A judicial decision setting limits to the corporate liability of directors

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The Madrid Court of Appeal has rendered a decision on 3 November 2015 in which it set limits to the corporate liability of a Spanish company's CEOs.

The case heard by the Court can be summarised as follows: in 2007, METROVACESA, one of the largest property companies in Spain, granted a €50 million loan to one of its subsidiaries for the purchase of long-term convertible bonds (ten years) with an annual interest of 1.25%, issued by a Luxembourg company. The investment was later reduced to €40 million following a partial redemption by the issuer. The transaction was promoted by the president of the board of directors and carried out by its Corporate Development Department, without the involvement of the CEO.

Sometime after the transaction had been executed and once the financial situation of the issuer was analysed, METROVACESA concluded that it would not recover the investment.

On the basis of the above facts, METROVACESA brought an action against its former CEO pursuant to the Spanish Companies Act. METROVACESA sought damages in the amount of €40 million (plus interest) from its former CEO, claiming that he had acted negligently in the execution of his duties by not informing himself about the destination of the funds and preventing the transaction.

The Commercial Court of Madrid dismissed the claim. The Court of Appeal has now confirmed the first instance's decision and laid down some criteria relating to directors' liability.

The Madrid Court of Appeal said that a CEO has a duty to control the company's management that involves not only the day-to-day management, but also significant transactions. Nevertheless, it is reasonable that in a large company like METROVACESA not all the decisions are taken or supervised by the CEO.

The fact that the CEO had not personally promoted the transaction at hand does not *per se* release him from liability, because the internal distribution of the decision-making processes within a company does not automatically discharge directors from their responsibilities. Such a discharge would only come into play if there were reasons that justify a given act or omission of a company director.

Applying the above criteria to the case at hand, the Madrid Court of Appeal found that when METROVACESA's CEO became aware of the controversial transaction there were no reasons of sufficient weight against it. Therefore, the lack of reaction of the CEO was justified.

The Court took into consideration *inter alia* the following circumstances:

(i) It was not unusual for METROVACESA to finance said affiliate in similar transactions;

(ii) The loan to its affiliate had been granted under market conditions; and

(iii) The amount of the loan was not excessive in the context of the day-to-day transactions of the company. Indeed, such a transaction fell within the limits of METROVACESA's ordinary transactions, which did not require previous authorisation by the board of directors.

In light of the above, the Court concluded that directors do not need to voice their objection against a given act or decision unless *warning signals of a certain entity* are present.

In our opinion, the Madrid Court of Appeal's approach to directors' liability is correct in that all the circumstances surrounding the case need to be taken into consideration. As the Court put it,

> *"it is important to have a realistic approach when determining what constitutes a reasonable degree of fulfilment of the duties inherent to directors' roles, especially when an omission is reported; the opposite could led us to the point of transforming directors' liability into a purely objective liability, which is a type of liability foreign to this legal figure".*