

MANAGEMENT BOARD MEMBER AGREEMENT OR EMPLOYMENT CONTRACT

March 2004

Lately, my reminder that an employment contract cannot be concluded with a management board member for performing the management board member's tasks has caused big excitement. It is rather exceptional to observe how the principle that was regulated in 1992 is reaching people's consciousness only so many years later. Is it really possible that in the Estonian business world the law is observed so lazily, and this is done in the field concerning the persons of whom we expect particular carefulness and attention.

Pursuant to clause 7 (10) of the Employment Contracts Act, the relationships of a company and its directing bodies are not employment relationships in the context of the Employment Contracts Act. Thus, an employment contract cannot be concluded with a person performing only the duties of a management board member, and the guarantees arising from the Employment Contracts Act do not extend to the person. In enacting such a regulation, the legislator has presumed that a management board member is not the weaker party of the relationship who should be protected, and has considered a management board member's extensive authorities and freedom of action in respect of the company.

The essence of a management board member agreement

If a management board member consents to be elected to the management board and is thereupon also elected, a agreement has been entered into between him and the company that has to be regulated according to an authorisation agreement under the Law of Obligations Act.

There is no established compulsory form of the authorisation agreement. Therefore, the management board member's agreement can be entered into verbally. Nevertheless, it is recommended to conclude the agreement in writing.

The decisive criteria in differentiating between an employment contract and a management board member's agreement are the tasks performed in reality. In case the management board member only manages the company's activities and does not

perform any other tasks in the company, only a management board member's agreement can be concluded with the person.

There have been cases when a person with whom an employment contract has been previously concluded is elected as a management board member and he starts to perform only the duties of the management board member. In case the duties do not change (e.g. managing director), a new contract is usually not made. In case the duties do change, the corresponding change is entered into the existing employment contract. However, this practice is wrong. If the person only continues to perform the duties of a management board member, then pursuant to the court practice it is considered that the employment contract is terminated by the agreement of the parties. The Tartu Circuit Court formed this opinion in its decision from 21 March 2001.

But election to the management board need not always terminate a previously concluded employment contract. The person may simultaneously have several contracts with the company: the management board member's agreement to act as a management board member and also an employment contract to work on a particular position. For example, when a lawyer working under an employment contract is elected as a management board member but he also continues to perform the obligations of a lawyer, the employment contract with him need not be terminated (or is not automatically terminated), but it is recommended to conclude a management board member's agreement with him in addition. A similar judgement was given by the Supreme Court on 26 November 2002. In this particular case, the apartment association Vikerlase 13 had elected an accountant who had previously worked under an employment contract as a management board member. After being elected as a management board member, the accountant continued to perform the duties of an accountant. In 2000, he was recalled from the management board and the apartment association did not wish to apply the Employment Contracts Act, claiming that the employment contract had been terminated by the agreement of the parties upon his being elected as a management board member. However, the court found that if the work performed by the management board member under the employment contract did not compose the performance of a management board member's obligations, the Employment Contracts Act had to be applied. Consequently, in this particular case there were two contracts — an employment contract to perform the duties of an accountant and an oral agreement to perform the duties of a management board member.

If a person has, for example, two contracts with a company, then in terminating the contracts it is vital to pay attention to the fact that these contracts are not related to each other. Both contracts have to be terminated separately, applying in addition to the contract's own regulation also either the Employment Contracts Act or the Law of Obligations Act.

If no written agreement is concluded with a management board member, later it can prove to be very difficult to establish under which terms the agreement was concluded with the person. There may even occur a situation where some previous terms of an employment contract have transferred to the terms of a management board member's agreement.

In order to conclude, alter or terminate a management board member's agreement, it is necessary to have a decision of the supervisory board of the public limited company

or of the shareholders of a private limited company. In case there is no decision, the transaction is void and the parties will have to return everything received pursuant to it.

As a rule, interpretation problems of the management board member's agreement arise only then when the management board member is recalled from the management board. Questions emerge whether a written notice should be given of the termination of the agreement, whether the termination should be reasoned, and whether compensations should be paid for the termination. Pursuant to the Commercial Code, a management board member can be removed without prior notification, without any reasoning and without any compensation.

Content of the agreement

It is possible to regulate very exactly the relationship of the parties in a management board member's agreement. The more precise and complete the agreement, the more probable it is that disputes between the parties can be prevented.

In case no written agreement has been concluded with the management board member or the agreement terms have not been established precisely enough, the law serves as a basis in the determination of the content. Pursuant to the law, the content of a management board member's agreement is made up of the mutual rights and obligations that have been specified by various laws and the articles of association, result from the essence or purpose of the agreement or the established practice of the parties, or result from the established practice of the given profession or field of activity, the principles of good faith and reasonableness, etc.

