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How to Avoid Pitfalls in the Capital Increase of a German *GmbH*

– Recent Decision of German Federal Court on Prepayments of Capital and on Disguised Capital Contributions in Kind –

Introduction

In this newsletter we will discuss a decision of the German Federal Court of Justice (*BGH*), the highest German court in civil matters, of July 10, 2012 (docket no. II ZR 212/10). The decision was rendered on the increase of the registered share capital of a German Limited Liability Company (*GmbH*), and in particular on how payment of the cash capital contributions subscribed to must be effected. Before we go into greater detail, it may make sense to first briefly have a look at how cash capital increases in a *GmbH* are to be implemented under German law. In a nutshell, the procedure of the capital increase, as statutorily provided for, is as follows: the shareholders must first resolve, in a resolution to be notarized, (i) on the capital increase and the corresponding amendment of the articles, (ii) on whether the new contributions shall be made in kind or in cash (in the case at hand: in cash), and (iii) on who shall be entitled to subscribe to the new shares issued. The persons entitled to subscription (often, but not necessarily, the existing shareholders) must then, in a declaration to be notarially certified, expressly subscribe to the new shares. Thereafter, the subscribers pay in the capital contributions and the managing directors (all of them) report, in a notarially certified letter, the capital increase for registration in the commercial register. Upon registration in the commercial register the capital increase will become effective.

Facts of the Case

The procedure just described was not completely adhered to in the case decided by the *BGH*, with severe consequences. What had gone awry was that the (only) shareholder who had resolved on the capital increase, had already paid in the entire cash amount of about

one million Euro two weeks prior to the resolution. Most of it had already been lost in the course of the company's business activities. Of the paid-in amount, only a small portion was still available to the *GmbH* when the resolution was adopted. The shareholder, probably advised by the notary recording the capital increase or by his lawyer that this was not as it should be, paid in the full amount again after the resolution. At the same time, the *GmbH* refunded his first payment of the contribution and paid one million Euro back to the shareholder. A couple of years later the *GmbH* went bankrupt. The administrator now turns to the shareholder and demands that the capital increase amount of one million Euro be paid again.

The Decision of the *BGH*

The facts of the case can be divided into two separate parts. The first is the premature payment of the capital contribution before the capital increase was resolved upon, and the second is the renewed payment combined with the repayment of the first contribution. Althouth both parts involved, respectively, the payment of one milion Euro to the *GmbH*, neither payment was legally successful in effecting the cash contribution subscribed to. As for the first topic: the premature payment of the contribution, the prepayment, does not have any discharging effect at all on the obligation to pay in the subscribed capital. The reason therefor is that, at the time payment is made, there is no claim of the *GmbH* yet. Such claim only comes into existence once the capital increase has been resolved upon. Prior to that, the claim is just not there. Although the *BGH* has repeatedly held, in precedents over the past decades, that the premature payment lacks discharging effect, this still happens more often than one would think; insolvency administrators therefore tend to look at the timing of payments in connection with past capital increases quite intensely. Be that as it may, the legal consequences of the prepayment of capital are (i) that the *GmbH* can still claim payment of the capital contribution and (ii) that the shareholder has a claim for repayment of the funds contributed prematurely on the grounds of unjust enrichment against the *GmbH*.

Curing this awkward situation is not easy. The shareholder in the case decided by the *BGH* certainly has opted for the wrong course of action and that brings us to the second part. It is not sufficient to just pay in the capital anew and to get a refund for the first contribution by the *GmbH* in full (more or less using the funds just paid in for the second time). Under German corporate law (and in German legalese), such actions result in a so-called disguised capital contribution in kind (*verdeckte Sacheinlage*) in the form of a so-called pay-back-and-forth-procedure (*Hin- und Herzahlen*). What the shareholder actually does here – or rather:

what the law says he is considered to be doing – is not paying in cash as he is supposed to do in acknowledging his subscription duties but rather contributing his claim for repayment of the first contribution instead. He could do so but only by way of an open capital increase in kind, expressly declaring his claim for repayment as a contribution in kind by way of which to effect the capital increase. In this context he would then also be required to furnish evidence on the value of the claim for repayment which must of course match the nominal amount of the capital increase. Failing to do so – as was the case here – results in a disguised capital contribution in kind. The consequence of a disguised capital contribution in kind is, again, that the claim of the company for payment of the cash contribution is not discharged. The *GmbH* is therefore still entitled to payment.

Until a couple of years ago, there was nothing what the shareholder could do about it once a disguised capital contribution was detected; he just had to pay in the amount of the cash capital contribution again without any ifs and buts. However, this has changed. There is now a provision in the statutes that provides for the true value of the (disguised) capital contribution in kind – in the case at hand the claim of the shareholder for repayment of his first, premature contribution – being deducted from the still existing claim of the company for payment of the capital contribution. The true value is to be ascertained as per the time the capital increase in question was reported for registration in the commercial register. The burden of proof is with the shareholder. Since dealing with weighing evidence and assessing facts falls outside the compentencies of the *BGH*, the case was sent back to the competent Higher Regional Court with the instruction to look at the case anew from this true-value angle (which the Higher Regional Court had failed to do the first time).

Recommendation

In cash capital increases the contributions must be made in cash only and they must not be repaid to the subscriber or any entity related to him. The subscriber should avoid any transactions between himself and the *GmbH* in the context of the capital increase that could be regarded as (i) constituting a repayment of his contribution, (ii) disguising a capital contribution in kind or (iii) otherwise casting a shadow on the cash nature of his contribution. Further, the subscriber should refrain from paying in any funds as contributions towards the capital increase before the capital increase has been resolved in a notarial deed. The advance payment lacks discharging effect towards the capital contribution obligation. If he pays prematurely, he incurs the risk of having to pay in the contribution again.

- If you have questions on the foregoing, please contact either of (all of them qualified both as attorneys and as notaries):

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