Corporate Governance

On the possibility of not including in the articles of association all or some of the legally defined circumstances in which a shareholder must abstain from voting (Art. 190(1) of the Spanish Companies Act)

This paper discusses whether, under the freedom in drawing up the articles of association (Art. 28 of the Spanish Companies Act), the shareholders of a company limited by shares can do away with all or some of the legally defined circumstances Art. 190(1) in which a shareholder involved in a conflict of interest with the company is prohibited from voting at the general meeting.

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1. Introduction

Article 190(1) of the Spanish Companies Act (LSC) provides that shareholders may not exercise their voting rights at a general meeting when resolutions are to be passed on certain matters (those specified in the article itself). This Act thus lays down a "duty to abstain" in certain (highly qualified) situations involving a conflict of interest. In the remaining (unclassed) events of conflict, the shareholder is not deprived of the right to vote and the protection of the company's interests is entrusted to the contest procedure, the success of which, however, is favoured by a reversal of the burden of proof (since, when the vote of the shareholder(s) involved in the conflict proves decisive, it is for the company and, where appropriate - Art. 206(4) LSC -, the shareholder(s) affected by the conflict, to prove the conformity of the resolution with the company's interests; the burden of proving the harm to said interests will only lie with the challengers in the case of positional conflicts). Challenging a resolution passed with the decisive vote of a shareholder involved in a conflict is therefore the (*ex post*) remedy that can generally be used, whereas imposing on the shareholder a duty to abstain (*ex ante* remedy) is, in the legal system, an exceptional solution, applicable only in the cases expressly provided for.

Given the foregoing, the question arises as to whether the shareholders can deviate - by means of the appropriate provisions in the articles of association - from the regime contained in the aforementioned Art. 190(1) LSC. In other words, whether it is possible to eliminate in the articles of association all or some of the statutory events in which the shareholder's duty to abstain at a general meeting arises.

2. The (possibility of) deletion in the articles of association of all or some of the statutory events in which a shareholder is obliged to abstain from voting at a general meeting

2.1. *The problem*

The question is whether, under party autonomy (Art. 28 LSC), the articles of association may allow the exercise of voting rights at the general meeting by a shareholder whose expulsion is under discussion, or whose shares are subject to a discussion at the general meeting on whether or not to authorise him to dispose of them in cases where their transferability is restricted (by law or by the articles of association), or when it is discussed whether to release him from an obligation, grant him a right or provide him with any financial assistance, or even, assuming that the shareholder is at the same time a director, in respect of a resolution releasing him from obligations arising from the duty of loyalty.

Although it is not a unanimous opinion, there seems to be a predominant tendency in scholarly writings (both prior to the 2014 amendment of the LSC and subsequently) to consider that it is not possible to eliminate the shareholder's duty to abstain from voting in relation to (any of) the resolutions specifically mentioned in Art. 190(1) LSC. According to this line of thought, the statutory list would therefore be unrepealable: party autonomy (Art. 28 LSC) would not be sufficient to allow the articles of association for the elimination or reduction of said list.

This idea is indisputable. And this is not because it is simply assumed that the legal regime is mandatory (that the legal provision has a mandatory nature, the scope of which would have to be demonstrated) or because it is understood that only when the law expressly permits it is it possible for the articles of association to displace the legal regime of companies limited by shares. The strength of the argument lies in my opinion - in the basis of the rules on conflicts of interest, which seek to prevent one such - the corporate interest - from being harmed when it collides (sometimes, even when there is merely a risk that it may collide) with the interest of the shareholders (or of the directors, in other cases). And, in the specific case of Art. 190(1) LSC, the legislator has sought to identify a set of particularly qualified situations involving a conflict for which, precisely because they are perceived as posing a special (greater) risk to the company's interests, a measure as radical as the preventive deprivation of the affected shareholder's voting rights has been envisaged. In this sense, it has been said on occasion that the aforementioned Art. 190(1) LSC contains an irrebuttable presumption that, in the cases mentioned therein, the shareholder will vote to satisfy his interest and to the detriment of the company. From this perspective, one could, in fact, argue against the possibility of the articles of association modifying this regime in order to reserve a different treatment to the statutory one for the cases specified (a

regime which, insofar as it preserves the company's interests, should be considered - according to this view – not subject to party autonomy).

