Corporate Governance

Two clarifications from the Supreme Court on the rules for the disposal of essential assets and the scope of protection of the business judgment rule

In its Judgment 1045/2023 of 27 June, the Spanish Supreme Court, in proceedings contesting the resolutions of the Board of Directors of a public limited company, has provided certain clarifications regarding the legal concept of essential assets in the context of Article 160*a* of the Spanish Companies Act and on the scope of protection of the business judgment rule under Article 226(1) of the aforementioned statute.

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1. Background

§ 1. The Board of Directors of a public limited company agreed to arrange a syndicated loan to the company for a maximum amount of EUR 70 million. The terms of the loan included the provision that the company could only dispose of assets worth more than half a million euros if the price obtained from the disposal was reinvested within six months or used to repay debt with the lending institution. The resolution was passed with four of the six board members voting in favour and the other two voting against.

§ 2. The above operation was intended to provide the financing of the Business or Strategic Plan of the group to which the company belonged, which was approved for the years 2017 2021. In this operation, the company in question had the status of borrower, as the centralised manager of the group's cash and cash equivalents. In any case, the specific purposes of this financing were to: *a*) refinance existing financial debt; *b*) finance industrial investments, and *c*) finance the corporate needs of the group companies that would form part of the financing perimeter (in fact, the group companies appeared as guarantors and potential beneficiaries of the credit facility granted).

§ 3. One of the dissenting directors challenged the resolution. As to what is mainly relevant here, the complainant claimed the following:

a) An infringement of Article 160*f* of the Companies Act ("LSC") in so far as it confers on the general meeting of shareholders the power to decide on the disposal of essential assets. In the challenger's view, the resolution that had been passed would strictly speaking "result in the acquisition of funds in the amount of up to EUR 70 million", so that, given that the total value of the company's assets was EUR 132 million, such an operation should be considered as the acquisition of an "essential asset" and would therefore require the approval of the shareholders in general meeting.

b) An infringement of article 20 of the articles of association, which required a favourable vote of 70 % of the members of the Board of Directors for the passage of resolutions on "the use, disposal and sale of the company's real estate, except for the lease of such real estate, provided that the lease term does not exceed 15 years and that the lease is agreed on market terms. The arrangement of mortgages or other charges or liens on the company's real estate. The passage of resolutions the implementation of which could indirectly lead to any of the actions indicated in the two preceding paragraphs". According to the director challenging the resolution, the financing agreement would include obligations not to dispose of assets in excess of EUR 500,000 (*cf. supra*, § 1) and, consequently, in so far as it could affect the company's real estate, it could not have been validly passed only with the vote of two thirds of the directors.

§ 4. The claim was dismissed at first instance. The Provincial Court of Zaragoza (Fifth Chamber) partially upheld the statutory appeal and, in its Judgment 885/2019 of 8 November (ECLI:ES:APZ:2019:2208), held the Board's resolution void in so far as it had approved the financing plan assuming a prohibition to pay dividends (in violation - according to the Provincial Court - of Article 160a LSC). However, the Court of Appeal upheld the court of first instance's decisions as regards the points mentioned above, *sub* § 3.

§ 5. The claimant lodged an appeal in cassation based on two grounds which raised again issues already brought up in the claim. In the first of these, the powers of the board of directors to pass the contested resolution were disputed on the grounds that such powers lied with the general meeting of shareholders as the resolution concerned an operation involving essential assets (Art. 160*f* LSC). In the second grounds, in the alternative to the previous one, the appellant argued that, if the Board were considered competent, the contested resolution would also be ineffective because it had not obtained the favourable vote of the enhanced majority of directors required by the articles of association; to this end, the appellant further argued that, in view of this circumstance, the lawfulness of the resolution could not be based - as the Provincial Court would have done - on the protection of the business judgment rule (Art. 226(1) LSC).

§ 6. The appeal was ultimately rejected by the Supreme Court in its Judgment 1045/2023 of 27 June (ECLI:ES:TS:2023:2897).

