

interim international

Round Table

in Munich on Wednesday, November 26, 2003

Speech

Topic:

**Liability Risks incurred by Managing Directors of a GmbH  
(German company with limited liability)  
under Civil Law**

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## **Liability Risks of a GmbH Managing Director under Civil Law**

### **I. Overview**

1. Areas of liability (Sections 43, 30, 64 GmbHG, 823 BGB).
2. Exclusion of liability during stage of formation and with regard to notifications to the Registry Court (e.g. the payment of capital contributions, no over-evaluation of contributions in kind, no founders' preference rights, declarations to the Registry Court, liability for acts carried out in the name of the company before registration according to Sec. 11 (2) GmbHG – German law pertaining to companies with limited liability).
3. Distinction between the normal course of the business / company crisis (especially insolvency/preservation of capital)
4. Distinction as to claimants (company, shareholders, third parties)

### **II. Liability in the normal course of the business**

#### **1. Principle set out in Sec. 43 GmbHG (German law pertaining to limited liability companies)**

##### a) Principle:

Non-compliance with the duty to apply the due care of a prudent businessman: objective criteria, subjective abilities of the managing director are irrelevant; the burden of proof lies with the managing director (“standard of a person holding the position of authority of an administrator of third parties’ property”)

##### **Example:** Theater case

The managing director of the Theater-GmbH is the art director and at the same time the commercial director of the theater; notice of termination is given because of cash deficit; managing director argues not to be the right man for activities of a commercial character and that he has not been sufficiently monitored by the shareholders.

##### b) Case groups:

- duty to factually and comprehensively carry out the duties associated with the company management (especially the implementation of business opportunities)
- duty to carefully prepare entrepreneurial decisions
- duty to use in the management of the company all possible strategies which can reasonably be expected in view of a risk reduction for company (installation of a monitoring system in analogy to Sec. 91 II AktG – stock corporation law); risk management system only as from a certain size)
- duty to make decisions for the company's benefit

##### **Examples:**

- purchase of real estate without purchase price hedge
- business transacted by managing director only in the interest of the group's parent company

c) Approach in business economics:

- attempt to implement particular case decisions into a comprehensive body of rules (principles of regular company management, Code of Best Practice); not yet recognized in case law and in the literature, but corporate governance principles are increasingly followed (under way)

d) legal consequences of liability (principle: compensation of decrease in assets)

- damage is any reduction of company assets made contrary to the company's objective

**Example:**

Service of undue liabilities by fixed deposits, damage due to loss of interest by reduced fixed deposits (Court of Appeal of Koblenz, NJW-RR 00 483)

- loss of image?
- compensation of lost benefits

**Example**

Managing director takes advantage of business opportunity on his own account (or e.g. spouse) but not for the account of the company leads to compensation of lost profits; besides subrogation in analogy to Sec. 88 (2) AktG, Sec.113 HGB (German Commercial Code)

e) Ventures

- Principle: breach of duty by the implementation of a hazardous business transaction; it is always the particular case which is considered in view of the nature/size of the company, the financial situation, the importance of the management measure and the risk involved
- managing director has entrepreneurial freedom of action
- limits of "permitted" risk are exceeded if the risk in comparison to the chance of profits is disproportionate, i.e. if
  - the probability of a failure outweighs a successful business transaction
  - although hardly any probability that the risk will realize, the failed action would jeopardize the existence of the company
  - managing director does not use strategies he can reasonably be expected to apply for a risk reduction and/or for averting damage

**Example:** export case

Managing director fails to obtain for an export business (= difficult to enforce titles in case of non-performance) a bank guarantee from customer (besides an information on customer's credit standing) for the payment of the purchase price.

f) Exemption from liability (avoidance strategies)

- division of areas of responsibility for the management
  - basically a limitation of liability is possible

- not in the case of essential measures or of obvious mismanagement in another unit
- not in case of vulnerability to insolvency
- Discharge by directive or subsequent approval of the shareholders' meeting (discharge by directives of a majority of the company only if laid down in the articles of association);
  - no exemption from liability if managing director informed/advised shareholders insufficiently
  - no exemption from liability in case of resolutions in contravention of the law (Sec. Sec. 43 (3) s. 3 GmbHG): e.g. violation of boni mores, implementation subject to penalty or jeopardizing the existence of the company
  - no exemption from liability if back-up is necessary to satisfy company's creditors (Sec. 43 (3) s. 3 GmbHG)
    - approval of a management measure by all shareholders
    - application of staff privilege (disputed)

**2. Sec. 43 III in connection with Sec. 30 I GmbHG (payments made from share capital)**

**3. Liability in tort to third parties because of a breach of commercial and organizational duties**

- wilful infringement of property rights, impairment of third party property
- breach of commercial and organizational duties
  - Principle: liability to third parties for omission of pertinent measures proper to avoid damage
  - Problem: in principle duties of the managing director in relation to the company cannot establish guarantorship in relation to third parties

**Example:** construction material decision

Supplier delivers construction material to GmbH subject to reservation of title. Due to a bad organization in the GmbH the supplier's title is extinguished by the installation of the supplier's material in the construction, supplier asserts claims for damages against the GmbH's managing director personally.

