

# Transformation of an Association into an Institute

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**Abstract:** *The paper focuses on the changes in the area of legal persons brought by the new Czech Civil Code. The new Civil Code recognizes three types of legal persons: corporations, foundations, and institutes. The process of transformation is aimed at the societies that were founded according to Act No. 83/1990 Coll., on association of citizens, as amended, and which became associations by the Civil Code since its effectiveness, i. e. on January 1, 2014<sup>64</sup>. Associations founded according to the New Civil Code cannot be transformed into institutes. The form of an institute is suitable for associations where no member basis is present or ones where its members are at the same time also its employees. With regards to the association, the law recognizes two types of transformation, that is – voluntary, and obligatory. The obligatory transformation was done by the Civil Code when societies became associations, however, the voluntary transformation can be done sustaining on the decision of the supreme body. The society could be turned into an institute or into a social cooperative. The transformation process does not have any support in the legal regulation – that is why there are so many questions to be answered and interpreted.*

**Key words:** Institutes · Transformation of Legal Form Association · Association Law

**JEL Classification:** K1· K13

## 1 Introduction: Association (former Society) and Institute

The association is defined by the Czech Civil Code as a corporation that is formed at least by three persons either natural or juridical led by a common interest which is important to them. The range of the associations in the Czech Republic is quite broad, on one hand there are many associations founded by three members, and on the other hand there are societies with many members. The legal regulation of societies used to be ruled by Act No. 83/1990 Coll., on association of citizens, as amended. This act was annulled by the new Civil Code. Legal persons of private law in general are regulated by the Czech Civil Code. Societies from the beginning of their existence have always dedicated their activity in order not only to support their members' interest, but also to support the public life. In order to support the public life, many societies provide services to the public in the area of social, health care and educational services. The basic features of a society are membership and operative association self-government. This means that the society has to have a member base, which is able to actively decide on the operation and activities of the association and it is not bound by dependent relations typical of employment law. Members, in order to preserve the essence of the association self-government, cannot simultaneously be employees of the society. According to the New Civil Code, an association may actually develop the main and a secondary activity. The main activity represents the means to realize the common interests or social activities. The biggest debate arises precisely in defining secondary activity. The secondary activity may be of business character, nevertheless, it should not reach such a level that it can be considered comparable to the business, i. e. the association has not operated primarily for the purpose of profit.

Unlike associations, institutes are legal entities that are not based on membership – on the contrary, the employment contracts prevail. Contrasting foundations, they are not created in order to provide donations to the public, which is why their capital can be consumed, but to provide socially or economically useful activities. Pursuant to Section 402 of the New Civil Code "an institute is a legal person created for the purpose of pursuing socially or economically useful activities using its personal and property resources. An institute pursues activities which are equally available to everyone under predetermined conditions". Section 403 of the New Civil Code develops further the meaning of the secondary activity saying "if an institute operates a business enterprise or another secondary activity, its operation must not be to the detriment of the quality, scope, and availability of the services provided as the primary activity of the institute. An institute may only use its profit to support the activities for which it was formed, and to pay the costs of its own administration". Both associations and institutes are legal entities of private law that are not founded in order to do business, but, on the contrary, to provide services that are publicly beneficent (Lavický, P, et al, 2014). Nevertheless, associations are based on membership, which could be not found in institutes.

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<sup>64</sup>Section 3045 par. 1 of the New Civil Code: Societies (in Czech: „sružení“) under Act No. 83/1990 Coll., on associations of citizens, as amended, are considered to be associations (in Czech: „Spolky“) under this Act. A society has the right to change its legal form to an institute or social cooperative under another statute.

## 2 Methods

In this paper there is an emphasis put on analytical method of logical deduction and on method of legal comparison. The purpose of this paper is to achieve by means of interpretation and scientific methods a reliable description of transformation of an association into an institute with respect to the New Civil Code and the possibility provided in Section 3045 thereof.

## 3 Results

### *Transformation Itself and the Problems Connected to the Process*

The transformation of a legal person is regulated in Sections 174 – 184 of the New Civil Code. Pursuant to Section 175 a legal person may change its legal form only where provided by a statute. The change of a legal form is one type of a transformation of a legal entity and it is a process where the inner legal relations are changed by preserving the existence of the legal entity, also with regards to its identification number. The change in a legal form does not lead to the dissolution or termination of a legal person whose legal form changes, but merely to a change in its legal situation and, in the case of a corporation, also the legal status of its members.

