

Strategy options for addressing the legal liability of Czech executives

To insure or to get advice, that is the question for executives of LLCs in the Czech Republic as well as in Germany, Austria, and France

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Abstract— One of the most popular forms for business conduct in the EU, including the Czech Republic, is the limited liability company (LLC). Europe 2020 as the key growth strategy for the EU underlines the significance of the competitiveness of EU businesses and endorses their operation. Unsurprisingly, Czech, German, Austrian and French businesses often opt for the LLC form and the single internal market is an arena populated by LLCs managed by executives. Surprisingly, the liability of these executives is addressed by various strategies across the EU. Therefore, it is highly instructive to comparatively analyze this issue and the manner of its solution in these EU member states.

Keywords—limited liability company (LLC), liability of executives, D&O insurance.

I. INTRODUCTION

Our global economy is marked by economic, and other, crises, and the increasing demands for getting an edge in competitiveness requires that businesses select the right form for their establishment as well as for their operation. In other words, the optimal business form and the employment of information systems and technology are critical for businesses, especially small and medium sized enterprises (“SME”) in the EU [1]. Each and every business, but particularly SMEs, need to fight for a sustainable competitive advantage and to be more effective and efficient than their rivals [2]. To put it another way, many businesses in the EU undergo a continuing study and often come to the conclusion that, for business management, legal, tax and other reasons, the best form for their status and business conduct is either an individual setting using a contractual framework for sharing the intellectual and other property, such as licensing and franchising [3] or a simplified corporate setting through the Limited Liability Company (“LLC”). In other words, the correct employment of the LLC can lead to an improvement in the business performance and thus ultimately lead to a sustainable competitive advantage [4].

The LLC has a legal personality and the corporate veil shields its associates-members. The organ acting in the name of the LLC is the executive and thus the first targets of unhappy stakeholders of the LLC is the LLC itself and, of course, its executives. In each state, the national law sets the legal framework and dimension of this liability. Nevertheless, the

majority of the EU member states share a relatively similar model allowing for the casting of blame for certain damages caused by the LLC, or even suffered by the LLC itself, upon executives. In other words, executives of an LLC ending up in bankruptcy or otherwise landing in serious problems can envisage himself or herself in trouble.

Both, LLCs and their executives, are exposed to a strong pressure and they, of course, assume risks. The maximized competitiveness and tough global market make it extremely challenging to reconcile the multivarious interests of all stakeholders of a LLC with the interest, not just of the LLC itself, but above and beyond that, to the very executives themselves.

Therefore executives of LLCs in the entire EU explore with a great amount of interest about how to be shielded from unwanted legal liability. Interestingly enough, there is a myriad of options, strategies, methods and instruments, and executives of LLCs from the Czech Republic seem to generally make different choices than executives of LLCs in other EU member states. In other words, while the frameworks are similar and the operation is also of a like manner, it comes as a bit of a surprise that the methods used in the addressing of potential risks is dramatically different.

Thus, it is highly instructive to research, analyze and present a comparative overview of the basic features of the legal liability of executives in Germany, Austria, France and in the Czech Republic and to assess the selection of strategies adopted by the executives of LLCs in these various countries. An integral part, obviously, of such an evaluation would be a field search and thus a questionnaire inquiry was duly performed and is offered up here. The results shed new light, as well as bringing up other important questions suggesting an interesting potential for further research to be made in this arena. It goes without saying that this issue has a direct impact on the everyday business operations of LLCs in the EU, and thus it is no doubt influencing the internal single market, as well as all of us in the EU.

II. THE LEGAL LIABILITY OF EXECUTIVES OF LLCs IN GERMANY, AUSTRIA AND FRANCE AND FAVORITE STRATEGIES HOW TO ADDRESS IT

Germany, Austria, and France share the same legal tradition as the Czech Republic, namely they belong to the continental law family, as opposed to the *common law* family. The LLC as a business form is set in a similar manner in these four countries, and basically the executives of LLCs in Germany, Austria, France and the Czech Republic are exposed to a similar risk to see their legal liability applied.

