

Legal Alert

February 2011

PARALLEL EXISTENCE OF EMPLOYMENT WHILE AN EXECUTIVE / BOARD MEMBER AFTER THE SUPREME ADMINISTRATIVE COURT'S DECISION

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- This paper summarizes the currently much debated issue of the parallel existence of employment while an executive or board member of the company, including a description of the risks arising from this parallel existence and possible solutions.

In recent days the Czech media triggered unprecedented hysteria about the Supreme Administrative Court's decision dated 9 December 2010, no. 3 Ads 119/2010-58, prohibiting the parallel existence of the performance of a position in a corporate statutory body and an employment relationship, including possible negative consequences for the company and especially its executives as well as board members.

This special edition of our newsletter is in response to the Supreme Administrative Court's decision and at the same time introduces the basic outlines of possible proposals to solve the negative consequences of the prohibited parallel existence.

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- According to established case law in many cases the parallel existence of employment while a board member is not acceptable.

1. What is the essence of parallel existence and what has changed after the Supreme Administrative Court's decision?

Since the end of the 90s the Supreme Administrative Court's case law has held the view that simultaneous employment while being a member of a statutory body (after this "parallel existence") is not allowed when the employee's job description does not include other competences than those belonging to the legal competence of being a member of a statutory body.

Over time, however, the Supreme Court's has interpreted the "business management" of a company boarding a very broad way when, according to the Court's case law, such activity besides negotiating on behalf of the company is included in the legal competence of the statutory body. Such broad interpretation of "business management" leads to the conclusion that each parallel existence in the case of a managerial employee is very problematic and in many cases unacceptable.



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However, it has always remained undisputed that parallel existence is admissible if the actual job description contains activities other than those falling within the performance of the statutory body (or its member).

The above rules, however, have often been underestimated and the consequences of the invalid employment contracts downgraded. The reason has been mainly that as opposed to wages, board member's remuneration is not tax deductible for the company.

The December decision of the Supreme Administrative Court thus does not produce any breakthrough in current judicial practice as it is largely in line with the aforementioned case law of the Czech civil courts. Its essential meaning is that through this decision this case law has been implemented in the administrative law area, specifically in the question of a managing director's (and at the same time simultaneously executive's) nonparticipation in the sickness insurance scheme as an employee.

Extending parallel existence to the public law area may indeed have significant implications not only for companies in the field of taxation, but especially for the statutory bodies and their (non)participation in the state sickness and pension insurance scheme.

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- This problem potentially concerns executives and board members.

2. Who is affected by parallel existence?

Potentially, all Czech companies and their executives / board members, provided that they also have entered into an employment relationship with the company, may be affected by the issue of parallel existence.

Of course, not each parallel existence can be considered inadmissible and it will be necessary in each case to carefully assess the real contents of the work performed under the contract and the scope of business management involved.

In some cases, such as the parallel existence of a managing director and executive, with regard to the above case law of the Czech courts, parallel existence is usually impossible.

A unique position applies to banks because the parallel existence of leading employee positions and board membership is directly prescribed by law.



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- A number of risks result from the parallel existence of employment while an executive or a board member, both for the company and for (the members of) the statutory board.

3. What are the risks connected with prohibited parallel existence?

In the area of private and public law, we have identified in particular the following possible negative implications of the prohibited parallel existence:

3.1. For the company:

3.1.1 Potential invalidity of the contracts and other legal acts taken by the only executive / board member by virtue of his/her employment position as a leading employee (eg as managing director), provided that pursuant to the company's articles of association two or more executives / board members should always act on behalf of the company at the same time.

3.1.2 Negative tax implications regarding paid remuneration and other benefits under the invalid employment contracts concluded with the board members, ie such expenses are not tax deductible for the company (executives are concerned only in a limited scope, when their pay is a tax deductible expense for the company) the result may be an additional tax recovery or reduction of the tax loss.

3.1.3 Executives' / board members' claims for remuneration for the performance of their position, provided that the wage was paid to them, up to four years back.

3.2 For executives / board members:

3.2.1 The possibility of the company to claim refunds on the basis of invalid employment contracts, up to four years back, eg in the case of insolvency or hostile takeover.

3.2.2 Loss of protection provided by the Labour Code (eg protection from employment termination, limited liability for damages, annual leave entitlement, etc).

3.2.3 Employer's liability insurance for damage caused by industrial injuries or occupational diseases does not apply to executives / board members.



