

## **Directors' duty of diligence and business judgment**

Madrid, June 2023

The Spanish Supreme Court (SSC) has issued an interesting ruling<sup>1</sup> upholding a liability action by a subsidiary of one of the world's leading telecommunication companies against its directors and finding that their behaviour did not fall within the business judgment rule<sup>2</sup>.

The SSC ordered the directors to pay the damages suffered by the company due to a tax fraud committed by some of its suppliers regarding which they failed to adopt any mitigating measures.

The main facts can be summarized as follows:

- In July 2013 the Spanish Tax Agency (STA) opened an investigation regarding a possible VAT fraud involving several suppliers of the company.
- On 4 February 2014 the STA held a meeting with an employee of the company's tax department. She was informed about the fraud and requested to carry out an internal investigation.
- On 30 April 2014 a new meeting was held, although on this occasion between the STA and some of the company's managers and directors. The latter were requested to put an end to the commercial relationships with the suppliers. However, they failed to comply with the request alleging that they considered the evidence against the suppliers inconclusive and that the termination of the relationships with them would be detrimental for the company's business.
- On 17 July 2014, after new requirements from the STA, another meeting was held and the company's managers and directors conveyed their decision to collaborate with the STA.
- On 29 January 2015 the company signed a tax compliance certificate before the STA admitting it (i) had carried out transactions with the suppliers involved in the tax fraud, (ii) should have known that those transactions were part of a fraud and (iii) hence, was not entitled to deduct the VAT paid to those suppliers from January 2011 to February 2014, which amounted to circa EUR 72 million.

The company then brought a liability action against its directors based, among other grounds, on their lack of diligence for not having put in place adequate measures, despite being aware of a serious tax risk, and claimed as damages the tax debt that the company had to pay due to the regularization.

A first instance commercial court of Madrid dismissed the claim and the company filed an appeal before the Madrid Court of Appeal (MCA) that was partially upheld.

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<sup>1</sup> Judgment of the SSC 443/2023 dated 31 March 2023.

<sup>2</sup> Article 226 of the Spanish Companies Act.

The MCA found that the directors deliberately failed to implement the necessary measures after the company had been informed of an ongoing tax investigation, breaching thus their diligence duties. However, the damages awarded by the MCA were lower than those claimed by the company, namely the VAT that the company had not been able to deduct between February 2014 and August 2014.

The MCA's decision was appealed before the SSC by both parties.

Among other grounds, the directors alleged that the MCA's decision breached the Spanish business judgment rule and the SSC's case law since (i) it was influenced by a hindsight bias, given that the MCA should have analysed the directors' behaviour "based on the information they had during the reference period" and (ii) business decisions cannot be second guessed only because they have had negative consequences.

The SSC upheld the directors' appeal partially, as it reduced the period during which the directors should be held liable. The SSC found that it should start when the directors surely became aware of the fraud and were formally required to terminate the commercial relations with the suppliers involved in the fraud (i.e. 30 April 2014).

However, the SSC dismissed the remaining grounds of the directors' appeal:

- (i) It confirmed the casual link between the directors' omission to adopt measures and the damages suffered by the company, stating that "had the directors adopted the necessary controls, the STA would not have obliged the company to carry out a tax regularization".
- (ii) It found that the directors' omission was out of the scope of the business judgment rule, since it did not result from a mistaken strategic or business decision, which are the types of decisions protected by this rule, but from an omission to terminate the relationship with the suppliers involved in the fraud.
- (iii) Finally, it is worth mentioning that a serious illness suffered by one of the directors did not prevent the SSC from confirming his joint and several liability. The SSC noted that, although the director had remained aside from the company's management until mid-2014, he had not formally resigned and had participated in the meetings regarding the tax investigation.

As seen in the case at hand, directors should not only be cautious by putting in place preventative measures, but also vigilant and cooperative when an investigation is opened, regardless of the impact this may have on the business.