It is instrumental to observe that the first trio, namely Germany, Austria and France have moved, gradually over time, toward a *common law* approach in relation to the function of executives and its ramification and manners about how to address it, i.e. toward the USA model. Thus, executives of LLCs in Germany, France and Austria are liable for their actions and carry a fiduciary duty, and their actions are scrutinized under the Business Judgment Rule.

The German LLCs, *GmbHs*, are represented by their executives *Geschäftsführers* bound by the duty of loyalty, *Treuepflicht*, which derives from the general requirement of acting in good faith. Their liability is further reinforced as *Geschäftsführer-Haftung*, which is mandating the observance of the Business Judgment Rule. The German trio *Treue-Sorgfalt-Sicherheit* means that the German executives are *Dirigent auf dem Drahtseil*, i.e. they are tightrope walkers, akin, somewhat, to Karl Wallenda.

Boldly, *Geschäftsführers* have got to stand up to high standards and their strategic as well as operational decisions can be challenged easily, especially during any difficult times of their LLCs. In other words, the red numbers on the financial statements of their LLC can become red lights for them, and, even worse, they can lead to an attack on the assets of such *Geschäftsführers*. To describe completely the dark scenario, the possibility of criminal charges and a jail sentence needs to be mentioned.

Logically, *Geschäftsführers* must address this danger. A very popular strategy is to get an exoneration statement by the LLC. It is easy to acquire it, but it is a rather soft and supplemental instrument, because such a statement is not, per se, the liberation cause. Similarly, the “run away” option is attractive only prima facie, because the resignation from the function does not lead to a liberation.

Thus *Geschäftsführers* clearly know that their job is highly hazardous and that their good relationship with LLC associate-members, as well as a fast exit plan, are rather weak strategies to tackle their heavy legal liability. Under such circumstances, no experiments are done and the majority of *Geschäftsführers* look for a solution to such an American issue by American instruments. In other words, they want to address the danger of the Business Judgment Rule imported from the USA as it is done in the USA. Therefore, the typical German solution consists of taking out a special type of insurance, namely *Versicherungsschutz D&O*, i.e. Directors & Officers Insurance (“D&O Insurance”), and to so address the presumed severity linked to the application of the standard of the care and the diligence of a good businessman [5].

The German’s well known inclination to reduce risk thusly leads to a search for additional instruments, i.e. the D&O Insurance is often complemented by contracts, exoneration statements, and , the establishment and observance of the corporate compliance program [6].

In Austria, the setting is similar and executives of LLCs not satisfying the threshold of a good businessman’s performance of their function can see their legal liability brought into play. This is a likely scenario in the case of the bankruptcy of the LLC. Further, the statute of limitations for the executives of Austrian LLCs is rather unusually long. Thus, Austrian executives can be questioned and challenged for their acts and omission during a five years long time span, i.e. the five years long prescription period means that an executive must bear the risk to be proclaimed liable and to lose his own personal assets for something what happened “many years ago” in a LLC, maybe in which he was not involved for several accounting periods. Thus, the Austrian drive and interest for the D&O Insurance is absolutely logical in such a context.

Executives of LLCs in France, *gérants de S.A.R.L.*, or even in the case of a company formed by a sole trader *E.U.R.L.*, are in a similar, if not identical situation, their legal liability can be claimed and prosecuted based on their alleged breach of the business management duty. Again, the bankruptcy of the *S.A.R.L.*, can have significant negative consequences for the personal financial sphere of *gérants*. The statute of limitations is 3 years, thus it is sufficiently long enough to cause worries. The D&O Insurance is a popular strategy, and considering the particularities of the French employment and social security system, it is often combined with the unemployment insurance of the executive, *gérants*, i.e. the D&O Insurance is presented in a package with the *assurance chômage*.

