of the new regime can be seen considering the *effect it will have on the presentation of takeover bids*. Until now, the decision to launch a takeover bid clearly fell within the exclusive remit of the management body, meaning that a resolution of the general meeting was only required when the consideration for the same was to consist of securities, which the latter had to issue (Article 14.5 RD 1066/2007). But with the new regime, the authorisation of the general meeting will be necessary when through the takeover bid the quantitative thresholds of Article 160 LSC are surpassed. This should not be a problem in the event of a voluntary takeover bid, due to the expressly envisaged possibility of subjecting it to the prerequisite of "approval by the general meeting of the bidder company" [Article 13.2.c) of RD 1066/2007] – a provision introduced with foreign companies subject to a similar regime in mind. Meanwhile, the new regime should have a significant impact on the possibility for one company to acquire control of a listed company and thus be in the position of a mandatory takeover bid, due to the impossibility of subjecting the latter to an equivalent prerequisite.

The additional powers of the general meetings of listed companies; in particular, "subsidiarisation" transactions

In addition to the above amendment, the LSC Reform Act also envisages a series of additional powers for the general meetings of listed companies by means of the inclusion of Article 511 *bis*. In particular, these powers refer to the approval of the remuneration policy for directors (something we will be specifically analysing in another chapter), and also to

(i) "*the transfer of essential activities hitherto performed by the company itself to dependent entities*, even where the company maintains full control thereof", and

(ii) "those transactions whose effect is equivalent to the *liquidation* of the company".

In this regard, and like in Article 160 LSC, the essential nature of the activities and the assets is assumed "when the volume of the transaction exceeds twenty-five percent of the total assets on the balance sheet."

As such, in listed companies, the general meeting has to grant approval not just for the transfer, acquisition or contribution of essential assets, but also for the transfer of essential activities to dependent companies, even where it maintains control of the latter ("*subsidiarisation*"). While it does not specify what should be understood by "essential activities" in this regard, it does not seem necessary that it entail a branch of activity or economic unit, due to the need to differentiate this scenario from the segregation transaction governed by the Structural Modifications Act (Article 71).

Any transfer of essential activities must be to "dependent entities", understood as controlled companies – be they existing or newly created – otherwise the applicable regime would be that of "contribution" of essential assets to another company, addressed in Article 160.

Required majorities

There is no mention in said articles of the majority needed to approve the resolutions in question. However, according to new Article 201 LSC, it is worth considering that they will in principle have to be approved –unless the by-laws establish a higher majority – by a simple majority of the votes of shareholders present or represented at the general meeting, that is, when there are more votes in favour than against. An absolute majority of votes, on the other hand, is only required for the adoption of the resolutions referred to in Article 194 LSC (Article 201.2), which has not been amended by the LSC Reform Act and does not include the acquisition, transfer or contribution of essential assets among the resolutions which require a reinforced quorum.

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2. Announcement and operation of the general meeting

Key aspects:

- The percentage of share capital necessary to exercise minority rights in listed companies is reduced to 3%
- In listed companies, shareholder associations representing at least 1% of the capital and shareholders with more than 3% are granted the right to obtain the identity details of shareholders from Iberclear
- In listed companies, the provision of information prior to the meeting is enhanced, and restrictions on the right of attendance and the right of financial intermediaries holding shares on behalf of different persons to issue conflicting votes are regulated
- In general terms, the rule on matters being voted separately is established, the majorities necessary for the approval of resolutions are clarified, the duty for a shareholder to abstain due to a conflict of interest is extended to joint stock companies and some aspects of the right to information are modified

Introduction

Both the Study by the Expert Committee and the LSC Reform Act expressly include enhancing the role of the general meeting and promoting shareholder participation among their main reform objectives. This aim is not a new one, it has been a feature of virtually all corporate governance reforms approved in recent years, both in Spain and in the EU, as well as in the recommendations from international bodies.

The general meeting, as the body on which the shareholders deliberate, faces serious structural problems that affect its effective development and operation, particularly in the case of large listed companies. The existence of numerous shareholders has an effect not just in terms of increased cost and complexity in preparing general meetings, it also hinders the discussion on the different matters, leads to absenteeism and disaffection and worsens agency problems between managers and owners, among others.

These problems are intrinsic to listed companies and the consequent failures in the system of corporate governance are considered one of the indirect and underlying causes of the current financial crisis. This has led the need to promote shareholder activism to be in the spotlight, and this aim has become one of the principles behind the laws governing listed companies.

In this context, the LSC Reform Act, following the proposals of the Study by the Expert Committee almost to the letter, has approved a series of quite diverse reforms in relation to the announcement and operation of the general meeting. Some affect not just listed companies but all Spanish companies, which is an indication of the *vis expansiva* of matters in relation to corporate governance. Moreover, like in other areas of the reform, the legislator has opted for introducing mandatory rules in matters that were previously subject to self-regulation, which points to a paradigm shift in the regulation of certain aspects of corporate governance.

The new threshold for minority rights in listed companies

In addition to the individual rights that correspond to all shareholders, the LSC assigns another series of rights to those shareholders (applicable in the case of both joint stock and limited liability companies) holding a minimum stake in the share capital, which in most cases is a 5% holding. These are what are known as minority rights, such as –among others- the rights to request the call of a general meeting, to add items to the agenda of a general meeting already called, to prevent the directors refusing to deliver requested information by citing company interests, to request notarial minutes of the meeting, to bring liability actions against the directors, to challenge board resolutions or the right to present proposed resolutions on items already included or that should be included on the agenda of the general meeting.

The LSC Reform Act has amended Article 495 LSC by reducing the

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percentage of capital necessary to exercise minority rights in listed companies, which now becomes 3% (the threshold of the significant stake for communication purposes), while the current 5% stake continues to apply, in general terms, for non-listed companies.

This reduction in the percentage should be welcomed, although it is worth asking whether the reform should not have been more ambitious and gone for an even lower percentage, as the 3% will still be difficult to reach in many cases. Moreover, it seems reasonable from the point of view of simplicity and legal certainty that the legislator have opted for a fixed threshold for assigning minority rights, instead of the option taken by the Proposed Mercantile Code of defining the notion of minority in variable and diminishing terms depending on the share capital.

Extension of the right to ascertain the identity of the shareholders to minorities

The LSC Reform Act has also amended Article 497 LSC in relation to the right of listed companies to obtain the necessary details to identify their shareholders from Iberclear.

Until now, the LSC attributed this right exclusively to the issuer company (see also Article 118.3 LSC), although some regulations extended it – albeit with debatable legal effectiveness - to all shareholders (Article 22.3 Royal Decree 116/1992). In any event, the reform has considered that this right cannot be configured as an individual right of all the shareholders and has opted to restrict it, together with shareholder associations representing at least 1% of capital, to those shareholders holding a minimum stake of 3%. Therefore, this right is conceived as a minority right, which in practical terms can be instrumental in terms of the exercise of other rights also linked to holding a minimum stake in the capital (such as requesting that a general meeting be called or having new items included on the agenda, when the requesting shareholder seeks to obtain support for his proposals from other shareholders).

Announcement and attendance at the general meeting

The Study by the Expert Committee proposed strengthening the right to information of the shareholders of listed companies in order to facilitate effective access to proposed resolutions as of the moment the general meeting is called, so that the shareholders can decide how to exercise their rights (information, voting, etc.). Following this proposal, new Article 518 *d*) LSC clarifies that the full text of all proposals and of "each and every one of the items on the agenda" must be supplied, except those that are "purely for information purposes", in which case it will be necessary to have a report from the management body discussing said points.

The question arose due to the previous wording of this rule, which seemed to accept that proposed resolutions on certain items of the agenda could be missing or that they could be published after the announcement of the general meeting. This practice, in particular, has been used in relation to the appointment of directors. The new text will no doubt help to enhance the information given to shareholders, guaranteeing that they have the chance to be apprised of all the proposals to be discussed and decided on at the meeting sufficiently in advance. But at the same time, the reform may introduce an element of inflexibility in those cases in which the need to appoint one or more new directors –a frequent occurrence- arises after the general meeting has been called.

As for the right to attend general meetings of listed companies, a new Article 521 *bis* is introduced, reducing the threshold that the by-laws can stipulate for attending a general meeting to no more than one thousand shares, with a view to avoiding excessively high percentages of share capital being required, thus unduly restricting said right. This threshold contrasts with the one in a thousand that applies to the share capital of non-listed joint stock companies (Article 179.2 LSC).

Separate votes for each matter

The LSC Reform Act has introduced a new Article 197 *bis* in the LSC, applicable to both listed and non-listed companies, which establishes recommendation 5 of the Unified Code (a recommendation that all Ibex 35 companies declared they fulfilled) as a legal obligation. It expressly recognises the need to have separate votes at general meetings on those matters that are materially independent and specifies that, in any event, the following matters must be voted upon separately (i) the appointment, ratification, re-election or removal of each administrator; and (ii) amendments to Articles or groups of Articles of the by-laws that are deemed autonomous.

Splitting of votes and conflicting votes

The issue of the splitting of votes and conflicting votes in listed companies has been mainly highlighted in those cases in which the holder of the shares is a depositary or nominee acting on behalf of one or more beneficial owners, as in the traditional case of foreign investors who hold their shares via a chain of financial intermediaries.

The problems arose because the formal holders of the shares could find themselves disqualified from splitting or

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exercising the corresponding conflicting votes, in accordance with the voting instructions received from their clients. With a view to addressing this situation, recommendation 6 of the Unified Code proposed that listed companies should be able to split the vote in these situations. Article 524 LSC (added by Act 25/2011) also tackled this matter, although in a clearly defective manner. On the one hand, the conflicting vote referred to cases in which the clients designated a professional financial intermediary to represent them, meaning that the formal holder of the shares is entitled to vote –as it appears as a shareholder in the register- without the need to obtain any power of attorney. On the other hand, disproportionate and clearly unnecessary duties to inform were established for the financial intermediary.

The reform has clarified these aspects. It is now specified that intermediaries who appear legitimised as shareholders "but who act on behalf of several parties, may in any event split the vote and issue conflicting votes" when they receive different voting instructions (Article 524.1). It also clarifies that intermediary entities may delegate their vote to "each of the indirect holders" or to the beneficial owners or, if applicable, to third parties designated by the latter, "with no limit on the number of delegations granted" (Article 524.2).

Calculation of the vote

Article 201 LSC contained the general principle of the adoption of resolutions by the general meeting of joint stock companies by a majority of the votes of shareholders either present or represented. But in referring to the "ordinary majority", it raised a doubt as to whether a relative/simple majority or an absolute majority was required and, as such, how null votes, blank votes and abstentions were to be treated.

The LSC Reform Act has clarified that *in general terms, the majority must be simple or relative*. That is, it is understood that the majority must be calculated taking into account only votes in favour over votes against. Therefore, blank votes, abstentions and null votes are not taken into account, which facilitates the formation of majorities and, as such, the adoption of resolutions by the general meeting.

Nevertheless, this general rule lapses in certain scenarios. On the one hand, the reform also specifies that *resolutions to amend the by-laws or similar measures* (Article 194 LSC) *require an absolute majority*, which is a new development, and when the general meeting has been convened at second call with a quorum of less than 50% of the capital, the favourable vote of two-thirds of the capital present or represented is required (Article 201.2 LSC). On the other hand, the possibility for the by-laws to raise the legal majorities, which may refer either to the capital attending the meeting or the total share capital, is maintained.

Conflicts of interest of shareholders

Until now, Article 190 LSC only regulated the duty of shareholders to abstain due to conflicts of interest in limited liability companies, leading to an *ex ante* control of this kind of situation. In joint stock companies, meanwhile, the absence of a rule on conflicts of interest of shareholders meant that this kind of situation was controlled *ex post*, by the possibility of challenging resolutions considered abusive and harmful to the company's interests, when approved with the participation of the shareholder affected by a conflict.

Following the reform, Article 190 LSC *extends the duty of shareholders to abstain in certain conflict of interest scenarios to joint stock companies* where it previously only applied to limited companies. This refers to resolutions involving: (i) authorising a shareholder to transfer shares or participations subject to legal or by-law restrictions; (ii) excluding it from the company; (iii) releasing it from an obligation or granting it a right; (iv) providing any kind of financial assistance; or (v) excusing it –when also an administrator – from the obligations derived from the duty of loyalty, pursuant to the provisions of new Article 230 LSC.

In relation to *any other conflict of interest scenario* in which a shareholder might find itself, it is now specified –clearing up a question that had led to some controversy – that "*the shareholders will not be deprived of their right to vote*" (Article 190.3 LSC). Nevertheless, when the vote of the shareholder(s) involves an interest that is contrary to that of the company (and provided that it does not refer to the position they hold in the company, as would be the case of resolutions on the appointment, removal or enforcement of administrators' liability) and has been decisive in the approval of the resolution, which has been challenged, the company and if applicable the affected shareholder(s) will bear the burden of proof in accordance with the company's interests (Article 190.3 LSC).

Shareholders' right to information

In relation to the right to information, the LSC Reform Act has just introduced some amendments to the general regime for this right (Article 197 LSC) as well as in the specific regime for listed companies (Article 520 LSC).