**III. Liability in crisis**

**1. Obligation to file for insolvency, Sec. 64 (I) GmbHG, Sec. 17 et seq. Insolvency Act (InsO)**

**a) Over-indebtedness (Sec. 19 InsO)**

- draft of an over-indebtedness balance sheet
- to distinguish: positive and negative prognosis of continued existence
- assets side:
  - Contrary to the commercial balance sheet the value to be assessed in case of negative prognosis for a continued existence is the value the assets had

when realized in the insolvency proceedings (liquidation or disruption values).

- In case of negative prognosis for a continued existence; in particular disclosure of hidden reserves; devaluation of items which cannot be utilized outside the ongoing business.
  - In case of positive prognostics for a continued existence: in particular capitalization of intangible assets (not acquired against payment) – “goodwill”
- liabilities side:
- Particular feature amongst others: (equity replacing) shareholders' loans with regular subordination need not be entered on the liabilities side
- over-indebtedness balance sheet is normally established on basis of the commercial balance sheet in spite of the particular features
- no waiting for the next annual financial statement allowed in case of indications for over-indebtedness

b) Illiquidity (Sec. 17 InsO)

- Sec. 17 (2) s. 1 InsO: if the company is unable to meet its mature payment obligations
- the former element of “perpetuity” has been repealed, claims are also “mature” if creditor “keeps quiet”
- avoidance strategy: liquidity planning (exact date if necessary)

c) Threatening illiquidity (Sec. 18 InsO) is merely a “voluntary” reason for insolvency

**2. Liability for breach of the obligation to petition insolvency proceedings, Sec. 823 (2) BGB in connection with Sec. 64 (1) GmbHG, Sec. 64 (2) GmbHG**

a) Requirements:

delayed or omitted petition for insolvency proceedings (“three-week deadline”, Sec. 64 (1) GmbHG

- three-week deadline must not be exhausted if there are no sufficient indications for a successful reorganization

b) Legal consequences:

- criminal act, Sec. 84 (1) No. 2 GmbHG
- liability for delay of insolvency acc. to Sec. 823 (2) BGB in connection with Sec. 64 (1) GmbHG
  - in relation to “new creditors” whose claims only accrued after vulnerability to insolvency, principally for the full damage
  - in relation to “old creditors” normally only for “quota damage”
- Liability to the company
  - liability for damages, Sec. 43 (2) GmbHG
  - liability for payments after occurrence of over-indebtedness or illiquidity inconsistent with the due care of a prudent business man, Sec. 64 (2) GmbHG (no right to claim compensation)

- liability for damages in case of too “early” filing for insolvency also conceivable

c) Avoidance strategy: internal division of business areas

Each managing director is principally committed to file a petition as from the beginning of the crisis/vulnerability to insolvency. Each managing director has to get a picture of the situation of the company by appropriate instruments (duty of observation)

Avoidance strategy: resignation from office

**Liability for unpaid wage taxes Sec. 34, Sec. 69 AO**

- The managing director is personally liable for the payment of wage taxes if taxes are wilfully or by gross negligence not paid in due time, (i.e. 10<sup>th</sup> day in the month).
- In case of lack of liquidity, wages have to be reduced for the payment of wage taxes (“the tax office must not be treated worse than the own employees”)

**4. Liability for unpaid contributions to the social security, ( 823 (2) BGB in connection with Sec. 266 a Criminal Code (StGB)**

- non-payment of employees’ contributions to the social security is subject to penalty under Sec. 266 a StGB and entitles social security institutions to claim compensation under Sec. 823 (2) BGB
- liability requires intent which is, however, presumed
- obligation of payment is independent from actual payment or non-payment of wages! – no liability in case of absolute illiquidity
- but: liability if illiquidity is caused by breach of duties; breach is assumed if the illiquidity is due to payments being made to other creditors between the payment of wages and the date on which contributions to the social security fell due (liquidity planning!)

**Example:**

The company has to pay a gross salary amounting to 300, a net salary amounting to 200, social security contributions amounting to 100 and there is a remaining liquidity of 200 and there are other urgent liabilities of 100; the managing directors agree with the staff on a respite for the payment of salaries until the expiry of the next month.

**5. Preservation of share capital**

a) Sec. 30 GmbH: no distribution of company’s assets to shareholders if distribution leads to a deficit balance (net assets must cover share capital)

- the term “distribution” is to be understood in the large sense of the term which means that also business transactions between the company and shareholders, which are disadvantageous for the company, are included.
- Legal consequences:
  - primary liability of the receiving shareholder, contingent liability of the other shareholders, (Sec. 31 (3) GmbHG), contingent liability of the managing director to the shareholders, Sec. 31 (6) GmbHG
  - liability to the company in case of fault, Sec. 43 (3) GmbHG

- shareholders' resolution on the distribution does not discharge if back-up is required for the satisfaction of creditors.
- equity replacing loans Sec. 32 a, b GmbHG
- no liability if no deficit balance is caused (Sec. 30 (1) GmbHG)

**6. Avoidance strategy: D&O-insurance insurance**