SQUIRE PATTON BOGGS

Directors' Duties – Czech Republic

Considerations for Directors When a Company Is in Financial Difficulty

This quick guide summarises the duties that directors of companies incorporated in the Czech Republic are subject to, and how those duties change when the company is insolvent or at risk of being insolvent.

It also gives an overview of the personal risk to directors when the company is in financial difficulty.

This note is intended as an overview and should not be relied on as legal advice. Should you require legal advice in relation to your specific circumstances, please contact the Restructuring & Insolvency team members whose contact details are at the end of this note.

Directors' Duties When Solvent

- Directors are obliged to act for the welfare of the company. In particular, directors are obliged to act with due managerial care, which includes, among others, the duty of loyalty or the duty of confidentiality.
- Directors must also act with diligence, based on sufficient information and in the defendable interest of the company.
- Directors are responsible for managing the company's business affairs (*obchodní vedení*), which generally includes organising and directing the conduct of the company's business, including the decision-making relating to business strategies.
- Directors are also responsible for proper bookkeeping and proper management of prescribed records of the company.

Financial Distress

Directors' Duties When Insolvent, or at Risk of Being Insolvent

- Directors of a limited liability company shall convene a general meeting without undue delay after becoming aware of the company's impending insolvency (*hrozící úpadek*), or from other serious reasons, in particular where an objective pursued by the company is jeopardised.
- Directors of a joint stock company shall convene a general meeting without undue delay after finding out, that the accumulated loss of the company reached such a level, that if paid from the company's disposable resources the remaining loss would reach a half of the company's registered capital, or given all circumstance the occurrence of this situation can be expected, or because of other serious reasons.
- Directors are obligated to file an insolvency petition on behalf of the company without undue delay when they learn of the company's insolvency, or should have learned of it had they exercised due managerial care.
- The above-mentioned duties applicable to when the company is solvent apply in the case of insolvency, as well.

It is important for directors to understand their directors' duties, as well as how their actions and the decisions the board makes when the company is in financial distress, could expose them to personal liability, criminal sanction and risk.

Below is an overview of the potential claims and potential exposure for directors if the company is insolvent or at risk of insolvency.

Liability for Damage Caused to the Company

If a director breaches their duties, they must compensate the company for any damage and/or harm caused to the company resulting from such breach. This also includes compensation for non-proprietorial harm. A director can be relieved from the duty to compensate if they prove that the failure to act with due managerial care was caused by an extraordinary impediment that emerged independently of their will.

Liability for Damage Caused to the Creditors

A director who does not file an insolvency petition on behalf of a company, although they are obliged to do so, is liable to the company's creditors for damage, harm and/or other injury caused by such breach of duty.

A director can be absolved of liability only if they can prove that the breach of duty (to file the insolvency petition) had no impact on the amount available to satisfy claims lodged by creditors in the insolvency proceeding. A director may also be absolved if failure to fulfil the duty to file for insolvency was due to facts that occurred independently of the director's will and they could not have averted them even if they had used their best efforts, as may be reasonably required from a person in the same position.

Obligation to Make up a Shortfall in the Company's Assets

- In case of a bankruptcy (*konkurs*) of a company, if a director contributed to the bankruptcy by breaching their duties, an insolvency court can order them to provide a performance up to the difference between the total of the company's debts and the company's insolvency estate (in Czech: *majetková podstata*).

Obligation to Surrender Profit or Benefits Received

- **Violation of the duty to act with due managerial care**. If the director breaches their obligation to act with due managerial care, they are obliged to surrender any profit or benefit they received in connection with such breach. If the director cannot surrender the profit, they are obliged to compensate the company for such profit in monies.
- **Contribution to insolvency of the Company**. If a company is declared insolvent based on an insolvency petition filed by other person than the company and the director contributed by breaking their duties to insolvency of the company, they shall, upon the request of the insolvency trustee approved by the insolvency court's decision, surrender any profit they received in performance of their function (e.g. remuneration) and any other proceeds received from the company within up to two years preceding the commencement of the insolvency proceedings.

Criminal Liability

A director may be criminally liable for their actions. The criminal liability of the director is separate and independent from the criminal liability of the company.

Czech law recognises a special category of so-called "insolvency criminal offences" under which the director may be sentenced and banned from activities or imprisoned for up to eight years. Insolvency criminal offences include damaging the creditor, preferential treatment of the creditor, causing insolvency, breach of duty in insolvency proceedings and plots in insolvency proceedings.

A director may commit a number of other criminal offences in connection with the (impending) bankruptcy of the company or insolvency proceedings, such as breach of duty in the administration of other's property or misrepresentation of management and assets.

Also, a director may be subject to criminal liability if he fails to secure proper bookkeeping of the company.

Financial Penalties

A director may also be liable for the misdemeanours committed in connection with the performance of their office, as a result of which they can be, most typically, fined with a penalty or sentenced with a ban on activities. However, there are also other types of administrative penalties.

Liability as Guarantor

Liability for other damage or other loss – If a creditor of the company cannot recover its debt from the assets of the company, the director acts as a guarantor of such debt up to the amount of damage and/or harm that the director caused to the company, and that they failed to compensate.

Disqualification

- **Contribution to insolvency of the company** – The insolvency court disqualifies a director from holding office as a member of the statutory body of any company, when the insolvency court imposes an obligation to the director to surrender profit or benefits received or an obligation to provide a performance up to the difference between the total of the company's debts and the company's insolvency estate.
- **Disqualification for failing to act with due managerial care** – A court may, even ex officio, decide that a director may not hold the office as a member of the statutory body of any company, if the director, anytime during the past three years before the commencement of the proceedings, repeatedly or seriously breached their duty of due care or, where applicable, any other duties associated with the exercise of their office.

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Practical Tips to Mitigate Liability

- Consider D&O insurance (note: the extent of D&O insurance cover depends on the specific policies of each insurance company).
- Seek instruction to act by shareholders' meeting (note: shareholders' instructions do not relieve the director from the obligation to act with due managerial care; however, shareholders' awareness could constitute a mitigating factor).
- Seek advice from legal professionals and financial advisers and keep track of other steps taken before making a business decision.
- Take all precautionary measures to avert an impending insolvency and do everything in order to minimise the damage to the creditors of the company, e.g. by applying for state aid and/or the temporary measures; protecting cash flow by collecting overdue receivables; and extending payables (note: the Late Payment Directive restriction).
- Directors should constantly observe the commercial and financial situation of the company and assess whether the company is solvent.
- Directors should avoid preferential treatment of specific creditors.
- If liquidity issues arise, the directors need to assess whether the company is insolvent and, therefore, obliged to file an insolvency petition.
- Directors should consider if the company's creditors will agree a voluntary solution, i.e. to defer payments or agree a repayment schedule.
- Directors should verify whether any company loan repayments are due in the upcoming period. Identify the key contractual provisions and the risk of (cross) defaults happening while considering the imminent implications of the defaults.
- Directors should make use of any available governmental support, as not doing so may be considered a failure to act with due managerial care and result in their personal liability.