SWISS CONTRACT LAW

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Contract for the chairman of a listed company: how to manage a conflict of interests?

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A stock corporation whose board of directors is reduced to two members due to a dispute among shareholders cannot validly enter into a contract of mandate (director) and employment (manager) with the chairman of the board without violating the prohibition of self-contracting, even if the chairman does not sign the contract himself but has empowered the CEO to do so.

Judgment of the Federal Supreme Court of 4 March 2022

Case Reference: 4A_488/2021

Facts

The case concerned a public company listed on the stock exchange. A conflict had arisen among the shareholders, which led to the non-re-election of three out of six directors. A new chairman of the board was appointed, as well as a new CEO (who was not a board member). Later on, a member of the board resigned, leaving henceforth two members on the board: the chairman and another director.

An employment and mandate agreement had been drafted by the company and the chairman. This agreement had been signed by the second director and the newly appointed CEO on behalf of the company. To this end, a power of attorney had been specifically granted to the new CEO by the chairman and the second director. The agreement provided for two types of remuneration: a fixed monthly salary under the employment contract and a fixed annual fee as a member of the board of directors. In addition, a termination notice period of six months was provided for.

A few months later, a new board of directors was elected. It had decided to freeze the remuneration of the chairman and to dismiss him with immediate effect. The latter filed a claim in court for more than CHF 500,000 to cover salary remuneration, administrative fees, participation in profit-sharing plan, unused PTO, reimbursement of expenses and compensation for unjust dismissal.

The lower courts held that the employment and mandate agreement was void. Given that the board of directors consisted of only two members and that one of them was caught in a conflict of interests (i.e. the chairman), the board could not grant a power of attorney to the CEO. Since the chairman had to be aware that he was orchestrating the signing of a contract contrary to the law and the company's articles of association[1], he was acting in bad faith and could therefore not rely on the void contract.

Issue

The issue was whether the employment and mandate agreement had been validly concluded or whether it was null and void due to the prohibition of concluding a contract with oneself. In the case of the latter, the question of a fictional application of the employment contract due to the services rendered (*de facto* contract theory) also arose.

Decision

I. Is the contract void because of the prohibition of self-contracting? (para. 5)

The Federal Supreme Court explained that a contract concluded with oneself corresponds to a situation whereby the same person is a party to the legal act in two different capacities: on the one hand on his or her own behalf, and on the other hand as the representative of another person. This situation, like dual representation, entails a risk of conflict of interest. For this reason, a contract concluded with oneself is not permissible and therefore invalid, subject to two exceptions:

(i) the nature of the transaction itself precludes any risk of harm to the principal (this is particularly the case where the agreement is concluded on market terms); and (ii) the principal has consented in advance or ratified the agreement.

These principles also apply to the legal representation of a legal person by its bodies. The legal person is presumed to tacitly exclude the power of representation for any act that may create a conflict of interest between its own interests and those of its representative. The consent or ratification to such an act must originate from a body occupying the same rank as the body having signed the act or higher.

In the case at hand, it was found that the parties involved had devised a scheme to circumvent the rules prohibiting self-contracting by granting the CEO a power of attorney authorizing it to sign the employment agreement with the chairman. The Court also found that because of its subordinate position, the CEO did not meet the requirement of an independent body of the same rank and was, therefore, not qualified to approve or ratify the conclusion of the employment agreement. Furthermore, it had not been proven that the remuneration terms of the employment agreement were actually in line with the market.

Thus, the contract was deemed void on the grounds of the prohibition of self-contracting.

II. Should the contract, despite its invalidity, still be applied in a fictitious way because of the work performed? (para. 6)

Under labor law, when a pseudo-employee has entered into an employment contract which is subsequently found to be null and void, the employee may claim the application of a *de facto* contractual relationship in order to be remunerated for the work it has performed, unless it knew that the contract was null and void (Art. 320 para. 3 of the Swiss Code of Obligations [SCO]).

The Federal Supreme Court held that it could be inferred from the circumstances of the present case (*i.e.* granting a subordinate manager special power to sign an employment and mandate agreement on behalf of the company) that the chairman was aware that such a contract may not be valid, and had accepted such an outcome in the event that it be proven true.

Since the chairman was aware of the deficiency in the contract, he could not rely on Art. 320 para. 3 SCO and the existence of a *de facto* contractual relationship.

Key takeaway

In the event that a company is in a delicate situation due to a dispute among shareholders that has led to a nonfunctional board of directors, it is advisable to wait until the dispute has been settled and the composition of the board of directors has been reconstituted, before entering into contracts with members of the board. It is further advisable for companies to implement rules, bylaws or internal regulations explicitly dealing with conflicts of interests.

Comments

This judgment highlights two sets of rules under the general law of obligations:

I. Contracts concluded with oneself

The principle of the prohibition of self-contracting is well established under Swiss law. The risk of such contracts for a company is well known, since the people who run a company can take advantage of their position in order to obtain undue benefits. In this view, it is less a question of a prohibition on self-dealing than of a prohibition on using the company to obtain an undue personal advantage.

As there are several ways of bypassing this prohibition, scholars have proposed to extend the prohibition to situations in which a director – who has a conflict of interest – empowers another person to sign a contract in which the former has a personal interest. This mechanism does not formally violate the prohibition against contracting with oneself, but it pursues the same goal by allowing the director involved to grant itself a personal advantage through the influence, or even the pressure, that he or she exerts on another person.