During the process of the transformation five statutes such as Act No. 89/2012 Coll., the Civil Code, Act No. 563/1991 Coll., on accounting, Act No. 90/2012 Coll., on business corporations, and Act No. 125/2008 Coll., on transformation of corporations, can be used, nevertheless, finally, only Act No. 89/2012 Coll., and maybe the Act No. 563/1991 Coll. on accounting, regarding some specific problems narrowly connected to the accounting, can be used. The law is interpreted by the interpreting rules, and analogy or subsidiarity represent some of them. The transformation of associations into institutes is not expressively regulated in the law but there are provisions regulating transformations of business corporations and these norms that are most similar to those that are targeted can be applied also on the transformation of an association into an institute. Analogy in law is a legal norm helping to fill gaps in law. In any case, the analogous application of law is admissible only if there is no legal interpretation leading to an acceptable solution (Gerloch, A., 2009). As it has been already said before, the transformation process of an association into an institute is not regulated in any acts, that is why we should use by analogy the act on transformations of business corporations and draft a project including the formation deed. The project is then published for thirty days on an association's website approved by a supreme body, usually by a member's meeting in a public form before a notary. This practice is confirmed by a quick look into a collection of documents administrated by regional courts. A question whether the supreme body should decide on the change in a public form before a notary, or not, remains. In my opinion, no member's meeting in a public form before a notary is needed.

Another problem may arise relating to Section 176 of the New Civil Code in the sense of whether the change of a legal form is included under this Section and whether the decisive date has to be stated or not. I do not agree that the Section on decisive date shall relate to the change of a legal form despite the fact that the change of a legal form forms a part of a transformation according to Section 174. According to Section 183 par. 2 “if the date on which a draft contract or decision to change the legal form was prepared is not the date of preparation of balance sheet under a special legal regulation, a legal person shall prepare interim financial statements as of that date. The information used to prepare the financial statements as at the date on which the document changing the legal form is prepared may not precede the date of the legal person's decision to change its legal form by more than three months”. In the case of a change of a legal form no draft contract is prepared so there has to be an interim financial statement together with the project which is lately approved by the member's meeting, however within three months.

### *Subsidiarity of Foundations embodied in Section 418 of the New Civil Code and Its Problems*

Section 418 of the New Civil Code says “that in other respects, the provisions on foundations apply, by analogy, to the legal relations of an institute; however, the provisions on endowment principal and endowment capital do not apply”. This section embodies the rule of subsidiarity. The Czech term for the application of subsidiary legislation may be supportive or ancillary use. Supporting application of the law within a certain sector of legal relations assumes that there is a law that contains primarily applicable legal framework of these relations. The use of the supporting standards is triggered when an applicable standard preferably contains no custom solutions to specific situations. Relationship subsidiarity can therefore be defined as well as through the mutual relationship between specific and general regulation. The above described subsidiarity may cause some interpretative problems because there is a tendency to interpret also the provisions explicitly saying the regulation regarding the institutes in the light of the regulation regarding the foundations (Gerloch, A., 2009).

### *Formation of an Institute – Formation Deed*

Section 405 par. 1 of the New Civil Code says that an institute is formed by a formation deed or disposition mortis causa. The forming juridical act shall at least specify the name of the institute, registered office, purpose of the institute by defining its objects of activities, or, where applicable, its objects of business, indication of the amount of contribution, or non-pecuniary contribution, the number of members of the board of trustees and the names and places of residence of its first members, and details of the internal organisation if the institute, unless reserved for the by-laws of the institute. If the forming juridical act establishes a supervisory board, it specifies the number of supervisory board members and the names and places of residence of its first members. Those are the requirements regulated in Section 405 par. 1 of the New Civil Code. Pursuant to this section there is no requirement regarding the form unlike the regulation of foundations where in Section 309 par. 4 the notarial deed is needed. There were many uncertainties on this matter until a court decision appeared. In private law, generally, the principle that everyone has the right to choose any form of legal act is applied, unless an agreement between parties or a law provides otherwise (Section 559 of the New Civil Code). This principle also applies to the establishment of a legal entity. The provision of Section 418 of the Civil Code refers to the legal relationships of the institute and under this "legal relationships of an institute cannot be subsumed to the form of the founding legal actions – therefore no notary deed is needed for the form".<sup>65</sup> In my opinion there is a special section regulating the formation deed therefore there is no necessity to use Section 309 par. 4. In general, Section 123 par. 2 says that the writing form is needed for a formation document.

