GARRIGUES
Commentary

Corporate Governance and Corporate Responsibility

2-2014
December

Law amending the Corporate Enterprises Law to Enhance Corporate Governance

Contents

1. Introduction

Law 31/2014, of December 3, amending the Corporate Enterprises Law ("**LSC**") in order to enhance corporate governance was published in the Official State Gazette on December 4, 2014.

This Law stems directly from a decision issued by the Spanish Cabinet on May 10, 2013, whereby a committee of experts on corporate governance matters (the "**Committee of Experts**") was set up to propose the legislative initiatives and reforms needed to guarantee good corporate governance at companies, and to provide support and advice to the Spanish National Securities Market Commission on changes to be made to the Unified Code of Good Governance for listed companies.

On October 14, 2013, the National Securities Market Commission published the result of the first part of the Committee of Experts' work: a study on proposed legislative amendments in the area of corporate governance (the "**Report**").

The changes introduced by this new law amending the LSC are based on the Report and respect practically all of its recommendations. They can be grouped under two main heads:

- Shareholders' meetings: reforms geared towards expanding the powers of the shareholders' meeting, strengthening minority shareholders' rights and ensuring transparency in the information received by shareholders.

- Boards of directors: reforms aimed at tightening the legal rules on directors' duties and liability, promoting diversity on boards in terms of gender, experience and expertise, introducing the role of 'coordinating director'–where one person holds office as chairman and as chief executive officer–, shortening the term of office of directors to 4 years, clarifying the rules on compensation and its approval by the shareholders' meeting, or making the nominations and remuneration committee legally mandatory, like the audit committee, for listed companies.

2. Legislative amendments relating to the shareholders' meeting and shareholder rights

2.1 Powers of the shareholders' meeting

- The powers of the shareholders' meeting of all corporate enterprises have been amended to include the acquisition or disposal of essential assets or their contribution to another company (art. 160), as partially provided for in current recommendation 3 of the Unified Code for listed companies. Unlike recommendation 3, the statutory reform does not require that the acquisition or disposal entail an actual change in the corporate purpose, it being sufficient for the transaction to involve essential assets. The law presumes that an asset is essential where the amount of the transaction exceeds 25% of the value of the assets listed in the last approved balance sheet.

- The power of the shareholders' meeting to scrutinize management matters has been broadened to include all corporate enterprises (art. 161). Before, that power only seemed to be reserved in the case of limited liability companies.

- The powers of shareholders' meetings of listed companies have been broadened in line with the current wording of recommendation 3 of the Unified Code[1] to cover the following matters: inclusion in subsidiaries of essential activities, transactions the effect of which is equivalent to the company's liquidation and, moreover, in line with other amendments, approval of the policy on directors' compensation (art. 511 bis).

2.2 Minority shareholder rights. Powers relating to the shareholders' meeting

- The 5% threshold previously stipulated by the LSC to able to exercise certain minority shareholder rights has been lowered to 3% in the case of listed companies (arts. 495 and 519).

2.3 Calling shareholders' meetings

- The right to information before shareholders' meetings of listed companies are held has been strengthened, particularly as regards the appointment of directors (art. 518).

2.4 Right to attend shareholders' meetings

- The maximum threshold requirable by the bylaws of listed companies to attend shareholders' meetings has been set at 1,000 shares, as opposed to 0.1% of the capital stock, which was the general rule (art. 521 bis).

2.5 Voting at shareholders' meetings

- At all corporate enterprises, it requires mandatory separate voting at shareholders' meetings on substantially independent matters, namely: (i) the appointment, ratification, reelection or removal of each director, and (ii) the amendment of bylaws by article or group of articles that form a self-contained unit and (iii) any matters for which the company's bylaws so provide (art. 197 bis).

- Three measures have been included to tackle the problem of conflicts of interest in decisions adopted by shareholders' meetings:

  - in the most serious cases, the former rules applying to limited liability companies: prohibition of the right to vote of the interested shareholder (article 190.1 and .2) have been adopted for all corporate enterprises with slight modifications;

  - in other cases, there is a presumption that the corporate interest is contravened where the resolution is adopted with the decisive vote of shareholders subject to the conflict of interest (art. 190.3); and

  - separate voting is required by the various groups of shareholders is required for bylaw amendments that have an asymmetrical impact from a substantive standpoint, resulting in discriminatory treatment (art. 293.2).