The general regime has been amended in order to avoid abuse of the right to information and in accordance with the proposal that inspired the reform –which is analysed in the chapter on challenging

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resolutions- to avoid strategic and instrumental challenges to the corporate resolutions based on insignificant formal infringements. Thus, the scenarios in which it is possible to deny the right to information have been increased and now cover cases in which "that information is unnecessary for the protection of the shareholder's rights, or there are objective reasons to consider that it could be used for purposes unrelated to the company or where public release of the same would harm the company or related companies" (Article 197.3 LSC). Different regimes are also established regarding the violation of the right to information exercised before the general meeting is held and when it is exercised during the same. In the latter case, the shareholder will be entitled to demand fulfilment of the information obligation and any damages caused, but the denial of said right will not constitute grounds for challenging the general meeting (Article 197.5 LSC). Moreover, it is stipulated that in the event of abuse or injurious use of the requested information, the shareholder will be liable for any damage caused (Article 197.6 LSC).

As for the additional regime on the right to information in listed companies, Article 520 LSC has been amended to (i) extend the term for exercising the right to information prior to the general meeting until the fifth day prior to the date set for the meeting (instead of the seventh, which used to be the case); and (ii) promote transparency and equality of shareholders in terms of information, requiring the publication on the company's website of valid requests for information, clarification or questions made in writing, as well as the written replies from the administrators of the company.

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3. Challenging corporate resolutions

Key aspects:

- The reform seeks to strike a balance between the protection of minority shareholders and avoiding abuse in the challenges of resolutions
- The current system for challenging is unified and systematised in order to facilitate the identification of those resolutions that can be challenged, the grounds for the same, entitlement to challenge and the term for bringing the action
- The distinction between null and annullable resolutions is removed
- A minimum percentage is required for shareholders to be entitled to challenge resolutions, except where such resolutions are contrary to public order
- Special conditions are established for listed companies

Reasons for the reform

The LSC Reform Act seeks to simplify the system for challenging corporate resolutions and strike a *balance between the principle of legal certainty and the stability of corporate resolutions*, on the one hand, and the *protection of shareholders and minorities,* on the other.

It has two main objectives: to maximise the material protection of minority shareholders and minimise the risks of opportunistic or tactical use of the right to challenge.

(a) Maximising protection of the interests of the company and of minority shareholders

This aim is to be achieved by unifying the grounds for challenges and removing the existing distinction between null and annullable resolutions.

From now on, there are only *resolutions that can be challenged* according to the grounds contained in the new wording of Article 204.1 LSC. This article includes as new entries the resolutions adopted in contravention of the regulations of the general meeting or, in the case of board resolutions, in contravention of the regulations of the board.

Moreover, the act explicitly extends the concept of *harm to the company's interests*, which had hitherto not been defined, associating it with the resolutions that do not cause damage to the company's assets, but are approved with an abuse of the majority. Such abuse is assumed when there is no reasonable need to adopt them and they benefit the majority to the detriment of the other shareholders (Article 204.1.II LSC).

(b) Minimising opportunistic use of the challenge of corporate resolutions

The main measure adopted to reduce instrumental and strategic challenges by minorities is to *establish minimum thresholds for stakes held in the capital in order to be entitled to challenge* (1 % in general and 0.1 % in listed companies), indicating that, below these thresholds, the shareholders will not be entitled to challenge resolutions, but merely to request indemnification for any damage caused to them (Article 206.1.II LSC). The replacement of the right to challenge with a purely compensatory remedy, which does not compromise the security and stability of the corporate resolutions, is a measure that has some significant precedents in Spanish law (see Article 47.1 of the Structural Modifications Act).

Moreover, the reform establishes a series of *situations where the challenge is inadmissible*..The aim is to avoid unjustified challenges that may have no purpose, such as resolutions rendered void or resolutions that were validly replaced by others (Article 204.2 LSC). In these cases, the reform introduces a new development that had been disputed in the courts until now, which is the possibility for resolutions to be remedied after the challenge has been filed.

Taking into account the reasons and principles behind the reform, it is easy to understand that the new unified regime only has two general exceptions, envisaged in the Act, and that constitute specific regimes for challenging resolutions: the rules applicable to *listed companies* (in which it is necessary to intensify the certainty of legal situations and avoid instrumental challenges) and

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the special treatment received by resolutions that can be challenged because they contravene *public order* (in relation to which the regime of entitlement is extended).

Resolutions that can be challenged

The description of resolutions that can be challenged is still contained in Article 204 LSC, although it has been amended considerably.

The main aspect of the reform, as mentioned earlier, is the *disappearance of the legal distinction between null and annullable resolutions*, which were subject to different regimes. This was a disturbing differentiation, originating from the traditional categories of ineffectiveness of legal transactions, which entailed significant differences with regard to terms and entitlement to challenge.

As of the reform, resolutions are only considered *challengeable* and the scenarios for challenging them are set out in greater detail; those that are contrary to the law or the by-laws being joined by resolutions that contravene the regulations of the general meeting of the company and, in relation specifically to the resolutions of the board of directors, the regulations of said body (Article 251.2 LSC).

The possibility of challenging resolutions due to infringement of the regulations of the general meeting, which is envisaged in general terms (Article 204.1 LSC) despite the fact that only listed companies are obliged to approve them (Article 512 LSC), could be considered at cross-purposes with the aim of the reform to avoid challenges due to minor formal infringements, in view of the nature of the regulations of the general meeting as essentially procedural rules that are subordinate to the by-laws and, as such, unlikely to affect shareholders' rights.

Another new development, as we have already mentioned, is the establishment of a ground of harm to the company's interests for the benefit of one or more shareholders or third parties consisting of *adopting resolutions by abuse of a majority*, indicating the requirements that can lead to said ground being considered to exist, without there being any harm to the company's assets: resolutions for which there is no "reasonable need" on the part of the company and that benefit the majority to the detriment of the rest of the shareholders (Article 204.1.II LSC).

The reform also elaborates on and specifies a matter of a practical nature that has given rise to debate in the past, namely the question of the *rule that resolutions rendered void or validly replaced by others cannot be challenged*. Article 204.2 LSC now clarifies that the challenge cannot be lodged even when the voiding or replacement of the resolution takes place after the claim has been filed and specifies the decision that the courts will have to adopt, rendering the proceedings concluded "due to supervening lack of object" (Article 204.2 LSC).

Finally, Article 204.3 LSC establishes four exceptions to the general definition of resolutions that can be challenged:

- The infringement of purely procedural aspects or requirements in relation to the announcement and constitution of the body adopting the resolutions, as well as for the approval of the same, unless relevant aspects are involved (e.g. form and term envisaged for the announcement, the essential rules on the constitution of the body or the majorities necessary for the adoption of the agreements).
- Incorrect or insufficient non-essential information supplied prior to the general meeting, which is complemented with the provisions of new Article 197.5 LSC in relation to the information requested verbally during the general meeting, and which cannot be used as grounds for a challenge in the event of infringement and will only entitle the party in question to seek damages.
- The participation of persons who are not entitled to do so, unless it is decisive for the valid constitution of the body.
- The invalidity of one or more votes that were not decisive for the formation of the majority (known as the "resistance test", formulated by case law up to now).

Expiry of the challenge

As for the term for challenging, new Article 205.1 LSC, following the removal of the different treatment of null and annullable resolutions, establishes a *general term of one year*.

However, a different regime is established depending on the body on which the resolutions are adopted (general meeting or board). Further exceptions are established, one of a substantive nature for resolutions that are contrary to public order (which does not represent a change in relation to the current rules) and another of a subjective nature, depending on whether or not the company whose resolutions are being challenged is listed.

(a) Resolutions of the general meeting

For those resolutions adopted at the general meeting, a general term of one year is established. But there is an *exception* to this term *in the case of listed companies*, whose resolutions, due to their relevance, are subject to stricter certainty and

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security requirements, and the term in this case is of less than *three months* (Article 495.2 LSC).

The only exception, which is already established in Spanish law, are *resolutions that are contrary to public order*, which are not subject to any term (Article 205.1). With the reform, actions to challenge corporate resolutions that due to their *cause* or *content* are contrary to public order, are complemented by those whose *circumstances* also render them contrary to public order.

Meanwhile, the calculation of the *dies a quo* contained in new Article 205.2 LSC reproduces the regime prior to the reform, which started counting on the date the resolution was adopted. But two new specifications are established, consisting of counting from the date of receipt of a copy of the minutes for those resolutions adopted in writing (a possibility that is in principle only open to the board of directors) and the date of validity for those resolutions recorded in the Commercial Registry — validity occurs with publication in the Official Gazette of the Commercial Registry (BORME) (Article 21.1 of the Commercial Code), while the previous regime referred to the moment of registration—.

(b) Resolutions of the board of directors

The term for challenging the resolutions of a board of directors is shorter, with a general term of thirty days being established (Article 251.1 LSC). Even though this matter could give rise to debate, we believe that this term does not apply to those resolutions considered contrary to public order.

In line with the previous regime, a distinction is made between the date on which the term starts depending on whether the challenge is lodged by the directors, who have thirty days to do so as of the adoption of the resolutions, or the shareholders entitled to challenge, who also have thirty days, although in this case as of when they become aware of the resolution, provided the general term of a year has not elapsed since it was adopted.

Entitlement

The new system of entitlement for challenging resolutions requires a distinction to be made between the resolutions of the general meeting and those of the board of directors. Moreover, it has to be taken in connection with the special provisions affecting listed companies.

(a) General meeting

The general regime entitles administrators, shareholders and third parties with a legitimate interest to challenge resolutions.

In particular, in relation to the shareholders, the reform introduces an important new development by linking entitlement to holding a minimum stake of the capital, meaning that the right to challenge ceases to be an individual right of the shareholder and becomes a minority right. And in this regard a distinction is established between unlisted companies (subject to the general regime) and listed ones, in which a lower stake is required.

Thus, in order to challenge resolutions of unlisted companies, the challenging shareholders will have to represent, individually or jointly, more than 1 % of the capital prior to the adoption of the resolution (Article 206.1 LSC). But for listed companies, this threshold is lowered to 0.1 % of the capital (Article 495.2.*b*) LSC], due to the fragmented shareholder profile that is characteristic of these companies and the advisability of not limiting the right to challenge excessively.

The reform also establishes the possibility for the by-laws to lower these thresholds in order to further extend the right to challenge (Article 206.1.II LSC), although it is unlikely that this option will be used very often.

There is also an exception to the need to have a minimum stake in relation to resolutions contrary to public order (Article 206.2 LSC), which can be challenged by any shareholders, even if the person in question became a shareholder after the resolution had been adopted, as well as by administrators and third parties (without any mention to the need for a legitimate interest).

(b) Board of directors

In relation to board resolutions, Article 251.1 LSC recognised the entitlement of directors and shareholders representing 1 % of the share capital to lodge a challenge, although this percentage is reduced, like in the case of general meeting resolutions, to 0.1% in the case of listed companies [Article 495.2.*b*) LSC].

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4. Remuneration of administrators

Key aspects:

- Greater transparency and control over the remuneration paid to administrators, thereby reinforcing the role of the general meeting.
- The general meeting must approve the maximum amount of annual remuneration allocated to pay all administrators, due to their status as such.
- Directors who perform executive duties must sign a contract with the company setting out in exhaustive detail the remuneration system applied in return for such duties. Such contract must be approved by the reinforced majority of the board without the intervention of the director in question.
- Listed companies must approve a remuneration policy for their directors, which must set out both the remuneration to be paid to directors due to their status as such and in return for the performance of their executive duties. Such policy must be approved by the shareholders' general meeting for a term of three years.

Background and aim of the reform

Prior to the LSC Reform Act, the regulations on the remuneration of administrators were partial and limited, consisting of a general regime applied equally to all Spanish companies–whether listed or not- and which did not consider the diverse nature of the remuneration items usually attributed to executive directors.

Thus, no distinct legal regime existed to regulate, as such, the remuneration to be paid to administrators of listed companies, apart from certain attempts made to implement measures to add greater transparency to remuneration systems, such as certain recommendations from the Unified Code (recommendations 33 to 36) or the obligation to draw up an annual report on the remuneration to be paid to directors, imposed under the Spanish Securities Market Act and now established in the new Article 541 LSC. Nor did the legislator pay particular attention to the different types of remuneration frequently received by administrators for performing executive duties, which –despite a few timid attempts by the courts to react to this- led to the development of remuneration practices outside of the corresponding corporate channels.

The main aim of the LSC Reform Act in this regard is to ensure *the shareholders' capacity to control the remuneration to be paid to administrators*, although always upholding companies' management and organisational capacity, while guaranteeing sufficient *transparency of said remuneration*. More specifically, the reform attempts to ensure that remuneration systems adapt to the market in which the company operates and to its financial situation at all times, it aims to establish a process for preventing potential conflicts of interest involving any of the participants when adopting the corresponding resolutions on administrators' remuneration and, in relation to executive directors, it approaches their remuneration with the purpose of unifying and standardising it.

