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.

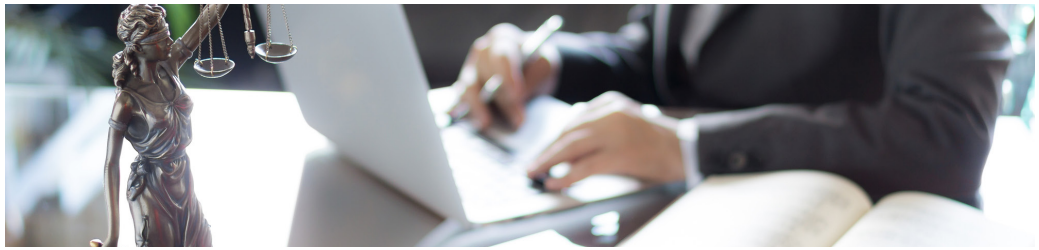
Financial Distress

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

- Directors 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.
- As per the proposed Act on Mitigation of the Impact of a Coronavirus SARS CoV-2 Epidemic (Lex COVID-19), the obligation to file an insolvency petition shall be temporarily suspended until six months after the end of emergency measures, but no later than 31 December 2020. However, this suspension does not apply where the insolvency occurred before the adoption of emergency measures, or where the insolvency was not mainly caused due to emergency measures making it impossible, or substantially more difficult, for the debtor to meet their financial obligations.
- Directors of the limited liability company and joint-stock company shall convene a general meeting without undue delay after becoming aware of the company's threatened bankruptcy (*úpadek*), or for other serious reasons, in particular where an objective pursued by the company is jeopardised.
- 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.

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.
- **Guarantee to fulfil the company's obligations.** Upon the request of an insolvency trustee or a creditor of the company, the court can order a director (or former director) to guarantee that the company fulfils its obligations if the company was declared insolvent and (i) the director was aware, or should have been aware, of the fact that there was an impending insolvency; and (ii) in breach of due managerial care, the director did not take all steps required or reasonably foreseeable steps to avert the insolvency.

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.
- **Failure to file an insolvency petition**. If a company is declared insolvent but the director failed to file an insolvency petition when they had a duty to do so, the director (or former director) shall, upon the request of the insolvency trustee, surrender any profit they received in performance of their function (e.g. remuneration) and any other proceeds received from the company within two years preceding the declaration of insolvency. The obligation to surrender arises if (i) the director was aware, or should have been aware, of the fact that there was a risk of insolvency; and (ii) in breach of due managerial care, the director did not take all the steps required or reasonably foreseeable to avert the insolvency.

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.

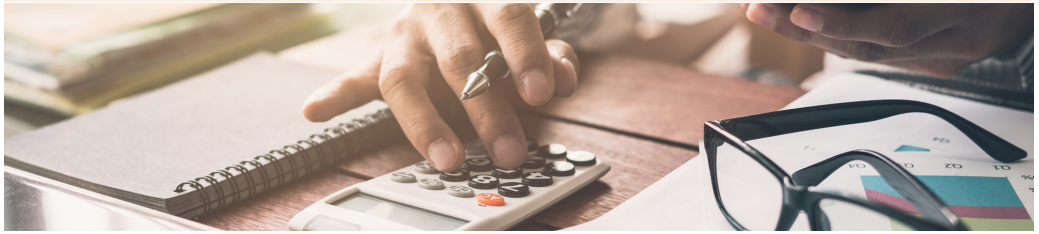
A director may commit a number of other criminal offences in connection with the (impending) bankruptcy of the company or insolvency proceedings, such as breach of duty in the administration of other's property or misrepresentation of management and assets.

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.

Disqualification

- **During insolvency proceedings**. The insolvency court may, even *ex officio*, decide that the director of a bankrupt company who was a member of the statutory body when the company decision on bankruptcy was issued, or afterwards, cannot hold the office as a member of the statutory body of any company, or act as a person in a similar position, for a period of three years.
- **Cause of insolvency**. The insolvency court can disqualify a director from holding office as a member of the statutory body of any company, or acting as a person in a similar position, if it appears that the action(s) of a director, when acting as a member of the statutory body, resulted in the bankruptcy of the company. After insolvency proceedings have been initiated, a court can disqualify a director, if their actions obviously contributed to a reduction of the insolvency estate (*majetkové podstaty*) and damage to the creditors.
- **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, or act as a person in a similar position, if the director, anytime during the past three years, repeatedly and seriously breached their duty of due care or, where applicable, any other duty of care associated with the exercise of their office.



For the latest updates on managing business risk during COVID-19, subscribe to *Restructuring GlobalView*

See our Summary of European Government Financial Support Guide to find out what financial support European governments are offering to help support businesses

For further information and to receive updates relating to the legal impact of COVID-19 please sign up to our COVID-19 Resource Hub.

Contacts

Veronika Vaneckova
Associate, Prague
T +420 221 662 265
E veronika.vaneckova@squirepb.com

Ivan Karpjak
Senior Attorney, Prague
T +420 221 662 269
E ivan.karpjak@squirepb.com

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.
- Take all precautionary measures to avert an impending bankruptcy 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. Should the directors discover the company to be insolvent, they will need to assess whether the company qualifies for the insolvency filing exception under the Lex COVID-19.
- Directors of companies that were not insolvent prior to 12 March 2020 should consider whether to take advantage of the extraordinary moratorium, aimed at protecting companies experiencing temporary payment difficulties due to emergency measures and COVID-19.
- Directors should properly document (i) that the company was not insolvent before 12 March 2020, and (ii) that the shortage in liquidity was caused by the extraordinary measures in connection with COVID-19.
- Directors should consider if the company's creditors will agree a voluntary solution, i.e. to defer payments or agree a repayment schedule.
- Directors may apply for a temporary suspension of the reorganisation plan for up to six months after the end of emergency measures, but no later than 31 December 2020. Once suspended, the company is not obliged to fulfil the approved reorganisation plan and the reorganisation cannot be transformed into bankruptcy (*konkurs*).
- 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 due to COVID-19, while considering the imminent implications of the defaults.
- Directors should make use of available governmental support (further details of which can be accessed below), as not doing so may be considered a failure to act with due managerial care and result in their personal liability.

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