[1] Part of which has been included in art. 160 for all corporate enterprises, as noted above.

- Article 524 has been amended to achieve a more appropriate treatment of the delegation of the power of representation and of voting by intermediary entities (vote splitting and different voting).

2.6 Adoption of resolutions at shareholders' meetings

- In the case of all corporations, the interpretational doubts over the calculation of majorities have been clarified according to the following rules (art. 201):
  - Ordinary resolutions: simple majority (more votes for than against).
  - Special resolutions (as referred to in article 194 LSC): absolute majority (more than one half of the shareholders present in person or by proxy at the meeting), unless, on second call, there are shareholders representing at least 25% but less than 50% of the subscribed voting capital, in which case two thirds of the capital present in person or by proxy at the meeting must vote for the resolution.

2.7 Shareholders' right to information

- In the case of all corporations (art. 197), the law:
  - distinguishes between the legal consequences of the different forms of exercising the right to information. In particular, it stipulates that the violation of the right to information exercised during a shareholders' meeting will only entitle the shareholder to demand performance of the information obligation, as well as any related damages, but it will not be a ground for challenging the shareholders' meeting;
  - introduces safeguards for the exercise of the right in good faith and to prevent its abuse.
- In the case of listed companies (art. 520), the law extends the time period which shareholders have to exercise their right to information before the shareholders' meeting until five days before it is held, and includes the obligation to post on the company's website answers to valid questions from the shareholders from the date they are given.

2.8 Challenging corporate resolutions

- Reforms aimed at maximizing the material protection of the corporate interest and of the minority shareholders (in the case of all corporate enterprises):
  - Unifying all cases for challenging resolutions under one general system for annulment of resolutions with a one-year time limit for doing so (three months in the case of listed companies), except for resolutions contrary to public policy (no time limit) (arts. 204, 205 and 495.2).
  - Clarifying that resolutions adopted in breach of the shareholders' meeting or board regulations are voidable (arts. 204.1 and 251.2).

- Expressly providing that the corporate interest is also damaged even though the resolution does not cause damage to the company's assets if it imposed in an abusive manner by the majority. It is deemed that a resolution is imposed in an abusive manner where it does not meet a reasonable need of the company and is adopted by the majority in its own interest and to the unjustified detriment of the other shareholders (art. 204).

- Reducing from 5% to 1% the percentage of capital that must be held by shareholders to challenge resolutions adopted by the board or any other collective managing body (art. 251.1). In the case of listed companies, it is set at 0.1% (art. 495.2).

- Reforms focusing on prevention of the opportunistic use of the right of challenge (also applicable to all types of corporate enterprise):

  - Restricting the legal standing to bring an action to challenge resolutions, so that 1% of the capital stock of unlisted companies and 0.1% in the case of listed companies is needed; with recognition, below those thresholds, solely of the right to claim the appropriate damages (arts. 206 and 495.2).

  - Establishing a series of cases in which a challenge would be inapplicable (art. 204.3), most notably: (a) the infringement of merely procedural requirements established by the law, the bylaws or in the shareholders' meeting or board regulations, for calling or constituting the meeting or for adopting the resolution; (b) the incorrect or insufficient nature of the information provided in response to the exercise of the right of information prior to the shareholders' meeting, except in the case of essential information; (c) the non-decisive participation of persons without the standing to do so; and (d) the invalidity or the erroneous calculation of votes, unless the invalid vote or the calculation error was decisive for the attainment of the required majority (stress test).

  - Preventing challenges that are unjustified because the resolution challenged no longer has any effect or has been validly superseded by another adopted before the action challenging it was filed. And if the revocation or replacement took place after it was filed, the judge will issue a decision terminating the proceeding for want of subject matter (art. 204.2).