Consequently, in addition to better defining and improving the regulations existing until now, the legislative reform grants certain additional competencies to the general meeting in relation to remuneration and establishes that the principles of *proportionality* and *reasonability* should govern the remuneration system applicable to administrators. In addition, the reform creates a system which is more specific and detailed in relation to the remuneration of directors of listed companies, and it regulates the remuneration system for directors who perform executive duties.

This is one of the aspects of the LSC Reform Act which has deserved the most attention, as a result of the relevance the issue of the remuneration of administrators has acquired in recent years within the debate on the corporate governance of listed companies.

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General system for the remuneration of administrators

The LSC Reform Act has amended, on the one hand, the general system for remunerating administrators, which applies to all Spanish companies, whether listed or not. Most of the differences in the system existing until now between joint stock companies and limited liability companies have been eliminated, since they generally lacked any objective justification and merely reflected the different origins of the respective laws governing them.

Thus, the post of administrator in Spanish companies continues to not be remunerated, unless the by-laws establish otherwise, in which case the remuneration system must be indicated (Article 217.1 LSC). Some examples of these possible *remuneration systems* which must be indicated in the by-laws are: (i) payment of a set amount, (ii) payment of expenses for attending board meetings, (iii) share in profit (which must be established in the by-laws or by the general meeting, within the maximum limit set in the by-laws: Article 218 LSC), (iv) variable remuneration with general indicators or parameters of reference, (v) remuneration in the form of shares or linked to performance (regulated in greater detail in Article 219 LSC), (vi) indemnification following removal (provided such removal is not due to a breach by the administrator of his/her duties) and (vii) the savings or pension plans deemed appropriate (Article 217.2 LSC).

Unlike the previous regulations, which gave no indication whatsoever in relation to joint stock companies as to which body has competence to set the remuneration of administrators and the decision-making capacity reserved to the shareholders, it is now required that *the general meeting approve the maximum amount of the annual remuneration allocated to pay all administrators,* a maximum amount which will remain in force unless it is modified by the general meeting itself (Article 217.3 LSC). The remuneration to be approved by the general meeting is, in any event, what corresponds to the administrators "*due to their status as such*", which in the case of the directors performing executive duties must be supplemented –as we will explain below- by any other remuneration items that may be included in the contract they must sign with the company (Article 249.3 and .4 LSC).

Furthermore, the general meeting also has competence to establish the distribution of the remuneration between the different administrators. Should it fail to do so, said duty corresponds by default to the administrators themselves or to the board of directors, which must take into consideration the duties and responsibilities attributed to each director (Article 217.3 LSC).

As a general rule, remuneration must be set *reasonably in proportion to the company's size*, its *financial situation* at any given time, and the *market standards for similar companies*. In addition, the remuneration system must now specifically be designed to encourage the company's long-term profitability and sustainability and to include the necessary precautions so as to avoid assuming excessive risk and rewarding unfavourable results (Article 217.4 LSC). This is, in any event, a series of indeterminate criteria with unclear legal content, which, in the most extreme cases, could serve to challenge or contest remuneration which is not duly in proportion to the company's financial situation or to the share in profit corresponding to the shareholders.

Remuneration of executive directors

The remuneration to be paid to directors who perform executive duties, different from what they might receive due to their status of administrator, is set, in principle, by the *board of directors*. But given the importance of this remuneration and the possible conflicts of interest it can entail, the LSC Reform Act has created a specific regulation which includes a series of precautions, such as: requiring reinforced majorities, the abstention of the directors in question and establishing, in the case of listed companies, that the board necessarily confine its actions to those resolutions previously adopted by the general meeting.

In this regard, when a member of the board of directors is appointed managing director or is attributed executive duties by any title (senior executive employment contract, commercial relationship, etc.), a *contract between the director and the company* must be executed (Article 249.3 LSC). This contract, which must be approved by the board of directors with the favourable vote of at least two-thirds of its members and with the director in question abstaining, must set out in detail *all remuneration items for which the executive director could obtain remuneration for the performance of such executive duties*, including, as the case may be, potential indemnification for his/her early removal from such duties and the amounts to be paid by the company as insurance premiums or savings plan contributions. Given the purpose of this contract, the director will not be able to receive any remuneration for performing executive duties if these amounts or remuneration items are not set out therein (Article 249.4 LSC).

As has already been stated, this remuneration for the performance of

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executive duties is different from or in addition to the remuneration which corresponds to "administrators due to their status as such", the maximum amount of which must be approved by the general meeting (Article 217.3 LSC). In this way, the legislator has intended to keep the management body somewhat independent, in terms of its ability to establish remuneration for executive duties, leaving shareholders out of this direct decision-making process. In any event, the remuneration to be paid to executive directors must also be governed by the principles of proportionality and reasonability and, in the case of listed companies, must be in line –as we will see- with the remuneration policy approved by the general meeting.

Specific system for listed companies

As stated above, the LSC Reform Act has established specific additional regulations in relation to the remuneration to be paid to the directors of listed companies.

Thus, in contrast to the general system applicable to Spanish companies, in the case of listed companies, an assumption is made that the post will necessarily be *remunerated*, unless otherwise indicated in the by-laws (Article 529 *sexdecie*s LSC). This rule is undoubtedly justified by the special responsibility and dedication required from directors of listed companies, but also by the actual practical situation of these companies.

It cannot be inferred from this, however, that the remuneration to be paid to the administrators of listed companies need not be the subject of the appropriate provision made in the by-laws. The remuneration policy for directors which the general meeting must approve –as we will see- must in any event be in line with the "remuneration system set out in the by-laws" (Articles 529.1 *septdecies* and 529.1 *novodecies* LSC). This seems to confirm that, beyond the assumption that the post will be remunerated, the remuneration item or items to be received by the directors will indeed have to be set out in the by-laws.

In particular, the remuneration of directors due to their status as such and remuneration for the performance of executive duties

The board of directors must approve a *remuneration policy for the directors*, at the proposal of the appointments and remuneration committee, in relation to the remuneration of the executive directors [Article 529.3.*g*) *quindecies* LSC], which must in turn be subject to approval by the shareholders' general meeting. Said policy must set out, at the least, the *annual remuneration to be paid to all directors due to their status as such* and the *remuneration system applicable to directors who perform executive duties*.

In relation to the remuneration corresponding to directors due to their status as such, the remuneration policy must follow the system established in the company's by-laws and must indicate the maximum amount to be paid to all directors in this regard (Article 529.1 *septdecie*s LSC). It will fall to the board of directors to determine the individual remuneration of each director (contrary to the general rule in Article 217.3 LSC), and the board must consider for this purpose the duties and responsibilities attributed to each director, whether the director is on board committees and all other objective circumstances deemed relevant (Article 529.2 *septdecie*s LSC).

Regarding the remuneration paid to directors for the performance of executive duties, this must be established –as we have seen- in a contract between them and the company, which must be in line with the directors' remuneration policy. This policy must set out: (i) the annual fixed amount of remuneration and its variation during the period to which the policy refers, (ii) the different parameters for setting the variable components, (iii) the main terms and conditions of their contracts, including, in particular, their duration, indemnification due to their early removal or the termination of the contractual relationship, and (iv) exclusivity clauses, post-contractual non-compete clauses and/or minimum-term or loyalty to the company clauses (Article 529.1 *octodecies* LSC). Establishing the remuneration to be paid to the executive directors and the terms and conditions of their contracts with the company corresponds in any case to the board of directors (Article 529.2 *octodecies* LSC).

Necessary approval of the remuneration policy by the general meeting

One of the main legislative changes of the LSC Reform Act in terms of remuneration to be paid to directors of listed companies consists of attributing decision-making powers to the shareholders' general meeting which go beyond the approval, in an advisory capacity, of the annual report on the directors' remuneration. It has been considered necessary, for the good governance of listed companies, that the general meeting have effective decision-making capacity in relation to the directors' remuneration, including regarding which different payment components should be included, as well as the parameters and terms for establishing their remuneration.

In this regard, *the remuneration policy for the directors of the company*, which must be adapted as appropriate to the remuneration system established in its by-laws, *must also be subject to approval*

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by the shareholders' general meeting as a separate item on the agenda, at the proposal of the board of directors and subject to a report by the appointments and remuneration committee (Article 529.1 and .2 *novodecies* LSC).

The remuneration policy for directors will remain in force during the three financial years following the one in which it was approved by the shareholders' general meeting, in such a way that any amendment or substitution of such policy during said time must be again approved by the general meeting (Article 529.3 *novodecies* LSC). However, if the annual report on the directors' remuneration is rejected during the consultative vote during the ordinary general meeting, the remuneration policy applicable to the following year must be revised and subjected for approval by the next general meeting prior to being applied, regardless of the corresponding three-year period not having elapsed (Article 529.4 *novodecies* LSC).

Although the general rule is that directors cannot receive any remuneration not established under the remuneration policy in force at any given time, the possibility of the general meeting expressly approving other special remuneration items seems meanwhile to be acceptable (Article 529.5 *novodecies* LSC).

The transitional regime on the approval of the remuneration policy

Given this new requirement whereby the remuneration policy must be approved by the general meeting, and in order to harmonise this with the pre-existing system for drawing up the annual report on the remuneration to be paid to the directors and on the latter being subject to a consultative vote by the general meeting (now established in Article 541 LSC), the LSC Reform Act has taken care to establish, in its transitional provision (section 2), a *specific transitional regime* for this new discipline, so as to avoid possible disruptive situations. In particular:

(a) if the first shareholders' ordinary general meeting held after 1 January 2015 approves the annual report on the directors' remuneration following a consultative vote, it will be construed that the company's remuneration policy contained therein has likewise been approved for the purposes of the new regime established in Article 529 *novodecies* LSC, and will apply from then on; but

(b) if, on the contrary, the shareholders' ordinary general meeting does not approve said annual report following a consultative vote, the directors' remuneration policy must be subject to the binding approval of the shareholders' general meeting no later than the end of the following financial year, effective as from the year after that.

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5. Administrators' rules of conduct. Duty of care and duty of loyalty

Key aspects:

- The LSC Reform Act adopts what is known as the *business judgement rule*, which prevents judges from revising strategic decisions and business decisions made by administrators
- Distinctions are made within the regime on administrators' liability, depending on the functions they effectively perform
- The main provisions on the duty of loyalty are reformulated while others are added, such as the administrators' obligation to always apply their own criteria and not accept instructions from third parties or have ties with them
- Within the duty of loyalty, two type of obligations can be distinguished: basic or substantive obligations, which constitute absolute prohibitions, and certain key obligations referring to cases of conflicts of interest, which by contrast can be the subject of an exemption

Rules of conduct and general meaning of the reform

The post of administrator entails that the party holding such post be subject to rules of conduct which set out a series of "duties". These duties reflect the guidelines or criteria for acting which administrators must abide by in the performance of their roles, and they serve, in the event of a breach, as a basis for their potential liability. These are *duties to act or rules of conduct*, often known by their English name as "fiduciary" duties, which are reduced to two main duties: the *duty of care* and the *duty of loyalty*.

The foregoing regulation of the rules of conduct had its origins in the Act of 17 July 2003 on the transparency of listed companies, which in turn resulted in the fulfilment of the recommendations of what is known as the "Aldama Report" of 2003[1]. The current reform of the LSC, which has in turn included numerous provisions from the Proposed Mercantile Code of June 2013, is limited in essence to perfecting the existing discipline, mainly by specifying the contents of the duty of care and reformulating the general contents of the duty of loyalty and its main provisions.

This regulation applies to all Spanish companies and not only to listed companies, which have not been the subject of any specific provision in this regard. Still, the reform has been clearly dominated and inspired by the uniqueness of listed companies. These rules of conduct applicable to administrators are an *essential part of any corporate governance system*. The regulatory function of these rules is to align the interests of the administrators with those of the shareholders, both for the purpose of creating value and for sharing it, and this is also the main purpose of the corporate governance movement. Furthermore, the existence of an effective system for determining administrators' liability, which enables any infringement of their rules of conduct to be identified and sanctioned, also constitutes an essential element for creating trust in securities markets.

Different treatment of negligence and disloyalty

Although both duties contribute to defining the role of the administrator, the LSC Reform Act fulfils the main goal of treating them each differently, according to the consequences associated with their infringement.

In essence, the main inspiration behind the LSC Reform Act is that Spanish law should be *benign and tolerant with infringements of the duty of care*, or with what would constitute the problem of negligence (thus, the business judgment rule –as we will see-), yet *strict and severe with infringements of the duty of loyalty*, which can be summarised as disloyal conduct (which explains –as is analysed in the chapter on administrators' liability- the possible direct exercise by the minority of corporate liability actions for these types of infringements).

The reasons relate above all to the different objective significance attributed to each of such types of conduct and, in

[1] *Report by the Special Committee to ensure transparency and security in the markets and in listed companies*, dated 8 January 2003

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practical terms, to the greater or lesser probability of them being displayed. Not only do infringements of the duty of care not bring any benefit to those who commit them, but also, in general, they tend to be more visible and can be recognised and sanctioned by shareholders and by the market. The consequence, then, is that administrators lack, as a matter of principle, the incentives for carrying them out. Disloyal conduct, on the other hand, can entail a personal benefit or gain for administrators, although at the shareholders' expense; therefore, it is more likely to be put into practice. And due to its nature, disloyal conduct tends to disguise itself as everyday transactions which are formally correct, which also makes this conduct more difficult to identify and prosecute.