### *Remuneration of Members of Elected Bodies: Director as a Statutory Body, Board of Trustees, and Supervisory Board or Inspector*

High responsibility of members of elected organs for the rightful operation of legal persons entitled them to be remunerated for their functions. Similarly, this regulation applies to the supervisory board or to the inspector, if either of the controlling body was established. The possibility and methods of providing rewards to members of the board of trustees, supervisory board and the director is regulated by the founder in the formation deed, otherwise Section 414 of the New Civil Code shall be applied saying "unless the formation deed provides that the members of the institute's bodies are entitled to remuneration for the discharge of their office and how it is to be determined, the director is conclusively presumed to be entitled to a usual remuneration; the offices of the members of other bodies are presumed to be honorary. In such a case, the board of trustees determines the amount of the remuneration of the director or the manner of its determination". The law does not *expressis verbis* say that the function of a director can be honorary. However, with respect to the main principles, on which the New Civil Code is based, by the *argumentum a maiori ad minus* it can be deduced that the honorary function of a director can be regulated in the formation deed. If the formation deed does not say anything then the function has to be remunerated and the director is entitled to a usual remuneration determined by the board of trustees (Lavický, et al, 2014).

### *Director*

The director is the governing statutory body of an institute. Pursuant to the law it is a monocratic body. Unlike associations the statutory organ of an institute cannot be collective, at least the law is silent regarding this problem. Can the formation deed or by-laws state that the statutory body is collective? In my opinion, by *argumentum ad minori ad maius*, it can be deduced that the function of a director does not have to be only monocratic, however, the formation deed may regulate a collective statutory organ. The by-laws may provide another name for this body, provided that it is not misleading as to its nature. The director may not be a member of the board of trustees, and a member of the supervisory board or another body of a similar nature, if established. The board of trustees elects and removes the director except for the first director who is appointed by the founder in the formation deed in accordance to Section 123 par. 1. of the New Civil Code. I strongly disagree with the polemics on that fact written in the article (Duva, J., & Šveřepová, K. 2015).

### *Board of Trustees*

Board of Trustees is regulated in Sections 409 – 412 of the New Civil Code. The members are appointed and removed by the founder. If it is not possible, the members of the board of trustees are elected and removed by the supervisory board, if established; otherwise, the board of trustees elects and removes its members on its own. The term of a member of the board of trustees is three years. The members can be elected repeatedly. The membership on the board of trustees is incompatible with the membership in the supervisory board. The law in the above-mentioned provisions does not *expressis verbis* say that the members of the board of trustees cannot simultaneously be employees, unlike Section 363 of the New Civil Code saying "unless the foundation charter provides additional restrictions, the persons not eligible to be members of the foundation board shall include any person who: a) is a member of the supervisory board of the foundation, b) is employed by the foundation, or c) has a criminal record related to the purpose of the foundation".

<sup>65</sup>Vrchní soud v Praze, 7 Cmo 295/2015, [PR 11/2016 p. 416]

The rule of subsidiarity cannot be used here, in my opinion, because Sections 409 – 412 of the New Civil Code are special to Section 363 of the New Civil Code. The commentary to the Civil Code by Lavický is silent regarding to this fact, as well. Nevertheless, with respect to the competences of board of trustees it is obvious that they cannot perform their office if they are in an employment relation.

#### *Controlling body: Supervisory Board or Inspector as an Obligatory or Facultative Body*

Section 418 of the New Civil Code refers to the provisions regulating foundations where an establishment of a supervisory body is obligatory. Therefrom it could be deduced that the supervisory board or the inspector is an obligatory body of an institute. However, Section 409 par. 3 “where supervisory board has been established”, Section 405 par. 2 saying “if the forming juridical act establishes a supervisory board”, and Section 408 par. 2 “member of the supervisory board or another body of a similar nature, if established”, prompt to be facultative. The institute can establish either supervisory board or inspector as a controlling body, which would be convenient in case of the drawing off donations.

#### **4 Conclusions**

The above-mentioned new regulation brought a common general regulation of legal persons of private law which could be regarded as a progress, resp. as a good step forward. However, there are some uncertainties that shall be solved by practising and applying the law consisting in which kind of law shall be applied to the process of transformation when a legal form is changed. The choice of law is relevant with respect to the possibility of the necessity of a notary either regarding the form of formation deed or the decision of the supreme body approving the change of a legal form. One has to realize that this kind of transformation is final, there are no other provisions on that associations can be transformed into institutes and vice versa. This possibility has been given only to societies which were obligatorily transformed into associations by the efficiency of the New Civil Code since 2014. However, this obligatory change did not affect the legal form as such, it was rather a terminology and systematic change in order to make the associations more transparent. The voluntary transformation of an association into an institute based on Section 3045 par. 1 of the Civil Code shows many uncertainties regarding the interpretation of the law mainly with respect to the formation deed and elected bodies due to the interpretation laws as analogy, subsidiarity or *lex specialis derogat legi generali*.

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