Compensation for loss of office 'under market conditions' provided for in articles of association

(Supreme Court Judgment no. 35/2025 (First Chamber) of 16 July)

Judgment analyses claim filed by former CEO for non-payment of loss-of-office compensation provided for in articles of association (legal regime preceding the 2014 amendments to the Companies Act).

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1. Introduction

1.1. *The case*

The circumstances of fact addressed by Supreme Court (First Chamber) Judgment no. 35/2025 of 16 July relate to the claim filed by a former CEO against the listed company that removed him for poor performance and refused to pay him compensation for loss of office in a case that predates the Companies Act Amendment (Corporate Governance) Act 31/2014 of 3 December. At that time, a director's service contract was not required for the remuneration of directors with executive functions, so the provisions on such remuneration in the company's articles of association would apply.

The articles of association contained, among other component elements (items) of remuneration, the right to obtain "compensation in the event of loss of office not owing to a breach". According to the articles of association, the amount of remuneration for each financial year would be determined (ex post) by the board of directors at the proposal of the appoint-

ments and remuneration committee, and would have to be ratified by the shareholders in general meeting. The articles of association also provided the following: "The Board shall ensure that remuneration is guided by market conditions and takes into account the responsibility and degree of commitment involved in the role that each director is called upon to perform".

The claimant's loss of office (as CEO) was approved in October 2011, and the board of directors' resolution setting ex post his remuneration for that financial year did not include the twenty days worked during said month, the proportional part of the fourteenth month pay, the variable remuneration for the second half of the financial year or the compensation for loss of office not owing to a breach (no-fault loss of office). The board of directors' view was that as the director was removed for poor performance of the duties and responsibilities of the position, he should not earn any compensation. The resolution setting the remuneration was ratified at the general meeting.

1.2. *The claim*

The director did not challenge the board or general meeting resolutions, but filed a claim against the company to demand payment of the outstanding remuneration (fixed and variable), plus compensation for no-fault loss of office of more than eight million euros, which he calculated in accordance with the compensation established in the articles of association of comparable companies (three years' remuneration would be the 'market conditions' of compensation in these listed companies).

The defendant company opposed the payment of both the outstanding remuneration and the compensation for loss of office. It was argued that, as the director had not challenged the resolutions setting the remuneration for the 2011 financial year — without including any of the items of remuneration claimed in the lawsuit — those resolutions became valid and enforceable. Furthermore, the statement of defence argued that the compensation of eight and a half million euros sought in the claim was excessive and that, at most, a sum (three and a half million euros) should be awarded that did not exceed the amount represented by one year and three months' remuneration. As we will see below, acknowledging this minimum as acceptable may have been a mistake.

1.3. *The judicial response*

The Companies Court's judgment dismissed the claim in its entirety for the same reasons contained in the statement of defence: the loss of office was due to a breach of the duties inherent in the position and, in the absence of challenge, the board resolution that set the remuneration in the stated terms and the general meeting resolution that ratified it were valid, effective and enforceable.

The Madrid Provincial Court (Twenty-Eighth Chamber), in judgment of 12 June (ROJ: SAP M 6860/2020), allowed in part the appeal lodged by the former CEO and ordered the company to pay the proportional amount of the fixed remuneration for the twenty days worked in October plus the sum of three and a half million euros as compensation for loss of office. The judgment of the court of first instance dismissing the claims for payment of the proportional part of the fourteenth month (not listed as an 'item' of remuneration in the articles of association) and variable remuneration (due to lack of evidence of satisfaction of the requirements for accrual) was affirmed.

The Supreme Court judgment affirmed the Provincial Court's decision, while establishing legal doctrine on three issues that are of interest for the application of the regime (past and present) regarding directors' remuneration and, in particular, compensation for loss of office.

— The first issue concerns whether the failure to challenge the resolutions of the board of directors, the shareholders in general meeting or both on the setting of directors' remuneration prevents claims for the payment of remuneration not included in those resolutions.

