VOZÁB & CO.
ADVOKÁTNÍ KANCELÁŘ / LAW OFFICES

Pod vilami 10, 140 00 Praha 4, Česká republika / Czech Republic
Tel: (00420) 241 416 220 / Fax: (00420) 241 405 321
Email: office@vozab.com / www.vozab.com

Law and Business Newsletter 3/2012

Edition 3|2013: **Recodification of Civil Law**
Changes in Commercial Law

This edition of our newsletter addresses the new civil legislation coming into effect on January 1, 2014. The main changes impacting business, especially those concerning contracts and corporations are outlined herein.

New Legislation

The main feature of the new legislation is that the New Civil Code (Act no. 89/2012 Coll., hereinafter the NCC) consolidates general civil law, commercial law, and family law issues into one unified code in order to create a singular, integrated legal basis for all civil law and thus eliminate duplication of some regulations as well as interpretation ambiguities. The NCC will be the universal basis for civil law, whereas specific aspects of business relations are to be considered on an ongoing basis in relevant provisions, contract types, and so on.

On the other hand, business corporations (companies and cooperatives) have been separated and are to be regulated by the Business Corporations Act (Act No. 90/2012 Coll. - hereinafter the BCA), which will govern the technical details of particular types of corporations. It should be kept in mind that the NCC regulates the general basis of legal entities, and, though subject to certain exceptions, it can always be applied supportively to business corporations.

Furthermore, it is necessary to point out that, due to the specific nature of the relations it regulates, Labor Law will remain a separate body of legislation within the scope of Act No. 262/2006 Coll., the Labor Code.

International Private Law is another area of legislation that will be governed separately by Act No. 91/2012 Coll., on International Private Law, which specifically addresses civil relations with international constituents (determining applicable law and court jurisdiction, etc.).

Generally, the new legislation, namely the NCC, attempts to surmount socialist views of civil law and represents a reversion to emphasis on the free will of the individual and his liability for his welfare and everything that he exerts influence on. This is evident in many respects. Put simply, the new legislation allows for greater deviation from statutory regulation; there is greater scope for waiving claims in advance; there is greater variability for managing property and addressing various situations; the NCC will also grant greater flexibility in contractual arrangements and narrow the scope of formal reasons for questions the validity and enforceability of claims. In cases in which the court, despite the sweeping range of legislative changes (the NCC alone comprises over 3000 paragraphs), is unable to

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identify a satisfactory solution to a dispute, it can apply the principles of equity and justice to reach a good arrangement of rights and obligations for the parties involved. There is far greater emphasis on individual liability; individuals will have to think more carefully before acting (i.e. prior to entering into contracts, signing documentation, or underestimating or neglecting specific obligations). Under certain circumstances, silence can imply consent with a contract offer, and there is much greater potential for passivity resulting in the loss of claims.

Naturally, the protection of weaker parties in civil relations, that is to say the protection of consumers, employees, family, infants, minors, and the disabled, etc., remains unchanged.

General recodification issues concerning business activities

Business and Community (Marital) Property. The changes in legislation bring with them a new rule stipulating that debts (other than those arising from daily and common family needs) taken over by one of the spouses without the consent of the other will not fall within the marital property regime (e.g. debts taken over by one of the spouses within his/her business activities). The use for business activities of community property by one of the spouses will be subject to the consent of the other spouse only in the event that the value of the property used for business activities exceeds the scope of the marriage property relations. It is necessary to obtain such consent before using community property for the first time (it is not required to obtain consent for the use of less valuable property that does not exceed the scope of the property relations of the spouses).

Concluding a contract based on general business terms and conditions (in other words, silence can imply consent). If general terms and conditions are stipulated in both the offer and acceptance of a contract, the said contract shall be concluded in accordance to both of these sets of terms and conditions, provided that neither set contradicts the other (including not only congruous conditions, but all the terms and conditions that are not inconsistent with “competing” terms and conditions and vice versa), unless any of the contractual parties rules out conclusion of the contract without undue delay upon receipt of acceptance.

Reasonably unexpected provisions in general terms and conditions are ineffective. Provisions of general terms and conditions which could not be reasonably expected by the other party are ineffective, unless they are expressly accepted by the relevant party; any opposite arrangement shall be disregarded. The deciding factor will not only be the content of such an arrangement, but also the means in which it is formulated (e.g. very small print, inappropriate positioning of text, etc.). Therefore, it is strongly recommended to review all existing general terms and conditions and make necessary changes to wording, highlight certain passages, and so on.

The terms used in business relations will be attributed the meaning they usually have. This is an interpretation rule that may help clarify the expression of the will in business relations.