The adaptation of the duty of care according to the nature of the post and the functions performed

The duty of care can be summarised as the need for administrators to act "with the care expected from an *orderly businessperson*" (Article 225.1 LSC). This legal standard refers to the degree of dedication, competence, foresight and knowledge required when managing any company. It is a model equivalent to that of the "reasonable businessperson" used by some international instruments, which must be assessed according to the size of the company, the sector in which it is active and the activities it carries out. The duty of care is related to the *creation or maximisation of value*, due to the administrators' status as managers of third-party assets.

The LSC Reform Act has adapted administrators' general duty of care, by relating it to the "nature of the post and the functions attributed to each one of them" (Article 225.1 LSC). Although the board of directors takes the form of a collegiate body and all of its members are jointly and severally liable as a rule (Article 237 LSC, which has not been amended), it is thus in keeping with the *differentiation or specialisation of functions* which is, in practice, characteristic of more complex forms of administration, such as the case of listed companies. The degree of competence and dedication –the required care- cannot be the same for an executive director, to whom the effective management of the company is entrusted, as for an external director, whose post mainly entails supervisory functions. The task of each director and the latter's required conduct by extension, can also be determined by the board committees on which he or she participates or the duties entrusted to said director, and by the resulting division of work within the body in question.

All administrators are subject to a duty of care. But this does not mean one single, uniform duty for all; instead, this duty must be defined according to the functions effectively performed by each one.

Duty of care and the business judgment rule

The most relevant reform of the LSC in terms of the duty of care is in relation to the express adoption in Spanish law of the theory borrowed from English law, and in particular from US law, known as the *business judgement rule*, which the LSC has rechristened as "*protección de la discrecionalidad empresarial*" (Article 226).

This business judgement rule applies to *management* acts in relation to the company. Meaning those strategic and business decisions whose adoption is subject to technical and discretionary criteria, through which both innovation and risk taking are channelled, as these form part of a business's activities (an acquisition or investment, the launch of a new product or service, etc.). Provided that certain prerequisites are fulfilled, these decisions are presumed to be in line with the standards of an orderly businessperson. Therefore, although these decisions may, in time, be revealed as erroneous and even ruinous for the company, administrators cannot be considered negligent nor be held legally liable whatsoever as a result. A type of *legal immunity* is thus created in relation to these acts, based on the assumption that, in these cases, administrators are acting in good faith and in the belief that they are acting in the company's best interests.

This business judgment rule gives form to a principle already roughly set out in Spanish case law, which rejected that "the analysis of the intrinsic correctness [of business decisions] in terms of its economic aspects can be overseen by the courts" (Judgment of the Spanish Supreme Court of 17 January 2012). This judgment is based on different types of considerations. The intention is to prevent a severe regime of liability through negligence from operating as a hindrance or obstacle to the assumption of risks typical of any business activity. The waters are muddied further by the difficulties which usually exist in discerning, after a time, if the hypothetical economic damage deriving from a business decision should be attributed to the mere risk or to a negligent act. And this should be contrasted with the danger associated with a court judging these decisions, due to the inexistence of any technical rules (*lex artis*) which would permit them to be assessed objectively, the judges' usual lack of technical training, and the obvious risk of their assessment acquiring a "retrospective bias", associating the fact that economic losses were caused with the negligent nature of the decision behind them.

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However, the application of this business judgment rule is subject to the fulfilment of certain prerequisites, as established in Article 226.1 LSC:

- the administrator must have acted with *sufficient information*, in terms of a decision made with ample facts and sufficiently reasoned and thought out. In fact, obtaining the necessary information to properly perform the role of administrator is not only a right of the administrator, but also –as the new Article 225 LSC specifies- a true duty;
- the administrator must act within the context of a *proper decision-making process*; that is, according to the corporate rules governing the decision-making process; and
- the administrator must act *in good faith and without a personal interest*, which rules out those decisions in which he or she has a direct or indirect interest, as well as those affecting –as indicated in Article 226.2 LSC- other administrators or related parties. In cases where the administrator's impartiality is compromised, his or her actions must be judged according to the parameters, not of the duty of care, but of the duty of loyalty, which are stricter and more thorough.

In any event, an administrator's liability is not simply derived from the non-fulfilment of these prerequisites. Instead, the judicial immunity protecting the management acts will merely disappear, and thus the judge will recover all of his or her authority to judge the merits of the decision which caused the economic damage to the company.

The reformulation of the duty of loyalty and its various forms

The other rule of conduct comprising the post of administrator is the duty of loyalty or of care, which had been contained until now in the "*faithful representative*" standard. But this form of conduct has been reformulated in the LSC Reform Act, which now requires that administrators act "with the *loyalty of a faithful representative*, *acting in good faith and in the company's best interests*" (Article 227). A faithful representative, or loyal representative, is one who always strives to promote and defend the interests of the persons he or she represents and who puts those interests before his or her own, in particular when the two conflict. Just as the duty of care focuses on creating value, the duty of loyalty concerns the *distribution or sharing of value*, thus preventing administrators from exercising their duties for their personal gain and to the detriment of shareholders.

The reform has, in essence, specified and systematised the different manifestations of the duty of loyalty, while adding other manifestations to the existing ones. In particular, a distinction is made between: (i) different *"basic" or substantive obligations* deriving from this duty (Article 228), which contain actual absolute and unconditional prohibitions, and (ii) a series of *key obligations*, referring to the "duty to prevent conflict of interest situations" (Article 229), which, on the contrary, contain relative prohibitions that, as such, can be subject to exemptions "in special cases" (Article 230.2).

The substantive obligations include some already contained in the LSC, such as the duty of secrecy [Article 228.*b*)] and the duty to refrain from discussions and voting on resolutions or decisions in which the administrator has a direct or indirect conflict of interest [Article 228.*c*)]. But other obligations have been added, such as: (i) the general duty not to use the administrator's powers "for purposes other than those for which they were granted" [Article 228.*a*)], which encompasses any case of abuse of authority or –to use a Public Law term– misuse of power, and (ii) the obligation to act at all times "under the principle of personal liability with freedom of judgement and independence with regard to instructions and third-party ties" [Article 228.*d*)], which is an especially relevant rule in the case of *consejeros dominicales* (proprietary directors representing a substantial or controlling part of the share capital) and, in general, those who have any ties to a shareholder or a third party.

The duty to avoid conflict of interest situations and its exemption regime

In addition to the basic obligations comprising the inalienable core of the duty of loyalty, this duty imposes another series of key obligations which derive from the administrators' general duty *not to put themselves in situations in which their interests may collide with those of the company* [Article 228.*e*) LSC].

Among these key obligations are also some which were already included in the previous legislation and which have, in any case, been the subject of certain technical improvements. This is the case in particular of: (i) the prohibition against using the company's name and invoking the status of administrator [Article 229.1.*b*)], although only –as the LSC now specifies- when this is to unduly profit from private transactions; (ii) the prohibition against taking advantage of the company's business opportunities [Article 229.1.*d*)]; (iii) the prohibition against performing, either on their own or

under the direction of another, activities which compete with those of the company [Article 229.1.*f*)], and (iv) the obligation to notify the other administrators, the board of directors or the general meeting –as the case may be- of any situation in which there is a direct or indirect conflict of interest with those of the company (Article 229.3). But new obligations have also been added in this context, such as: (i) that of carrying out transactions –with certain exceptions- with the company [Article 229.1.*a*)]; (ii) using the company's assets for private purposes [Article 229.1.*c*)] and, (iii) obtaining advantages or remuneration from third parties in relation to the performance of the role [Article 229.1.*e*)].

Given their nature as supporting or supplementary obligations –unlike those "basic" obligations set out under Article 228 LSC- these obligations *can be the subject of an exemption*, although never in general and only "in special cases" (Article 230 LSC). The general meeting, in some cases, and in others the management body (although in this case only when the independence of the members granting the exemption is ensured) can therefore authorise the administrator to perform the transaction in which the conflict of interest occurs. This would be the case –for example- of an authorisation to use the company's assets, to take advantage of a business opportunity or to execute a transaction with the company.

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6. Administrators’ liability regime

Key aspects:

- Presumption of guilt of the administrator when the act or omission in question contravenes the law or the by-laws
- Extension of the liability regime to de facto administrators, including both non-appointed administrators or administrators whose appointment has expired, as well as shadow administrators and natural persons representing administrators who are legal persons
- Making the system for bringing a corporate liability action more flexible, by reducing to 3% the capital required in listed companies for minority standing purposes and for bringing a direct action, without the need for a prior general meeting in the event of violation of the duty of loyalty
- Establishment of a statute of limitations period of four years for corporate and individual liability actions as of the date on which the action could have been brought

Objectives of the reform

The LSC Reform Act has contributed modifications to the administrators' liability regime, following the example of neighbouring legal systems, with a view to adapting it to the tightening up of administrators' duties, particularly those of loyalty or trust, and in order to facilitate the exercise of the corresponding liability actions.

As the Study by the Expert Committee indicates, the updating and tightening up of the duties of administrators and their liability regime was a matter that had been pending for some time, despite the fact that it is at the very heart of corporate governance. In fact, as far back as in 2006, the Unified Code recommended the Government to reform the administrators' liability regime in order to make it tougher and more effective, proposing a recognition of "the direct standing of shareholders to bring liability actions due to disloyalty", among other measures.

However, the LSC, being a restated text, and thus unable to introduce innovations to the legal system, did not reform the system of duties and liability of company administrators, certain formal modifications apart. Hence the urgent need to carry out a reform in the context of a general revision of the rules of corporate governance such as the one embodied in the LSC Reform Act.

Objective scope of the liability regime

The material prerequisites for administrators' liability are, as we know: (i) causing *harm* to the company's assets or, in the case of an individual action, to those of shareholders or third parties; (ii) the existence of an *unlawful or illegal action or omission* on the part of the administrator, and (iii) the necessary existence of a *causal link* between said action or omission and the harm caused (Article 236.1 LSC) which, if it exists, would oblige the administrator to answer to the company, the shareholders and third parties, as the case may be.

Specifically, administrators' liability is triggered in those scenarios in which harm is caused due to acts or omissions (i) contrary to any legal provision in force (failure to call a meeting by a particular deadline, failure to draw up the accounts, etc.); (ii) contrary to the company by-laws, or (iii) carried out in breach of the duties inherent in their post. This would be the case in particular of acts or omissions that violate the *duty of diligence or care* (with the special category of "the business judgement rule" established in new Article 226 LSC, which guarantees a lack of liability for purely management decisions that end up causing harm) or that violate the *duty of loyalty or trust*, in those cases in which the administrator is performing his duties for his own benefit and to the detriment of the interests of shareholders. The reform –as analysed in the foregoing chapter – justifies its vocation as a measure that is benign with *acts of negligence*, while at the same time hardening its stance on the liability of administrators in relation to *acts of disloyalty*.

The only modification included in relation to the material prerequisites for liability addresses fault by the administrator. Following the reform, Article 236.1 LSC specifies that *there must be "wilful misconduct or fault"*. But this clarification merely reflects the way that the Courts

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had already been interpreting the administrators' liability regime. In this regard, it was understood that the unlawful or illegal act of which the administrator was accused had to be culpable, which would imply the application of the general legal rules applying to civil liability (excluding cases such as *force majeure* or unforeseeable circumstances) and also encompass any kind of fault (*in vigilando*, *in eligendo*, *in instruendo,* etc.) as a source of liability.

One thing that is new, however, is the *presumption of guilt* of the administrator in the absence of evidence to the contrary *when the act contravenes the law or the company by-laws*. This rule, which entails a reversal of the burden of proof (the claimant only has to prove the existence of the act or omission that contravenes the law or the by-laws, and the administrator has to prove that the breach was not culpable), is undoubtedly justified because a breach of the law or the by-laws indicates improper and negligent conduct as a matter of principle.

It is also worth looking at how fault is traditionally considered the same as serious negligence. The latter concept traditionally formed part of the precept we are studying, as part of the formula "*malice, serious negligence and abuse of authority*", envisaged in the 1951 Joint Stock Companies Act ("*Ley de Sociedades Anónimas*") meaning that it will have to be considered included here, even if not specified in the new wording of Article 236.1 LSC.

In addition, the fact that *the intervention of the general meeting does not constitute an exonerating factor* in relation to administrators' liability remains unchanged, as the law still states that the fact that a harmful act or resolution was adopted, authorised or ratified by the general meeting will not release the administrator from liability (Article 236.2 LSC).

Subjective scope of the liability

The most significant modification of the administrators' liability regime refers to the *extension of its subjective scope or ambit*.