It should be pointed out in the management board member's agreement which requirements the company has imposed on the position of the management board member (e.g. language skills, existence of certain skills and experience, etc.). The management board member should also confirm his suitability for the position and also the correctness of the documents and data submitted by him. Confirmations can be required also concerning competitive action, criminal records and the lack of conflict of interest with the relevant partners of the company (e.g. family connections).

It is recommended to establish very precisely a management board member's terms of reference, duties, relationships of subordination, regular reporting requirements, the rules of decision making in case of substantial business transactions, obligation of consulting specialists, etc. It is also possible to enact these questions with some other internal instrument and these are also obligatory to the management board member. It is recommended to endorse such internal instruments by a decision of the superior body to the management board.

Management board member is obliged to fulfil his commitments with the usual diligence expected of a member of a directing body and he will have to be loyal to the legal entity. It is rather complicated to give meaning to these definitions — it depends on several circumstances and current situation. Still, it is possible to set some rules of play beforehand and one possible place for this is definitely the management board member's agreement. Thus, it is possible to establish, for example, that the management board member will not be held responsible if he has followed all rules of diligence. Thus, it can be required that he should engage specialists in certain

transactions, take several competing tenders, co-ordinate action with the supervisory board, adhere to budget and action plan, etc. In case the management board member has observed all this, it can be established by the agreement that he will not be held responsible within the company in case of such transactions. As business activities are always connected with very high risk, it is also possible to obtain liability insurance regarding a management board member's field of activity (not very easily in Estonia at present, but certainly through foreign insurance companies).

As the labour laws do not apply to the relationship of a management board member, the working time, duration of holidays and the obligation to co-ordinate holidays should also be specified. During the holidays, the company has to pay the management board member the average pay only if it has been established in the agreement, and compensation for unused holiday upon the termination of the agreement should also be specified.

Remuneration payable to the management board member has definitely to be specified in the agreement, and it has to be designated by the decision of the supervisory board similarly to other benefits granted to the management board member. It is also recommended to specify the reimbursement of expenses incurred upon performance of duties, work equipment given to the management board member and the reimbursement of related expenses.

It has to be specified which activity is considered a competing activity and who are the competitors of the company. Often also the prohibition on competition of the management board member is prescribed in the agreement after the termination of the agreement and generally compensation is paid for it also after the termination of the agreement.

It is recommended to specify which information is considered as the company's business and production secrets and which information the management board member may disclose without any restrictions. Pursuant to the Law of Obligations Act, the confidentiality of such facts has to be maintained which the mandator has a legitimate interest in keeping confidential, above all by maintaining the mandator's production or business secrets. Upon suspicion, the management board member's responsibility could be enacted to receive prior consent e.g. from the chairman of the supervisory board. In case of group associations, rules of confidentiality that cover the whole group's business and production secrets are often established. Confidential information is usually defined as information connected with the whole production and marketing process, data on customers and cooperation partners, the company's payroll system, action plans, strategic decisions, price policy of products and services, etc.

The grounds for responsibility and contractual penalties payable for the breach of agreement have to be determined by the agreement. Claiming compensation for certifiable damages alone need not cover actual damages caused to the company, as the certification of actual damage may often prove to be very complicated. For example, when a management board member is distributing information on some relevant sales strategy or competing with the company, the real damage may not be exhaustively documented and the damage can arise only in the future.

There have been many discussions pertaining to the formulation of the Commercial Code pursuant to which the management board has to observe the lawful directions of the supervisory board. Thus, if the direction of the supervisory board is unlawful, the management board will not be exempted from responsibility to compensate for damages caused by the execution of such a decision. The management board member is always obligated to assess whether he is presented a lawful direction or not. It is recommended to specify in the management board member's agreement how the management board member should behave if he believes that the direction given by the supervisory board is unlawful or contrary to the company's interests.

In addition, it is possible to specify in the agreement, for example, matters related to copyright and other intellectual property. From the management board member's point of view, it is vital to specify also the responsibility of the company to arrange promptly for the deletion of the management board member from the register after the agreement has been terminated, because an incorrect entry can often have unpleasant consequences for the former management board member. There have been cases when the commercial register or the Tax and Customs Board imposes a fine on a management board member entered into the register who in reality is no longer performing the duties of a management board member. Also, it is possible to provide for a penalty for ensuring the deletion of the management board member from the register.