Common business practice shall be taken into account, unless agreed otherwise. When interpreting the expression of the will, common business practices shall always be taken into account; however, the parties may agree otherwise and rule out such business practices. Therefore, the parties shall bear in mind that such a provision (including/excluding the application of a common business practice) may be useful in business contracts.

Specific changes in particular types of contracts concerning business relations

Lease Agreements. It is expressly stipulated that it is possible to lease a part of an asset as well as an asset that has yet to come into existence. The new legislation offers a modified means differentiating between various types of lease agreement (the lease of a flat / lease of non-residential premises), while the deciding factor is not the nature of the premises, but the intended use. Regardless of the nature of the relevant premises, the legal regime will depend on the purpose of use: housing,

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commercial, or other purposes (community services, etc.). The legal status of leased premises will thus remain irrelevant and may not serve as grounds for nullity of a lease agreement. According to the transitional provisions of the NCC, tease agreements concluded prior to the effectiveness of the new legislation will be governed by the NCC (this is an exception to the general rule stipulating that contracts shall be governed by the law effective at the time of their conclusion; this exception will also apply to contracts governing bank accounts).

Contract of Purchase and Sale. The new, uniform legal regulation of purchase and sales contracts is based on the current regulation in the Commercial Code. The purchaser will be able to acquire property from a non-owner, provided that the purchaser acts in good faith. In order to determine the rights of the purchaser, the NCC has abandoned the practice of distinguishing between repairable and non-repairable defects of goods and it introduces a principle of intensity of the implications of the defects (i.e. defects resulting in a substantial or insubstantial breach of contract). The purchaser will be enabled to claim hidden defects of immovable assets up to 5 years from purchase (previously 6 months). Although there are still various expert discussions concerning the terms of statutory warranty, in our opinion, the 2-year warranty ceases to exist in the new legislation for the sales of goods, and the common concept of liability for defects, which existed at the time of purchase, will apply. The deadline for making a claim for those defects will be a maximum of 24 months from the date of purchase; however, the legislation presents a new provision in support of consumers: if a defect arises within 6 months of a purchase, there is a rebuttable presumption that the defect had existed at the time of purchase. If the defect arises later, it will be the consumer who shall bear the burden of proof that the defect was already in existence at the time of purchase.

Contract of Purchase of an Enterprise. Concerning the purchase of an enterprise, the parties will be able to exclude some items from the transfer of ownership, given that the remainder of the enterprise maintains its status as an independently organized and viable entity. Regarding debts appertaining to the establishment, the purchaser will take over only those debts that he/she knew about or must have known about. If the seller's creditor does not approve the assumption of the debt by the purchaser, the purchaser shall act as guarantor that the debt will be met.

Contract for Work. The new regulation of contracts for work is based on the provisions of the existing Commercial Code. Performance of such contracts shall subsist in the completion and delivery of the work, whereas the work itself is deemed complete when its ability to serve its (agreed) purpose can be demonstrated. The work shall be deemed defective if it fails to meet the provisions of the contract at the time of delivery. If defects are apparent prior to delivery, the customer may refuse to accept the work and insist on proper performance of the contract. If the customer decides to take delivery of the work anyway, he/she shall be granted rights arising from liability for the defects. Building and Construction Works are to be regulated by special legislation.

Bank Contracts. The number of types of bank contracts is being reduced to a singular bank account contract governed by the NCC. According to transitional provisions, bank account contracts concluded prior to 1 January 2014 will also be governed by the NCC (this is an exception of the general rule stipulating that contracts shall be governed by the law effective at the time of their conclusion; this exception will also apply to lease agreements concerning immovable property).

Business Corporations and New Legislation

General issues:

Changes in responsibility of statutory body members and executive directors (hereinafter executives). Unlike the current Commercial Code, the NCC contains an express definition of the concept of due care and diligence. The notion of due care and diligence is defined by three main features - the executive shall act with ***indispensable loyalty, necessary knowledge, and carefulness***. Mere acceptance of appointment to a function that exceeds the scope of one's abilities shall be viewed an act of malpractice. The BCA strengthens that concept through another aspect known as the

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Business Judgment Rule. Should an executive proceed with loyalty to the company, yet, on the basis of available and carefully considered information, selects a plan of action that is subsequently determined to be incorrect, the executive shall not be held liable for the potential negative impact of such a decision. The aspects taken into consideration will be the executive's assessment of risk and other factors that led to the choice of the specific course of action. For instance, it will be applicable in cases of collapse of the capital markets or unexpected changes to some significant trade articles (real estate, gold, petrol, etc.).

