PRAGUE'S HIGH COURT OF APPEAL: THE PROVISION IN A SHAREHOLDERS AGREEMENT WHEREBY THE SHAREHOLDERS AGREE TO ENSURE THAT THE DIRECTORS NOMINATED BY THEM FOLLOW THEIR INSTRUCTIONS IN DAY-TO-DAY MANAGEMENT IS INVALID

Prague's High Court of Appeal ruled in its judgment of 23 January 2019, file ref. 14 Cmo 23/2018 (the "**Ruling**"), that the provision in a shareholders agreement imposing an obligation on the company's shareholders to ensure that the board of directors members nominated by them follow their instructions in day-to-day business management is invalid because it is in conflict with Section 194(4) of the Commercial Code, which stipulated a prohibition on instructions being given to board of directors members regarding day-to-day management.

The contested provision of a shareholders agreement stated that if a need arises to provide funds to a joint-stock company (in Czech *akciová společnost*), the shareholders are obliged to ensure that the company's board of directors members nominated by them agree on the amount of the funds needed and that they deliver a written request for the provision of funds to the shareholders along with a draft loan agreement. Any breach of the shareholders' obligation to ensure the compliance with the obligation of the board of directors members was subject to a contractual penalty.

In its Ruling, the High Court of Appeal stated that any decisions on how a company's operations are to be financed are part of the company's business management, i.e. day-to-day management (in Czech *obchodní vedení*), which falls within the responsibilities of the board of directors. The High Court of Appeal concluded that the contested provision of a shareholders agreement is therefore invalid because it is in conflict with Section 194(4) of the Commercial Code which prohibits anyone from giving instructions regarding day-to-day management to the board of directors. The High Court of Appeal thus upheld the first-instance ruling which dismissed an action for the payment of a contractual penalty with the explanation that the contractual penalty had not been validly agreed upon in the shareholders agreement. The case at issue was being decided under the Commercial Code. However, the High Court of Appeal also refers to Section 435(3) of the Business Corporations Act as currently in force because the rule concerned has not changed in terms of its content following the recodification. It can thus be assumed that the High Court of Appeal would render a similar ruling even if this provision were considered under the Business Corporations Act.

The Ruling was published in the *Právní rozhledy* journal together with a postscript saying that a provision contained in a shareholders agreement that is

Key issues

- Ruling by Prague's High Court of Appeal file ref. 14 Cmo 23/2018 of 23 January 2019
- The provision in a shareholders agreement imposing an obligation on the company's shareholders to ensure that the board of directors members nominated by them follow their instructions in day-to-day management is invalid because it is in conflict with law, specifically with Section 194(4) of the Commercial Code (Section 435(3) of the Business Corporations Act), which imposes a prohibition on instructions regarding day-to-day management being given to the board of directors
- The Ruling was published in *Právní rozhledy* no. 8/2019
- The Ruling was subject to severe criticism by several legal theorists whose comments were published in *Právní rozhledy* no. 17/2019

in conflict with Section 435(3) of the Business Corporations Act is null and void on the grounds of being clearly in conflict with the public policy, because the provision concerned sets out a rule of a status nature that defines an internal corporate relationship between a joint-stock company's governing and supreme bodies.

Shareholders agreements often contain obligations regarding performance by a third party within the meaning of Section 1769 of the Civil Code. An opinion prevails in relation to the actions of the board of directors that shareholders cannot agree on anything more than a promise of intercession pursuant to the first sentence of Section 1769 of the Civil Code, i.e. they cannot assume an obligation for a certain result but only for intercession with the board of directors members that a certain result will be achieved, because the board of directors members are obliged to perform their office with due managerial care, and thus independently.

CRITICISM OF THE RULING

The Ruling as well as the commentary published together with it, declaring similar provisions in shareholders agreements to be invalid, have thus caused surprise among experts. A very critical stance against them was taken, for instance, by Bohumil Havel, Kristián Csach and Jan Lasák in their comment published in *Právní rozhledy* no. 17/2019, where they described the Ruling as one of the most significant negative interventions in the functioning of the Czech equity and transaction market since the beginning of the new millennium. The key criticism of the Ruling can be summarised as follows.

Czech private law does not prohibit shareholders agreements. Shareholders agreements can also contain provisions that are contrary to articles of association and law, because a mere contradiction between a shareholders agreement and articles or association or law does not necessarily entail its invalidity. The contradiction of a shareholders agreement with a mandatory rule of corporate law should render the shareholders agreement invalid only in those instances where the purpose of the statutory rule so violated requires that not only the provision of articles of association contravening law but also the shareholders agreement establishing an obligation be held invalid.

The courts must always examine whether a particular decision is part of day-to-day management or whether it is rather a decision having strategic importance, as no general answer can be given to this question in relation to a certain type or kind of decision but always a specific one that takes account of the specific circumstances in which a certain decision is being made. For instance, the financing of a business corporation will fall under day-to-day management if the decision relates to the financing of day-to-day operations. However, a company's financial structure can be a key factor in the company's economic substance having an important impact on its value and as such will rightfully be the focus of the shareholders' interest. It will therefore be an issue of strategic importance. A certain guide for considering whether a decision falls under day-to-day management or whether it is an issue of strategic management is provided by the case law of the Czech Supreme Court, the most recent being judgment file ref. 31 Cdo 1993/2019 in which the Grand Chamber has defined day-to-day management in relation to the persons authorised by a company's governing body to be in charge of day-to-day management.

The discussed provision of the shareholders agreement should rather be construed so as to contain an obligation of the parties to make their best effort to ensure that the board of directors members seek an agreement and a solution to the lack of funds and subsequently deliver a draft loan agreement containing specific details. The shareholders agreement then does not lay down a binding instruction but rather follows a specific purpose to be achieved through the efforts of the parties. In other words, the shareholders did not agree to give binding instructions to the board of directors members but agreed on a procedure to be followed, which would logically be based on the assumption that the board of directors members who were to quantify the required amount of the loan would act with due managerial care. The shareholders agreement did not interfere in any way with the obligation imposed on the board of directors members to act with due managerial care.

It needs to be added that the provisions of a shareholders agreement are not binding on the board of directors members themselves (unless they are also the company's shareholders, which was the case at hand). Hence, the effects of a shareholders agreement are limited in this respect – no one may insist that board of directors members take certain actions on the basis of the shareholders agreement. If board of directors members decide to act in contradiction with the shareholders agreement, this contradiction will not render their decision invalid. A shareholder bound by the provision concerned naturally remains to be bound by the contractual obligation to make its best effort to ensure that the board of directors remedies this contradiction or that it does not make such a decision. However, this is purely a contractual liability having an effect limited in scope to only the parties to the shareholders agreement.

Last but not least, it may be pointed to the reinforced role of the principles of the autonomous will and freedom of contract of parties under recodified civil law. Both these fundamental principles make it much more difficult to seek the invalidity of the provision of the shareholders agreement at issue.

The position taken on the Ruling by the Czech Supreme Court , which has yet to rule on the case within the appellate review proceedings, will undoubtedly be of key importance for the practice of corporate law in the Czech Republic. If the Supreme Court upholds the Ruling, it could have a major impact on the current practice of negotiating and preparing shareholders agreements. The Supreme Court would nevertheless have to thoroughly deal with the arguments outlined above, which we consider convincing.

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