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# ESSAY

## INSOLVENCY OF A GERMAN LIMITED LIABILITY COMPANY: DE FACTO SHAREHOLDERS, GROUP LIABILITY FOR INDIVIDUAL SHAREHOLDERS

Daniela Weber-Rey†

### I. INTRODUCTION: LIMITED LIABILITY

According to the Limited Liability Companies Act (Gesetz betreffend die Gesellschaft mit beschränkter Haftung, GmbH Act), only the assets of a limited liability company (GmbH) can be used to satisfy the liabilities of the GmbH to its creditors. Limited liability is also enjoyed by all limited partners and the corporate general partner of a special form of German partnership known as a GmbH & Co. KG.

### II. CASE LAW EXCEPTIONS: PIERCING THE CORPORATE VEIL

In the event that the GmbH's or GmbH & Co. KG's assets are insufficient to meet all their debts, it would be obviously desirable for creditors that shareholders or persons or corporations in positions equivalent to shareholders could be held liable for such debts. Such a move, however, would entail piercing the traditional corporate veil of the corporate entity. However, this has been allowed by the Federal Supreme Court (Bundesgerichtshof, BGH) in the following cases.

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### A. *De Facto Shareholder Liability*

The bank had imposed an obligation on the indebted enterprise not to make any important decisions or to enter any agreements without the bank's prior consent. Shares in the enterprise had been pledged to the bank as security. Additionally, an agreement had been reached the effect of which was that the indebted enterprise did not have to pay off its debt to the bank unless its audited accounts showed profits for the previous business year. When the enterprise's financial situation deteriorated, the bank forced the enterprise to call in business consultants. These consultants took over the de facto management of the enterprise. They sold the goods in stock and used the profits to decrease the enterprise's debt with the bank. Two months later, the enterprise filed for bankruptcy. The trustee in bankruptcy demanded that the bank repay the sales profits to the enterprise.<sup>1</sup>

According to Secs. 32 a and 32 b GmbH Act, if a shareholder makes a loan to a GmbH in circumstances in which a prudent businessperson would have provided additional equity capital to the GmbH rather than loan capital (capital-replacing loan) and such a loan is repaid to the shareholder within twelve months prior to the GmbH's filing for bankruptcy, the shareholder shall be obliged to reimburse the GmbH with respect to the amount repaid.

The enterprise concerned in this case was a GmbH & Co. KG. According to Sec. 172 a of the German Commercial Code (Handelsgesetzbuch, HGB), the said Secs. 32 a and 32 b GmbH Act are applicable to this particular structure of a limited partnership which has a GmbH as its sole general partner. In that case, the Court held that even though a pledgee of company shares is not a shareholder as referred to in Secs. 32 a and 32 b GmbH Act, it can be subject to shareholder liability in compliance with these provisions if it could be said to be in a position equivalent or at least similar to that of a shareholder. In determining whether the pledgee was in such a position, the Court based its decision on the following criteria:

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<sup>1</sup> Judgment of July 13, 1992, BGH II. Zivilsenat, *Entscheidungen des Bundesgerichtshofes in Zivilsenat* BGHZ 119 (1992) 191-194.

1) The Court took several financial aspects into consideration. The enterprise had assigned for security purposes to the bank all present and future claims of the limited partners to profit distributions. In addition, all rights to the payment of compensation in the case of withdrawal of a partner and the rights to the payment of possible liquidation profits and to the payment of the purchase price in the event of sales of partnership shares had been assigned as security. Furthermore, the partnership was only obliged to pay back loans if its audited accounts showed profits for the previous business year. The Court pointed out that the typical characteristic of third party financing agreements is that interest rates are fixed independently of profits. The bank had therefore obtained financial benefits that are normally reserved for shareholders.<sup>2</sup>

2) Secondly, structural aspects were taken into account. The law provides that shareholder rights in general remain with the pledgor if shares are pledged as security. However, the bank had reserved the right to intervene in crucial decisions of the GmbH & Co. KG. Not only did the bank control the day-to-day running of the business through the consultants who acted virtually only on the bank's behalf, but also the limited partners were obliged to obtain the bank's prior consent with respect to all fundamental matters.<sup>3</sup> Thus, the bank was in a position to influence the partnership's policy and management to such an extent that, in fact, the shareholders could no longer exercise their rights.

