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LIABILITY OF STATUTORY ORGANS IN LIMITED LIABILITY COMPANIES

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Abstract

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Statutory organs of business companies (and similarly of co-operatives) have numerous obligations imposed by generally binding provisions; relied with these is the liability for non-fulfilment of the latter. Some of the obligations are imposed directly by the laws, some are assumed on contractual basis. Their infringements may lead to the liability for the situation and consequences occurred. The regulation of the liability of persons engaged in the company's bodies covers persons that are entrusted by the management of foreign assets. Sometimes these are in fact not entirely foreign assets because, although the assets are legally owned by the business company, persons acting as statutory organs are mostly partners (shareholders) in these companies as well. As such they manage the foreign assets but the company properties were created by their contributions or through the business by themselves. The paper analyses the requirements laid down for the function of managing directors (jednatel) in the limited company. Consequently it analyses the scope of the liability of managing directors firstly, in relationship to the company's creditors (persons standing outside the company) and, subsequently, in relationship to the shareholders. It also presents and characterises the recent trends in the Commercial Court's judgement of the conditions required for the liability for damage and claims for damages put forward by action to recover damages by the managing directors. *De lege ferenda* the paper recommends that the legal regulation will be amended by provisions limiting the scope of persons to be appointed as executive director and/or extending the liability for damages for the partners of the company in cases where the damage in such cases can not be compensated by the executive director and the partners should bear consequences for their *culpa in eligendo.*

limited liability, managing director, liability towards creditors, liability towards shareholders

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METHODS AND RESOURCES

The aim of the present article is to analyse the requirements laid down for the function of managing

directors (jednatel) in the limited liability company (thereinafter also "LLC"). Consequently it analyses the scope of the liability of managing directors firstly, in relationship to the company's creditors (persons standing outside the company) and, subsequently, in relationship to the shareholders. It also presents and characterises the recent trends in the Commercial Court's judgement of the conditions required for the liability for damage and claims for damages put forward by action to recover damages by the managing directors.

The examination of the liability of statutory organs in business companies shall be carried out and focused on the legal framework given for the limited liability company. Analysis will be enhanced by the comparison with existing or prepared legal regulation in the Slovak Republic, this because of identical roots of both regulation and many similarities, notwithstanding the fact, that both regulations go by their own ways for more that 15 years.

RESULTS AND DISCUSSION

Evaluation and exact description of the achieved results and/or stating the statistical significance The executive director (called in Czech terminology as "jednatel") in the limited liability company is very frequented position entrusted to managers within the legal regulation in the Czech Republic. The number of persons appointed to this position may reach about 350 000 persons. Especially in limited liability companies with small number of partners it is quite frequent that all partners or majority of them are at the same time appointed as executive directors. And as in the Czech Republic the LLC with relative small number of partners prevail, we may presume that the number of persons appointed to this position is rather higher than data quoted. This means that the problems connected with the liability of the executive directors is very frequented and topical at the same time. The topicality of the problems follows on one side the fact that that the legal regulation of the liability in the Czech business law is of quite recent date (2004), on the other side also the fact that the interpretation of the relevant provisions is sometimes different and the questions of interpretation have close relation to the liability when performing the tasks of executive directors. Another argument in favour of the topicality of the problems outlined is the effort of some LLC and persons who occupy the position of executive directors as partners in these companies to avoid possible consequences of bearing the liability for performing the function by appointing such persons as executive directors who especially by their very limited capability, insufficient education undeveloped feeling of responsibility do not offer adequate guarantees for the proper performance of the function of executive director.

Requirements to the performance of function of executive directors in LLC

The Czech Commercial Code does not define requirements for the performance of executive director in a business company for each type of such companies (and thus also for LLC), that perform such activities as subject of business that are trade licenses under the Trade License Act (TLA). However it is true that statutory organs of business company (including LLC) must fulfil general requirements for carrying out trades ruled by the provision of section 6 of TLA namely

- achieve 18 years of age,
- poses capacity to perform legal transactions,
- have clean record.

There are no problems in order to fulfil these criteria but the fulfilment itself does not safeguard the proper performance of the function in the company by the person in question.

The Commercial Code imposes in Section 194 para. 5 to executive directors of LLC duty to perform the function with the diligence of a careful manager. The diligence of a careful manager does not belong among the legally defined notions, however, we may state that under this not on we generally understand the knowledge and experience necessary for the performance of specific function, having due regard to the subject of business or activities (ELIÁŠ, K., 1999).