2.9 Shareholder associations and forums

- It implements the rules on associations of shareholders of listed companies, completing the current rules by establishing the requirements for their formation (*inter alia*, they must have at least 100 members and none must own more than 0.5% of the company's capital), and the prohibition against receiving, directly or indirectly, any amount or financial advantage from the listed company, and including the obligation to have their accounts audited so as to ensure greater transparency in their activities (art. 539.4).

2.10 Knowledge of the identity of shareholders

- It reserves the right of the shareholders of listed companies to know the identity of fellow shareholders, shareholders having an individual or joint holding of at least 3% of the capital stock and any associations of shareholders formed at the issuer and representing at least 1% of the capital stock, solely for the purposes of facilitating communication with the shareholders for the exercise of their rights and to better defend their common interests (art. 497).

3. Legislative amendments in relation to the legal status of directors, the composition and functioning of the board of directors, the rules on directors' compensation and board committees

3.1 Status of directors: duties and rules on liability (applying to all types of corporate enterprises)

- Duty of diligence: it has completed the rules by establishing different regimes having regard to the functions entrusted to each director, and to enshrine in legislation the so-called 'business judgment rule', the aim of which is to protect the entrepreneur's discretion in matters of strategy and in making business decisions. The law also makes explicit the right and the duty of directors to request the necessary information to make informed decisions (arts. 225 and 226).

- Duty of loyalty: it has improved the order and description of the obligations flowing from such duty, completing the current list–above all, in the area of conflicts of interest–, and extending it to *de facto* directors in a wide sense. And also, it has extended the scope of penalties beyond indemnification for the damage caused, so as to also include returning the ill-gotten gains (arts. 227 to 232 – 231 remains the same – and 236).

  In particular, it develops the rules on the imperativeness of, and exemption from, the duty of loyalty (art. 230), stipulating that the rules on the duty of loyalty and on the liability for its breach are imperative and cannot be limited in the bylaws. This notwithstanding, the company may grant individual exemptions, authorizing a director or a related person to perform a certain transaction with the company, to use certain corporate assets, to take advantage of a specific business opportunity or to obtain an advantage or compensation from a third party. The authorization must necessarily be resolved on by the shareholders' meeting where it relates to an exemption from the prohibition on obtaining an advantage or compensation from third parties, or where it relates to a transaction whose value exceeds 10% of the corporate assets.

- Rules on liability: to extend the rules on directors' liability to similar persons and to facilitate company actions for liability against directors, reducing the ownership interest needed to qualify for standing and permitting, in cases of breach of the duty of loyalty, such an action to be filed directly without having to wait for a resolution by the shareholders' meeting (arts. 236, 239 and 241 bis).

3.2 Board of directors: composition, powers and functioning

- A provision has been added that expressly and directly establishes an obligation on the managing body of a listed company to take the form of a board of directors (art. 529 bis.1).

- A programmatic provision has been added for listed companies, which recognizes the relevance of diversity in the composition of their boards in terms of gender, experience and expertise (art. 529 bis.2).

- Certain powers have been reserved to the board, establishing for such purpose a list of nondelegable powers applicable to listed and unlisted companies alike (art. 249 bis), and another specific additional list, in line with recommendation 8 of the Unified Code, for listed companies (art. 529 ter). Express references have been included in this last article to tax elements in the area of strategy and risk control and management policies.

- At least four board meetings a year, one in each quarter, have been laid down for all corporate enterprises (art. 245.3).

- In the case of listed companies, it has also introduced an obligation on directors to attend meetings, a ban on nonexecutive directors delegating to executive directors, and the right of board members to receive sufficiently in advance the agenda for the meeting and the necessary information to debate and adopt resolutions on the business to be transacted (arts. 529 quater and quinquies).

3.3 Board chairman

- Also in the case of listed companies, it has implemented rules on the functions of the chairman of the board and established the need for a prior report from the nominations and remuneration committee for his or her appointment (art. 529 sexies).

- It has made compulsory the role of 'coordinating director' where the same person holds office as chairman and as chief executive officer, together with his or her functions and the procedure for his or her appointment (art. 529 septies).

3.4 Board secretary

- As in the case of the chairman, for listed companies, it has implemented rules on the functions of the board secretary and established the need for a prior report from the nominations and remuneration committee for his or her appointment (art. 529 octies).