- 3.2.3 Nonparticipation in the state sickness insurance scheme (such regulation applies to board members and since 2009 also to executives) as well as nonparticipation in the state pension scheme (for board members) or a substantive reduction of eligible payments (for executives) for the duration period of the prohibited parallel existence, even though the company has duly paid the insurance contributions .

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- This situation should be relatively simple to solve in the future. Elimination of harmful consequences already incurred, however, requires a detailed analysis of the case.

4. Are there any possible solutions to prohibited parallel existence?

4.1 Addressing the future

The future solution to prohibited parallel existence and its negative implications lies, in our opinion, in the following three possible basic courses of action:

4.1.1 A single contract for the executive's / board member's performance

From a legal point of view, a clear solution is to modify (or conclude a new) contract for the performance of the executive / board member and terminate the employment.

It is possible to draft a contract in a manner which will compensate to the maximum extent for the loss of the labour law protections as well as disadvantages associated with the absence of state pension and sickness insurance.

It should be borne in mind that all changes to the contract for the performance of said positions will be subject to the prescribed approval.

4.1.2 "Non-executive" Board of Directors or Executives

The second option is the strict separation of the leading employee's performance from the performance of the executive / board member in the company, if such division can be organized and staffed.

Please also note that such non-executive board member / executive has a direct statutory right to fair remuneration, and in particular provided that such function should be performed free of charge (eg as an employee of a foreign shareholder), it is necessary to appropriately address the issue of remuneration by a (duly authorized) written contract. Also the implementation of the "four eyes rule" will be legally more complex.



4.1.3 Maintaining the admissible parallel existence

This procedure can be recommended only after prior careful consideration of the job description of the particular employee who will be serving as a board member at the same time.

We always strongly recommend concluding and approving a written agreement on performance and carefully modulating the job description in terms of business management by virtue of performance of the statutory body (or its member) position.

4.2 Solutions to past prohibited parallel existence

Provided that in a particular case the inadmissible parallel existence of managerial employment while an executive / board member was found in the past, we are afraid that current legislation does not offer any 100% solution to all the problematic issues.

However, it is a legal duty of executives / board members to proceed to mitigate or reduce possible damages and take corrective measures. In light of the above risks, in our opinion, any company in which the prohibited parallel existence used to exist, must consider the following steps:

4.2.1 Settlement with the company

Wages paid under invalid employment contracts create unjust enrichment and this issue should be resolved properly. At the same time it is possible to settle the unpaid remuneration for performing their position, if performed without a contract.

4.2.2 Nullity of contracts concluded with third parties

After evaluating the potential negative impacts it is necessary to consider whether the possible invalidity of the contracts concluded by the leading employee (and executive / board member at the same time) in a manner inconsistent with the written course of action of the statutory body can also be resolved.



4.2.3 Relations with the Tax Office

Provided that the company incorrectly applied the board member's remuneration as a tax deductible expense, it should be considered whether in a particular case it is possible and appropriate to prevent tax recovery from the tax office by the filing of additional tax returns.

4.2.4 Relations with the Social Security Authority

If executives / board members could be banned due to prohibited parallel existence from participating in the sickness as well as pension insurance scheme at all or only to a limited extent, the chance to apply for reimbursement of paid insurance premiums as overpayment of insurance should be considered.

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- Given the seriousness of the problem it is necessary to carefully consider the appropriate solution and if needed, consult with tax and legal advisors.

5. What kind of remedial action is recommended?

The starting point of any measure must be, in our view, a quick review of your company, to see if you are affected by the problem of illegal parallel existence and to what extent.

In the case of a prohibited parallel existence finding, we recommend immediately proceeding with its elimination using any of the solutions outlined above in accordance with the specific conditions in your company.

When addressing the past parallel existence's negative implications it is necessary to carefully consider and prepare to resolve them in coordination with legal and tax advisors. Isolated adoption of one measure could cause more harm than good.

It should also be noted that the Ministry of Finance and in particular the Czech Social Security Authority (CSSA) still hold a rather reserved opinion on illegal parallel existence, perhaps with regard to the possible negative fiscal impacts on public finances. The CSSA in its communication of 10 February 2011 assumes that the problem will relate to "isolated cases", and not likely the several thousand companies in which the inadmissible parallel existence can be expected according to our estimates.

It is also possible that risks connected with previous parallel existence can be addressed in a relatively short time by some form of legislative measures or governmental guidance note considering the intense pressure of business associations.

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Finally, there remain unresolved questions in the issue of parallel existence (eg as a result of the solely relative validity of acts in employment law since 2007 or the question of termination of employment as a result of appointment as a statutory body (member)), which can have a significant impact on the evaluation of the above mentioned risks.



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