COFOLA 2010: the Conference Proceedings, 1. edition. Brno : Masaryk University, 2010, ISBN 978-80-210-5151-5

LIABILITY OF COMPANY SHAREHOLDERS

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Abstract in original language
Příspěvek se zabývá ručením společníků za závazky obchodních společností v českém právu. Autor rozebírá jednotlivé případy ručení a jeho charakter a zamýšlí se nad jeho praktickou použitelností a vhodností jeho zákonné konstrukce. Kritice podrobuje především ručení společníků společností s ručením omezeným.

Key words in original language
Obchodní právo, obchodní zákoník, ručení, ručení za závazky společnosti

Abstract
This contribution is focused on shareholders liability for company obligations as it is regulated in Czech law. The author describes different models of shareholders liability and their characteristics and also analyses their practical usability. The closing part of this contribution provides a detailed critical view of private limited company shareholders liability.

Key words
Commercial Law, Commercial Code, Guarantee, Shareholders liability

The shareholders liability is an integral part of Czech Commercial law. In this contribution I wish to provide basic insight into it and analyze practical usefulness of this regulation.

I am using term shareholder liability in this text, as it is commonly used in international legal English. However, from the isolated point of view provided by Czech national law it would probably be more accurate to call it shareholder guarantee, as we strictly distinguish liability as a primary duty to fulfill obligation from guarantee, which is considered to be subsidiary and akcesoric duty and therefore forms obligation secondary to the duty of debtor[1].

Abovementioned conception of guarantee applies in full to shareholder liability. Because of this, shareholders might be held liable only in case that

[1] Štenglová, I., Plíva, S., Tomsa, M., et al: Obchodní zákoník, 12th edition, Praha 2009, 1397 pgs., ISBN 978-80-7400-055-3.

the company has not fulfilled its obligations and shareholders duties are dependent on existence of the primary obligation of the company.

The shareholders liability differs greatly depending on company type. While private limited companies use a traditional system based on share capital and its payment, public limited companies do not tie their shareholders with any guarantee. Unlimited companies (partnerships) as companies built on personal participation of shareholders are complete opposite of this - shareholder liability is unlimited. Finally, Commandite companies (special limited partnerships) form a hybrid way with two categories of shareholders, one of them with unlimited liability and the other liable as in private limited companies. For all company types there is common rule governing shareholders liability after termination of the company.

The unlimited company is a little unusual construct, as is a company in the legal sense and therefore is a separate legal entity, rules governing its functioning, however, would suit more a mere trade association - unlimited liability of shareholders, personal participation of shareholders on company operations, no separate company bodies, all profits are distributed directly to the shareholders and all losses are covered by them.

This constitutes the one comparative advantage that the unlimited companies have over the other company types - more favorable taxation (the income is not taxed by companies income tax but only by the regular income tax when the profits are distributed amongst shareholders and therefore double taxation is excluded). On the other hand this also means that the company may not keep any profits in reserve for future expenses or investments, which makes it rather unsuitable for growing enterprises.

In addition the shareholders liability in unlimited companies is considered to be very strict. Shareholders jointly guarantee company obligations in full with all their property, which may be found too restrictive. It results in unwillingness to become unlimited company shareholder, because most entrepreneurs or inventors find this to be too much of a risk. It also negates one of the construction pillars of modern corporations which is limiting shareholders risk to bring more resources to enterprise and allow the entrepreneurs to calculate the risks they are undertaking.

Therefore, almost no unlimited companies are established in Czech Republic and some of those few bypass the unlimited liability by having shares owned solely by limited companies - in this case the unlimited liability extents only to assets of such company (which might be minimal) and shareholders of the controlling company are protected by its limited character. We must note that this solution is flawed though, because it cancels the tax advantage the unlimited company would otherwise have.

This raises question, whether we even need unlimited companies at all or whether trade associations regulated by Civil Code are sufficient form for

unlimited liability business. In any case, the unlimited liability is very unpopular in Czech Republic and is used so scarcely that the unlimited companies are generally perceived as something strange and peculiar rather than as a trustworthy and solid corporation template.

Compared to unlimited liability the shareholders liability in public limited companies can in short be described as non-existent. The shareholders do not guarantee any company obligations, their share on the company is considered to be an investment, rather than bond of participation on company activities. As such, their investment might be lost, but they shall never (with exception of cancelled companies) be liable for any company debts. This reflects the character of these companies well - they are supposed to be a platform allowing capital investments in enterprise and this should not be compromised by requesting their personal participation or guarantee.

Private limited companies are considered to be capital companies as well; however their focus on small and mediocre business brings reasons for certain differences. Therefore their shareholders might be held liable for company debts in case that company share capital has not been paid up in full. All shareholders jointly guarantee company debts up to the sum of unpaid contributions[2]. This conception originates from the traditional systems based on protecting company creditors by setting and maintaining certain level of share capital.

In light of current developments these systems seem to be outdated as share capital (even if all shareholder contributions have been paid completely) provide only a shoddy protection and certifies nothing that certain amount of money (or contributions in kind in guaranteed value) has been provided to the company. Much too often the share capital becomes a ghost image in a few months as the contributions are regularly used to finance the business - purchase materials or equipment, pay workers wages, etc.