Among the scope of the notion diligence of a careful manager we can include following duties

- to obtain and take into account in decision-making entire disposable information concerning the subject-matter of the decision to be taken,
- keep in secrecy the confidential information and facts whose disclosure to third persons could cause injury or endanger the interests of the company or its partners,
- not to prefer his own interests or interests of only some of the partners or third persons to the interests of the company.

The availability of information necessary for decision-making of the executive director must be interpreted in that way that it concerns

- information available from frequently accessible information sources or from the inside of the company where the executive director is engaged,
- information that concern – as to its content – the subject-matter of the decision to be taken and
- as to the quantity it concerns information that is sufficient for taking the decision.

The availability of the information can be defiant also in a negative way, i.e. what can be considered as information insufficiency and thus as non-fulfilment of the requirement of diligence of a careful manager, and on the contrary, what exceeds the scope of the obligation to obtain information necessary for taking the decision.

The Commercial Code does not define the notion of confidential information either. It may be

concluded, however, that for confidential information shall be held information that is not frequently known, was not published, concerns directly the company the executive manager is engaged in and the enclosure of which could cause injury to toe company or threaten the interests of the company and/or its partners.

It is obvious that the performance of the statutory body in business company with the diligence of a careful manager. The Slovak Commercial Code, very close to the Czech Code in many aspects, can use in defining the notion confidential information the as legal regulation of Section 132, para. 1 Act on Securities and investment services. According to this provision, for confidential information can be held an information that

a) awas not published;
b) concerns one or several emitters or one or several investment instruments accepted for trading at the stock market or other relevant fact important for the exchange rate development or for the price of one or several investment instruments;
c) could, after its publishing, substantially influence the rate or the price of investment instruments accepted for trading at the stock market ands thereby bring to the holder or to other natural or legal person any advantages (MAJERÍKOVÁ, M., OVEČKOVÁ, O., 2005).

It is obvious that the performance of the function of a statutory body in business companies requires a certain degree of professional knowledge, capability, skills or other capacity (e.g. decisiveness, resolvedness, prudence etc.), attached to the individual concerned ("capacity" thereinafter). However, he does not need to prove this capacity in any way, e.g. by education, practical experience, passing an exam, obtaining a certificate etc. When considering who will be the most suitable candidate for the function of statutory body in a business company, the partners will follow their own ideas and opinions without examining if the person in question has certain education, practical experience or passed an exam proving its capability to perform such a function. When adopting a wrong decision that could have influence to the state of their business assets, they have chances enough to replace the person in question by another. Other situation will occur in the case when the partners in a business company should be interested in running business to the detriment of the creditors or if the present members of the statutory body would not be willing to accept the increased risk for the performance of their functions.

The persons performing the function of statutory body in business companies should be capable to perform such a function not only from the point of view of the interests of company and/or its partners but also from the point of view of the interests of the creditors of the company in question or of third persons in general.

Neither the Czech law or Slovak law presume that a person acting as statutory body in a business company would not be interested in fulfilling of his/hers tasks, this e.g. because he/she does not fear any detrimental consequences to his/hers property – e.g. if he/ she does not own any property and will not be in a position to compensate the damage caused by breaking the duties of a statutory body, this even in the case when he/she will be obliged to such performance by a court decision. In the sphere of commercial law are the acts of participants of business transactions motivated primarily by economic reasons. Therefore when examining the liability of persons acting as statutory body we need to examine the economic reasons that lead to the company's decision of legally appointing as the statutory body a person that will act albeit according to the instructions of the company partners, however, in the final effect against the interests of the company and especially those of third persons. This construction seems to be illogical and hardly probable one, however, the reality may be different. There are enough examples proving that persons acting as statutory body in a business company have not acted with the diligence of a careful manager or, rather have not acted at all and by this paradoxically did not acted against the interests of the company where they have been appointed as statutory body, and/or its partners, but acted to the detriment of the company's creditors or third persons in general. For characterising these persons the title "white horses" has been established.

Under such circumstances e.g. the requirement for specific education, amount of practical experience or passing a defined exam by this person could obviously work as certain protective elements. They would reduce the scope of persons that can perform the function of a statutory body in business companies at present because they fulfil the minimum criteria (age, capacity to perform legal transactions and clean record) but simply do not understand or understand insufficiently which duties follow for them from their appointment to the function.

