DIRECTORS' CONTRACTS – CLARITY AT LONG LAST

In its April 2018 judgment in the *MIDESTA* case, the Grand Chamber of the Czech Supreme Court reversed its long-held – and rather notorious - view on the interplay between corporate and employment law in the field of contracts governing the terms of office of directors of Czech corporations. The issue, known on the local market colloquially as "*concurrency of positions*", has haunted Czech companies and their directors for many years, and has been subject to a number of twists and turns in both statutory and case law.

It seems now, that at long last, the story might finally be over, with the *MIDESTA* judgment bringing both clarity and practical workability to Czech corporate practice.

The problem with "concurrency of positions"

Up until about the mid-2000s, it was very common for Czech companies to enter into a dual relationship with their directors. The terms of the directors' corporate office would have been documented in a commercial-law governed service agreement, or sometimes even left to be regulated by statutory rules alone (for the risks related to this, see our recent client briefing on the *EURO MALL* case). In parallel, companies would also enter into employment-law governed agreements, setting out the terms of the directors' executive employment. The reasons for this dual structuring have been many and they have varied in time, including initial differences in the tax and social security treatment of the two types of arrangement. Even after these were removed, corporate directors often insisted (and still insist) on being employed with the company as well as elected to the board, the former arrangement being often perceived as more secure from the directors' point of view and also more beneficial to the directors in terms of rights under the state social security system, etc.

Key points

- **The Grand Chamber reversed previous Supreme Court's case law on directors' agreements**
- **Employment agreements entered into between Czech companies and their directors will no longer be at risk of being found unenforceable**
- **However, key parameters of the relationship between a company and its director will nevertheless always be subject to the mandatory rules of company law, not employment law**

Much to the surprise of all those involved, a line of Supreme Court cases starting in 2004 put this practice in question. The case law argued that it was not lawful for a company and its directors to enter into an employment relationship in so far as the job description overlapped with the remit of the directors' corporate office. This development had quite dramatic consequences for the parties, in particular the directors. With the validity of their employment-law governed agreements put in question, the directors could potentially face claims for the return of salaries and other benefits paid to them under their agreements, a risk which tended to materialise in particular where the director and the company parted ways on less than amicable terms, or if the company ended up insolvent.

The issue came to the fore in the early 2010s and resulted in an amendment to the Czech Commercial Code (which then harboured the law of corporations), which sought to reverse the case law by specifically foreseeing "*concurrency of positions*" and thus to make it clear that statutory law had no objections to it, provided that the

conditions set out in the new rules were met. Unfortunately, these rules were repealed on 1 January 2014 when the Commercial Code was superseded by the new Civil Code and the new Business Corporations Act which failed to take the rules over.

Thus, after a brief respite, Czech corporate practice was again facing uncertainty on the very basic issue of the proper legal regime of the directors' offices. One high profile litigation between a company and its former director hinging on the problem of "*concurrency of positions*" resulted in the Constitutional Court taking, to the surprise of many, a very critical stance on the Supreme Court's case law (judgment no. I. ÚS 190/15 of 13 September 2016, in re *OLMA*). Following the *OLMA* case, the market has been eagerly awaiting the Supreme Court's response. The opportunity came in the *MIDESTA* case.

The facts of the case at hand

The facts in the *MIDESTA* case (judgment no. 31 Cdo 4831/2017 of 11 April 2018) exemplify the risks following from the Supreme Court's case law quite well. A former chairman of the board of PROFIMONT, a Czech joint-stock company, was defending a claim by PROFIMONT's insolvency trustee who sought to reclaim salaries paid to the director between 2008 and 2010 under an employment-law governed agreement entered into in 2008. The plaintiff based the suit on the argument that, in line with pre-existing Supreme Court case law, the employment-law governed agreement was void because the job description (the defendant was employed as a CEO) essentially overlapped with the defendant's responsibilities as the chairman of the company's board. Apparently, while the case was pending, PROFIMONT's trustee assigned the claim to *MIDESTA,* who stepped into the litigation as the plaintiff in the trustee's place.

The case made it all the way to the Supreme Court, the trial and the appellate courts having struck the suit out on the basis of various arguments, including having regard to the Constitutional Court's intervening decision in re *OLMA*. Importantly, it appears from the facts as they were rendered in the Supreme Court's judgment that the courts were satisfied that there was no causality between the defendant having served as PROFIMONT's director and the company's subsequent insolvency.

The Grand Chamber's judgment

At the Supreme Court, the case made it to the Grand Chamber.

In an extensive opinion, the Grand Chamber decided to reverse the court's previous case law. It took the view that corporations and their directors are free to choose the Labour Code as the governing code of the contract setting out the terms of the director's office. Equally, the parties are also free to enter into two parallel agreements, one setting out the terms of the director's office as such, the other documenting the terms of his or her employment with the company. However, the mere fact that the parties have chosen to agree the terms of the director's services under the Labour Code will not turn the relationship between the company and the director into one of employment whereby the director would perform work under the company's directions. No matter what type of agreement the parties choose, the Grand Chamber held, the relationship between the company and the director will always remain a business law relationship, and the agreement entered into will thus not alter the mandatory rules of company law applicable to relationships between companies and their directors. Employment law rules will apply only in as much as they do not interfere with such mandatory company law rules.

To be as instructive as possible, the Grand Chamber went on to give a number of examples of issues which will always remain subject to company law. These will include the shareholders' flexibility in appointment and dismissal of the director, the minimum legal requirements which a director must meet, the director's remuneration and the approval of the remuneration by corporate bodies, the director's duties (including the duty of care and of confidentiality) and the corresponding liabilities, in particular the fact that the liability cannot be limited, as well as the corporate approval of the terms of the agreement itself. For these reasons a careful consideration is recommended rather than making general references to either the Labour Code or the company law when drafting or amending the directors' agreements.

CLIFFORD CHANCE

Implications of the *MIDESTA* case for current corporate practice

The *MIDESTA* case has been decided under the law as it was prior to the end of 2011. However, rather than being a draw-back, this makes the case useful in the present circumstances. This is because by repealing the Commercial Code's bespoke rules addressing the issue of "*concurrency of positions*", the new codes in force since 1 January 2014 basically returned the law to the state in which it was at the time relevant to deciding the *MIDESTA* case.

The current rules in Sections 59 to 61 of the new Business Corporations Act indeed closely match those pursuant to which *MIDESTA* was decided. One can therefore argue that the *MIDESTA* case not only puts a lid on a rather ugly past, but also serves as useful guidance on the legal position under the current law. This is despite the fact that the *MIDESTA* litigation did not end with the Grand Chamber judgment, the Supreme Court having quashed the previous decisions on jurisdictional grounds and returned the case back to first instance. The reasoning on the substantive issues was pronounced so clearly that there are strong grounds to believe that the market will nevertheless be able to rely on them.

CONTACTS

Tomáš Richter
Of Counsel

T +420 222 555 222
E tomas.richter
@cliffordchance.com

Veronika Kinclová
Associate

T +420 222 555 222
E veronika.kinclova
@cliffordchance.com

Alex Cook
Managing partner

T +420 222 555 222
E alex.cook
@cliffordchance.com

David Koláček
Partner

T +420 222 555 222
E david.kolacek
@cliffordchance.com