

VK&t

NEWSLETTER NO. 4 – RECODIFICATION

Dear clients,

The subject of this newsletter is to outline to you the summary of major changes in the area of Executives (Service) Agreements. The members of corporate bodies of capital corporations that have Executive's (Service) Agreements must bring their attention to transitional provisions of the Act on Business Corporations (Act. No. 90/2012 Coll.), (the "BCA"), particularly to its section 777(3). Pursuant to this provision, the Executive's Agreements must be modified within a period of 6 months commencing as of January 1, 2014, otherwise the execution of the office of the corporate body will be considered as carried out for free.

The new law is more detailed than the previous law (Section 66d of the Commercial Code) and allows greater possibilities to regulate internal relations within business corporations.

The Executive's (Service) Agreement (hereinafter as the "*Service Agreement*") remains optional, while capital corporations (limited liability corporation and joint stock company) must execute any *Service Agreements in written form* and must have these approved (including any amendments) by the supreme body of the corporation, i.e. the general meeting. An agreement executed in other than written form (orally or implied by conduct) would be considered invalid, and raises a question whether the performance of the relevant corporate office would be considered as for free (see comments below). *Service Agreement* in written form is also recommended for all remaining types of corporations due to legal confidence and also the need to have it approved by the supreme body (agreements executed in other than written form would lead to difficulties in the approval process).

The *Service Agreement* must be submitted to the supreme body of the corporation for approval. In case of a limited liability corporation and a joint stock company, the approval is given by the general meeting. If the members of the board of directors of a joint stock company are elected by the supervisory board, the same body must also approve their *Service Agreements*. In this respect the new law corresponds to the previous law.

Pursuant to Section 59(2) of the BCA, it is possible to obtain consecutive (additional) approval of the agreement within capital companies. Also note Section 59(4) of the BCA, pursuant to which the supreme or another legitimate body (supervisory board pursuant to Section 438(2) of the BCA or Section 463(1) of the BCA) must approve the agreement *without any undue delay*; absence of such approval (due to actions on the side of the corporation) constitutes a right of the relevant member of the corporate body to a service fee for the performance of the office *at standard rate*, not at the rate agreed under the Service Agreement. In order to avoid this unwanted situation, it is recommended in practice to obtain the approval of the relevant corporate body and the relevant office holder for the Service Agreement, prior to its execution.

With respect to joint stock companies, consider also the new possibility under the BCA that allows the founders of the company to choose either the dualistic (general meeting, board of directors and supervisory board—Section 435 *et seq.* of the BCA) or monistic structure (administrative board and statutory director—Section 456 *et seq.* of the BCA) of its corporate bodies. In case of the monistic structure, the management of the company may be concentrated into the hands of one person only, as the relevant bodies can be single-membered. Companies are not obliged to expressly (actively) opt for one or the other system, but in the absence of such selection or in case of doubts with respect to interpretation of the Articles of Association, it is presumed that the company opted for the dualistic system.

In case of the monistic system of management of a joint stock company, the Service Agreement of the statutory director is approved by the administrative board (Section 463(1) of the BCA). If the board of directors of a joint stock company operating in the dualistic system is appointed by the supervisory board (this power must be vested to the supervisory board by the articles of associations—Section 438(1) of the BCA), the supervisory board also approves the Service Agreements for the individual members of the board of directors (Section 438(2) of the BCA).

Pursuant to Section 48 of the BCA, absence of required approval of the supreme body of the corporation for legal acts renders such acts invalid; such invalidity may be claimed within 6 months from the day the person authorised to claim such invalidity learned about it, and no later than within 10 years from the relevant legal act. It is therefore relative invalidity, not absolute (“automatic”) invalidity. As the “approval” of the Service Agreement by the supreme body of the capital company should be nothing more than “approval”, the application of Section 48 of the BCA must also be considered in respect to Service Agreement where such approval is absent.

In capital corporations, the Agreement must be executed in written form and approved by the supreme body of the corporation. If the agreement does not specify the remuneration, it is deemed that the office is performed *for free* (Section 59 (2),(3) of the BCA). Failure to include remuneration provision in the Service Agreement can cause to the office holder significant impact to his earnings.

The Service Agreement for capital companies must include the description of all individual components of the service fee, benefits and profit share entitlements, including any methods for their calculation (Section 60 of the BCA). Namely the Service Agreement must include the following information:

- specification of all individual components of the service fee to which the office holder is (or may be) entitled, including specification of any in-kind contributions, pension and other scheme contributions and any other benefits that are to be provided;
- specification of the amount of the service fee and the method for its calculation and its type;
- specification of rules for any bonus schemes and profit share (if applicable);
- information concerning any benefits and payments to the office holder based on transfer of securities or security option plans, applicable also to any close persons of the office holder.

Failure to comply with the requirements specified in Section 60 of the BCA may lead to application of Section 59(3) of the BCA—i.e. the performance of the office will be considered as for free. This negative impact will not apply in the three following exemptions presumed by Section 59(4) of the BCA:

- a) if the Service Agreement or the provisions concerning the remuneration of the office holder contained therein are invalid due to reasons accountable to the company; or
- b) if the Service Agreement is not entered into due to obstacles on the side of the company; or
- c) if the supreme body of the company fails to approve the agreement without any undue delay after the appointment of the relevant member of the corporate body into the office

In the above case the service fee will be set at a standard rate applicable at the time of the execution of the Service Agreement or, if no Service Agreement had been entered into, at a rate corresponding to the rates applicable to corresponding activities performed by the member of the relevant body at the given time (Section 59(4) of the BCA).