2. On the legal concept of *essential asset* in the context of Article 160*a* LSC

§ 7. The first question facing the Supreme Court was whether Article 160*f* LSC was applicable to the case. An affirmative answer would have led to an upholding of the challenge to the board's resolution on the grounds that the board had unlawfully encroached on the exclusive powers of the general meeting. However, Judgment 1045/2023 was inclined to consider

that a financing operation such as the one approved by the governing body could not be understood to fall within the scope of the aforementioned legal provision. The reasons for this were based on the ideas summarised in the following paragraphs.

§ 8. The Supreme Court began by recalling that the aforementioned Article 160*f* (introduced into the Companies Act by Act 31/2014) is in line with the doctrine of the so-called implicit *or unwritten powers* of the general meeting (which, according to the Supreme Court, even before the 2014 amendment, had already been assumed - albeit also "implicitly" - by the case law in judgments 722/2006 of 6 July [ECLI:ES:TS:2006:4252], 117/2007 of 8 February [ECLI:ES:TS:2007:695], 285/2008 of 17 April [ECLI:ES:TS:2008:1382] and 426/2009 of 19 June [ECLI:ES:TS:2009:5729]). Thus, the provision reserves to the general meeting the power to adopt decisions which, although due to their business nature they could in principle be formally taken by the directors, produce an effect equivalent to that of resolutions whose passage necessarily lies with the general meeting (such as those aimed at conversions, amendments to the articles of association, the liquidation of the company or other actions of similar significance). The logic of this rule seems obvious: the practical results of such decisions can have a substantial impact on the legal or economic position of the shareholders and on the economic or legal structure of the company. In short, they bring about changes capable of affecting the original intention of the shareholder to invest in the company under certain conditions. Precisely for this reason, the final decision must be entrusted to the shareholders at a general meeting and cannot be taken by the directors.

§ 9. On the basis of the foregoing, the judgement we are commenting on noted that, in order to decide whether or not a resolution has as its subject matter an operation concerning essential assets, it is necessary to interpret Article 160*f* guided by systematic and teleological criteria. In other words, it must be borne in mind, on the one hand, that the rule intends to refer to operations that produce results functionally equivalent to those of others that typically fall within the scope of the general meeting's powers. On the other hand, it should be borne in mind that the purpose of the rule is to confer on the general meeting (in short, on the shareholders) the power to pass resolutions that substantially affect the legal and economic position of the shareholders or the structure or activity of the company. In relation to the above, it should be borne in mind that the factual requirements of Article 160*f* LSC cover both transactions in which assets are disposed of or contributed to another company and those in which the company acquires those assets. But - it is worth stressing this point - in any of the aforementioned hypotheses, what is relevant will be that the consequences of the transfer are, in factual terms, equivalent to those of the transactions that typically have to be the subject of a decision of the shareholders in general meeting (for example, because their significance is comparable to a significant conversion or amendment of the articles of association or because they substantially alter the original calculation of the risk assumed by the shareholder). In short, the Supreme Court concludes, "it is essential to consider the consequences that the operation has from the point of view of the activity and legal and economic structure of the company, of its subsistence or of the risk initially assumed by the shareholders".

§ 10. Given the wording of Article 160*f* (which refers to the acquisition, disposal or contribution of essential assets), *in principle*, financing operations would not be included in the said article's factual requirements (unless they

involve, even by way of guarantee, the possibility of a disposal of important company assets). However, as can be deduced from the use of the expression *in principle*, the Supreme Court did not wish to radically close the door to the possibility that, exceptionally, a financing operation could be understood to be included in the factual requirements of the provision (although this would never be the case for the ordinary management of the company or those operations aimed at obtaining the necessary resources to carry on the company's business). However, for this to be the case - i.e. for the powers to approve an operation of this nature to necessarily lie with the general meeting by application of Article 160*f* LSC - it would be necessary - in accordance with the above in paragraphs 8 and 9 - for the financing operation in question to jeopardise the company's viability, substantially modify the conduct of its business (or the way in which its corporate purpose is pursued) or profoundly alter the calculation of the initial risk of the shareholders or their position of control.

