Corporate & Commercial

Invalidity of contracts on the basis of breaches of directors' duty of loyalty

As to whether shareholders also have standing to bring actions for the "invalidation" of contracts under Art. 232 of the Spanish Companies Act.

ÁNGEL CARRASCO PERERA
Professor of Civil Law, University of Castilla-La Mancha
Gómez-Acebo & Pombo, Academic Counsel

1. Invalidity of illegal company contracts

Although case law initially refused company shareholders standing to seek the invalidity of contracts entered into by the company [Supreme Court Judgments of 5 November (RJ 1997, 7933) and 21 November 1997 (RJ 1997, 8095)], as of 2013 this case law has been reversed. If, in accordance with the general legal doctrine, all those interested in the invalidity of a contract have standing to seek the invalidation of contracts that are void ab initio on the basis of a sham transaction or *ex turpi causa*, according to the new legal doctrine the standing of shareholders should not be limited anymore. Thus, Supreme Court Judgment 215/2013 of 8 April (RJ 2013, 4597): contract with an unlawful purpose consisting of the transfer of property that constituted the company's assets to another company of which only the rest of the shareholders of the transferring company formed part, under the appearance of a sale and purchase; Supreme Court Judgment 498/2014 of 23 September (RJ 2014, 5044): contract with an unlawful purpose, by contribution of properties split from the initial property, integrated in a transaction aimed at stripping to the detriment of the minority shareholders; Supreme Court Judgment 575/2015 of 3 November (RJ 2015, 4939): appropriateness of ab initio contractual invalidity in a case of financial assistance:

contracts that form part of the plan aimed at stripping the company subject to insolvency proceedings of its assets and placing them in the hands of the shareholders to prevent creditors from collecting their claims. According to this judgement, the fraud on creditors does not limit its potential to founding the avoidance action, but can also be the basis for invalidity due to an unlawful purpose or absolute simulation; the common unlawful purpose of defrauding creditors is a case of *ex turpi causa* that determines invalidity ab initio and the action to declare void (ab initio) for simulation or unlawful purpose due to fraud on creditors and the avoidance action can be brought in the same claim, the latter in the alternative.

Any company contract that violates an imperative or a prohibition, whether external or internal to the Companies Act ("LSC"), is an illegal contract under Article 1275 of the Civil Code ("CC"), provided that it is likely to adversely affect the property content of the proprietary right attached to the status of shareholder, beyond his relational position as such a shareholder. It does not matter whether the negative effect occurs in the extra-corporate sphere of the injured party ("direct harm" of Art. 241 LSC) or *uti socius*, as the beneficial and expectant holder of a claim for the distribution of company profits (harm to the company assets of Art. 236 LSC). The situation would not change if it were considered (not that I do) that the abuse of fiduciary power entailed by misfeasance "abrogates" the power of representation of Article 234 LSC. This does not seem to be the case, because then it would not explain why the contract can be "voided" in accordance with Article 232; there would be no voiding defect, it would be an unenforceable contract as per Article 1259 CC.

It should then be noted that the material scope of the shareholders' standing to sue for invalidity of contracts is more extensive than that of the standing to claim *iure proprio* liability of the company directors in accordance with Article 241 LSC ("directly harming the interests of the shareholders"), because the action to declare void a contract is always brought *iure societatis*.

The contract can be attacked regardless of whether the company resolution authorising it is challenged under Article 204 LSC. The proceedings initiated to challenge the company resolution will normally be preliminary in the sense of Article 43 of the Civil Procedure Act ("LEC"); but they may not be, because the judgement as to transactional validity or invalidity is not conditioned by the procedural fate of the company resolution. In the civil track a preliminary analysis of the validity of the agreement can be carried out *incidenter tantum* and without the effect of res judicata (Art. 42 LEC).

There is an additional material justification to give the shareholders standing to challenge contracts concluded within the scope of the company's representation or authorised by resolution of the general meeting. It cannot even be suggested that this standing should be reserved to the company, because in most of the cases decided on this issue it is revealed that the shareholders' standing is required by the need for effective judicial protection of these shareholders who, through invalidity, seek to protect their interests *against the company itself,* which is very often *in malam partem,* because the spurious interests of the director are normally aligned with the interests of the majority of shareholders. Consequently, most of the cases decided deal with regular or irregular financial assistance carried out by the company in favour of a controlling shareholder (e.g. a cash pooling scheme, Las Palmas Provincial Court Judgment mo. 156/2015 of 18 May).