Although the LSC –following the amendments introduced by the Listed Companies Transparency Act ("*Ley 26/2003, de 17 de julio, sobre transparencia de las sociedades cotizadas*")- already extended the scope of liability to include *de facto administrators*, the LSC Reform Act has specified that this concept includes both (i) *de facto administrators themselves*, understood as those who hold the post without any appointment or whose appointment is null or expired, or by virtue of some other appointment (improperly appointed administrators, whose post has expired, etc.), and (ii) *shadow administrators*, understood to mean those whose instructions are followed by the administrators (Article 236.3 LSC). This second category, because of its breadth, is the one that generally gives rise to the most uncertainties in practice, due to its possible application in the context of groups of companies or even creditors of companies in distress.

Moreover, in those cases in which the management body is in the form of a board of directors and there is no permanent delegation of powers to one or more executive directors, the person to whom the maximum powers of management have been attributed in the company, regardless of their job title, also falls under the system of liability, the actions of the company based on its legal relationship with said person notwithstanding (Article 236.4 LSC).

Finally, the LSC Reform Act has also addressed a matter that had given rise to numerous doubts in practice, namely the legal status of *natural persons representing administrators who are legal persons*. In this regard, it has clarified that the person must meet the legal requirements established to be a administrator, be subject to the same general duties of any administrator and, in the event of a breach of these duties or the commission of acts contravening the law or the by-laws, will be jointly and severally liable with the administrator that is a legal person (Article 236.5 LSC).

Joint and several liability of administrators

The *joint and several nature of the liability of administrators* (Article 237 LSC) is unaffected by the reform, except in relation to natural persons representing administrators who are legal persons who –as we have just seen- will be jointly and severally liable with the legal person (Article 236.5 LSC).

In this way, the grounds for exoneration from administrators' liability will continue to apply, and those who can prove that they did not intervene in the adoption or execution of the resolution or act in question and (i) were unaware of its existence, or (ii) while aware of it, did everything possible to avoid the harm or, at least, expressly opposed the resolution or act, will not be held liable.

This joint and several liability amounts to establishing a *presumption of guilt* of all members of the management body, insofar as they all will be liable unless they can demonstrate that one of the grounds for exoneration exists. This represents a reversal of the burden of proof, as it relieves the claimant of the need to identify the specific administrators that should be held materially liable for the unlawful act or omission. The joint and several liability of administrators should, in any event, be assessed taking into account that they do not all have the same duty of diligence, because this will now depend

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–according to new Article 225.1 LSC- on "the nature of the post and the duties attributed to each one". As a result, while all the administrators are jointly and severally liable in principle, they do not all have to face the same charge.

Corporate actions and individual actions

The reform maintains the traditional dichotomy of *corporate liability actions* (Article 238 LSC) and *individual liability actions* (Article 241 LSC). Even though the prerequisites for liability are the same for corporate and individual actions, the aims sought by the two are different.

While the purpose of the corporate action is to indemnify the company's capital affected by the administrator's action or omission, an individual action seeks to indemnify those whose own assets have been directly affected by the action or omission. In the case of an individual liability action then, the indemnification is for the injured party (which may be a shareholder of the company or a third party) and not the company, as in the case of a corporate liability action (even in the event it is brought subsidiarily by a minority, in the event the company fails to act).

Standing to bring a corporate liability action

Further to the above, one of the objectives of the reform consists of *tightening up the system of administrators' liability, generally speaking, but specifically in relation to the possible violations of the duty of loyalty or trust*.

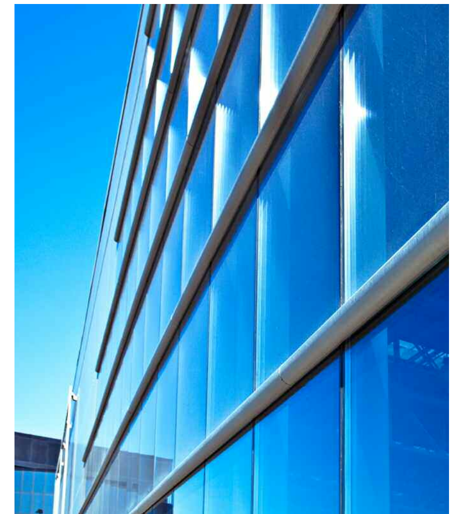
In this regard, one of the most significant changes resides in the standing to bring a corporate liability action. On the one hand, the reform reduces the percentage of capital required to request a general meeting to be called to decide on whether or not to bring the corporate liability action and, in the event of a refusal or inactivity on the part of the company, to bring said action in order to defend the company's interests, which in the case of listed companies is now 3% of capital [Article 495.2.*a)* LSC] as opposed to the 5% required generally. On the other hand, this minority can *bring the corporate liability action directly*, without the need to first raise the matter in a general meeting, *when the action is based on a violation of the duty of loyalty*, with a view to facilitating the sanction and punishment of disloyal conduct (as opposed to merely negligent behaviour, which merits more benevolent treatment).

Moreover, also with a view to providing an incentive for minorities to bring corporate liability actions, it is envisaged that, in the event the claim is upheld in full or in part, the company will be obliged to pay any necessary expenses incurred by the claimant, unless it has already received full reimbursement of said expenses or where the offer of reimbursement of expenses was unconditional (Article 239.2 LSC).

The subsidiary standing of creditors to bring corporate liability actions is maintained. The reform does not alter this system, which allows creditors to bring a corporate liability action against administrators when the company or its shareholders fail to do so, albeit only when the company's assets are insufficient to pay its credits (Article 240 LSC). This is however a hypothesis with scant practical relevance, due to the prevailing application of the corresponding insolvency regime in these cases rather than administrators' liability.

Statute of limitations period for liability actions

As far as the statute of limitations period for liability actions is concerned, the



reform provides clarification on a point that case law has been debating for some years.

Under the old rules, and in the absence of an express provision, case law considered that the statute of limitations period for both corporate and individual actions was the one set out in Article 949 of the Commercial Code, albeit with certain qualifications. This latter precept envisaged that the statute of limitations period was four years as of when the administrator in question left his post. But the majority of case law was of the opinion that this four-year period should be counted from the moment when the harm in question is caused or becomes known and not as of when the administrator leaves his post.

The LSC Reform Act, with a view to dispelling any doubts in this regard, has introduced new Article 241 *bis*, expressly regulating the statute of limitations period for corporate and individual actions. According to this rule, *the statute of limitations period for liability actions against administrators*, be they company or individual, *will be four years "counting from the date on which it could have been brought"*.

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7. Delegation of powers by the board of directors including those powers which cannot be delegated

Key aspects:

- An agreement must be entered into between the company and the member of its board of directors appointed managing director or to whom executive duties are entrusted, which must be approved by a qualified majority of the board members
- The powers of the board which cannot be delegated have increased, affecting all sorts of Spanish companies
- Additional powers which cannot be delegated are established in the case of listed companies, with a view to upholding the general duties of supervision and control corresponding to the board of directors

New regime with respect to delegating powers

An important amendment has been introduced pursuant to the LSC Reform Act with respect to the regime for delegating powers in favour of the board of directors. The reform meets the need to reinforce the role of this body within the corporate governance system, especially (but not only) in the case of listed companies, by regulating in greater detail an issue of particular practical importance which to date had not been given more than partial and limited attention from the legislator.

The reform has had a twofold impact on the regime for delegating powers:

(i) by imposing *additional requirements for the approval of the delegation of powers* by all Spanish companies (new Article 249 LSC); and

(ii) *by restricting the power to delegate certain duties of the board of directors*, thereby establishing the minimum core responsibilities which must be maintained by the board and which cannot fall under the control of one or more of its members (in particular, of the managing directors and/or executive committees). The powers that cannot be delegated are set out in a list applicable to all Spanish companies (new Article 249 *bis* LSC) and there is also an additional list of responsibilities required only of the board of directors of listed companies (Article 529 *ter* LSC).

Formal requirements for delegation

In relation to the approval of the delegation of powers, the former wording of Article 249 LSC is substantially maintained. In this way, and provided that the by-laws do not stipulate otherwise, the board may delegate part of its powers *to one or several managing directors or executive committees* (with it now being possible to have more than one executive committee). The possible permanent delegation of powers should be understood, logically, without prejudice to the general or special powers which the board may confer to any person, including any of its members. This notwithstanding, compared to the previous regime, two additional steps have been added or are required to adopt delegation resolutions.

Firstly the board is required to establish "*the content, the restrictions and the types of delegation*" (Article 249.1 LSC). The delegation resolution must include –as was already established in Article 149.1 of the Mercantile Registry Regulations- a list of the powers delegated or, as is more common practice, reference to the fact that the delegation comprises all the powers which may be delegated by law or in accordance with the by-laws. And when such delegation is carried out in favour of several directors or committees, it will be necessary to establish the rules for the distribution of responsibilities between them and the regime for performing them (i.e., on a joint and several basis or jointly).

The second step consists of the company entering *into an agreement with the director appointed managing director or to whom executive duties are entrusted by means of any other title* (for example a senior executive contract or a provision of services relationship), which must be approved with the favourable vote of two-thirds of the board members and with the abstention of the directors in question (Article 249.3 LSC). This agreement –which is analysed in the section regarding directors' remuneration- must cover "all the remuneration items" for which the executive director "may obtain remuneration for the performance of executive duties", with the payment of any remuneration for items or amounts not specified in the agreement being prohibited (Article 249.4 LSC). As the agreement refers to the remuneration

associated with the performance of "executive duties", it is plausible in any event that it will be separate from any other remuneration that may correspond to the directors "in their capacity as such" (new Article 217 and, for listed companies, Article 529 *septdecies* LSC). In the case of listed companies, moreover, the agreement must comply with the remuneration policy approved by the general meeting (Article 249.4 and Article 529 *octodecies* LSC), notwithstanding, logically, that it may regulate other aspects of the management relationship other than remuneration (dedication, duration, exclusivity regimes, etc.).

Powers of the board which cannot be delegated

Another relevant amendment of the LSC Reform Act on this subject matter, and applicable to all Spanish corporations, is the *increase of powers which cannot be delegated by the board of directors*. Prior to the reform, the only powers whose delegation was expressly prohibited was "the disclosure of information on corporate management and the presentation of balance sheets to the general meeting", as well as the powers conferred to the board by the general meeting, except in those cases where the board had the general meeting's express authorisation to delegate such powers.

After the reform, the new Article 249 *bis* LSC continues to include these same powers among those which may not be delegated, although the first refers, with greater technical precision, to the "drawing up of the annual accounts and their presentation to the general meeting". But apart from the foregoing, the list of powers which cannot be delegated has increased considerably. Even so, they refer primarily to powers which other regulations attribute to the board or powers which even under the former system used to be understood –despite the paucity of legal regulation- to correspond to the board in their entirety, as they affect its organisation and its own management body position within the company's corporate structure. In particular, the abovementioned Article introduces the following new powers which cannot be delegated:

a. Supervising the effective operation of the committees created by the board and the activities of the executive bodies and managers appointed by the board. This would include supervisory duties and control over the operation of any committee which the board may have created in accordance with its powers of self-organisation, and in particular the audit and appointments and remuneration committees which listed companies are obliged to create (Article 529 *terdecies* LSC), as well as supervising the activities of any executive director or manager appointed by the board.

b. Determining the general policies and strategies of the company.

c. Authorising or granting exemption from obligations derived from the directors' duty of loyalty, in those cases in which -in accordance with the terms of the new Article 230 LSC– the granting of the authorisation or exemption (the carrying out of a transaction with the company, taking advantage of a business opportunity, etc.) corresponds to the board.

d. Organising and operating the board, including creating committees, approving board regulations, appointing board members, establishing rules to call and deliberate at meetings, etc.

e. Drawing up any type of report required of the management body by law, but only when the procedure to which the report refers may not be delegated. This would be the case of reports justifying an amendment of the by-laws proposed by the board to the general meeting, or the equivalent reports required -among other scenarios- to increase the capital by means of non-monetary contributions or by offsetting credits, to issue convertible bonds or –in the case of listed companies after the reform- of the justifying report which must be included with the proposals for the appointment or re-election of directors (Article 529.5 *decies* LSC). Moreover, this new Article clarifies a previously controversial issue: the lack of necessity for the board to approve the procedures report in those cases when such procedures have been delegated to any of its members or to the executive committee (for example, an increase in capital delegated by the general meeting with the capacity to confer the powers to any other person).

f. Appointing and removing the company's managing directors, as well as establishing the terms and conditions of their contract. The new provisions are in keeping with the regime for delegating powers under Article 249 LSC, which should also extend to the members of the executive committees.

g. Appointing and removing managers who report directly to the board or any of its members, as well as establishing the basic terms and conditions of their contracts, including their remuneration.

h. Making decisions on the remuneration of the directors, in line with the by-laws and, if applicable, the remunerations policy approved by the general meeting. This provision is also in keeping with the new regulation on the remuneration of directors and, in particular, with the remuneration-related responsibilities reserved to the board itself (Articles 217.3, 249.3, 529 *septdecies* and 529 *octodecies*).

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i. Calling the general shareholders' meeting and drawing up the agenda and the proposed resolutions. This power of the board also derives from the general capacity of "the directors" to call the meeting (Article 166 LSC), as the traditional interpretation was that it could not be delegated or exercised by the board's executive bodies.

j. Policy regarding own shares or participations. This provision, despite its general nature, only seems applicable to the policy with regard to the own shares of Spanish joint stock companies, given the severe restrictions faced by limited liability companies in acquiring their own participations.