Such test had been carried out by the Federal Supreme Court in the case at hand, leading to the conclusion that the chairman managed to get the contract signed by another person, but to his own advantage. The circumstances of the case appear to be decisive, in particular the fact that the CEO was given a unique and specific power to co-sign the agreement

with the chairman.

However, this is an after-the-fact analysis. It is questionable whether the company could not enter a contract with the chairman until all the other members of the board had been appointed. This situation could have extended over a longer period of time and the company had to continue to be managed in the meantime. There is little doubt that a prolonged blockage situation would have had negative consequences for the company as well as for the various stakeholders. One may ask whether it would have been advisable to balance (purely internal) quorum requirements against the company's legitimate interest in having an effective governing body.

Furthermore, the Federal Supreme Court had been quick to dismiss the question of whether the remuneration conditions were in line with the market. However, one may wonder whether this criterion should not have been the most important in this particular case, where formally, the contract had not been concluded by the chairman himself. In any event, it is surprising that the employee (in this case, the chairman) should have to bear the consequences of the absence of proof of a remuneration in line with the market. Given the difficulties in providing evidence on directors' remuneration – fact acknowledged by the Federal Supreme Court itself –, it seems to us that the evidentiary requirements in this respect should not be too high, so as not to unduly penalize the employee.

II.* De facto *contractual relationship in case of an invalid contract

The legal text (Art. 320 para. 3 SCO "[w]here an employee performs work in good faith for the employer under a contract which is subsequently found to be invalid, both parties must discharge their obligations under the employment relationship as if the contract had been valid until such time as one party terminates the relationship on grounds of the invalidity of the contract") provides for a *de facto* contractual relationship in the case where an employment agreement turns out to be null and void, in order to prevent the worker from providing unpaid work. The exception of bad faith is intended to punish the person who has entered into a contract for which he or she was aware of the fact it was not valid. It is an extremely harsh penalty given that the contractual partner is enriched by the work of the other party without having to pay any salary.

From this point of view, the requirement that the (limited) validity of the employment contract be subject to the good faith of the employee is objectionable in itself: the question that should be answered here instead is whether or not the employee deserved to be paid for the service he or she had provided (cf. Hartmann Stephan, Rückabwiclung und "faktisches Vertragsverhältnis" bei ungültigen Arbeitsverträgen – Bemerkungen zu BGE 132 III 242 ff., *in* ZBJV 2007, p. 277 ff., in particular p. 286 f.). The good faith of the employee is not relevant to answer this question. Besides, it is interesting to note that the Federal Supreme Court had already recognized that the requirement of good faith may lead to unfair results, which is why it had advocated for a restrictive interpretation of the notion of good faith in this context (cf. ATF 132 III 242).

Regardless of the question of good faith, the conclusion reached by the Federal Supreme Court in this judgment does not seem entirely convincing. In particular, by denying the existence of a *de facto* employment contract, the Federal Supreme Court has opened the door to other pressing questions which remain unanswered. Indeed, as the Federal Supreme Court indicated, due to the absence of a valid contract the involved parties could assert claims for unjust enrichment against each other. Specifically, the company is enriched by the work performed by the chairman, while the chairman is enriched by the salary paid by the company. To the extent that these two claims are of equal value, they would be extinguished by set-off. This outcome would thus lead to a situation comparable to a *de facto* contract.

However, the same would not be true if the chairman's work were to be considered a case of "forced enrichment" ("aufgedrängte Bereicherung", cf. Hahn Anne-Catherine, *in* Furrer Andreas/Schnyder Anton K., Handkommentar zum Schweizer Privatrecht, Zurich 2016, Art. 64 SCO N 8). Since the company could not validly accept the work performed due to the lack of quorum of its board of directors, this work was in a way "forced" on the company. If this analysis were to be retained, the chairman alone would be deemed enriched, and therefore only *he* would be required to return the salary received. Conversely, the company would not be required to compensate him, or, if so, only according to the rules of business management. Then, could the chairman possibly assert a salary claim on the basis of an agency without authority relationship under Art. 419 et seq. SCO? It is difficult to answer this question without knowing the precise circumstances surrounding the chairman's work. Moreover, the very possibility to assert such a claim under agency principles is a matter for debate among legal scholars (cf. Héritier Lachat Anne/Chappuis Christine, *in* Thévenoz Luc/Werro Franz, Commentaire romand du Code des obligations I, Basel 2021, Art. 422 SCO N 17).

One key consideration remains: is it fair for a person who has worked, knowing that the employment agreement is null and void, to not be entitled to remuneration? A negative answer does not seem to be reconcilable with the system of the law of

obligations. Either a person has provided a service to another and the latter is thereby enriched, whether the contract is null or valid, or the person has caused damage to another and must be liable under the rules of tort. Derogations from this fundamental principle should only be admitted to a limited extent.

The Federal Supreme Court seems – at least in an intuitive sense – to agree with the above reasoning, since it felt obliged to specify that in the case at hand the rules on unjust enrichment were not invoked by the chairman and that "financial benefits" had nevertheless been paid to him in exchange for his activity, which justifies, to a certain extent, not awarding him any additional amount. Such considerations could be interpreted as an implicit recognition of the status quo.

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[1] See in particular Article 17 of the company's articles of association: "Composition [...] The board of directors of the company shall consist of three or more members".

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