One of the possibilities how to prevent the appointment for executive director in LLC somebody who does not safeguard – in spite of his education and intellectual capacities – the performance of this function with the diligence of a careful manager, is the legislative definition of an education qualification for the performance of this type of function (e.g. high school education or passing of a professional exam). Another option can be to extend the institute of preliminary approval by a competent State institution to the performance of given function by the person proposed. The institute of the preliminary approval is used and applied e.g. in the banking or insurance branches. The essence of this institute is that the person proposed must fulfil the criteria prescribed by law for the performance of the function and the State institution (in the case of the state control over the financial market the Czech National Bank) must give its approval, after consider-

ing whether the proposed person fulfils the criteria, to its appointment to such function. The approval is valid for a period of one year. However, both the previous approval and the intellectual census, could not apply to the executive directors in all LLC, but – for instance – only to those companies that are obliged under the Accounting Act to publish the information on their business results in a specified way (according to the Accounting Act, No. 563/1991 Gaz., business companies and co–operatives (when they create obligatory equity) must have, among others, their individual profit and loss account certified by auditor and prepare Annual reports when they meet in the previous year at least two of the following conditions 1) total sum of their assets exceeded 40 million Czech Crowns 2) net turnover exceeded 80 million Czech Crowns 3) average calculated number of employees exceeded 50).

The conditioning of the appointment to the function of executive director in LLC by an intellectual census could not be contrary to the Constitution because this would not cause a restriction of the right to run a business, only the right of the partners in LLC to appoint the executive director would, i.e. the person entrusted by the administration of the company assets (and by that with properties of their own) would be reduced.

Neither the requirement of a preliminary approval with the performance of function of executive director, awarded by the competent State institution, e.g. the Company Register Court or an body of business self–government, created with authorisation of the State, would be contrary to the Czech Constitution.

The tendency to perform some legal acts only by persons that fulfil the qualification requirements, e.g. with the involvement of services of advocates when closing contracts for purchasing of real estate or dealers with securities etc. can be seen as one of the contemporary trends through which the company (state) tries to provide protection to persons not educated enough or lacking the necessary practical experience before unallowable practice performed by other persons. An information society for which the contemporary society is held, is characterised, among other, by the fact, that by far not all persons can understand various products offered on the market and take decisions with due regard to all relevant circumstances. It seems as the society would split into a society of well informed persons, society of medium informed persons and society of insufficiently informed who because of the lack of information and knowledge are not capable of a fully-fledged existence within the society.

A specific question is whether it is possible that courts of justice will assess – within their discretion powers – for an act *contra bonos mores* a situation when this person objects that a business company has appointed for executive director a person for that it knew that he/she will be not capable of acting with the diligence of a careful manager because he/she has insufficient education and/or intelligence for such acting. In the case of a positive answer to this question we could solve the problem of establishing "white horses" as executive directors event without legislative changes in the contemporary legal regulation.

This could, in the event of an positive answer, solve the problem of appointing so called white horses in the position of executive directors even without legislative change of the regulation in force. The court as a body applying law considers the question in the framework of its discretion; however, the decision can be only within the defined limits, conditions, alternative rates, etc. (PRUSÁK, J., 1995). The court is in its considerations on the question nevertheless bound by the existing legal regulation, however, it is not a case of bound discretional right (even in the case of the free discretion, no court can decide *contra legem*). When evaluating the question of the capability of a natural person to perform the function of executive director under the existing legal regulation, the court would probably decide *contra legem* if it would evaluate the appointment of such person in the function of executive director as an act that is in contradiction with "*bonos mores*" or as an act contrary to the law or circumventing the law and thus invalid in accordance with Section 39 of the Civil Code.

A question that can be also discussed is the alternative ruling of protection of third persons interests towards the business companies in that act "white horses" in the functions of statutory bodies. We can mention in this connection the initiative of the Slovak legislators where the ministry of justice submitted the draft act introducing so called registers of disqualification that should include a list of persons disqualified through their previous activities by breaking the duties set for them by the law as for persons in specific positions (STRAKA, P., 2008). In this register should be recorded not only persons that have acted as members of statutory bodies in business companies or other entrepreneurial entities, but also members of Supervisory Boards, former administrators, liquidators, procurers, branch office managers – i.e. the so called persons liable. A person recorded in the register of disqualifications could not, for a specified period of time, not only to perform the above quoted functions but also participate in a foundation or other activities of business companies including the silent partnerships. Such person, however, could be recorded in the register of disqualifications only ex post, i.e. after he/she has committed a qualified breach of duties when performing the functions in question – in certain cases only after repeated breaches of these duties. The creation of the register of disqualifications should thus have first of all precautionary effects, i.e. should motivate persons acting in such positions to avoid breaking their duties and thus preserving then capability to perform the functions in statutory bodies also in the future.