3.5 Appraisal of the board of directors and of board committees

- It has introduced the requirement for a mandatory annual appraisal for the boards of listed companies and their committees. The result of the appraisal must be recorded in the minutes of the meeting or attached as an exhibit (art. 529 nonies).

3.6 Appointment of directors

- It has been established that proposed appointments or reelections of board members, in the case of independent directors, will fall to the nominations and remuneration committee and, in all other cases, to the board itself. Proposals must be accompanied by a supporting report from the board that assesses the competence, experience and merits of candidates, which will be attached to the minutes of the shareholders' meeting or the board meeting; and that the proposed appointment or reelection must also be preceded by a report from the nominations and remuneration committee (art. 529 decies.4 to .7).

- The cooptation system at listed companies has been amended, doing away with the need to be a shareholder, and a solution has been provided in the case of a vacancy arising after a shareholders' meeting has been called but before it is held, specifying that the board can appoint a director until the next shareholders' meeting is held (art. 529 decies.2).

- The possibility at listed companies of designating deputies has been removed (art. 529 decies.3).

- At listed companies, the maximum term of office of directors has been shortened from 6 to 4 years (art. 529 undecies). In accordance with the transitional provision of the law, directors appointed before January 1, 2014 may complete their terms even if they exceed the maximum term laid down in article 529 undecies of the LSC.

3.7 Definition of the different classes of director

- The definitions of the different classes of director provided for in Order ECC/461/2013, of March 20, 2013 have been included, i.e., executive, nominee and independent directors, and that of other nonexecutive directors has been maintained (art. 529 duodecies).

3.8 Directors' compensation. Special consideration for board members' compensation

- For all corporate enterprises (arts. 217 to 219 and 249.3):
  - Programmatic references have been included which must serve as inspiration for decisions on director's compensation, and which include the reasonableness of the compensation, in keeping with the company's economic situation and with the functions and responsibilities attributed to them, so that the compensation system is geared to promoting the company's long-term profitability and sustainability, while building in the necessary safeguards to avoid excessive risk-taking.
  - It has been provided that the bylaws must set out the system for directors' compensation according to their functions as such, and that the annual compensation for the directors as a whole must be approved by the shareholders' meeting. The compensation system stipulated in the bylaws must define the compensation item or items, which may consist of one or more of the following: a) a fixed allowance; b) attendance fees; c) share in profits; d) variable compensation with general reference indicators or parameters; e) compensation in the form of shares or linked to their performance; f) severance for removal, provided that the removal is not based on a breach of the director's functions; and g) such savings or welfare systems as are deemed appropriate.
  - The rules on compensation for directors who perform executive functions have been clarified generally and adequate safeguards have been provided for their establishment by the board. An agreement must be executed between the chief executive officer and the company, which must first be approved by the board with the affirmative vote of two thirds of its members (and with the abstention of the director in question), and attached as an exhibit to the minutes of the meeting.
- For listed companies (arts. 529 sexdecies to novodecies):
  - It has been provided that the office of director must necessarily be compensated.
  - The minimum terms of the policy on directors' compensation which must be approved by the board, at the proposal of the nominations and remuneration committee, and submitted to the shareholders' meeting for approval have been established. It will fall to the board, in the context of the compensation policy resolved by the shareholders' meeting, to determine the compensation for each director, according to his or her management and executive functions.

- A requirement has been added to submit to the shareholders' meeting for approval, at least once every three years, the company policy on directors' compensation as a separate item on the agenda (without it being possible to make any modification or payment for the discharge of, or termination from, the office of director unless envisaged by and consistent with such policy, or specifically approved by the shareholders' meeting).

- Consultative voting on the compensation report has been retained. Notwithstanding the consultative nature of voting, if the report is rejected, it will become necessary to review the compensation policy, which must be submitted to the next shareholders' meeting for approval (even if the three-year period mentioned above has not yet passed).

- In accordance with transitional provision of the law, in the event that the first annual shareholders' meeting that is held on or after January 1, 2015 approves report on compensation on a consultative basis, it will be deemed that the company's compensation policy it contains has also been approved for the purposes of the provisions of art. 529 novodecies. If the report is not approved on a consultative basis, the compensation policy must be submitted to the shareholders' meeting for binding approval not later than the next fiscal year.

