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ARTICLE

The Reform of the German GmbH Law: New Opportunities and New Hazards for Non-German Companies and their Creditors

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Introduction

On 25 May 2007, the German Government presented its Draft Act on Modernisation of the German Law on Limited Liability Companies – GmbH – ('MoMiG', 'Draft Act'), which is expected to become effective in the first half of 2008.[2] The Draft Act particularly intends to increase the attractiveness of the German GmbH and to overcome competitive disadvantages it suffers in comparison to foreign legal forms, in particular to the Limited Liability Company of England & Wales (the 'English Ltd'). The regulations will also partially apply to non-German companies. This article will outline the Draft Act's essential alterations and will point out that the Draft Act involves both opportunities and new hazards for non-German companies, their shareholders, directors and creditors.

Limited duty for non-German companies to file for insolvency in Germany

The Draft Act extends the existing duty to file a petition for the opening of insolvency proceedings if the company is overindebted or illiquid. While currently this duty only applies to directors of companies incorporated under German law, under the Draft Act, any kind of corporation and partnership will be affected, as long as they do not have an individual as a general partner.[3] In principle, the Draft Act now also provides a duty for non-German companies, their directors and – vicariously – their shareholders,[4] to file for insolvency not later than three weeks from the occurrence of overindebtedness or illiquidity. But, contrary to the view of several publications,[5] the Draft Act does not provide such duty for non-German companies which do not possess assets in the territory of Germany.

In fact, one has to distinguish between non-German companies, whose centre of main interest ('COMI') is located outside Germany but within the territory of the European Union, primarily the territory of the Council Regulation (EC) No 1346/2000 on insolvency proceedings (hereinafter 'EIR'; EIR excluding Denmark), and companies established outside the European Union. This consideration is important as EU companies are only affected by the Draft Act if they possess an establishment within the territory of Germany. By the wording of the Draft Act, the duty for non-EU companies to file for insolvency is already imposed if they have assets in Germany, since the German international insolvency law (for non-EU companies) provides for commencement of secondary proceedings in Germany only if the company has assets – as opposed to an establishment – in Germany.

In this respect, however, the wording conflicts with the legislative history and reasoning. According to this, non-German companies shall only be subject to such duty if the COMI is located in Germany and German insolvency law is applicable. Hence, during the legislative procedure, a clarification of the wording is due. Non-German companies with neither an establishment nor assets within Germany are not affected in any circumstances. This notion ostensibly conflicts with both the wording and the legislative history.

Pursuant to the German international insolvency law[6] and the EIR,[7] the Draft Act's relevant regulation

Notes

1 With support of Mr. Steffen Ganninger, legal trainee with Schultze & Braun.
2 For details to the incentive and the development of the German law reform see also: U. Noack, 'Der Regierungsentwurf des MoMiG – Die Reform des GmbH-Rechts geht in die Endrunde' [2007] *Der Betrieb* 1395 et seq.
3 Sec. 15a Draft Act concerning the German Insolvency Code (*Insolvenzordnung, InsO*).
4 See below under 'Intensified protection of creditors' interests'.
5 S. Lürken, 'German law reform could halt migration' [2007] *Global Turnaround* 7 et seq.
6 Sec. 335 German Insolvency Code (*Insolvenzordnung, InsO*).
7 Art. 4 para. 1 EIR.

will only be applicable to non-German companies if the (hypothetical) main insolvency proceedings can be opened in Germany. Basically, this is only the case if the company's COMI is located in the territory of Germany. If the COMI is situated outside of Germany, German courts only have jurisdiction to open secondary insolvency proceedings if the company possesses assets (in the case of non-EU companies) or an establishment (in the case of EU companies) in the territory of Germany. In that case, the effects of secondary proceedings are restricted to the assets of the company situated in Germany.