— The second issue is whether applying the business judgment rule (Art. 226(2) of the Companies Act [LSC]) to determine whether the director breached the duties inherent in the office he held for the purposes of a provision on compensation for at-fault loss of office ('bad leaver clause') is lawful.

— Finally, there is the issue of the requirements for claiming and proving the 'market conditions' that determine the amount of compensation for loss of office claimed provided for exclusively in the articles of association.

2. Compensation for loss of office as part of the remuneration system and scope of resolutions setting its amount

As we have pointed out, the order to pay compensation for loss of office was based on the fact that the company's articles of association established the right of directors performing executive functions to earn "compensation in the event of loss of office not owing to a breach".

According to the relevant article, "the determination of the amount [...] of the compensation for loss of office is the responsibility of the Board of Directors, following a report from the Appointments and Remuneration Committee", which should ensure that remuneration "is guided by market conditions and takes into account the responsibility and degree of commitment involved in the role that each director is called upon to perform".

In addition, the following was provided: "The remuneration established in accordance with the provisions herein must be laid before the shareholders in General

Meeting for ratification each financial year".

There is no need to challenge the resolution of the shareholders in general meeting or of the board of directors in order to claim remuneration, if it is due

The defendant company argued that the articles of association are organisational rules that do not grant personal rights, whereby the right to compensation would arise only from a resolution of the shareholders in general meeting ratifying the remuneration for the financial year proposed by a resolution of the board of directors. If the director was not satisfied with his remuneration because the resolutions did not grant a right to any compensation, he should have challenged those resolutions, which would be valid and enforceable as long as not held void.

This argument was rejected by the Provincial Court with the following reasoning:

a) The articles of association are of the same nature as contracts, so there is no doubt that an article can be a source of personal rights, like any other contract.

b) In this case, the articles of association provided that directors "shall be entitled" to compensation in the event of no-fault loss of office, so the right to compensation arises upon loss of office, not upon approval of the resolution determining the amount of compensation owed.

c) If the company refuses to pay the compensation (or the director does not agree with the amount set because it does not meet the 'market conditions' criterion set out in the articles of association), the director may seek any of the remedies provided for in the Civil Procedure Act (LEC) to protect his legal position, including an order to be paid compensation in the event of a dispute (Art. 5(1) LEC: "The courts may be asked to order the payment of specific consideration, to declare the existence of rights and legal situations, to establish, modify or terminate the latter, to enforce, to grant interim relief and any other type of remedy expressly provided for by law").

In short, the Provincial Court concluded that challenging the resolution setting the remuneration was possible, but not necessary:

> In this context, it is worth noting, even if not as legal precedent in nature or scope, that there are numerous cases in which our Supreme Court has examined claims by company directors seeking remuneration that the company refused to pay them, cases in which the Supreme Court examines the merits of the case as a matter of course and without at any time questioning the possible inadmissibility of this type of action where the claimant director has not exhausted the corporate channels by first challenging the internal resolutions that determined the position adopted and expressed by the defendant company. In this

> regard, reference can be made, among others, to the Supreme Court judgments of 24 April 2007, 31 October 2007, 19 December 2011, 10 February 2012, 25 June 2013, 3 April 2014, 17 December 2015 and 20 November 2018.

The Supreme Court confirms the idea that an article of the articles of association providing for the right to compensation for (no-fault) loss of office gives rise to the personal right to claim payment thereof (note that the case predates Act 31/2014):

> The regulation of the system for determining remuneration contained in article 43.2 of the articles of association, which essentially entrusts determination of remuneration to the Board of Directors, following a report from the Appointments and Remuneration Committee and subsequent ratification by the shareholders in General Meeting, does not mean that the creation of the right is subject to recognition by the company's bodies, as if the creation of the right depended on their will.
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> The right is protected by law and the articles of association, provided that the above conditions are met (with reference to 'no-fault' loss of office), and the intervention of the Board of Directors and the General Meeting are the channels through which the company's will is formed in response to this claim. And it is precisely the company's reluctance to recognise the claimed right that justifies the judicial remedy sought by demanding the remuneration the director considers appropriate from the company.