2.2. *The reasons for supporting a position in favour of the possibility of "reducing" (or deleting) in the articles of association the list of resolutions on which an affected shareholder may not vote.*

Despite what has just been stated, my intuition goes in a different direction (or, at least, partially different): I believe the possibility should be admitted - at least as a rule, but see 2.3 below - of the articles of association of a company limited by shares eliminating all or some of the events of abstention set out in Art. 190(1) LSC. This is due to two considerations of a different nature, which I will try to explain below:

a) First of all, account should be taken of the special treatment that the law reserves in this area for public limited companies and, specifically, with regard to resolutions authorising a shareholder to transfer shares subject to restrictions in the articles of association or deciding on his expulsion from the company. In the light of Arts. 123(1) and 351 LSC, it is clear that, in the case of public limited companies *and in the general case*, the existence of clauses in the articles of association limiting the transferability of shares or providing for events of expulsion is an unavoidable logical and systematic prerequisite for the existence of the duty to abstain of the shareholder affected by the resolution (the shareholder who intends to transfer his shares or the one who is to be excluded), In any case, it should not be forgotten that the law itself sometimes expressly provides for certain expulsion events applicable to public limited companies; this will be the case for public limited professional services companies - Art. 14(1) of the Professional Services Companies Act - and with worker-owned companies - Art. 16(3) of the Worker-Owned Companies). However, the law also requires the prohibition on voting to be "expressly provided for in the appropriate clauses in the Articles of Association regulating the restriction on free transfers or expulsions". Therefore, in a public limited company whose articles of association lay down limitations on the transferability of shares or provide for grounds for expulsion, the shareholder who intends to transfer or whose expulsion is being discussed may participate in the vote on the relevant resolution at the meeting (if this is necessary in accordance with the applicable provision in the articles of association), unless the articles of association themselves prohibit him/her from doing so.

It should be noted, however, that when the articles of association of a public limited company include restrictive rules on the transferability of shares or include events of expulsion of shareholders, the conflict of interest may arise - at the time of voting at the general meeting - in materially equivalent terms to those in which it typically arises within a private limited company (at least if the public limited company is a close or family-owned company, which will be usual precisely if there

are such clauses). And yet the legislator has expressly refrained from imposing a duty of abstention on the conflicting shareholder in such cases, leaving it to the shareholders to do so. It does not seem, therefore, that the law considers the existence of such a duty to be essential for the effective protection of a company's interests (in fact, it does not impose it in these cases) or, obviously, that its absence would be contrary to the principles that shape the company's legal form.

Well, in my opinion, the above points to the idea that the shareholders of a private limited company should be able to exclude from the articles of association the duty of abstention of shareholders, at least in relation to the resolutions we have been discussing (those indicated in letters [a] and [b] of Article 190(1) LSC; also - and a fortiori - when the subject matter scope of Art. 190(1) LSC itself has been expanded as a result of the freedom in drawing up the articles of association: for example, if the articles of association of the private limited company include grounds of expulsion in addition to the statutory ones, would there be any reason to prevent the articles of association from excluding - for the passage of expulsion resolutions based precisely on those grounds - the duty of abstention of the shareholder?) If the shareholders of a public limited company can prevent - simply by means of silence in the articles of association - the shareholder's duty to abstain from voting from arising, it seems reasonable to consider that the shareholders of a private limited company may, in cases where the conflict of interests frequently arises in equivalent terms, exclude the application of this preventive remedy by means of an express provision in the articles of association.

From here a second step can be taken to advance the reasoning. Assuming that in a private limited company it should be possible, by means of the appropriate rule in the articles of association, to eliminate the duty of abstention of a shareholder in the process of passing some of the resolutions indicated in Article 190(1) LSC (those in letters [a] and [b]), there seems to be no reason to deny the same possibility in relation to the others, both for public limited companies and private limited companies (see, however, 2.3 below). The idea - on which we will insist below - is that the shareholders can perfectly well be entrusted with the decision as to whether the challenging instrument is sufficient to protect the company's interests in the cases listed in the aforementioned Art. 190(1) because not even the law itself considers that applying an *ex ante* operative remedy (prohibition of the exercise of voting rights) is always and radically essential to provide sufficient protection for the company (to link up with something said above - at the end of 2.1 - it should be pointed out that the irrebuttable nature of a presumption does not mean that the rule imposing it is unrepealable).

b) Precisely in connection with the above, a second set of considerations should be assessed. In this respect, it

should be recalled that voting rights are one of the basic individual rights of the shareholder, so that the legal limitations imposed on them must be interpreted in a restrictive manner. Disenfranchising a shareholder is an extreme remedy, which can be very disruptive for corporate life. In fact, in relation to general meeting resolutions, the general rule is that set out in the first paragraph of Art. 190(3) LSC: in conflict-of-interest cases other than those provided for in the first paragraph (i.e. those not classed as such), shareholders shall not be deprived of their voting rights.