2. Article 232 LSC

Overlapping in part with Article 227, but going beyond it as far as it is relevant here, Article 232 LSC opens up multiple remedies in the event of directors' conduct in breach of the duty of loyalty. Not only corporate liability claims (cf. Art. 239(1) II), but also actions to restore, restrain and invalidate contracts. It is taken for granted in the provision that the challenge of company resolutions under Article 204 would also be admissible if the (misfeasant) conduct had crystallised in a "resolution".

Article 232 LSC ("invalidation") confirms that in the cases affected by the breach of duties of loyalty (at least in these cases) the resulting final contracts binding the company to the director, the company to a third party or the director to a third party can be voided. This action to declare void a contract is not, in principle, subject to restrictions of standing and may be brought by the company as well as by the shareholders (as stated by MASSAGUER).

Recourse to director liability claims does not close the door on actions to declare void contracts contrary to the duty of loyalty: Supreme Court Judgment no. 215/2013 of 8 April (RJ 2013, 4597), Supreme Court Judgment no. 498/2014 of 23 September (RJ 2014, 5044), and Supreme Court Judgment no. 316/2016 of 13 May (RJ 2016, 2040). Although collecting twice is not possible, there is compatibility between ordering recovery from the director and ordering the third party to reimburse. There is probably passive joint and several liability. Consolidation of proceedings is even more feasible given the terms of Article 239(1) II LSC. Actions can be consolidated, eventually, by the *vis attractiva* of the jurisdiction of companies courts, already proclaimed by case law.

Leaving aside those cases in which the action to restrain/restore has independent potentiality (e.g. Unfair Competition, Consumer Protection against unfair terms and practices), the restoring to which Art. 232 refers is nothing other than the material content, possible or necessary, of other actions. In these cases, restoring can be equivalent to the "restitution" of the effects of the invalidity or the "restitution" of the gains obtained through unjust enrichment. But, above all, restoring is the natural manifestation of the reparation in natura, which is the proper content of actions for redress (sic: redress in a specific form). In any case, it makes no sense to enthrone it as an independent action for the purpose of creating a standing for it that is different from that of the actions to declare void or for redress.

3. The prohibited legal classes of corporate misfeasance

3.1. *Statutory classes of intra-corporate prohibition (voting) and statutory classes of prohibited corporate business (resolutions) or transactions*

To the first classes belongs the type of vote the shareholder involved in a conflict of interest is prohibited (Art. 190(1) LSC) if it has not crystallised in a resolution ("rule of resistance", Art. 204(3)(c) and (d) LSC) or in a contract; it is out of the question for challenges brought by third parties other than the author of the prohibited act. Neither can this shareholder challenge the vote, nor the resolution arising from the vote, nor the contract arising from the vote *(nemo propriam causam turpitudinem allegare potest)*. On the isolated challenge of the vote, Madrid Provincial Court Judgment No. 403/2023 of 19 May.

Almost all prohibited classes may have crystallised in a company resolution or contract. Article 228(a), (b) and (d) and

Article 229(b) and (c) provide for cases in which the non-crystallisation of the prohibited conduct as lawful business is possible; more difficult in the cases of conflicts of interest in Article 228(e) and 229. There are some cases of prohibition which by their nature cannot go beyond the stage of the company resolution (Art. 190(1)(b), 228(c)), and can be challenged according to the rules of Article 204. The other types of prohibition in Article 190, 227, 228, 229 and 231 bis can also crystallise in contracts, with the company itself or with a third party.

3.2. *Classes of prohibition qualified by the absolute disvalue of action and classes subject to reservation of dispensation by the competent body*

To the first classes belong the types qualified by general clauses describing prohibited conduct with a disvalue of action (Arts. 190(1)(d) and (e); 227(2): "breach of the duty of loyalty"). To the second, prohibition clauses subject to a reservation of dispensation by the competent body. This distinction is only relevant when the conduct is that of the company director, not of the non-director shareholder.