§ 11. Transposing the above considerations to the specific case before it, the Supreme Court concluded that the contested resolution did not fall within the factual requirements of Article 160*f* LSC and that, therefore, its validity did not depend on its approval by the shareholders in general meeting. Indeed, the Supreme Court observed, among other things, *a*) that the financing operation did not entail the transfer or creation of any security on assets assigned to a line of business of the company; *b*) that, although the amount of the operation was very high, a significant part of the borrowed amount would be used to replace existing financing, so that the company's financial situation was not significantly worsened; *c*) that the operation allowed the financing of the Business or Strategic Plan for the years 2017-2021 of the group to which the defendant company belonged, thus enabling the continuation of the pre-existing business in accordance with the new business plan. Consequently, the consequences of that management act (the approval of the financing operation) could not be said to have substantially altered, despite its quantitative importance, the position of the shareholders or the legal or economic structure of the company (strictly speaking, it was a necessary action for the effectiveness of the previously approved plans and for the maintenance of the business in which the company had been engaged).

3. On the scope of protection of the business judgment rule

§ 12. In the second ground of appeal, the appellant claimed that the judgment of the Provincial Court had infringed Article 226(1) LSC in so far as it had relied on the application of protection of the business judgment rule to justify the failure to comply with the requirement under the articles of association of an enhanced majority of the members of the Board (*cf. supra*, § 3*b*). Obviously, this ground was in the alternative and should be considered only in the event that, if the first ground was rejected (as indeed it was), the Board of Directors was deemed to be competent to approve the financing operation.

§ 13. Indeed, the Provincial Court of Zaragoza, in order to rule out the infringement of the articles of association (art. 20) requiring the favourable vote of 70% of the members of the Board to pass resolutions on the "use, disposal and sale [...] arrangement of mortgages or other charges or liens on the company's real estate", relied on (among other arguments, but without much clarity) the content of Article 226(1), already mentioned. Specifically, in the first place, the appeal judgment acknowledged that the imposed limitation on the disposal of assets whose value exceeded EUR 500,000 would entail a "restriction of the freedom of

disposal" which, therefore, "could infringe the aforementioned article 20 in so far as it was not approved by 70 % of the members of the board of directors". However, it went on to state that the decision "to limit itself [*sic*] the board itself for strategic business reasons (to favour the granting of the syndicated loan) in the conditions for the exercise of the sale, use, disposal or encumbrance of real estate" did not infringe the articles of association because the board's resolution "does not modify that high percentage of 70 %, which is a guarantee for the company, and which continues to be required. It could not be sold, used or encumbered with less than that 70 % in favour". The Provincial Court added that "in accordance with the business judgment rule [...] it is guaranteed that this disposal, use or encumbrance will not exceed a series of limits, which favour the permanence of the assets within the company, as consideration for obtaining a bank facility".

§ 14. However, the Supreme Court disagreed, precisely on this last point, with the Provincial Court's approach (although, as we shall see a little later, this did not lead to the ground of cassation being upheld). And it did so by pointing out that the protection of the business judgment rule (which is framed in the regulation of the duty of due care of the company directors) does not dispense from compliance with the requirements under the law or the articles of association for the passage of the resolutions of the Board of Directors. Therefore, according to the judgment under consideration, if it were understood that in this case the resolution falls within the factual requirements of the article requiring an enhanced majority for its approval, the recognition of a sphere of business judgment would not be sufficient to uphold the validity of a resolution whose approval had not reached that qualified majority of votes in favour.

§ 15. Notwithstanding, as mentioned above, the Supreme Court also rejected the second ground of appeal because, in its view, the contested resolution did not actually have as its subject matter the use, disposal or sale of the company's real estate (nor could it indirectly trigger these actions) and therefore did not in any way fall within the scope of article 20 of the articles of association. Basically, it explained that the assumption of an obligation such as the one contained in the financing operation approved by the contested resolution (to reinvest the proceeds from the sale of assets exceeding EUR 500,000 within six months or to use them to repay debt) did not amount to an agreement by the company on the "use, disposal or sale" of a given asset. Of course, when the board had to decide on such use, disposal or sale of a real estate asset, it would have to do so with the enhanced majority required by the articles of association. However, this requirement under the articles of association affects the first aspect of the operation - the disposal of real estate - but not the decision on the use to be made of the proceeds of that disposal, to which the general rules for resolutions of the collegial governing body is applicable. Consequently, the Supreme Court ruled that the approval of the financing resolution by a simple majority of the members of the Board of Directors did not violate the requirement under the articles of association that certain resolutions be passed with an enhanced majority.