Non-German companies effected in part by the German doctrine of equitable subordination or recharacterisation of equity (*Eigenkapitalersatzrecht*)

The Draft Act deregulates and harmonises the complex German doctrine on equitable subordination or recharacterisation of loan as equity (*Eigenkapitalersatzrecht*). Currently, this doctrine is based on both legal regulations[8] and case law[9] and applies only to companies incorporated under German law. Under the Draft Act, the new regulations concerning the *Eigenkapitalersatzrecht* apply to any kind of corporation and partnership, as long as they do not have an individual as general partner, subject to the following:

Just as there exists a duty to file for insolvency, non-German companies whose COMI is located within the territory of the EIR are also affected if they possess an establishment within the territory of Germany. As to non-EU companies, the wording of the Draft Act does not require an establishment in Germany; pursuant to the German international insolvency law, the regulations concerning the *Eigenkapitalersatzrecht* are already imposed on non-EU companies if the companies have assets in Germany. But, like to the duty to file for insolvency, the wording conflicts with the reasoning which requires at least one branch establishment within German territory. Hence, in this respect, a revision in the current legislative procedure is also due.

Pursuant to the Draft Act, in the case of insolvency the company's shareholders are subordinated to other creditors with their claims arising from loans and 'economically equivalent legal acts' recharacterised as equity.[10] While currently such subordination requires that the company faces a financial crisis at the moment the obligation is created, the Draft Act includes all such claims regardless of the company's financial status. If these claims are settled less than one year before filing for insolvency or after this moment, the insolvency administrator has the power to avoid the corresponding legal acts and to claw back the adduced assets and payments. For creditors of German and non-German companies on which these regulations are imposed, the Draft Act may make it attractive to file for insolvency in Germany from the perspective of certain creditors. On the other hand, the Draft Act also implicates new risks for shareholders. But in this regard, one has to consider that these regulations are only imposed on shareholders filling the position as a company director or holding more than 10% of the capital. If the company is in a situation of impending overindebtedness, this regulation does not apply to loans granted by creditors acquiring shares in order to rescue the company until the overindebtedness is overcome.

However, the Draft Act also contains certain hazards for third-party creditors. If the claim is secured by a shareholder (e.g. by bail, land charge), on the company's insolvency the creditor first has to claim recourse over this security before claiming against the insolvency estate. If the company meets the claim so secured less than one year before filing for insolvency or after this moment, the payment can be avoided and reclaimed by the insolvency administrator.

Opportunity for non-German companies to develop their business activity as a GmbH or a German *Aktiengesellschaft*

Under the Draft Act, companies whose administrative seat is situated outside German territory will be able to develop their business activities both in Germany and abroad as a German GmbH or a German stock corporation – *Aktiengesellschaft* (AG). Until now, German law did not permit the incorporation of a German GmbH or AG whose administrative seat was situated outside German territory. In fact, both the administrative seat and registered office had to be situated within German territory.[11] Therefore, a non-German company whose administrative seat was situated abroad was not permitted to choose the GmbH or AG as its legal form. Equally, a German parent company could not incorporate its subsidiaries abroad as a GmbH or AG. The European Court of Justice (ECJ), in three consecutive judgements up to

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8 Sec. 32a, 32b German Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG*).

9 The basis decision of the German *Bundesgerichtshof* (Federal Court of Justice, BGH) was: BGH, 26 March 1984 – II ZR 14/84 [1984] NJW 1891 et seq.

10 Sec. 39 para. 1 no. 5 Draft Act concerning the German Insolvency Code (*Insolvenzordnung, InsO*).

11 See sec. 4a para. 2 German Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG*).

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the end of 2003, paved the way for the 'free movement' of corporations in the European Union.[12] By this, a non-German corporation can install its administrative seat within German territory, as long as its home country's law permits such relocation. For instance, an English Ltd can develop its main business activities within German territory as an English Ltd – as extensively used in the past three years – while the German GmbH or AG is so far banned by the German law from doing the same abroad. Henceforth, a non-German company will have the opportunity to maintain its administrative seat outside German territory and – nevertheless – to act as a German GmbH or AG. Only the registered office has to be situated within Germany.