All prohibitions are in principle subject to a possible reservation of dispensation (Art. 230). Every dispensation is subject in law to certain limits or restrictions. If the prohibited conduct is not duly exempted, it resumes its status as an absolute prohibition. If the prohibited conduct is to be exempted by the shareholders in general meeting, the dispensation requires a general meeting resolution, because the company cannot "ratify" otherwise. If the dispensation requires resolution of the governing body, it also requires the governing body resolution, because here, too, civil (mostly tacit) ratification is not a way of expressing company declarations. The dispensation is already unenforceable vis-à-vis the interested third party when the prohibited conduct has previously crystallised in the last possible business format: company resolution or, as the case may be, subsequent contract.

If the competent body waives *ultra vires* the conditions of validity of Articles 230 and 231 bis, the resolution can be challenged in accordance with the LSC. If, however, the improperly authorised conduct crystallises in a contract, the contract is concluded contrary to the prohibition of misfeasance and is therefore unlawful. Therefore, the contract resulting from an intra-group transaction resolution authorised by the directors under the conditions of Art. 231 bis can be challenged if the authorised transaction is contrary to the company's interests.

4. Invalidity / voidability

The distinction between invalidity and voidability is only of decisive importance today in terms of the duration of the limitation periods, and only as long as the (incorrect) case law is maintained which makes claims for (not only declaratory) orders arising from contracts void ab initio unlimitable and makes those for voidability subject to the four-year limitation (!) period of Article 1301 CC.

The civil case law of the Supreme Court that upholds the standing of the shareholder for actions concerning simulation and unlawful purpose is based on the undisputed fact that these are actions addressing what is void ab initio. However, the Madrid Provincial Court Judgment no. 299/2022 of 22 April 2022 *(El Enebro)* (JUR 2022, 230256) holds with a variety of arguments that the actions for "invalidation"

of contracts for breach of duties of loyalty are actions of voidability, precisely because the duty of loyalty can be dispensed with at the general meeting. However, the judgement betrays itself, because it consciously states that, despite this view, the claimant shareholder, and not only the company, as would be appropriate for an action to declare void, must be recognised as having standing.

Voidability (i.e., an action to void as opposed to an action to declare void) is not a good remedy for Art. 232 LSC, if it is understood that such a characterisation leads to the deprivation of standing for the shareholders.

There is no analogy between the structure of the cases of voidability concerning minors/disabled persons subject to guardianship in Article 1301 CC and the corporate cases of misfeasance not exempted by Articles 230 and 231 bis LSC. In those cases, voidability is imposed to protect the *person protected by the provision and who has issued a business statement potentially detrimental to his interests,* that is not the person (legal representative) who should have authorised or consented to the contract. The "superior" is not protected by civil voidability. The fact that something can be dispensed with does not mean that it is simply referred to the niche of voidability. It could very well be that contracts made without the intervention of the representative guardian are void ab initio, and they would not cease to be so because the contract would have been valid if the guardian had intervened.

Voidability protects the minor or the disabled person. Therefore, they are the ones entitled to request it and the limitation period begins to run only from the moment that these persons are in a position to sue themselves. This has nothing to do with the director engaged in misfeasance, who obviously cannot "confirm" in accordance with Article 1309 CC. Referring to the scheme of voidability would, it is said, deprive the shareholder of standing. But there is no connection between the civil law and this result either, because Article 1302 CC only deprives of standing the third party who contracted with the minor or disabled person, but the shareholder *in bonis* is not such a third party, he is not the *suspected* counterparty to the prohibited contract. The voidability (if it is such a thing) of Art. 405 of the recast version of the Insolvency Act ("TRLCon") does not deprive the creditors against the insolvent estate of standing. For its part, the restriction of standing in favour of the insolvency practitioner in Article 109(1) TRLCon is perfectly logical, because otherwise insolvency proceedings would be unmanageable; furthermore, there is the notable difference that the insolvency practitioner is assumed to be a third party *in bonis*, but generally not so the company whose director has carried out prohibited acts of management with impunity; it would be perverse to limit standing to a person who is very possibly a party to the fraud.

According to a widespread proposal, absolute invalidity protects supra-individual interests, whereas voidability protects the interests of the contracting parties. The proposal is probably not very nuanced, but it serves to deny the appropriateness of voidability if the intention is to exclude the standing of shareholders: they are not third parties outside the contractual exchange.

Art. 1306(2) CC cannot be applied to deny the shareholder restitution as the shareholder was not a party to the contract (detrimental to his interests) concluded by the two companies.

Disclaimer: This paper is provided for general information purposes only and nothing expressed herein should be construed as legal advice or recommendation.