The above criteria indicated that the bank was in a position equivalent to that of a shareholder. Therefore, the Court ruled that it was subject to shareholder liability according to the provisions of the GmbH Act. For this reason, the banks capital-replacing loan were to be reimbursed to the partnership.<sup>4</sup>

Any creditor who launches a detailed refinancing program with respect to an indebted company, will on the basis of the above criteria, quite easily find itself being held to be in a position equivalent to that of a shareholder. Hence, special attention should be paid to this development of case law, even though the liability of any creditor would be restricted to the amount of the loan granted to the company.

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<sup>2</sup> *Id.* § I, 1-2, at 194-195.

<sup>3</sup> *Id.* § II, 2.b, at 198.

<sup>4</sup> *Id.* § III, at 201.

## B. *Group Liability for Individual Shareholders*

A series of cases has triggered unlimited shareholder liability pursuant to the provisions of the Stock Corporation Act (Aktiengesetz, AktG). The AktG's provisions are directly applicable only to an Aktiengesellschaft, AG, which is the German equivalent of an English public limited company or U.S. Stock Corporation. The Courts, however, applied the rules on the so-called "de facto group of companies" (faktischer Konzern) by analogy to a GmbH for the first time in the "Autokran" case.<sup>5</sup> The development of the law following this decision up to the most recent judgment of the German Federal Supreme Court in the EDV case is shown in the following cases.

### 1. *The "Tiefbau" Case: Indirect Control*

An underground engineering company, a GmbH, had been granted substantial loans by a bank. An employee of the bank was appointed as one of the three managing directors of the GmbH. Another managing director was both a neighbour and friend of the bank's Chairman of the Board. Altogether, the shares held by these two directors amounted to 96 % of the total share capital. Additionally, 50% of the share capital had been financed by another company whose sole shareholder was the bank's Chairman of the Board. By influencing the GmbH's business policy, the bank managed to funnel money from the GmbH into another enterprise which was heavily indebted to the bank. This money was used to pay back part of the second enterprise's loans due to the bank. When the GmbH filed for bankruptcy, the receiver demanded that this money be paid back to the GmbH in order to satisfy claims of the GmbH's creditors.<sup>6</sup>

In its decision, the Court spelled out the requirements for the application of group liability rules to the so called "de facto group" with a GmbH as subsidiary: Liability according to Secs. 302 and 303 AktG requires a constant and extensive exertion of control over the GmbH. The liability of the parent company for all losses is based on the presumption that the management was guided by the parent company's interest to the detriment of

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<sup>5</sup> Judgment of September 16, 1985, BGH II. Zivilsenat, BGHZ 95 (1986) 330.

<sup>6</sup> Judgment of February 20, 1989, BGH II. Zivilsenat, BGHZ 107 (1990) 7-9.

the subsidiary GmbH. This presumption is rebutted if the parent company proves that the losses have been caused by circumstances that are independent of its control. The Court held that the two managing directors acted as fiduciaries for the second enterprise whose sole shareholder was the bank's Chairman of the Board.<sup>7</sup> Hence, the bank was presumed to (indirectly) control the GmbH constantly and extensively, because the alleged fiduciaries exercised permanent control over the company's financial transfers.<sup>8</sup> Since the presumption could not be rebutted by the bank, it was held liable as a controlling enterprise according to the rules of the "de facto group" in conjunction with the Stock Corporation Act.

## 2. *The "Video" Case: Applicability to Individuals*

Whereas the main significance of the previous decision was the determination that a corporate entity's indirect control over a company established group liability, the significance of the more recent "Video" decision was the determination that a single individual with direct control over a company can be liable according to the "de facto group" rules. An entrepreneur was a majority shareholder and sole managing director of a GmbH. In addition, he held the majority of shares in other companies and was the sole proprietor of another business. Later, he transferred his entire shareholding in GmbH to another person. When the GmbH filed for bankruptcy, he was sued for the payment of the company's debt.<sup>9</sup>

The Court argued that the entrepreneur's widespread and various entrepreneurial activities enabled him to further his economic interest not only in the GmbH but also in all of his other businesses.<sup>10</sup> This was held to create the danger of promoting individual interests to the detriment of the GmbH.<sup>11</sup> The relevant provisions of the Stock Corporation Act are designed to apply to any equivalent situation where a major shareholder of an AG conducts activities in other businesses or

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<sup>7</sup> *Id.* §§ I, 1.a.)-b.), at 9-12; III, 3.a.), at 16-19.