In this regulatory context, there does not seem to be any insurmountable obstacle to recognising as lawful the incorporation in the articles of association of clauses eliminating the duty to abstain in all or some of the legally defined cases. It should be borne in mind that this would in no way involve waiving the defence of the company's interests in cases of conflict of interest between the shareholder and the company. It would simply mean availing oneself of the general system, which is based on a *posteriori* control through the challenge of resolutions based on Arts. 190(3) and 204(1) LSC; a mechanism that can be deemed sufficient to deal with these problems (and which, by its very nature, must be regarded as - this one - not subject to party autonomy). Note that, at the end of the day, it is the company's interests that are at risk of being harmed when a conflict arises; in short, it is the interests of the shareholders as a whole that may be affected. They are therefore free to waive the adoption of preventive measures such as disenfranchisement in the articles of association and to choose to redress situations, where necessary, by means of instruments to challenge.

It is worth insisting on this point: with Çarticles of association that eliminate the duty to abstain in the cases (all or some of them) listed in Art. 190(1) LSC, shareholders would effectively rule out the possibility that in such cases the shareholder concerned will always and necessarily act seeking to obtain private advantages at the company's expense (an implicit assumption - as a principle - in the Act). Consequently, based on this premise, they would dispense with a preventive measure as far-reaching as the imposition of the duty to abstain from voting and would base the defence of the company's interests on the possible and subsequent challenge of the corporate resolution under the terms of Art. 190(3) LSC. It is true that experience probably shows that in the cases set out in the aforementioned Art. 190(1), the shareholder affected by the conflict tends to vote without consideration for the interests of the other shareholders and the company and with the temptation to harm them in order to obtain a particular advantage. However, this consideration would justify the default legal regime (which opts for a "preventive" remedy), but does not require such regime to be considered unrepealable to the extent that the shareholders deem it appropriate to opt for another remedy.

2.3. *The specific case of a general meeting resolution exempting a shareholder/director from the prohibitions deriving from the duty of loyalty*

Within the framework of the discussion in the previous section, special attention should be paid to general meeting resolutions whereby, in accordance with Art. 230 LSC, the shareholder/director is released from the obligations deriving from the duty of loyalty whilst holding office (Art. 190(1)(e) LSC).

The connection between Arts. 230 and 190(1)(e) LSC is obvious: the shareholder/director in respect of whom the meeting discusses whether or not to grant the mandatory dispensation may not take part in the relevant vote. The question lies in the fact that Art. 230 LSC itself stipulates, in its first paragraph, that the rules relating to the duty of loyalty are mandatory. And this raises the question of whether, contrary to what has been proposed as a general criterion above, it should be held in this case that the articles of association cannot eliminate the duty of abstention of the shareholder/director when the general meeting deliberates on whether to exempt him from the discharge of certain duties.

The problem must be correctly defined. It is not a question of discussing whether the articles of association can generally authorise the director (whether or not he is a shareholder) to engage in certain conduct or to carry out certain transactions. This does not seem to be compatible with the (mandatory) mandate of Art. 230 LSC. The question is another: to decide whether the articles of association can allow the affected director/shareholder (and potential beneficiary of the authorisation) to vote (without prejudice to the possible challenge of the resolution pursuant to the provisions of Art. 190(3) LSC) when the shareholders are faced with the task of deciding on this dispensation. And what makes this issue unique is the mandatory nature that the law itself attributes to the duty of loyalty rules.

Let this be understood. It is not disputed that the shareholder/director is in a conflict of interest when the shareholders' meeting decides to dispense with his duty of loyalty. Nor is it intended to assert that the conformity of the relevant resolution with the interests of the company should not be assessed. The idea is to analyse whether, in this particular case of conflict of interest, the articles of association may contain a waiver of the *ex ante* protection mechanism provided for by law (deprivation of the exercise of voting rights at the meeting in relation to the relevant dispensation resolution) and thus entrust the protection of the company's interests solely to the challenge remedy of Art. 190(3) LSC.