In sum, the D&O Insurance is a vital strategic instrument for executives of LLCs, especially of SMEs, and thus there is a healthy market for it, and many insurance companies offer D&O Insurance. Thusly, D&O Insurance is important for the business conduct of LLCs and a good business is done through it. As a matter of fact, over 50 insurance companies offer the Insurance D&O in Germany, among them that offer *Managerhaftpflichtversicherungen* are Allianz Versicherung AG, Chartis Euroope, Versicherungskammer Bayer, etc. There is a strong competition between these insurance companies and, as with life insurance or car insurance, each insurance company attempts to allure clients with some „specials.“

TABLE I. THE GENERAL COST OF D&O INSURANCE IN GERMANY IN 2013/2014

| Insured amount (insured coverage for executive liability) | The annual turnover of the LLC | | |
|--|--------------------------------|------------------------|-------------------------|
| | Up to EUR 1 000 000 | Up to EUR 5 000 000 | Up to EUR 50 000 000 |
| EUR 250 000 | EUR 602 | EUR 666 | EUR 898 |
| EUR 1 000 000 | EUR 1 124 | EUR 1 245 | EUR 1 677 |
| EUR 2 500 000 | EUR 1 706 | EUR 1 890 | EUR 2 545 |
| EUR 5 000 000 | EUR 2 353 | EUR 2 809 | EUR 3 783 |

Source: Prepared by the authors based on the data available at <https://www.kuv24->

manager.de/D%26O+Managerhaftpflicht/Details+zur+D%26O+Managerhaftpflicht/index.html?pageid=602&

III. THE LEGAL LIABILITY OF EXECUTIVES OF LLCs IN THE CZECH REPUBLIC AND FAVORITE STRATEGIES HOW TO ADDRESS IT

As indicated above, the economic and legal setting as well as tradition and social patterns are relatively similar in Germany, Austria, France and the Czech Republic. In addition, all of these countries share not only the continental law tradition and recent history, but as well are all members of the EU. Therefore, the single internal market stretches over them and a rather soft EU harmonization with respect to business forms and the general operation of business, including their liability, cover them.

A closer look into the Czech framework, which was recently re-codified and included in the New Civil Code and the Business Corporation Act, generates a similar impression about the extent and consequences of the legal liability of an executive of a Czech LLC, as with his or her colleagues in Germany, Austria and France. Therefore, Czech executives can see their legal liability applied not merely in financial dramatic situations for their LLC, and they risk sanctions in their personal property sphere as well as about their future activity options. A Czech executive whose LLC ended up in bankruptcy can be forced to return his past remuneration paid by the LLC to him or her, to pay damages, and may even be prohibited to perform the function of an executive for any Czech LLC.

Unlike their colleagues in Germany, Austria or France, Czech executives are informed only on a very general level, and, in particular, they do not possess detailed information about the possibility of a sanction through ordering the return of financial as well as non-financial profits, and the possibility for creditors or for the insolvency administrator to file such complaints. This surprising fact was established by an original inquiry made through the use of questionnaires distributed to a homogenous group of executives of Czech LLCs successfully operating in Prague. The sample included 50 executives, and 35 of them, i.e. 70%, admitted to their low awareness about their legal liability. After these disappointing results were obtained, all those 50 executives attended a seminar with a workshop and were duly informed about the nature and extent of their legal liability, as well as about strategies about how to address it. One of the presented options was the employment of professional advisors and their inclusion in strategic and even operational planning. Namely, since executives and their decisions are scrutinized under the Business Judgment Rule and their steps are reviewed in the light of the care of a careful manager, it becomes obvious that the position of executives is much stronger if they can show that, before the challenged decision or step, they contacted a professional and acted according to his or her advice. The reaction of the respondents was a plebiscite, i.e. all of them expressed their great interest to seriously consider this option and to engage in more consultations with tax experts, lawyers, and other business experts.

They are strongly inclined to hire qualified persons who will provide them with information about important issues

related to the management of a commercial corporation, so as to avoid the enforcement of claims against them, and thus to avoid their liability. With an almost certainty it can be stated that the cost for these advisors will be borne by the LLCs themselves.