In considering whether an executive has acted with due care and diligence, it will be important to compare his/her performance with that of other reasonably careful and diligent persons. When in doubt, the executive is the one who bears the burden of proof that he has acted with due care and diligence. The court, however, may decide that the party cannot be reasonably required to bear the burden of proof at all.

There is also a rule that the executive shall be held liable to the company's creditors for the company's debts, if damages have been incurred through breach of the executive's duties, and the creditor is not able to assert claims against the company.

Cases of company insolvency will also be subjected to stricter regulation. Once the court grants the company insolvency, it may also decide, based on a motion by the administrator or creditors, that the executive will stand surety for the company's debts, granted the executive knew of (or should have known of) the impending bankruptcy and failed to use all necessary and reasonable means to avert it.

The court may remove an executive from any corporation. The BCA will now enable court to remove any executive who fails to fulfill his/her obligations and brings the company to bankruptcy. The reasoning behind this provision is the motivation of the members of statutory bodies to act carefully and diligently, as failure to do so may result in the loss of the chance to perform similar duties in the future.

Concurrence of statutory body function and employment. Unlike the current legislation, the NCC and BCA do not expressly provide for the possible concurrent performance of company statutory body functions and an employment relationship, while the employment relationship also contains obligations of business activities within the company (e.g. Country Manager, Chief Executive Officer, etc.). Problems will not occur if the employment contract contains duties or a job description that are completely different from those of the management activities (e.g. when the executive also works as a graphic artist, IT administrator, or programmer, etc.). Initially, experts were of the opinion that the new legislation will allow for the concurrence of functions and employment; however, after further academic discussion, the current consensus is that concurrence will not be feasible. The case law of the Supreme Court will follow the course that was set prior to 2012 before concurrence was made expressly possible by amendment of the law. Therefore, it is recommended that executives always be remunerated (for management activities) as an executive or a member of the body pursuant to an executive service contract, not as an employee. Any executive employment relationship comprising management activities will be terminated as of 1 January 2014 (it will be deemed inapplicable and ineffective), and such a person will not receive remuneration based on that employment relationship; therefore, social security and health insurance benefits will not be deductible in the employment regime (as mentioned above, this will not apply to employment contracts which do not contain executive activities).

Provided that the remuneration of some executives is paid based on an employment contract containing business management obligations (e.g. is being paid for chief executive officer or country manager), it is necessary to terminate the existing employment relationship and enter into an executive service contract, or, where appropriate, to amend the current non-profit contract for pecuniary interest to pay remuneration and other allowances in the regime of the executive service contract.

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Executive service contract. This type of contract is regulated by the new legislation in great detail and it can be used for all members of different types of bodies within the corporation (e.g statutory body, supervisory board, administrative board, and chairman of the cooperative, etc.). In the absence of a proper contract, the relationship between the corporation and the board member/executive shall be governed by the NCC provisions concerning a mandate (contract of mandate). A substantial novelty is that the principle of remuneration is turned upside down - unless stated otherwise in the contract, executive positions are always performed for no pecuniary reward.

The contract may be effective only subject to approval of the supreme authority of the corporation (in capital companies it is the general meeting; in other companies it is the shareholders or membership meeting of the cooperative).

As stated above, executives will not be allowed to receive wages based on employment agreements for the performance of management activities in the company. Thus, if an executive is rewarded in accordance to the law as of 1 January 2014, it will be necessary to terminate the existing employment agreements and enter into a new executive service contract, or amend the existing contract to allow remuneration and other benefits to remain in the regime of the executive contract.

All payments to an executive for the performance of management activities based on an employment agreement will be viewed as remuneration without legal grounds; therefore, the respective executive will be obliged to pay back all such compensation. Moreover, all deducted social security and health insurance contributions related to such remuneration will not be deemed as legal, thus the person may be treated as uninsured. Furthermore, there may be problems with the tax deductibility of such payments. Although the proper interpretation of abovementioned provision is not yet entirely clear, it is highly advisable to adapt existing documentation to meet the demands of the new legislation.

Obligation to inform of conflicts of interests. There is a new obligation imposed upon executives to inform of any conflict of interests that may arise between them and the corporation.

Membership in the statutory body of the company. It will be possible for a legal entity to be a member of the board/statutory body. In such cases, the legal entity will be represented by a designated representative.