<sup>8</sup> *Id.* § II, 3.b.), at 19.

<sup>9</sup> Judgment of September 23, 1991, BGH II. Zivilsenat, BGHZ 115 (1992) 187-188.

<sup>10</sup> *Id.* § I, 1.a.), at 189.

<sup>11</sup> *Id.* § I, 1.a.), at 190, cf. Judgment of October 13, 1977, BGH II. Zivilsenat, BGHZ 69 (1978) 334, 337.

companies. For this reason, the entrepreneur - although being an individual - was treated like a controlling parent company, since his influence on the GmbH fulfilled the requirement of "constant and extensive control."<sup>12</sup>

The Court thus confirmed its prior decisions which establish "de facto group" liability on the basis of the above rebuttable presumption of "constant and extensive control."<sup>13</sup> However, the Court amended the prerequisites for liability defining the requirements for an individual to become subject to group liability:

An individual is liable according to "de facto group" rules if - he is a sole or majority shareholder of a GmbH and is at the same time the GmbH's sole managing director - and is also the sole proprietor of another business.

These characteristics will substantiate the rebuttable presumption that the individual concerned controlled the GmbH "constantly and extensively" and the legal consequences of this would be the direct and unlimited liability of the shareholder/director.

### 3. *The "TBB" Case: Clarification of Burden of Proof*

The Video case clearly had far-reaching implications for the individual shareholder/director and in a more recent case of the BGH, the Court has sought to further clarify when such a shareholder would be personally liable for the liabilities of the GmbH.<sup>14</sup> The Court held that such a shareholder could only be liable if in following his outside business interests, the shareholder does not take reasonable consideration of the concerns of the GmbH dependent upon him and in particular, in a manner that is not in compliance with generally accepted requirements, fails to ensure that the GmbH is able to meet its obligations.<sup>15</sup> If the GmbH and the creditors do not suffer to their detriment due to the actions of the shareholder, then it is not possible to claim against such shareholder. The onus of proof and presentation, therefore, is upon the creditor to demonstrate the circumstances implying the likelihood that the shareholder's

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<sup>12</sup> *Id.* § 2.b.), at 193.

<sup>13</sup> *Id.* § I, 2.b.), at 193-194.

<sup>14</sup> Judgment of March 29, 1992, BGH II. Zivilsenat, BGHZ 122 (1994) 123.

<sup>15</sup> *Id.* § III, 2.b., bb., at 130-131.

action damaged the business of the GmbH. Further details have to be substantiated by the controlling parent company, i.e., the defendant shareholder/director, if he knows the authoritative facts and if he can reasonably be charged with presenting such facts.<sup>16</sup>

#### 4. *Constitutionality of Case Law Rules*

Following the decisions of the above cases, considerable doubts had been raised as to the constitutionality of applying the Stock Corporation Act provisions to a GmbH by way of analogy, but the Federal Constitutional Court (Bundesverfassungsgericht, BVerfG) held in August 1993 that the application of the Stock Corporation Act to the shareholder/managing director of a GmbH can not be contested on constitutional grounds.<sup>17</sup>

#### 5. *The "EDV" Case: Extension of the Notion "Company"*

In a decision of December 13, 1993, the Court had the occasion to elaborate on the prerequisites for declaring an individual a controlling parent company.<sup>18</sup> Whereas before only individual shareholders/directors with sole proprietorship in another business had been held liable according to de facto group rules, the Court has extended the scope on all individual shareholders/directors who hold a substantial part of another company's shares.<sup>19</sup> Such shareholding is supposed to affect the shareholder's care for interests of any other business in which he is acting as managing director. All damages that can be shown to relate to this negative diversity of interests and to a consecutive misuse of constant and extensive control will hence have to be reimbursed by the shareholder/director.<sup>20</sup>

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<sup>16</sup> *Id.* § III, 2.b., dd., at 132-133.