The insurance option was not covered in detail during the meeting with this sample of Czech executives, and thus it can not be excluded that they may consider it as a plan B. Nevertheless, the already well established tied relationships between executives and providers of various services for their LLCs suggests, that the plan A is, and will be, an even more intense employment of advising experts.

IV. CONCLUSION

Our post modern global society relies on a very competitive market where knowledge is true power, with the employment of information systems and information [7], where business needs to be conducted in any feasible manner, including e-versions [8], and where no business can afford to suffer by a wrong establishment setting.

The corporate trilogy, or more precisely quarter-logy, generates a lot of dynamics [9], and especially within a LLC this can lead to a lot of internal, as well as external, tensions, while the liability of the key players is at its very heart. Germany, Austria, France and the Czech Republic seem to be countries where the LLC is a very viable and useful form for business conduct and many businesses, especially SMEs, go for it. These businesses are led, operated, and represented by executives who need to perform their function according to the Business Judgment Rule, they need to be careful and vigilant businessmen. Often, various stakeholders challenge executives and their liability, and especially if a LLC is not willing or not able to pay, they try to get damages from the executives and see the executives punished.

Honest executives need to operate and they do not want to be paralyzed with a constant fear. Dishonest executives want to enrich themselves and they do not care about the LLC and the LLC's stakeholders. Good executives want to assume reasonable risks and do stuff which the competitors cannot duplicate and through positive effects reach a sustainable competitive advantage [10]. Bad executives do not assume any risk or they assume unreasonable risk. All of them want to reduce, if not eliminate, any potential to raise their legal liability. They all consider various strategies and these strategies should shield the good executives and not the bad ... but the real life can show a completely different picture.

Nevertheless, we can already at this point conclude, that Czech executives rather spend LLC funds on paying for various advising to be recorded as a protection instrument in future law suits, while German, Austrian and French executives are inclined to pay, ideally for the executive, by the money of the LLC, the premiums for their D&O Insurance. .

Since the LLC is generally the paying party, it is legitimate to contrast the involved costs. The amount of the Insurance D&O premiums needs to be compared with the hourly fee payable to a legal expert. Table I shows that the premium in Germany is between EUR 602 and EUR 3 783. According to the Juve portal, the average hourly rate charged by an attorney

at law is EUR 238, but regarding commercial law lawyers, they seem to charge more, for an associate EUR 256 and a partner EUR 334 [11]. Considering the expected number of hours to be charged for advising regarding transactions and various LLC issues, the „Czech“ venue for addressing legal liability appears not effective, and way too expensive, as opposed to the German setting.

This issue needs to be perceived in the light of various international surveys showing that corporate executives may be focusing too much on legal liability, financial and compliance risks while underestimating strategic risks that have greater impact on the long-term success of a company [12]. Boldly, there is a true fear by executives to see their legal liability applied with consequences on their career, as well as personal assets. And this fear might become overwhelming and impair the selection of business strategies for companies.

Generally, executives, stockholders and even stakeholders of LLCs in the EU try to address the burning issue of the legal liability of executives by a set of instruments, including compliance and contractual instruments, and the critical plan B device is the insurance D&O, often offered as a kind of fringe benefit for executives. Plainly, if the liability needs to be shifted, then rather to a neutral insurance company than to the tax, accounting or legal adviser of the LLC. This solution looks more clean, less like circumventing law and business ethics and, last but not least, cheaper than to get and pay for reducing the risk of personal exposure and damages to be paid from the personal assets of the executive and his or her family. The Czech executives so far follow a different pathway, and it is unclear whether they do it due to their lack of knowledge of the insurance D&O or due to their willingness to get more jobs for their friends who are lawyers and financial advisors or just because the LLC stakeholders do not want executives to rely on the insurance. Interestingly, the Czech pattern ultimately ends with the insurance anyway, because e.g. lawyers need to carry the malpractice insurance.

In sum, strategies for addressing the legal liability of European executives are a very hot issue which, so far, has not received a strong academic interest and more research and

analysis needs to be done in order to offer a well based recommendation for businesses operating in the EU.

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