Additional powers of the boards of listed companies which may not be delegated

Apart from the powers which may not be delegated under the new Article 249 *bis* LSC, and applicable to all Spanish corporations, the LSC Reform Act also *expressly prohibits the boards of directors of listed companies from delegating a further series of additional powers*.

This regime is included in the new Article 529 *ter* LSC which, apart from a few minor changes, substantially reproduces recommendation 8 of the Unified Code on "responsibilities of the board" and which, logically, shares with it the objective -in the terms of the Code itself- of "preventing that, due to excessive delegation, the Board is unable to meet its most essential and unavoidable duty, that is, the "*general duty of supervision*", including the duty to define and encourage the strategic policies of the company and to supervise and control the bodies entrusted with its management.

The additional powers which the board of listed companies cannot delegate are as follows:

a. Approving the strategic or business plan, the annual management objectives and budget, the investment and financing policy, the corporate responsibility policy and the company's dividend policy.

b. Establishing the risk management and control policy, including tax-related risks, and supervising internal information and control systems.

c. Establishing the corporate governance policy for the company and the group of which it is the controlling entity; including the structuring and operation thereof and, in particular, approving and amending the corresponding regulations (as is also required in the case of the regulations governing the board of directors under Article 528 LSC).

d. Approving the financial information which, given their status as listed companies, the company in question must disclose on a regular basis. These provisions are in line with the general responsibility, which likewise may not be delegated, for drawing up annual accounts [Article 249 *bis* e) LSC] and with the liability declarations required of the directors with respect to the content of the regularly disclosed financial information (Article 35 of the Spanish Securities Market Act (LMV) and implementing regulations).

e. Defining the structure of the corporate group of which the company is the controlling entity, to avoid where possible –as affirmed in the Unified Code- "artificial and complex structures".

f. Approving any kind of investments and transactions which, due to their high amount or special characteristics, are strategic in nature or entail special tax risks, unless their approval corresponds to the general meeting (which could be the case according to the new wording of Article 160 LSC which requires the general meeting's approval in the case of the acquisition or transfer of essential assets).

g. Approving the creation or acquisition of stakes in special purpose vehicles or companies domiciled in countries or territories deemed tax havens, as well as any other transactions or operations of a similar nature which, due to their complexity, could jeopardise the transparency of the company and its group.

h. Approving, subject to a report issued by the audit committee, the transactions which the company or companies within its group carry out with directors, in the terms of Articles 229 and 230 LSC, or with shareholders owning a significant stake individually or jointly with others, including shareholders represented on the board of directors of the company or of other companies forming part of the same group, or with persons related to them. The said directors or those who represent or are related to the abovementioned shareholders should abstain from participating in

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the deliberation and voting on the resolution in question. This approval does not refer to those transactions which meet, simultaneously, three characteristics: (i) they are carried out under agreements whose conditions are standardised and are applied *en masse* to a high number of clients; (ii) they are carried out at generally established prices or tariffs by the person acting as supplier of the corresponding goods or service, and (iii) their amount does not exceed one percent of the company's annual returns.

i. Establishing the company's tax strategy.

Contrary to the situation existing in relation to those powers which cannot be delegated under Article 249 *bis* LSC, and given that in this case many of the responsibilities reserved to the board of directors refer to the company's management and administration, it is expressly permitted that, *when duly justified urgent situations arise, the corresponding decisions may be adopted by empowered persons or bodies*; however, these decisions must be ratified at the first board of directors' meeting held after their adoption (Article 529.2 *ter* LSC).

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8. The board of directors of listed companies (posts and operation)

Key aspects

- The posts of chairperson and secretary of the board of directors are regulated, requiring for their appointment a prior report from the appointments and remuneration committee
- An executive director may be appointed chairperson, but in this case the appointment will require the favourable vote of two-thirds of the directors and a coordinator director must be appointed from among the independent directors
- Non-executive directors may only be represented by another non-executive director
- The company is obliged to provide, sufficiently in advance, the information the directors require to comply with their duties, due to the connection between this information and the directors' general duty of diligence
- The boards of directors are obliged to carry out an annual appraisal of their performance and that of their committees

Essential nature of the board of directors

The LSC Reform Act introduces an Article 529 *bis* in the LSC, establishing that the management body of listed companies must take the form of a board of directors. This form of administration, which was implicitly required under other provisions (such as the obligation for listed companies to have board of directors' regulations –Article 528 LSC- or the requirement to have an audit committee –additional provision 17 of the Spanish Securities Market Act-) and which, in fact, all listed companies have, is now mandatory for listed companies.

The chairperson of the board

The new Articles 529 *sexies*, 529 *septies* and 529 *octies* LSC contain *detailed provisions*, previously non-existent, *with respect to the posts on the board of directors*, paying particular attention to their *appointment* and their *duties*. In particular the said Articles refer to the posts of chairperson (and vice-chairperson), secretary (and vice-secretary) and the new post of coordinator director, which is one of the main new developments with respect to posts on the board.

Article 529 *sexies* LSC establishes that the *chairperson* is the *"main party responsible for the efficient operation of the board of directors"*, with a wording similar to that of recommendation 15 of the Unified Code. The legislator has thus represented the "key role" of the chairperson –in the terms of the Unified Code itself- to achieve the correct operation of the board of directors, an aspect which previously -apart from the generic references to the authority of the board to appoint its chairperson- had not been expressly recognised in Spanish legislation.

Given its importance, the chairperson of the board of directors is assigned a minimum series of powers (Article 529.2 *sexies* LSC), notwithstanding any other additional powers which may be conferred thereto by law, the by-laws or the board regulations. The powers included in this list, which follow to a large extent recommendation 15 of the Unified Code, are as follows:

(a) Calling and chairing the meetings of the board of directors, establishing the agenda of the meetings and leading the discussions and deliberations.

(b) Chairing the shareholders' general meeting, unless otherwise established in the by-laws (a provision which was already included in Article 191 LSC prior to the reform).

(c) Ensuring that the directors receive *sufficient information* in advance so that they are in a position to discuss the points on the agenda. This power is in line with the duty to provide the directors with the information required to discuss and adopt resolutions at the board meetings (established in Article 529 *quinquies* and which is analysed below) and with the structuring of the directors' right to information as an actual duty (Article 225.3 LSC) and essential part of the duty of diligence.

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(d) Encouraging discussions and the active participation of the directors during the meetings, assuring their right to take the floor. This latter power -which as in the previous case is in fact a duty- seeks to encourage and compare different opinions, with a view to enhancing the nature of the board as a collegiate body and ensuring that its decisions are formed on the basis of a real exchange of criteria between its members.

Although this list of responsibilities is provided specifically in relation to listed companies, they are general powers which in practice are usually associated to the post of chairperson and which, accordingly, could likewise apply to Spanish corporations as a whole, as indicated in the Study by the Expert Committee.

Moreover, in relation to the appointment of the chairperson, it is necessary that, prior thereto, a *report from the appointments and remuneration committee* is obtained (Article 529.1 *sexies* LSC). This requirement must also be met with respect to the appointment, if applicable, of a vice-chairperson or vice-chairpersons. The wording of this provision does not seem to infer, however, that such report is mandatory for the removal of the chairperson and the vice-chairpersons by the board, which is not the case of secretaries and vice-secretaries, -as we will see below- nor does it apply to the proposals for the removal of directors by the general meeting (Article 529.3 *quindecies* LSC).

The appointment of an executive director as chairperson. The coordinating director.

The advisability of separating the *posts of chairperson of the board of directors and the chief executive of the company* is one of the corporate governance issues which has given rise to most debate over recent years, both in Spain and at an international level. In Spain this issue had only been addressed to date as part of the good governance recommendations (recommendation 16 of the Unified Code). The LSC Reform Act, following the criterion established in such recommendations, opts *against making it incompatible* for the same director to potentially hold both posts or duties, although it does impose certain *compensations and restrictions* in case they overlap.

The general principle is that, unless otherwise stipulated in the by-laws, the post of chairperson of the board of directors may fall to an executive director (Article 529.1 *bis* LSC). But in this case, in order to compensate and mitigate the accumulation of power implied by exercising both posts simultaneously, the following two measures are established:

(a) The appointment of an executive director as chairperson will require the favourable vote of *two-thirds of the members* of the board (Article 529.1 *septies* LSC), which is the majority also required for the permanent delegation of duties to the executive committee or to one or several managing directors and in order to enter into an administration agreement with them (new Article 249 LSC).

(b) The board of directors may appoint, with the abstention of the executive directors, a *"coordinating director"* from among the independent directors, who will be empowered to (i) request that a board of directors' meeting be called or the inclusion of additional points on the agenda of a board meeting that has already been called; (ii) to coordinate the non-executive directors; and (iii) to direct the regular appraisal of the chairperson of the board of directors (Article 529.2 *septies* LSC).

The coordinator director, based on the concept *lead independent director* in English speaking countries, is a new role under Spanish legislation, which to date was covered by the Unified Code (recommendation 16). It is a role designed to serve as a counterbalance to the roles of chairperson-executivedirector, presented as a compromise between the prohibition to exercise both posts on a simultaneous basis and the complete compatibility which had existed to date.

The secretary of the board

The LSC Reform Act has also reviewed the role of secretary –and the vice-secretaries- of the board, regulating both their appointment as well as their main duties (Article 529 *octies* LSC). These regulations, in the same way as those with respect to the chairperson of the board, also offer clear regulatory value for non-listed companies, given their general nature.

The duties attributed to the secretary of the board of directors, in addition to those that may be granted thereto by law, the by-laws or the board regulations, are as follows:

(a) Keeping the board of directors' documentation, reflecting in the book of minutes the development of the meetings and certifying their content and the resolutions adopted.

(b) Ensuring that the actions of the board of directors adapt to applicable regulations, the by-laws and to any other internal regulations of the company (such as the board regulations, committee regulations, the internal code of conduct relating to security market matters, etc.). On account of this duty, the secretarial role is legally conceived as a *guarantor of*

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the formal and material legality of the actions of the board of directors, which to date was only recognised in the good governance recommendations (recommendation 17 of the Unified Code) and, in general, in the regulations of the boards of directors of listed companies.

(c) Assisting the chairperson in the tasks related to the delivery to the directors of information relevant for the performance of their duties, which confirms –as indicated above- the relevance which is attributed to the directors' duty and right to information under the new regulatory framework.

As regards the secretary's appointment, he/she must be *informed in advance by the appointments and remuneration committee*, which also applies to the secretary's removal (Article 529.1 *octies* LSC). This is a rule that was already included in the Unified Code, designed –in the terms of its recommendation 17- to "maintain the independence, impartiality and professionalism of the secretary".

Operation of the board. Attending General Meetings

The LSC Reform Act has also introduced certain rules relating to the operation of the board, designed to encourage the active participation of the directors and the existence of real debate on the board. Its aim, in the terms of the Study by the Expert Committee, is for the board of directors to maintain a "constant presence in the life of the company", avoiding it becoming apathetic and passive.

Accordingly, a general duty is established for the directors to "attend board meetings *in person*" (Article 529.1 *quáter* LSC).

If they are unable to do so, they may appoint a proxy to represent them at the meeting, which must be another board member (Article 529.2 *quáter* LSC), as was already stipulated in the Mercantile Registry Regulations (Article 97.1.4). The new development, however, is the provision that *non-executive directors can only be represented by another non-executive director*. The aim is to thus avoid a weakening of the duty of supervision and control that non-executive directors (dominical, independent or other external directors, as defined in new Article 529.2 *duodecies* LSC) are obliged to meet in relation to the executive directors.

Information

Given the relevance of the directors being provided with the appropriate information for the performance of their duties and, in particular, to comply with their duty of diligence, the LSC Reform Act has expressly established the need for the directors to receive previously, and sufficiently in advance, the *information required for the deliberation and adoption of resolutions* on the corresponding matters (Article 529.1 *quinquies* LSC). The responsibility for ensuring compliance with this Article falls to the chairperson of the board, with the collaboration of the secretary.

The said Article includes two restrictions on the duty to inform directors:

(a) This obligation is only triggered with respect to information that is "required for the deliberation and adoption of resolutions", which implies that the information should refer to the different points included, as the case may be, on the agenda for the board meeting. This refers, in any event, to the company's duty to make the relevant information available to the directors, which may be completed with any additional information which the directors may request in the exercise of their *right* and their *duty* to ask for the appropriate information necessary "to meet their obligations" (Article 225.3 LSC).

(b) This obligation will be mitigated, for obvious practical reasons, in those cases where the board of directors is constituted or is called on an exceptional basis for *urgent reasons* (Article 529.1 *quinquies* LSC). According to the legal wording ("on an exceptional basis"), this is an option which may only be used in justified cases, in order to avoid this system being abused to force the directors to adopt decisions without the necessary information. This notwithstanding, the obligation does not cease to exist in these cases due to the exceptional circumstances, but is merely mitigated, whereby as a minimum the information which it is reasonably possible to provide given the circumstances should be delivered.

Performance appraisal.