As the management board member can be recalled regardless of the reason at any time, but the rights and obligations ensuing from the agreement expire according to the agreement, the termination of the agreement should be very precisely enacted in the agreement. If the compensation payable upon the termination of the management board member's employment relationship has not been previously agreed upon, the management board member will not have the right to ask for any compensation upon the termination of the agreement. Terms of advance notice, termination payments and cases in which advance notification does not have to be observed upon the termination of the agreement (e.g. breach of contract, loss of confidence, arrival of retirement age, long-term illness, liquidation, criminal punishments, etc.) should be regulated.

Pursuant to the Law of Obligations Act, it is possible to terminate the agreement concluded for an unspecified term of a management board member at any time. If the agreement has been concluded for a term of more than five years, the management board member can terminate the management board member agreement after five years with one-month advance notice. It is also possible to terminate the agreement as an exception without observing the term of advance notice, should it become evident that taking into account all circumstances and considering the interests of both parties it cannot be expected that the party wishing to terminate the agreement would continue to perform the agreement until the term of cancellation or the term of expiration of the board member agreement.

It is possible to draw up an agreement of a management board member following the principles enacted by the Employment Contracts Act (e.g. compensation receivable upon the termination of the agreement, term of advance notice, etc.). If the management board member's agreement does not include the provisions characteristic of an employment contract, it is not possible for the management board member to raise similar claims either.

Management board member's remuneration and taxation

The amount of remuneration of a management board member and the arrangements for payment must be stated by a decision of the supervisory board like all the other relevant terms of the agreement.

Pursuant to the Commercial Code, the remuneration payable to a management board member must correspond to the management board member's duties and to the company's economic situation.

Amendments to the Commercial Code, being prepared by the Ministry of Justice will give the supervisory board the right to reduce a management board member's remuneration unilaterally, regardless of the provisions of the agreement, when the economic situation of the company deteriorates. In such a case, it is possible for the management board member to terminate the agreement within one month. The proposed provision is in conflict with the principle of freedom of contract, as it gives one party the right to change the contract unilaterally regardless of the provisions of the contract, but at the same time it can be extremely necessary in order to protect the interests of the company and creditors. At the moment, it is still unclear whether the right of unilateral reduction of the management board member's remuneration will remain in the draft and whether the Parliament will approve it.

On 8 September 2003, the Supreme Court gave a decision concerning the payment of remuneration pursuant to an agreement concluded with a supervisory board member. The decision is applicable by analogy also to the remuneration of management board members. In this case, the general meeting had determined the remuneration of the member of the supervisory board for a shorter period than the term of agreement of the member of the supervisory board, and after the termination of the period, the company wanted to unilaterally change the amount of remuneration specified in the agreement. The court found that the member of the supervisory board had the right to claim the remuneration specified in the agreement, as the possibility to reduce remuneration had not been provided for in the agreement.

Social tax is paid on the remuneration payable to management board members similarly to the remuneration payable under employment contracts. Income tax is also deducted from the remuneration payable to a management board member. Similarly to other employees, it is possible for management board members to make contributions to the 2nd and 3rd pillar pension funds.

It is not required to pay unemployment insurance premium from a management board member's remuneration, as Unemployment Insurance Act does not extend to discussed contractual relationship. Pursuant to the Unemployment Insurance Act, a member of a directing or controlling body of a legal person is not an insured person. A member of a directing or controlling body is understood to be any authorised member of a body or person who, resulting from a corresponding law on the legal person, partnership agreement, articles of association or any other legislation regulating the action of the legal person has a right to participate in managing the activities of the legal person or in controlling the activities of a directing body. Directing and controlling bodies include among others the management board. If the unemployment insurance premiums have been paid from the remuneration payable to the management board member, it does not guarantee the protection of the management board member upon dismissal from the management board.

Conclusion

In order to avoid later disputes between a company and a management board member, it is recommended to conclude a written management board member's agreement, which will guarantee a better protection of the interests of both parties in the legal relationship. It is recommended that a management board member should require the conclusion of the management board member's agreement in writing before granting his consent and draft the agreement as thorough as possible, considering all circumstances to ensure sufficient legal protection.

It is time for management board members and companies to start thinking of how to prevent unpleasant disputes and unexpected surprises. Future management board members should think first and then act — a natural thing to do for every management board member, as they are the ones who are expected to be especially careful in managing duties. So, do not forget Murphy's Law that says: a knife that is too blunt to cut anything is sharp enough to cut your finger.

Karin Madisson, Senior Associate
Advokaadibüroo Sorainen Law Offices, Tallinn