Increased attractiveness of the German GmbH as legal form

In particular after the reform, it may be attractive for a non-German company to use this demonstrated opportunity to act internationally as a German GmbH. The Draft Act provides plenty of measures intending to make the German GmbH more attractive.

First, the Draft Act facilitates and accelerates the foundation of a German GmbH. The required registered capital is reduced from EUR 25,000 to EUR 10,000.[13] Regarding business start-ups, the Draft Act offers a new variation of the GmbH, the so-called *haftungsbeschränkte Unternehmergesellschaft* ('*UG haftungsbeschränkt*'), a limited entrepreneurship.[14] At the moment of foundation, this variation does not need any registered capital at all, but must accrue the 'normal' registered capital bit by bit. This flexibility will promote the development of new enterprises and at the same time provide a certain financial security to the creditors of these new enterprises. While currently one company's shares must amount to at least EUR 100 and be divisible by 50, under the Draft Act a capital share of EUR 1 is possible. Furthermore, the Draft Act offers the opportunity to hold more than one company share.

For an uncomplicated standard foundation (for example: formation by cash contribution, three shareholders at most), the Draft Act contains a standard draft of company agreement. Using this draft, the GmbH can be founded without the usually required notarisation of the entire agreement ('*notarielle Beurkundung*') – only the shareholders' signatures must be notarised ('*öffentliche Beglaubigung*').

Furthermore, the Draft Act intends to overcome legal uncertainties concerning the differentiation between cash contribution and in-kind contribution. According to settled case law in Germany,[15] a formal cash contribution effectively constitutes an in-kind contribution if the amount of the capital contribution only serves as compensation for an already adduced in-kind benefit (so-called '*verdeckte Sacheinlage*', covered in-kind contribution). If in that case the stringent regulations for in-kind contributions are not observed, the shareholder must provide the capital contribution again. The Draft Act regulates this legal concept of the *verdeckte Sacheinlage*.[16] Accordingly, the shareholder's obligation expires if he can adduce that the value of the *verdeckte Sacheinlage* equals the amount of the owing cash contribution. Otherwise he has to pay the deficit.

The Draft Act also aims to accelerate the incorporation of the GmbH in the companies' register. Currently, a GmbH with a business subject to authorisation (e.g. craftman's or gastronomic establishment) cannot be registered before obtaining the public authorisation. Under the Draft Act, the authorisation procedure no longer affects the registration process.

Cash Pooling

Furthermore, the Draft Act intends to provide legal certainty concerning so-called Cash Pooling. This term describes the internationally common procedure that within an affiliated group, funds are directed by the subsidiaries to the parent company in order to constitute common 'cash management'. In return, the subsidiaries get the right of refund. The German *Bundesgerichtshof* (Federal Court of Justice, BGH) decided in 2003 that loans granted by a GmbH to its shareholders can be illegal under certain conditions and can cause the directors to assume liability.[17] With regard to this, the question was posed among professionals as to whether the BGH also disallows Cash Pooling. The Draft Act now clarifies that a company's payment to a

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12 These decisions were *Centros* (ECJ, decision, 9 March 1999, case C-212/97 ; [1999] ECR I-1459), *Überseering* (ECJ, decision, 5 November 2002, case C-208/00 [2002] ECR I-9919) and *Inspire Art* (ECJ, decision, 30 September 2003, case C 167/01 [2003] ECR I-10155).

13 Sec. 5 para. 1 Draft Act concerning the German Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG*).

14 Sec. 5a Draft Act concerning the German Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG*).

15 BGH, decision, 24 November 2003 – II ZR 171/01 [2004] ZIP 263 et seq.

16 Sec. 19 para. 4 Draft Act concerning the German Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG*).

17 BGH, decision, 24 November 2003 – II ZR 171/01 [2004] ZIP 263 et seq. See also A. Tashiro, 'German Law on Cash Pooling in the Insolvency Context' (2007) 4(2) *International Corporate Rescue* 78 et seq.