There have also been some professional opinions of legal experts stating that in cases when the Service Agreement is not executed, the entitlement to a standard service fee will also be established (i.e. not only in situations described under Section 59(4) of the BCA), and the company shall provide remuneration at the standard rate.

Any other payments or benefits (save for those arising from statutory provisions of the Service Agreement) can be provided to the office holder only with consent of the relevant body that approved the Service Agreement and the statement of the controlling body (where applicable) (Section 61(1) of the BCA). This provision shows how the new law aims to protect the shareholders of business corporations against any unauthorised transfer of assets from within the company.

Section 61(1) of the BCA, i.e. the rule under which the body that approves the Service Agreement must also approve any other payments or benefits provided to the office holder, will also apply to any salary or in-kind benefits provided to the office holder or to any of his close persons, under employment contract that covers cases when the office holder is also an employee of the company (Section 61(3) of the BCA).

Another rule of significant importance that may bring a negative effect to the members of corporate bodies is determined under Section 61 (2) of the BCA. According to this Section, the company will not provide any payments or benefits under the Service Agreement or pursuant to Section 61(1) of the BCA, *if the execution of the office evidently led to bad financial results of the company*, unless the body that approved the Service Agreement decides otherwise.

The BCA furthermore determines that if the office holder is also to receive any shares or (option plans with respect to shares acquirement), the Service Agreement will also have to include all relevant terms and conditions for such option plans. This rule will also apply if the shares are to be acquired not by the office holder directly, but by any of his close persons.

We would like to bring your attention the following areas for your consideration:

1) Office Term

Pursuant to Section 439(3) of the BCA, the Service Agreement may specify the duration of the office term and in case of disputes between the provisions of the articles of associations and the wording of the Service Agreement, the office term specified under the Service Agreement shall prevail. The same shall apply to members of the supervisory board of a joint stock company (Section 448(4) of the BCA). If the Service Agreement does not include specification of the office term, it is presumed by the law that such office term had been agreed for 1 year.

2) Resignation Notice

Pursuant to Section 59(5) of the BCA the resigning member shall inform the body that elected him into the office about his resignation. As this solution may not be always the most optimal solution for the company, the law allows for the Service Agreement to agree on a different method (body) for notification about resignation from the office. Also note that under the new law, *a member of a corporate body may not resign from his office during a period in which his resignation is not suitable for the company*. The term “not suitable for the company” is to be yet interpreted by case law, but we can presume that this will apply to situations in which the resignation of the office holder would have a negative impact on the company that cannot be averted by any other means than the continuance of the office; for example, by his resignation, the office holder would endanger realization of some significant business deal that is already at its final stage.

The foundation of the new law is its emphasis on exercising the management of a business corporation with the care of diligent manager. In relation to the Service Agreement the key provision lays in *Section 62 of the BCA*.

Pursuant to the above Section, if the proceeding for declaration of bankruptcy is initiated by a third party (creditor of the company), by which the company is declared bankrupt, the members of the corporate bodies may be obliged to return any payments and in-kind benefits provided to them by the company during a period of two years preceding the bankruptcy declaration. This rule will apply if the individual members of the corporate bodies knew, or should have known, about the threatening bankruptcy (as classified by the Act No. 182/2006 Coll., Insolvency Act) and in breach of their duty of corporate management with the care of diligent manager did not carry out all required and reasonably presumed measures in order to avoid the bankruptcy. The company is deemed to have threatening bankruptcy if it can be justifiably presumed, with respect to all circumstances, that it will not be able to duly fulfil a significant part of its payment obligations as these fall due. The bankruptcy trustee will then be authorised to invite the members of the corporate bodies (applicable also to former members appointed during the two year period) to surrender their benefits received from the company. This may affect the individuals quite markedly. The new law also deals with situations when the company provided in-kind benefits to the members of the corporate bodies and the return of such in-kind benefit is now not possible. In such a situation, the office holder will be required to return financial compensation corresponding to the value of the in-kind benefit provided.

The BCA does not include any provisions regarding parallel execution of the office of the statutory body and managing employee (such as financial or managing director). Section 66d of the old Commercial Code allowed for such parallel engagement between the period January 1, 2012 and December 31, 2013, provided the statutory body (such as board of directors of joint stock company) delegated certain powers within the field of business management to one of its members and such powers could also be executed within an employment relationship. After January 1, 2014 we cannot find any such regulation in the new BCA or any other statutory provisions. This leads to ambiguity as to whether such parallel execution is allowed. Members of the statutory body will still be able to be employed by the company, but only for activities that do not overlap with business management of the company. Certain professional opinions lean towards the interpretation that it is also possible for the members of the statutory body to carry out activities that are classified as business management of the company in two different types of relations—corporate and employment. However the key condition for this should be a clear distinguishing between the individual activities and powers of the individual. This will be very difficult in practice and therefore we recommend having only a single agreement (Service Agreement) signed with the members of the statutory body of the corporation. The Service Agreement may also include provisions that resemble provisions common in employment contracts such as annual leave, benefits, etc.

The new law brings more demands to the office holders, while the repercussions for the breach of management duties will be more significant. We recommend having all existing Service Agreements reviewed by a professional to ensure their compliance with the new law and needs of the individual parties. From a practical point of view we suggest having all monies and other in-kind benefits, which are to be provided by the company to the office holders, described in the Service Agreement.

We believe that the above summary will allow you better orientation in the new law. We are available for all your requests for any additional information.

Our newsletters are prepared in order to provide general guidance on relevant matter and cannot be considered as exhaustive professional advice. We are not able and cannot address any specific circumstances or needs in this newsletter. We do not recommend acting upon the information contained therein without obtaining independent professional advice first which we will be glad to provide at your request. No representation or warranty is given as to the accuracy or completeness of the information contained in this publication.