Release of transactions between the company and related persons. Legislators have softened the rule existing in Section 196a of the Commercial Code. From now on, appraisal of the company's assets and general meeting approval will only be required in cases in which the company acquires property/assets against a payment exceeding 10% of its subscribed capital from an incorporator or shareholder (not from an extensive list of affiliates, as was previously required), and, furthermore, this requirement applies to the first two years of the company's existence. There will be no limitation in the flow of assets when the company transfers its property to the abovementioned persons. Moreover, legal requirements will be fulfilled if the appraisal is prepared by any of the experts stated on an official list of experts, who in turn do not need to be appointed by the court. The sanction for violation of this rule will not be the absolute nullity of the contract (as heretofore), but a fiction reflecting that the executive who voted for the property acquisition contrary to the respective provision of the BCA did not act with due diligence, and the incorporator or shareholder will be obliged to refund the company the amount exceeding the price set by the expert.

We would like to point out that the aforementioned property acquisition limitations apply expressly to joint-stock companies; limited liability companies are not limited in such a way.

Limited liability company:

Legal regulation of the limited liability company has seen significant revision bringing with it a more flexible enterprise and simplified business set-up process.

No mandatory minimum start-up capital of 200.000 CZK. One of the most significant changes is that the new legislation has abandoned the requirement of minimum start-up capital in the amount of

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200.000 CZK. The reason is that nowadays share capital says nothing about the reputation or solvency of a given company. Now, there will be a symbolic minimum capital for a one-person LCC in the amount of 1 CZK; in a two-person company it will be respectively 2 CZK, and so on.

Possibility of owning more than one share. The legislation has also abandoned the current concept of one sole share. Now, it will be possible for a memorandum of association to allow shareholders to hold more than one share. If a shareholder holding a 30% stake in a company buys another share worth 10%, the shares do not have to necessarily blend into one share, but may exist separately and independently, even if they are of the same kind (see below). Thus, the shareholder will be able to dispose of the shares independently of one another.

Variability of shares. Apart from basic shares, there is a new stipulation allowing for the creation (with no legal limitations) of other types of shares with different rights, such as, for example, shares with priority right to increase capital, shares for paying dividends, shares without voting rights (only rights to receive dividends), freely transferable and non-transferable shares, shares with the right of veto for some types of general meeting decisions, etc. As appropriate, one shareholder may hold more types of shares with different rights, or he/she may hold one each of different share types. This will lead to significant widening of the spectrum of different forms of cooperation and business partnerships. For example, the shareholders may allow a business partner to acquire a freely transferable share without voting rights, but with right of veto for some types of general meeting resolutions and with the right to a specified share of the company's profits.

Determining the exact number of executives. Regarding the number of executives, so far there has been a common practice to keep the memorandum of association variable, so that it is not necessary to amend the text of the foundation deed in case the number of the executives is changed. At the same time the legal theory emphasized that this approach is not appropriate, because the right decisions within the business management framework may be dependent on the exact number of executives. The BCA newly stipulates that the foundation deeds shall strictly determine the exact number of executive directors.

New features of foundation deeds/memoranda of association. Regarding all the abovementioned changes, it is necessary for the foundation documents to contain the following information: specification of types and designation of shares, number of executive directors and identification of an expert to provide reports on non-monetary investment contributions. On the other hand, some formerly mandatory facts are facultative, e.g. the administrator of the deposit prior to founding the company.

Change to the principle of consent for share transfer. Heretofore, it has been possible to transfer a share to another shareholder with general meeting approval, while the founding deeds can preclude such approval. This principle will be turned upside down with the forthcoming legislation - each shareholder may freely transfer his/her share to another shareholder, unless a provision of the foundation deed subjects such a transfer to consent by the company board (most commonly the general meeting, but the supervisory board may also come into consideration).

In the event that the shareholder wishes to transfer his/her share to a third party (who is not a shareholder of the company), there are two conditions in the existing regulation: Firstly, this possibility has to be expressly provided for in founding documents, and secondly, the consent of the general meeting is required for such a share transfer. In the new legislation, the former will not be necessary, but the transfer will still be subject to general meeting approval, unless it is stipulated otherwise in the foundation deed.

Shareholder capital contributions. Additional shareholder capital contributions are also subject to changes because of the new legislation. The BCA does not set forth any maximum amount for additional contribution, so that all issues concerning involuntary additional capital contributions will be governed by the founding documents. Involuntary additional capital contributions may also be

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associated with some types of shares (see above). All the transferees of company shares shall, therefore, carefully examine the type of share being transferred.

Moreover, the shareholder may, at any time and with no limits, provide the company with an additional, voluntary capital contribution. The only limit is the consent of the executive director (previously the consent of the general meeting).