In accordance with the terms of the Unified Code (recommendation 21), the LSC Reform Act has established the obligation of the board of directors of listed companies to carry out, on an *annual basis*, an *appraisal of its performance and that of its committees* and, based on the results, to propose an action plan aimed at correcting any shortcomings detected. The results of the appraisal must be included in the minutes of the meeting or attached thereto as an annex (Article 529 *nonies* LSC), to keep a record of the appraisal.

The LSC Reform Act has not established any requirement to carry out an appraisal specifically in relation to the performance of the chairperson of the board of directors. However the powers attributed to the coordinator director include directing a regular appraisal of the chairperson (Article 529.2 *septies* LSC). This would seem to infer that this

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individual appraisal will be necessary whenever a coordinator director is appointed because the posts of chairperson and executive director fall to the same person, and that, if this is not the case, the performance of the chairperson should be duly analysed as part of the general appraisal of the board's operation.

Diversity of the composition of the board of directors.

The LSC Reform Act has established the duty on the part of the board of directors to ensure that the director selection processes favour *diversity in the board's composition* and do not involve any implicit bias which could be interpreted as discrimination (Article 529.2 *bis* LSC).

Following the guidelines established by the European Commission in relation to EU corporate governance regulations, this new Article includes a wide-ranging definition of diversity, referring not only to "gender" but also to "expertise" and "knowledge". This notwithstanding, it gives priority to gender equality, by establishing that the selection processes should facilitate "in particular" the selection of female directors, in line with recommendation 14 of the Unified Code. However the obligation under this Article refers more to resources rather than results, as it does not insist on the board appointing female directors or male directors who meet certain characteristics, but merely that the selection processes favour diversity and are non-discriminatory.

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9. Appointment and types of directors in listed companies

Key aspects:

- The cooptation procedure in listed companies is amended, by removing the requirement for the appointed directors to be shareholders of the company, and if a vacancy arises after the general meeting has been called, a director may be appointed up to the date of the following general meeting
- The maximum duration of the post as director of a listed company is decreased to four years
- The proposals for the appointment of directors must include a justifying report from the board
- The proposal for the appointment or re-election of independent directors will be made by the appointments and remuneration committee and in the case of the other directors by the board itself, pursuant to a report previously issued by said committee
- The different types of directors are defined (executive, non-executive, dominical and independent)

Appointment of directors by cooptation

Given its importance for the corporate governance of listed companies, the LSC Reform Act has introduced a series of rules in relation to the appointment and re-election of directors, which affect both the general meeting as well as the board of directors itself. In relation to the latter, in addition to the powers to present initiatives and proposals corresponding to the board on a general basis, *the new developments added to the cooptation procedure* are particularly important, as this is the procedure typically followed by listed companies –as is well known- for the appointment of the directors.

On the one hand, the reform stipulates that in the case of listed companies *the director* appointed by the board via the cooptation procedure to fill a vacancy "*does not necessarily have to be a shareholder of the company*" [Article 529.2 a) *decies* LSC], unlike the procedure applicable to the other joint stock companies (Article 244 LSC). This is a requirement which in practice did not usually give rise to any particular problems, relating to the possibility of the person appointed director purchasing shares in the market, but which undoubtedly lacked any basis or importance in the case of open companies like listed companies.

On the other hand, the reform also stipulates that *when the vacancy arises after calling the general meeting and before it is held, "the board of directors may appoint a director up to the date of the following general meeting*" [Article 529.2 b) *decies* LSC]. This provision resolves in part an issue which to date had been the subject of certain debate, that is whether or not the board is authorised to exercise the power of cooptation after the general meeting has been called. But at the same time this provision should be interpreted in conjunction with the new Article 518 LSC, which requires listed companies to include on their web page –among other documents- the proposals for the appointment, ratification or re-election of board members as from the publication of the general meeting's announcement and up to the date of the general meeting. By virtue of this new procedure, if the vacancy arises after the general meeting has been called, the board of directors will not be entitled to make a new proposal for the appointment for submission to the general meeting or to present such proposal at the general meeting, as was standard practice to date in certain cases. But pursuant to the reform, the board of directors may opt in these situations to fill the vacancy by cooptation, with the particularity that the director thus appointed will have to be ratified, not at the "first" general meeting (Article 244 LSC), that is the meeting that has already been called, but at the "following general meeting".

Moreover, bearing in mind the circumstances affecting the composition of the boards of directors of listed companies and the particularities with regard to the procedure to appoint their members, the legislator deemed it appropriate that, as an exception to the general procedure, *substitutes should not be appointed in these cases* (Article 529.3 *decies* LSC), as an exception also to the general regime (Article 216 LSC). This ensures that the aptitude and suitability of the directors is evaluated at the time of their effective appointment.

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Proposals for the appointment and re-election of directors

The LSC Reform Act has also reviewed aspects relating to the procedure for making proposals for the appointment or re-election of directors, which to date was only addressed by the Unified Code and, by extension, in the internal rules and regulations of listed companies.

The new legal regime, in particular, tries to ensure the effective intervention of the appointments and remuneration committee (or, if applicable, the appointments committee for companies which have two separate committees), whose existence has become obligatory for listed companies (Article 529 *quindecies* LSC). And it also seeks to improve the information on directors available to shareholders, so that they may exercise their rights on more grounds and with greater transparency.

Accordingly, the said committee must participate in the appointment of all directors, although not always in the same manner. In the case of *independent directors*, *it is necessary that any proposal for appointment or re-election*, either by the general meeting or by cooptation, *is made by the appointments and remuneration committee* [Article 529.4 *decies* and Article 529.3 c) *quindecies* LSC], extending this same regime to the proposals for the removal of such directors by the general meeting]. This aims to enhance the effective independence of these directors, avoiding any interference in their selection from the executive directors or the shareholders represented on the board. The very definition of independent directors means it is impossible to consider as such any person "who has not been put forward for either appointment or renewal by the appointments committee" [Article 529.4 h) *duodecies* LSC]. And in the case of any *remaining directors (executive, dominical and other external directors)*, the proposal for the appointment or re-election corresponds to the board itself, although *it should be preceded in any case by a report from the appointments and remuneration committee* [Article 529.6 *decies* and Article 529.3 d) *quindecies*], which also applies to the proposals for the removal of these directors by the general meeting]. This new regime corresponds essentially with recommendation 26 of the Unified Code which, therefore, has become a mandatory rule.

It should also be borne in mind that the proposal for the appointment or re-election of a director, irrespective of whether it is made by the appointments and remuneration committee or the board of directors itself, must in all cases include a *report* from the latter analysing "the competence, experience and merits of the proposed candidate", and should be attached to the minutes of the general meeting or –in the case of cooptation- the minutes of the board meeting (Article 529.5 *decies*).

Moreover, this same regime extends to the *natural persons appointed as representatives of directors who are legal entities.* In particular, the proposal with respect to the natural person representative will be subject to a report from the appointments and remuneration committee (Article 529.7 *decies* LSC), so that the latter can analyse the merits and capacity of the person who will effectively carry out the director's duties. This rule is in line with the provisions under new Article 236.5 LSC, pursuant to which natural person representatives must comply with the same requirements and duties legally established for the directors.

Duration of the post as administrator

On a general basis, the duration of the post as administrator of joint stock companies is established in the by-laws, although it cannot exceed six years and said duration must be the same for all of them (Article 221.2 LSC). In the case of listed companies, the duration of the post will also be as established in the by-laws, although in this case -as now provided under the new Article 529 *undecies* LSC- the maximum term is reduced to *four years.* This ensures that the shareholders have to decide on the continuity of the directors more frequently, thereby reinforcing their accountability vis-à-vis the general meeting. The reduction of the term, which numerous listed companies had already included in their by-laws due to pressure in particular from the proxy advisors, does not apply to directors appointed prior to 1 January 2014, who may complete their mandates even if they exceed the 4-year term (section 3 of the transitional provision of the LSC Reform Act).

Finally, and pursuant to the same rules applicable to non-listed joint stock companies, it is envisaged that the members of the board of directors may be re-elected once or several times, for periods of the same maximum duration (Article 529.2 *undecies* LSC).

The categories of directors

Article 529 *duodecies* LSC defines the different categories of directors, in line with the traditional corporate governance-based classification (executive and non-executive directors, with the latter category comprising dominical, independent and other external directors). This definition and distinction of categories, which to date was found in the Spanish Securities Market Act (Article 61 bis) and in Order ECC/461/2013 (Article 8), both being contributory factors to the Unified Code, was necessary due to the numerous references included in the new regulations to the different types of directors regarding, for example, the

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composition of the committees within the board or to the status of the chairperson.

New Article 529 *duodecies* LSC substantially reproduces the definitions included to date in Order ECC/461/2013, albeit with certain amendments.

(a) Executive directors

Executive directors are those who carry out management *duties within the company or its group*, irrespective of the legal relationship maintained with such company (Article 529.1 *duodecies* LSC). Contrary to Order ECC/461/2013 (Article 8.2), there is no requirement, therefore, for such duties to be "senior" executive duties nor does executive status mean that the director has to be an "employee" of the company or its group. It comprises a functional principle linked to the performance of management duties, irrespective of whether they are provided under an employment or mercantile relationship.

In addition, two rules of prevalence are established for those cases where the same director has, at the same time, two different statuses, based on Order ECC/461/2013. Accordingly, those directors who are senior executives or directors of companies within the group of the company's controlling entity will be deemed dominical directors of the company, on the assumption that they represent the interests of the controlling entity itself. And when a director carries out management duties and, at the same time, is or represents a significant shareholder or is represented on the board of directors, he/she will be considered an executive director.

(b) Non-executive directors

Any other company directors are considered non-executive directors, and may be dominical, independent or other external directors (Article 529.2 *duodecies* LSC)

(c) Dominical directors

Dominical directors are those persons who hold a *stake equal to or which exceeds the one considered by law as a significant stake* (that is, 3%) or who have been appointed due to their status as shareholders, even if their stake does not reach such threshold, as well as those persons who represent the aforementioned shareholders (Article 529.3 *duodecies* LSC). This definition corresponds to the one contained in Order ECC/461/2013 (Article 8.3), and merely adds a series of scenarios where a shareholder is represented by a director.

(d) Independent directors

Independent directors are those persons who, appointed on the basis of their *personal and professional characteristics,* may carry out their duties *without being influenced by relationships with the company or its group, its significant shareholders or its managers* (Article 529.4 *duodecies* LSC). Despite this general description, a series of scenarios are established pursuant to which a director may not "under any circumstances" be classified as an independent director, which correspond substantially –apart from certain changes in procedure- to the terms of Order ECC/461/2013 (Article 8.4).

Moreover, these requirements to be considered an independent director are *minimum* in nature, due to the possibility –recognised under new Article 529.5 *duodecies* LSC- that the by-laws and the board of directors' regulations may establish additional incompatibilities for the appointment as such or impose stricter conditions for the consideration of a director as independent.

Finally, in relation to the registration of the appointment of a director at the Commercial Registry, the resolution adopted by the general meeting or the board must indicate the category of the director, which will be sufficient for registration purposes, without the commercial registrar being able to assess effective compliance with the prerequisites for the director in question to be placed in the said category. In addition, any incorrect allocation of director category will not affect the validity of the resolutions adopted by the board of directors (Article 529.6 *duodecies* LSC).

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10. Board of directors' committees of listed companies

Key aspects:

- The appointments and remuneration committee is now obligatory, and any failure to set up such committee shall be considered a serious infringement under the Spanish Securities Market Act (LMV)
- Certain recommendations of the Unified Code are included, becoming obligatory
- Both committees must be comprised exclusively of non-executive directors and at least two must be independent, including the chairperson

Obligatory nature of the appointments and remuneration committee

The new LSC dedicates three articles (529 *terdecies, quaterdecies* and *quindecies*) to the regulation of the board of directors' committees of listed companies.

The first of them allows the board of directors to set up specialised committees within the board, and to determine their responsibilities and operating rules, in accordance with its general powers of self-organisation (Article 245.2 LSC). In addition to this power of organisation corresponding to all boards of directors, not just those of listed companies, an obligation is established for the latter to set up an audit committee as well as an appointments and remuneration committee (or, if that is the case, two separate committees, one entrusted with appointments and the other with remuneration).

The main development in this area is, therefore, the obligation for listed companies to have an appointments and remuneration committee. Previously the setting up of such committee was a mere recommendation to ensure good corporate governance (recommendation 39 of the Unified Code), which was met in any case by all Ibex 35 companies.

Setting up an audit committee, however, was already obligatory for all "issuers of securities listed on official secondary securities markets", which included the listed companies, pursuant to additional provision 18 of the LMV, derogated by the LSC Reform Act, although the reform of the LSC has contributed certain developments to the existing regulations.

The audit committee: composition and operation

The new regulation of the audit committee, contained in Article 529 *quaterdecies* LSC, includes and combines elements of the previous version of the LMV and the recommendations of the Unified Code

The main development refers to the composition of the said committee, which now requires that all its members be non-executive directors (dominical, independent or other external directors, in accordance with the definition under the new Article 529.2 *duodecies* LSC). The exclusive presence on this committee of "external directors" was a recommendation of the Unified Code [recommendation 39.b)], as the LMV only required there to be a "majority" of non-executive directors.