<sup>17</sup> Judgment of August 22, 1993, BVerfG I. Kammer des zweiten Senats, *Neue Juristische Wochenschrift NJW* 2600 (1993) 2601.

<sup>18</sup> BGH II. Zivilsenat *NJW* (1994) 446.

<sup>19</sup> *Id.* at 1.a.).

<sup>20</sup> *Id.* § I, 1.c.). In a case concerning a labor dispute, the Federal Labor Court (Bundesarbeitsgericht, BAG) has adopted this point of view and declared the majority shareholders of a GmbH who also held the majority of shares in other companies liable for overdue wages and salaries owed by the GmbH. For details see: Judgment of March 8, 1994, BAG *NJW* 49 (1994) 3244.

## 6. *The "Architect" Case: Extension to Free-Lancers*

The very latest in this series of precedents has followed the previous decision in its tendency to enlarge the scope of a diversity of interest causing damage for a controlled company and, thus, triggering liability of its individual shareholder/director.<sup>21</sup> Declaring an individual a controlling parent company is no longer conditional upon such person's commercial activity - be it as shareholder in other companies or as sole trader but can also be justified by other professional activities, such as a free-lancer.

In that case, two self-employed architects cooperating in a non-trading partnership under the Civil Code mismanaged a General Partnership which sold the houses they had previously planned. The General Partnership had those houses built by a GmbH which was also controlled by the architects. This group structure enabled the architects to attract clients to the planning business for tightly calculated construction projects. The imminent risk for the construction business was neglected because it was limited by way of transfer to the GmbH. Ultimately the Court held that the Higher District Court had not properly considered the burden of proof and thus remanded the case to the lower instance.

Independently of this Supreme Court decision, the Higher District Court (Oberlandesgericht, OLG) of Munchen has come to the same conclusion in a case almost identical to the above cited.<sup>22</sup>

## 7. *Summary*

De facto group liability has become quite a commonplace risk for individual shareholders acting as managing directors in a GmbH. Although the guidelines set by supreme jurisdiction are still developing, the conditions for liability according to secs. 302, 303 AktG which are applied in analogy to GmbHs, are certainly fulfilled if:

- a) The individual shareholder can be treated like a controlling parent company because the individual holds at least a majority

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<sup>21</sup> Judgment of September 19, 1994, BGH II. Zivilsenat, Zeitschrift für Wirtschaftsrecht ZIP 21 (1994) 1690.

<sup>22</sup> Judgment of April 21, 1994, OLG München ZIP 22 (1994) 1776.

of the GmbH's shares; and he is managing director of the GmbH, not necessarily its sole managing director (see II. 6. *supra*); and he is- at the same time sole proprietor in another business; or at least majority shareholder in another company; or- working as a free-lancer, and;

b) Constant and extensive control by such shareholder/director has been misused in a way that, (i) no due respect has been paid to the interests of the controlled company (GmbH) and ii) any detriments hereby caused to the GmbH are so complex that they cannot be identified and compensated individually but only as a whole.<sup>23</sup>

### III. CONCLUSION

The principles of *de facto* shareholder liability and group liability for individual shareholders in a GmbH have been developed by case law by way of analogy to statutory provisions. Both principles result in a (though limited) piercing of the corporate veil and are still in a state of flux. The case law on *de facto* shareholders of a GmbH has not yet been extended to a general recognition of shadow directors as known under the Anglo-American legal system. However, it is very well possible that courts will look for opportunities to further develop this concept. Currently, *de facto* shareholder liability applies only in limited cases and leads only to a restricted liability.

There are a number of precedents which have elaborated on the development of principles establishing a group liability of individual shareholders of a GmbH. The prerequisites of such liability and the burden of proof will have to be defined more clearly by future judgments. Case law has already "corrected" a too extensive liability of individuals being subject to group liability by clarifying the burden of proof for establishing the link between the shareholder's action and the damage to the company and its creditors. Since the principles of group liability lead to an unlimited liability of individuals having a substantial influence on the management of a GmbH, courts will have to be particularly cautious when extending statutory liability by analogy to similar sets of circumstances.

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<sup>23</sup> Judgment of March 29, 1992, BGH II. Zivilsenat BGHZ 122 (1994) 123, 130.