The introduction of the register of disqualifications would, however, not solve the problem of the

"white horses" because a "white horse" can be used only once and there is a large number of potential "white horses".

The common feature of all above quoted proposals is, that they not remove the problem of qualification necessary for performing the function of executive directors, they can only reduce it to smaller or larger extent.

Liability of executive directors in limited liability companies

The detailed legislative ruling of the liability of executive directors in LLC in comparison to the liability of partners as statutory bodies in the partnerships (public partnership) and general partner (*complementaire*) in special limited partnership (*commandite*) follows the capital – based character of the LLC. The executive director who

- breaches its duties, especially the duty to perform the function with the diligence of a careful manager, the duty to keep in secrecy the confidential information and facts the disclosure of which to third persons could cause injury, or
- when performing his function prefers his own interests and/or interests of only some of the partners or third persons before the interests of the company

shall be liable for the damages caused by such breach of the duties.

However, the evaluation of the prohibition to prefer his own interests and/or interests of only some of the partners or third persons before the interests of the company can course problems in certain cases. As doubtful may occur especially preferring of interests of only some of the partners before the interests of the company. It can frequently occur that in a given LLC the interests of individual partners can differ and when deciding e.g. at the general assembly (thereinafter also "GA") it can be agreed that the interests occupied by some partners become identical with the interests of the company, whereas interests of other partners will differ from the interests of the company. E.g. if a LLC has several partners (for example five partners have identical shares in the company equity), in the position of executive directors of the company act only two of them and the general assembly of the LLC decides by the majority of three shares (including the votes of two partners acting as executive directors at the same time), the question then arises whether – when implementing this resolution of the company's GA, that contravenes to the interests of the two opposing partners – the executive directors acted in accordance with their duty not to prefer the interests of only some company partners. However, the example quoted above does not quite cover the purpose of the provision of Commercial Code, because the situation born in mind by it would occur rather in the case when the executive director would prefer the interests of some partners not on the basis of a GA resolution, but on a request of some partners only. The Code admits for the executive director liberation from the liability for damage caused by performance of the function, when he can prove that he has just implemented the resolution of the company's GA. However, this ground for the liberation hasn't absolute consequences because a GA resolution, even when not contrary to the legal provisions, deed of association or company's Statutes, can be contrary to the interests of the company, as it can be adopted as a consequence of the abuse of majority or minority of votes when it discriminates one of the partners. Under such circumstances the executive director would not exclude his liability by arguing that he has implemented the GA resolution (Ovečková, O. in MAJERÍKOVÁ, M., OVEČKOVÁ, O., 2005).

However, if the resolution of GA would contravene to legal provisions, deed of association or company's Statutes, the executive director would not avoid his liability by arguing that he/she has implemented the resolution of the GA.

The regulation of the liability of executive directors can be divided into two areas with respect to the persons entitled for damages:

a) Liability in relationship to the company's creditors, i.e. persons standing outside the LLC.

The basic precondition for the liability for the company obligations by members of statutory bodies is that they are liable for the damage caused to the company. According to the legal provisions of Commercial Code the members of statutory body that are responsible towards the company, bear joint and severe liability (what means that creditors can demand the compensation of the damage from one of the executive directors or from all of them, in both evens up to the full amount of the damage caused).

b) Liability towards the partners of the company

Also here is the basic precondition for the liability of the members of statutory bodies towards the company partners that they are liable for the damage caused to a partner as a consequence of adopting a resolution of the GA contrary to the legal provisions, deed of association or company's Statutes or for providing a compensation in the case of breaking a fundamental right of the company partner.

The law provides furthermore that the members of statutory body of a company that are responsible for the damage caused to the company caused by the fact that they did not proceed in accordance with their legal duties when adopting a GA resolution, bear joint and severe liability for the company obligation and it is not important whether the court of justice declared the resolution for void as a consequence of such proceeding.