No diligent entrepreneur would ever take share capital as a proof of credibility of a company. It may sometimes indicate the scope of commercial activities, but it is completely unusable when it comes to evaluating the company economical situation. Therefore the share capital is deemed to loose importance and many states are leaving corporate models based on it - usually not by a direct abolition but rather by loosening the rules for its creation, evaluation of contributions in kinds, allowing establishment of so called 1$ companies (companies with share capital set at 1 unit of currency and therefore having share capital only formally), etc.

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[2] Bartošíková, M., Štenglová, I., Společnost s ručením omezeným, 2nd editon, Praha: 2006, 677 pgs., ISBN 80-7179-441-4.

I can't help myself but doubt, whether it is desirable to subject private limited company shareholder to a guarantee of company debts in case that not all contributions have been paid. This seems to make the private limited company closer to personal companies[3] and compromises its capital character. Does the paid share capital really provide higher standard of protection to company creditors? Should the payment of share capital still be perceived as an instrument providing security to third persons? Shouldn't we rather shift the paradigm, let creditors evaluate credibility of a debtor company on their own and seek contractual securities than try to protect them with a malfunctioning legal protection? In case that we choose this point of view (similar to that in public limited companies) it would mean that the payment of contributions into company share capital would become more of a bipartial contract concluded between company and shareholder. The protection of third person would not be completely excluded, however instead of providing a direct guarantee it would rely on duty of diligence of the statutory bodies and their liability in case of breach.

Let's leave criticism of share capital guarantee as a whole and get back to analysis of shareholder liability. Another reservation I have against shareholders guarantee in private limited companies grows from its effects. On first glance, all might seem to be perfectly all right. The shareholder guarantee is limited by the sum of unpaid contributions, whenever shareholder covers a company debt, he might set his payment off against his obligation to pay share capital or if this is not possible utilize compensation claims against the company or other shareholders.

However, the shareholders liability for company debts is not terminated by payment of company debts[4]. It stays in effect, until share capital is completely paid and until this fact is incorporated in the commercial register[5]. It is therefore not only possible to claim payment of company debts from a shareholder who already fully paid his contribution (this alone I find controversial), moreover payment of such shareholder does not liberate him of his guarantee pro futuro. This fact allows other creditors (or even the same creditor in case that he has more than one receivable) to file guarantee claims law-suits against the same shareholder. The protection the shareholder benefits from only sets the amount of money up to which he is guaranteeing each company obligation.

This I consider to be discriminating. The individual shareholder may have fulfilled all his obligation to company and despite this he may be held liable

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[3] Bartošíková, M., Štenglová, I., Společnost s ručením omezeným, 2nd editon, Praha: 2006, 677 pgs., ISBN 80-7179-441-4.

[4] See also Decision of the Supreme Court from 27th January 2004, 29 Odo 629/2003.

[5] Štenglová, I., Plíva, S., Tomsa, M., et al: Obchodní zákoník, 12th edition, Praha 2009, 1397 pgs., ISBN 978-80-7400-055-3.

for other shareholders unpaid contributions. He has, of course, the recourse claims against company and such shareholders, but the way to company might become a long struggle with uncertain results. I do not believe that such model is suitable for a capital company (though private in character) and would welcome either abolishment of private company shareholder liability or at least limitation of each shareholder's liability to his own debts to the company.

In addition to this, the limitation of guarantee afflicting each obligation separately creates an uneven position of creditors - rather than proportional satisfaction of all creditors, it would lead to small obligations being satisfied completely and larger obligations only partially. Also, the a creditor with one large obligation will be in much worse situation than the same creditor with the same debt divided into a number of smaller obligations.

On the other hand, we have to remember, that the effects of shareholders guarantee are limited to companies with share capital that has not been paid in full. It may happen that the shareholders will pay their contributions after company creditor has raised his guarantee claims against them - the eventual law-suit would take some time before it is resolved. One of such cases happened to be decided by the Supreme Court and it has stated that the court may not grant the creditor rights arising from shareholders liability if by that time all contributions have been paid and this has been incorporated in the Commercial register[6]. This conclusion actually significantly limits the usefulness of shareholder guarantee, as shareholder gets the choice to either pay the company debts as guarantor or pay the share capital to the company. This may become of interest in cases in which multiple creditors are raising claims against company or shareholders - often such claims will in total exceed the sum of unpaid contributions. The shareholder may try to avoid such "guarantee trap" by paying his contribution or even paying other shareholders contributions in their stead to terminate shareholders liability as a whole. This might be a way how to deal with the troubling situation of multiple claims described above.

The draft of new Corporations Act, which is meant to replace regulation of company law contained currently in Commercial Code, does not change much in the shareholders liability. Despite no major modifications are made, one change will influence the liability of shareholders of private limited companies in future. The draft allows establishment of these companies with no less than 1 CZK of share capital. In such companies the shareholders liability will be completely excluded as so low share capital provides no space for unpaid contributions.

[6] Decision of Supreme court NS 29 Cdo 281/00 published in Soudní Judikatura 127/00

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