The Supreme Court also concludes that neither the Board nor the General Meeting resolutions need to be challenged:

> Although both the Board's resolution and the subsequent ratification by means of a General Meeting resolution could have been challenged through the appropriate channels, such a challenge was not the only recourse available to the removed director to claim his right against the Board's decision denying it, nor was it a necessary prerequisite for bringing the legal action.
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> It is therefore irrelevant, for the legal action brought by the removed CEO to be successful, that, having been informed of the Board's decision to deny him the compensation and variable remuneration claimed, he did not challenge that Board resolution or wait to challenge the General Meeting resolution ratifying it. Consequently, it is also irrelevant that the statutory time limit for challenging those resolutions has passed.

In conclusion, the right to compensation for loss of office arises from the moment

the event giving rise to the entitlement provided for in the articles of association (loss of office) occurs. The company's unjustified refusal to pay the compensation — expressed through its corporate bodies (board of directors with ratification by the shareholders in general meeting) — enables a claim for money owed plus interest, without the need to challenge such resolutions.

3. Bad leaver and scope of the business judgment rule (Art. 226(2) LSC)

The most complex factual issue in the dispute between the company and the removed director was to determine whether the loss of office was owing either to defective performance of the obligations inherent in the position or, on the contrary, to a simple loss of confidence in the director (*ad nutum* revocation). As this is a fact that prevents the payment of compensation for loss of office (an exception), the burden of proof of non-performance would fall on the company, and the Provincial Court did not consider it proven that the claimant had breached his duty of care whilst holding office or, in other words, that he had acted in dereliction of duty, taking into account that the obligation to manage is an obligation of conduct and not of result.

In order to justify its decision, the judgment considered, correctly, that it should analyse the allegations of lack of care made by the defendant company on the basis of the business judgment rule provided for in Article 226(2) LSC, which, although not in force at the time of the events, would respond to a principle established in case law prior to the 2014 amendments to the Companies Act, which would prevent "turning the judge into an oversight body for financial misjudgement".

In the court's opinion, the director made his decisions (strategy to refinance the loan for the acquisition of Repsol shares) in good faith, without personal interest, with sufficient information and in accordance with an appropriate decision-making process, which would allow the standard of care required of a director to be considered fulfilled (together with, therefore, the no-fault nature of the loss of office). Even so, the court analysed the conduct and did not find that the decisions taken "were reckless, let alone manifestly or indisputably reckless, which is what would be required in order to consider that he had breached his legally required duty of care, taking into account the nosiness judgment rule".

The 'cassation' appeal (appeal on the grounds of a breach of the provisions governing the determination of a dispute) claimed an improper application of Article 226(2) LSC because it was not in force at the time of the events and because it was a rule designed exclusively to resolve director liability claims.

The Supreme Court rejected the grounds for this appeal for the following reasons:

> The court does not apply a legal provision retroactively, which did not exist at the time the events under trial took place, but rather resorts to prevailing 'truisms' in the adjudication of corporate disputes (referring to legal topics, such as a repertoire or repository

> of points of view or approaches) to guide the resolution of the case. In this case, these are truisms that allow for an analysis of whether there has been a breach by the executive director that would justify his removal and, therefore, non-entitlement to compensation for los of office.
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> In any case, and regardless of the standard of care applied, it should be noted that the Provincial Court does not identify any dereliction in Mr Roberto's conduct.

To this it adds that the business judgment rule does not only apply in the field of directors' liability:

> The fact that a breach of the duty of care in strategic and business decision-making is normally reflected in liability claims (Articles 236 et seq. LSC) does not preclude other consequences, such as, in this case, the removal as an executive director without entitlement to compensation. Thus, this business judgment rule has been used by the Court outside the framework of director liability claims [citing the Supreme Court judgment of 17 January 2012 on the challenging of company resolutions].