The scope of the liability is limited by the amount of the duty of the members of statutory body to compensate the damage. The liability terminates at the moment when a member of the statutory body reimburse the company for the damage.

One of the problems in the legal regulation of the executive director's liability for damage in connection with the performance of his function is how to prove the breach of duties by the statutory body

members. The Amendment to the Commercial Code by Act. No. 370/2000 Sb. brought many positive changes in the regulation of liability of statutory bodies for damage caused to the company. One of them it the shift of the burden of proof for causing damages to the statutory body members. The legal regulation of the burden of proof for damages caused in the course of performance of the function of executive directors became more favourable from the point of view of the company and partners because the burden of proof is born – in case of doubts whether the executive director proceeded with the diligence of a careful manager – by the executive director in question. The liability of the executive director is joint and severe what is undoubtedly positive from the point of view of the company, its partners or third persons.

The specific feature of the regulation of liability for damages by the Slovak Commercial Code is that it contains explicit demonstration of cases considered as breaches of duties in which the executive director is liable for damages caused. It concerns cases when the executive directors decided on provision of benefits to the partners contrary to the law and caused damage to the company, e.g. if they decided on payment of profit shares contrary to the provision of Section 123 of the Slovak Commercial Code ("SCC" thereinafter), if they decided on the returning of deposits to the partners during the existence of the LLC (Section 123 SCC), on payment of compensation share contrary to the rules defined (Section 150 SCC). The demonstrative enumeration of situation in which the executive directors are obliged to pay for the damages suffered by the company due to the breach of a duty by executive directors in performance of the function makes it possible that the injured company and/ or the creditors can demand compensation of suffered damages also for the breach of other duties by the executive directors.

However, the company is often not interested in the demanding of compensation from the executive directors, e.g. because the executive director is the majority shareholder on the company in question and insisting on the payment would cause "breakdown" of the company. Similar situation may occur when a company partner acts as the executive director only because he was "persuaded" to do so by other partners and another person would not be interests in such function because its performance is mostly without any remuneration and demanding compensation of damages would thus be – according to non-written rules – at least not ethical in the viewpoint of most of the partners.

Passivity of the company in demanding the compensation of damages from the executive director can be broken by a partner who does not identify himself with this passivity and feels himself limited or jeopardised in his rights. Any partner is entitled to raise by an action lodged to the court on behalf of the company request for compensation of damages towards the executive director. He has to bear the costs of the proceedings, but is entitled to their compensation in the event that the company succeeds with the action and the court orders to the executive director obligation to compensate the costs of the proceedings.

Compensation of damages can be demanded – beside the company and the company partners – also by creditors of the company but only if they could not be satisfied from the company assets. The position of the creditor is strengthened in this case also by the fact that his claims towards the executive director dos not cease if the company waives his demands to compensation of damages and/or concludes a valid agreement on composition.

However, the entitled person will be satisfied only after the damages suffered by him will be compensated by the executive director. But here the circle – in the case the executive director should be a "white horse" – will close, because this person simply does not have any property from that the demands of the entitled persons can be satisfied. In such cases will this reality not be changed even an aggravation of the regulation towards strengthening the liability of executive directors. Again, as more efficient seems to be the prevention consisting in the restriction for such persons to perform the given function, in this case to be appointed as the executive director of LLC.

CONCLUSIONS

The examination of the scope of responsibility of the executive director in LLC have shown that the legal instruments available in the regulation of this topic in the legal order of the Slovak Republic could intensify the efforts to provide a solid legal position to those persons that have suffered damages from a LLC for that the executive director bears liability. The construction of the existing legal instruments given by the Czech Commercial Code does not provide the persons entitled to the compensation of damages suffered with efficient tools how to succeed in their efforts. *De lege ferenda* it may be recommended that the legal regulation will be amended by provisions limiting the scope of persons to be appointed as executive director and/or extending the liability for damages for the partners of the company in cases where the damage in such cases can not be compensated by the executive director and the partners should bear consequences for their *culpa in eligendo.*

SUMMARY

The paper analyses the requirements laid down for the function of managing directors (jednatel) in the limited company. Consequently it analyses the scope of the liability of managing directors firstly, in relationship to the company's creditors (persons standing outside the company) and, subsequently, in relationship to the shareholders. It also presents and characterises the recent trends in the Commercial Court's judgement of the conditions required for the liability for damage and claims for damages put forward by action to recover damages by the managing directors.

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