In addition, at least two of the members of the committee must have independent status (compared to one member required to date under the LMV), of which one at least will be appointed on the basis of his/her knowledge and expertise in accounting, audit procedures or both.

The chairperson of the audit committee must be one of the independent directors. Similarly in this case, the new LSC opts for the criterion advocated by the Unified Code [recommendation 39.c)], in contrast to the former version of the LMV, which required the chairperson to be a non-executive director but not necessarily an independent director. The maximum duration of the post as chairperson (4 years) remains unchanged, as does the possibility to re-elect him/her one year after the 4-year term has ended.

Notwithstanding the legal provisions, it is necessary for the by-laws or the board of directors' regulations to establish the number of members of the audit committee and to govern the operation thereof, favouring independence in the performance of its duties (Article 529.3 *quaterdecies* LSC).

The audit committee: Duties

The new LSC also regulates the minimum duties which correspond to the audit committee, without prejudice to the fact that logically they can be increased via the by-laws or through the board of directors' regulations. In this regard, the list of responsibilities is basically the same as the one already established in the

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LMV, although certain duties have been added which, to date, were provided in the Unified Code, such as:

- Regularly gathering information from the external auditor on the audit plan and its execution [previous recommendation 45.2 a.)]
- Informing the board in advance on all aspects included in the law, the by-laws and the board of directors' regulations and, in particular, with regard to:
  - The financial information which the company must make public periodically;
  - The creation or acquisition of stakes in special purpose vehicles or entities domiciled in countries or territories deemed as tax havens; and
  - Transactions with related parties.

The duties established in this section (which correspond to recommendation 47 of the Unified Code) will not be carried out by the audit committee when they are attributed by the by-laws to another committee made up exclusively of non-executive directors and of, at least, two independent directors, one of which must be the chairperson. This could be the case, for example, of the approval of related transactions, when this responsibility is attributed to the appointments, remuneration committee or to another committee with supervisory and control duties.

Finally it should be borne in mind that the audit committee regime is also applicable to the issuers of securities other than the shares listed on official secondary markets (new ninth additional provision LSC), as was the case under the previous LMV regime.

The appointments and remuneration committee

The obligation of the listed companies to set up an appointments and remuneration committee, or if applicable two separate committees, constitutes –as seen above- one of the main developments of the reform in this area, by raising what was previously a mere recommendation under the Unified Code to legal status.

The composition of this committee is governed, in any case, by the same parameters as the audit committee (Article 529.1 *quindecies*). Accordingly, all its members must be non-executive directors [and was already established in recommendation 39.b) of the Unified Code], with at least two of them being independent directors (in line with recommendation 49 of the Unified Code, which stipulates that the majority of its members should have such status even if the committee has more than three members). As is the case of the audit committee, the chairperson must be one of the independent directors. But, unlike the audit committee, there is no maximum duration for the mandate as chairperson, nor does a period of one year need to elapse before the chairperson may be re-elected.

As occurs in the case of the audit committee, the by-laws or the board regulations must establish the number of committee members and will govern the operation thereof, favouring independence in the performance of its duties (Article 529.2 *quindecies*). With respect to its duties, the new LSC attributes to the appointments and remuneration committee certain minimum duties, which are summarised below:

- Evaluating the expertise, knowledge and experience required to be a board member, defining the duties and aptitudes needed of the candidates who are to fill each vacancy and assessing the time and dedication necessary to efficiently perform their assignment;
- Setting an objective with respect to equal access of the gender less represented on the board and preparing guidelines on how to achieve this objective;
- Submitting to the board proposals for the appointment, re-election or removal of independent directors and reporting on the proposals for the appointment, re-election or removal of the remaining directors;
- Reporting on the proposals for the appointment and removal of senior executives and the basic conditions of their contracts;
- Analysing and organising the succession of the chairperson of the board and of the chief executive of the company, submitting proposals to the board so that the succession is carried out in an orderly and organised manner;
- Proposing to the board the remuneration policy with respect to directors and general managers or those persons who carry out their senior executive duties reporting directly to the board, the executive committees or managing directors, as well as the individual remuneration and other contractual conditions of executive directors, ensuring that such policies and conditions are met.

As can be seen, the duties attributed by the new LSC to the appointments and remuneration committee correspond substantially to recommendations 26 and 50 of the Unified Code.

However, in relation specifically with gender equality on the board, it should be

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borne in mind that the new LSC does not merely reproduce current recommendation 14 of the Unified Code, which encourages gender equality when filling vacancies, but has gone much further. The appointments and remuneration committee now assumes a more active role in this area, having been entrusted with setting an objective with respect to equal access of the gender less represented on the board (which is really an euphemism to refer to female directors) and preparing guidelines on how to achieve this objective.

Moreover, in relation to the issuers of securities other than the shares listed on an official market, the ninth additional provision of the LSC refers only to Articles 529 *terdecies* and 529 *quaterdecies*, but not to Article 529 *quindecies*, which is the Article which establishes the regime applicable to this committee. Nonetheless, it may be inferred from the foregoing that the issuers of securities must also have an appointments and remuneration committee, not only because this is required under Article 529 *terdecies* LSC, but also because under new article 100.b) LMV an infringement will be deemed to exist if issuers of securities traded on official secondary markets do not have an audit committee and an appointments and remuneration committee, "in the terms established in Articles 529 *quaterdecies* and *quindecies*" LSC.

Entry into force

In accordance with the transitional provision of the LSC Reform Act, any amendments introduced in relation to the board of directors' committees enter into force on 1 January 2015, and must be "agreed at the first general meeting held after such date".

However, to the extent that compliance with the obligations relating to the existence, composition and duties of both committees is an area that falls essentially within the remit of the board of directors, the interpretation of such provision is unclear. This first general meeting would have to proceed to adapt the by-laws if the regulation with respect to committees is not in line with the new legal regime (this adaptation cannot under any circumstances be considered a prerequisite for the full enforceability of such new regime). But in any case, resolutions regarding amendments to board committees must be adopted by the board of directors, preferably at the first meeting held in 2015, without any need to wait until the first general meeting is held.

Infractions and sanctions

As is to be expected, the new regulation of the audit committee and the appointments and remuneration committee form an integral part of the rules on compliance and conduct of the securities markets, supervised by the Spanish Securities Market Commission (CNMV) (new seventh additional provision of the LSC).

In this regard, in accordance with the LMV sanction regime -as mentioned above- if an issuer of securities does not set up an audit committee as well as an appointments and remuneration committee in the terms established in Articles 529 *quaterdecies* and *quindecies* LSC [Article 100.b) LMV], and fails to meet the rules on the composition and assignment of the duties of such committees, this will be treated as a serious infringement.

As a result any listed companies which are not currently complying with the new regulation with respect to board committees must adopt as soon as possible the resolutions required to meet the terms of such regulation.

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11. Annual corporate governance report and annual report on the remuneration of directors

Key aspects:

- The LSC Reform Act reproduces the regulation on the annual corporate governance report previously contained in the Spanish Securities Market Act, with minor changes
- It also includes the pre-existing regulation on the annual report on the remuneration to be paid to directors, although with certain changes in order to adapt it to the new regime on their remuneration and, in particular, to the requirement that listed companies approve the directors' remuneration policy

Meaning and general aspects of the reform

The LSC Reform Act adds two new articles to the LSC in relation to the annual corporate governance report (Art. 540) and the annual report on remuneration paid to directors (Art. 541).

The two articles form a new section of Chapter IX ("Corporate information"), of Title XIV ("Listed companies"), on the "Annual corporate governance report and annual report on the remuneration of directors", which serves to conclude the text of the LSC.

Although the regulation on the annual corporate governance report and the annual report on the remuneration of directors is included for the first time in the body of the LSC, the mandatory nature of the reports, their content, basic structure and the publicity requirements to which they are subject *are not actually new*. Articles 61 *bis* and 61 *ter* of the Spanish Securities Market Act –which are expressly repealed by the LSC Reform Act (Repealing Provision)– set out the same requirements, except for a few minor changes we will explain below.

Annual corporate governance report

The main purpose of the annual corporate governance report is to provide a detailed explanation of the listed company's government structure and practical operation.

The LSC Reform Act has maintained the advance *publicity* requirement, which in essence consists of notifying the Spanish Securities Market Commission of the report in the form of a relevant event, and announcing it as such (Art. 540.2 and 3, LSC). This requirement is further supplemented by the provisions of Spanish Order ECC/461/2013, of 20 March, which sets out the contents and structure of the two reports ("**Order ECC/461/2013**") and gives details on the requirement to "publicise" this report (Art. 9).

As for the *contents* and *structure* of the new annual corporate governance report, these aspects must be determined by the Ministry of the Economy and Competitiveness or be expressly authorised by the Spanish Securities Market Commission (Art. 540.4 LSC). This is the same method for delegating approval as was used by Spanish Securities Market Commission Circular 5/2013, of 12 June, based on the authorisation of Order ECC/461/2013, to approve the current standard report.

The annual corporate governance report must be structured into eight main sections:

1. Ownership structure of the company, including:
    a. Information on shareholders holding significant stakes;
    b. Information on stakes held by members of the board of directors and shareholder agreements;
    c. Information on securities not traded on a regulated Community market, on the different share classes and treasury stock;
    d. Information on rules regarding the amendment of corporate by-laws.
2. Restrictions on the transferability of securities and voting rights.
3. Administrative structure of the company, including:
    a. Composition, organisation and operation of the board of directors and its committees;
    b. Identification, functions, posts and remuneration of directors;
    c. Information on directors' powers and in particular on their authority to issue or buy back shares;
    d. Information on agreements entering into force, being modified or terminated in the event of a change of control;
    e. Information on indemnification or golden parachute clauses in the event of dismissal, resignation or change of control;
    f. *Information on measures adopted to achieve gender equality (a balanced presence of men and women) on the board of directors*.

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4. Transactions with related parties between the company and shareholders, directors or senior executives and intra-group transactions.
5. Systems for controlling risk, including tax risk.
6. Operation of the general meeting.
7. Degree of compliance with corporate governance recommendations, or explanation, as the case may be, as to why these recommendations were not followed under the "comply or explain" principle.
8. Description of internal supervisory systems in place, in relation to the disclosure of financial information.

We have highlighted above the two new aspects introduced by the LSC Reform Act: (i) the need to inform on gender equality measures adopted; and (ii) the need to inform on the risk control systems adopted in relation to tax risk.

Since the LSC Reform Act foresees that the Spanish Government will issue a report, at the proposal of the Ministry of the Economy and Competitiveness, on barriers faced by senior citizens and persons with disabilities when accessing information on listed companies and when exercising their voting rights (Additional Provision Two), it may be that, in the future, some mention must also be made of these aspects (gender equality, risk control) in the report.

Annual report on the remuneration of directors

In addition to the annual corporate governance report, listed companies are also required to draw up and issue an annual report on the remuneration to be paid to their directors. This Report, which was already regulated in the Spanish Securities Market Act, *acquires greater significance following the LSC Reform Act*. This can be seen in the numerous amendments the Act makes with regard to the remuneration of administrators, and especially for listed companies, which –as has been analysed and among other measures- must be approved during the general meeting, in the form of the *directors' remuneration policy* (Art. 529 *novodecies* LSC). The LSC Reform Act itself has established a specific transitional regime for this new obligation regarding directors' remuneration (Transitional Provision), so as to harmonise it with the requirement that listed companies subject the approval of the report on remuneration to a consultative vote by the ordinary general meeting and in order to avoid potentially disruptive situations (an issue which has been analysed in the section on the remuneration of directors).

The regulation on the annual report on remuneration was drafted, in any event, in response to the concern set out in the Preamble of the LSC Reform Act "that remuneration to be paid to directors adequately reflect the company's performance and that it be properly aligned with the interests of the company and its shareholders". The annual report on the remuneration of directors is, in this regard, a fundamental instrument for ensuring transparency and information for shareholders and investors.

The *publicity* requirement of the annual report on the remuneration of directors is equivalent to that established for the annual corporate governance report: the report must be issued in the form of a relevant event (Art. 541.3 LSC) and is subject to a consultative vote by the ordinary general meeting (Art. 541.4 LSC). This requirement is also supplemented by the provisions of Order ECC/461/2013, which reproduces the key aspects of the regime applicable to the annual corporate governance report (Art. 12).

The LSC Reform Act contains no major legislative changes in relation to the content of the annual report on the remuneration of directors (the standard for which was approved by Spanish Securities Market Commission Circular 4/2013, of 12 June), apart from some technical and grammatical improvements. In this regard, it specifies that the information on directors' remuneration must include "those who receive or should receive remuneration, *due to their status as such* and, as the case may be, for *performing executive duties*" (Art. 541.1 LSC), according to how the two types of remuneration established for Spanish companies in general are differentiated (Arts. 217.3 and 249.4 LSC) and more specifically for listed companies (Arts. 529 *septdecies* and 529 *octodecies*). It also clarifies that the report must provide details on the individual remuneration accruing "*for all remuneration items*" for each director during the preceding year (Art. 541.2 LSC).

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