In order to answer the question posed, it is necessary to determine whether the mandatory nature legally attributed to the duty of loyalty rules must be understood to be limited to what refers to the director's duty of loyalty as such or whether, on the contrary, it includes the duty of abstention of the shareholder/director in the event of a conflict of interest expressed within the general meeting. The issue is, of course, highly debatable, since it is not easy to delimit exactly what the subject matter scope of the mandatory nature proclaimed in Art. 230(1) LSC is. However, it could be argued that the mandatory nature established in the

aforementioned Art. 230(1) LSC affects all the rules that one way or another shape the directors' duty of loyalty and, therefore, also the provisions of Art. 190(1)(e) LSC, an article that must be seen as an integral part of that legal regime. This means affirming that the deprivation of the voting rights of the affected shareholder/director in the case analysed is a necessary consequence that the articles of association cannot remove. It should be noted that if the dispensation resolution were passed by the company's board of directors (Art. 230(2) LSC), the shareholder director should not participate in the discussion and voting on the resolution (Art. 228(c) LSC); nor should the sole director in conflict grant the dispensation. There is no scope for the articles of association to eliminate this duty of abstention (of the director). It would therefore be contradictory if, when the authorisation falls within the remit of the general meeting, the articles of association could authorise the shareholder/director to participate in the vote (even in a decisive manner) when, materially speaking, the content and implications for the company's interests of the relevant decision are identical, regardless of whether it is passed by the governing body or at the general meeting. In reality, although a formal distinction can be made between the conflict of interest subject to dispensation and the conflict of interest arising at the time of deciding on such authorisation, the latter is merely a derivative of the former, so it seems logical to consider its rules equally mandatory insofar as it forms part of the set of unavoidable safeguards (in this case procedural) provided by law to ensure that the flexibility introduced by the possibility of dispensation does not result in harm to the company.

3. The passage of the resolution amending the articles of association to reduce or eliminate the cases in which the shareholder must abstain from voting.

Assuming the correctness of the conclusions previously reached (*supra*, 2), the question arises as to whether the possible amendment of the articles of association eliminating the prohibition on voting by the affected shareholder in (all or some of) the cases of Art. 190(1) LSC would require the consent of all the shareholders or whether, on the contrary, a majority agreement would be sufficient.

In my opinion, the consent of all the shareholders is not necessary in order to eliminate by means of the articles of association the duty of abstention that weighs on the shareholder when the general meeting discusses the passage of any of the resolutions set out in the aforementioned Art. 190(1) LSC. And the same rule should be followed when, within a public limited company, the rule in the articles of association expressly prohibiting the affected shareholder from voting on resolutions aimed at expelling him or authorising him to transfer his shares is eliminated.

I do not believe that any individual rights would be affected by such resolution. Nor - as far as I am aware - is there any legal provision (express or implied in the system) which requires the agreement of all the shareholders in order to carry out an amendment of the articles of association in the sense indicated.

A particular question arises when the amendment resolution is intended to be passed after a conflict has already arisen with one of the shareholders and, precisely in connection with that conflict, with the aim of allowing the affected shareholder to exercise the right to vote in the appropriate discussion (in the limit,

the resolution to amend the articles of association to remove the duty to abstain could be passed at the same general meeting at which it is intended to subsequently pass one of the decisions referred to in Art. 190(1) LSC and with a view to that meeting). In this case, the question arises as to whether the resolution to amend the articles of association itself might not in fact constitute a resolution granting a right (the right to vote) precisely to the shareholder who, because he is already involved in one of the cases of conflict in Art. 190(1), should in principle abstain from voting. If this approach is considered to be correct (which depends to some extent on the content to be given to the notion of a general meeting resolution *granting a shareholder a right*), there would already be a conflict in relation to the resolution amending the articles of association (the resolution eliminating the duty to abstain) and the affected shareholder would therefore be prohibited from exercising the right to vote in relation to that resolution (Art. 190(1)(c) LSC). If, on the other hand, this approach is not shared, and assuming the existence of conflict of interest with regard to the amendment resolution, Art. 190(3) LSC would apply.