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shareholder is legally permitted as long as the emerging right of refund is fully fledged. Therefore, in principle, Cash Pooling remains licit under German law.

The acquisition of corporate shares in good faith will eventually be possible under the Draft Act. Actually, the acquirer of corporate shares is obliged to run the risk that the corporate shares are not owned by the seller. In practice, the parties try to minimise the acquirer's risk by warranties. But such warranties can only lead to the seller's liability for the acquirer's damages if the corporate shares are actually owned by a third person and this person is not willing to assign the corporate shares. The acquirer thus fails in his real aim, namely the legally effective acquisition of the corporate shares. Henceforth, under the conditions that:

(1) the seller is – incorrectly – registered as a shareholder in the particular shareholders' list at the commercial registry;

(2) the list has been incorrect for at least three years and does not contain an objection; and

(3) the acquirer is assuming the seller's position in good faith,

such acquisition will be effective in law.[18] Alternatively, if the list has shown the untrue shareholder for less than three years, the acquisition in good faith is effective if the list's incorrectness can legally be attributed to the true shareholder.

Intensified protection of creditors' interests

The Draft Act is to counteract the tendency to abuse the German GmbH in order to damage creditors' interests. Henceforth, creditors' interests will enjoy better protection. First, the duty to file a petition for the opening of insolvency proceedings in the company's illiquidity or overindebtedness will no longer apply only to directors, but also to shareholders, if the GmbH does not have a director – for example, if the last director abdicates.[19] This duty is excluded if the single shareholder does not know the company's illiquidity/overindebtedness or the vacancy of the director's position. In the past, the rules relating to the filing for insolvency effectively ceased if the directors went into hiding. The new shareholders' duty to file for insolvency of its company will inhibit such action. Violation of the duty to file for insolvency is actionable and can lead to liability for damages suffered by the creditors. Secondly, the Draft Act broadens directors' liability to the GmbH. Actually, directors in principle have to compensate payments settled in the company's illiquidity or overindebtedness. Under the Draft Act, directors are also liable for payments to the shareholders, provided that these payments necessarily would lead to the company's illiquidity and that the director could realise this.[20] By this broadened liability, the German Government intends to prevent the company's assets being plundered by shareholders in advance of insolvency. Thirdly, the Draft Act will make it administratively easier for creditors to assert their legal rights. Each GmbH must state a German business address registered in the Commercial Registry.[21]

Conclusion

By no means is the Draft Act a purely German national matter. For a non-German company, it offers a new opportunity to develop its business as a German GmbH or German AG while maintaining its headquarters outside German territory. In this respect one has to keep in mind that the German GmbH law notably intends to satisfy equally the company's need for free development and the creditors' interest in certain financial security. On the other hand, the duty for non-German companies to file for insolvency in Germany under certain conditions and the new regulations concerning the German *Eigenkapitalersatzrecht* bring along new risks for non-German companies, their shareholders and directors. For certain creditors though, this may make it attractive to seek insolvency proceedings under German insolvency law. We already know of the 'migration' of German companies to England in the case of financial crisis and impending insolvency. [22] Time will show whether the German GmbH law and insolvency law reform is the beginning of a creditors' 'migration' to German insolvency law.

Notes

18 Sec. 16 para. 3 Draft Act concerning the German Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG*).

19 Sec. 15a para. 3 Draft Act concerning the German Insolvency Code (*Insolvenzordnung, InsO*).

20 Sec. 64 para. 2 Draft Act concerning the German Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG*).

21 Sec. 8 para. 4 Draft Act concerning the German Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG*).

22 See A. Tashiro and V. Beissenhirtz, 'German Companies heading towards England for their rescue' (2007) 4(4) *International Corporate Rescue* 171 et seq.

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International Corporate Rescue

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