Share of Profits. One of the major changes is that the BCA enables the company to pay a share of profits without a prior general meeting resolution; there are, however, some conditions: Firstly, in the foundation documents, the shareholders will establish the type of shares with a fixed amount of profit sharing.; second, the economic results of the company will allow for the distribution of profits. It means that the provision of the foundation documents may overcome only a formal resolution on profit distribution, but not unfavorable economic situation.

Reserve Fund. The BCA will no longer require companies to create a statutory reserve fund; therefore, companies will be able to dissolve any previously created reserve fund subject to statutory conditions.

Extending possibilities for withdrawal from the company. The new legislation creates some new possibilities for shareholders to unilaterally withdraw from the company (e.g. disagreement with some general meeting resolutions, or when consent for a share transfer has been unreasonably declined by the GM).

Transitional provisions relating to business corporations

The NCC and BCA determine the complex rules for conflict of the old and new law as following:

- **Provisions of foundation documents contrary to the mandatory rules of NCC and BCA are repealed on the effective date of the NCC and BCA (expected to be 1 January 2014).** Having regarded the abovementioned rules, it will concern practically all joint-stock companies and limited liability companies. It will be necessary to amend the provisions concerning the types of existing shares and, in some cases, also the exact number of executive directors of the company, so that they meet the new legal requirements.
- **Business corporations are obliged to adapt their foundation documents to the new legislation by no later than 1 July 2014.**
- Executive service contracts shall also be adapted to the new legislation no later than 1 July 2014, otherwise the function will be deemed as being performed without pecuniary reward.
- The applicable law for existing business corporations will be the new legislation (the NCC and BCA), and simultaneously the current Commercial Code governing the rights and obligations of shareholders, unless they collide with the mandatory provisions of the NCC and BCA. However, it is still not clear to what extent the rights and obligations of shareholders shall be considered.

These rules mean that with respect to deep legal analysis, the rights and obligations of shareholders will be governed by the rules in the following order:

1. Mandatory provisions of the BCA
2. Provisions of foundation documents, unless they are contrary to the ad 1.
3. Provisions of the current Commercial Code, unless they are contrary to the ad 1.
4. Dispositive provisions of the BCA, unless they are contrary to ad 3.

This also applies to situations where the wording of foundation documents is adapted to the new legislation in time. Determining the proper content of the rights and obligations may be expensive and time consuming, if at all feasible. It may be difficult to determine what is to be considered a shareholder right or obligation, and if the same regime is applicable to shareholders, who gained the shares prior to 1 January 2014 and who gained them after 1 January 2014.

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Legal recommendations concerning business corporations

Choice of the new law and adjusting the foundation documents to the new legislation:

With respect to the abovementioned interpretation difficulties, practically all experts in the respective areas recommend choosing the new legislative regime (the NCC and BCA) for all the issues concerning corporations. The advantage of such an approach is that a parallel application of the old Commercial Code and the new laws (the NCC and BCA) will be thereby avoided.

Such a decision can be realized making changes to the foundation document in the form of a notarial deed. It is recommended to combine such changes with adaptation of the documents to the new law, which is required by law to be in place no later than 1 July 2014 anyway. For application of the new law in an existing company, it is necessary to:

1. carry out changes to the founding document
2. execute the changes in the Commercial Register
3. publish the relevant entry in the Business Journal

It must be emphasized that although the BCA specifies a term of 6 months for adapting the wording of foundation documents to the new law, as of the effective date of 1 January 2014, provisions of foundation documents that stand in contradiction to the mandatory provisions of the NCC and BCA will automatically cease to exist. Should companies wish to avoid legal uncertainty, it is desirable to modify the documents as soon as possible, so that it is clear which legal regime is going to be applicable from 1 January 2014 onward. Likewise, companies may proceed by choosing the new legislative regime for all issues concerning business corporations, whereas these changes can be carried out in 2013 and the NCC and BCA will be automatically applied beginning 1 January 2014. This is recommended to avoid parallel application of the current Commercial Code and the NCC and BCA and thus avoid potential interpretative difficulties.

Remuneration of members of statutory bodies:

Finding a proper solution for rewarding executives who are paid for managing activities as employees should be considered a matter of urgency. There is a statutory period provided for by the law within which executive service contracts shall be adapted to reflect the new legislation (by 1 July 2013); however, it must be kept in mind that the Transitional Provisions are not very clear and we therefore recommend acting promptly in order to ensure that executives are be granted their remuneration even after 1 January 2014.

This process will require:

1. concluding an executive service contract or amendment of existing contract responding to the new legislation
2. receiving general meeting / sole shareholder approval to conclude such a contract
3. carrying out changes in registration at the Czech Social Security Administration and Health Insurance Company

(this article is also available also at www.vozab.com/publications)