3.9 Board committees

- It has established the obligation to have a nominations and remuneration committee (or two separate committees), which will be composed of nonexecutive directors, two of whom must be independent, and the chairman of which must be elected from among the independent directors (arts. 529 terdecies and quindecies). In line with the latest practices, the law has included among its functions to establish a target level of representation of the gender with the lowest representation on the board and to issue guidelines on how to achieve that target.

- It has modified the composition of the audit committee: composed of nonexecutive directors; there must be at least two independent members, the appointment of one of whom must take into account his or her expertise in and experience of accounting and/or audit matters. The chairman must be an independent director (art. 529 quaterdecies).

- The provisions established for board committees and the audit committee will also apply to entities that issue securities other than shares admitted to trading on official secondary markets (additional provision nine).

3.10 Annual corporate governance report and annual report on directors' compensation

- The law has added a new article 540 to the LSC with the contents of the annual corporate governance report laid down in subarticles 1 to 6 of article 61 bis of the Securities Market Law, while repealing article 61 bis. The law has also added requirements for information on the measures that have been adopted to try to include on the board of a directors a number of female directors that would achieve a balanced male and female presence, as well as the measures, if any, agreed to by the appointments committee. The law has also added a reference to tax matters in relation to risk control systems.

- A new article 541 has been added to the LSC with the contents of the annual report on directors' compensation which replaces article 61 ter of the Securities Market Law, in line with the reforms approved in this law on the subject of compensation.

4. Other amendments

- During its passage through parliament, lawmakers seized the opportunity to include in the Law additional measures aimed at combating late payments. Thus, an obligation has been added to include in the directors' reports of companies that cannot file abridged income statements, the average period for payment to suppliers; and if this average period is longer than the maximum period set in the late payment legislation, the measures to be applied in the next fiscal year to reduce this time to the maximum period must also be indicated (art. 262.1). Listed companies must also include the same information on their website (art. 539.2). Additional provision three of Law 15/2010 amending Law 3/2004 establishing measures aimed at combating late payments in commercial transactions has been amended to establish the obligation to include the average period for payment to suppliers in the notes to the financial statements of all commercial companies. Listed companies must publish this information on their websites, as must unlisted companies that do not file abridged financial statements, if they have a website.

- Additional provision seven of the LSC has been amended to update its references to the oversight powers of the National Securities Market Commission.

- It is established that within six months after the law is approved, the government will, at the proposal of the Ministry of Economy and Competitiveness and of the Ministry of Health, Social Services and Equality, prepare a report on the barriers encountered by disabled persons or senior citizens to access information on listed companies and to exercise their right to vote at them.

5. Entry into force

The amendments envisaged in this law will enter into force twenty days after it is published in the Official State Gazette.

However, there is a transitional regime (transitional provision) where, besides what was already noted above regarding article 529 novodecies (compensation report and policy) and article 529 undecies (directors' maximum term of office), reference is made to the changes that are most relevant and may require changes to a company's bylaws or organization.

Accordingly, it is established that the amendments to articles 217 to 219 (compensation at all corporate enterprises), 529 ter (nondelegable powers of the boards of listed companies), 529 nonies (appraisal of the performance of the board and committees at listed companies), 529 terdecies, quaterdecies and quindecies (board committees of listed companies) and 529 septendecies and octodecies (directors' compensation at listed companies) will enter into force on January 1, 2015 and must be resolved on at the first shareholders' meeting held after that date.

More information:

Álvaro López-Jorrín
Partner in charge of the Corporate Department
alvaro.lopez-jorrin@garrigues.com
T +34 91 514 52 00

Mónica Martín de Vidales
Partner in charge of the Corporate Department
monica.martin.de.vidales@garrigues.com
T +34 91 514 52 00

Sergio González Galán
Partner in charge of the Corporate Governance Industry
sergio.gonzalez.galan@garrigues.com
T +34 91 514 52 00

Hermosilla, 3 - 28001 Madrid (Spain)
T +34 91 514 52 00 - **F** +34 91 399 24 08