4. Setting the amount of compensation: the director's appeal

With regard to setting the amount of compensation, the statement of claim merely specified the rules established in the articles of association of other listed companies that calculated the amount of remuneration using multiples of fixed remuneration.

According to the claimant, the articles of association of the companies compared established as an average the payment of compensation for loss of office corresponding to three years' fixed remuneration, which in this case amounted to eight and a half million euros. In addition, the compensation the director would have been entitled to earn for unfair dismissal under the Workers' Statute Act (days of salary per year worked) would result in a very similar amount, the payment of which is requested in the alternative. The statutory appeal also provided certain information regarding the calculation of compensation for loss of office paid to CEOs of comparable companies, all of which exceeded the amount requested in the claim.

The Provincial Court highlighted the deficiencies in the evidence provided by the claimant on this point, but resolved the dispute on the basis of a statement contained in the defendant company's response to the claim (in application of Article 405(2) LEC):

> However, we must bear in mind that on page 84 of its statement of defence, SACYR clearly stated that, in the event that the court did not uphold the grounds invoked for denying the compensation (bad leaver), then it considered that the compensation should not exceed the amount

> represented by one year and three months' remuneration.
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> That, and no other, will therefore be the quantification system we will opt for, not so much because this court has reached the conclusion that such a system leads to fair compensation, but because, in the absence of conclusive evidence as to what that fair compensation should be, evidence that the claimant has failed to provide, it is the only one that the defendant SACYR accepts, even if it is in the alternative.

The Provincial Court thus upheld the director's appeal and ordered the company to pay three and a half million euros in compensation for loss of office with interest, not from the date on which the compensation was set by the court (as would seem appropriate), but from the day following the end of the accrual period (1 January 2012).

The removed director disagreed with the Provincial Court's decision and appealed to the Supreme Court, claiming that the appellate judgment had deviated from the criteria established in the articles of association for setting compensation for no-fault loss of office ('market conditions') and, in doing so, had infringed Article 217 LSC (wording prior to Act 31/2014).

The Supreme Court rejected the appeal, being of the opinion that the Provincial Court did not violate this rule, but rather that there was a lack of evidence of the 'market conditions' applicable to the calculation of the compensation due in accordance with the articles of association, evidence that should have been provided by the claimant.

5. Conclusions

1) The first conclusion to be drawn from this judgment is interesting for all cases in which the determination of the specific amount of remuneration to be earned by a director is attributed to a body of the company, whether the general meeting of shareholders or the board of directors, based on the items of remuneration provided for in the articles of association or the service contract. The judgment makes it clear that it is not necessary to challenge the resolution if one does not agree with it. If the director is entitled to earn remuneration, he or she may claim payment regardless of whether or not he or she has challenged the resolution.

2) The second refers to the role played by the so-called *business judgment rule* in the general framework for determining the content of the duty of care required of any company director. This is an expression of the model of conduct of a reasonably diligent person, which integrates the obligation to manage as an obligation of conduct. As expressly provided in Article 226(2) LSC, the indicated standard of care shall be deemed to have been duly observed if the procedure laid down in that legal provision has been complied with. Logically, this applies for all purposes (*e.g.*, determining whether it is the case of a bad leaver) and not only

for the purposes of filing a director liability claim.

3) It is worth considering whether a case such as the one decided on in this judgment would be resolved in the same way under the legal regime for directors' remuneration provided for in the current Companies Act following the amendments carried out by Act 31/2014, which requires the approval of annual remuneration by the shareholders in general meeting (including compensation) or proof of the right to compensation in directors' service contracts. In our opinion, the mere inclusion in the articles of association of the right to compensation for loss of office 'under market conditions' would not suffice to claim payment if such remuneration has not been provided for in the relevant contract in accordance with the provisions of Article 249(3) LSC (in the case of directors with executive functions) or its amount is not included in the maximum remuneration that may be paid according to the resolution of the shareholders in general meeting (in the case of directors with supervisory functions) as required by Article 217(3) of the same piece of legislation.