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German Federal Court mitigates Liability Risks of Shareholders of a *GmbH*

- New Ruling on the so-called "Economic Re-Incorporation" -

Introduction

In this newsletter, we discuss a recent ruling of March 6, 2012 of the German Federal Court of Civil Justice, the highest German court in civil matters (*Bundesgerichtshof*, in the following referred to as *BGH*), docket no. II ZR 56/10, on the so-called "economic re-incorporation" (*wirtschaftliche Neugründung*). The term "economic" is somewhat awkward in this context. It should possibly, as will become apparent below, be replaced with "*de facto*". However, we will use it here as it comes as close as possible to the German original. To make the discussion more digestible for the non-German reader, we will first briefly look at the standard formation procedure of a German limited liability company (*Gesellschaft mit beschränkter Haftung*, in the following referred to as *GmbH)* and the basic liability rules. We will then outline the concept of economic re-incorporation which has been completely created by the courts and which is not provided for in German statutes. Finally, we turn to the new judgement of the *BGH*. Here, we examine in particular how it has clarified the heretofore unanswered question as to the extent of the liability of shareholders of a *GmbH* on the grounds of the economic re-incorporation concept.

Incorporation of a *GmbH*

The *GmbH* is formed by one or more founding shareholders adopting its articles of association and appointing one or several managing directors in a notarial deed. After the amounts required to be paid in as initial share contributions have been received by the company, its managing directors must apply for registration of the *GmbH* in the commercial register. The statutory minimum share capital for the standard *GmbH* is Euro 25,000.00. It is not uncommon for the shareholders to elect to pay in the entire amount when forming a *GmbH*. In any event, the funds paid-in must be at the unrestricted disposal of the managing directors and they must confirm in the application to the commercial register that this is so. Upon registration, the *GmbH* comes into existence as a legal entity, separate and distinct from its shareholders. The shareholders are, generally speaking, only obligated to pay in the share capital and they are only liable towards the *GmbH* for amounts not paid in, i.e. the amount of a possible shortfall between the net equity and the share capital at the time of registration of the *GmbH*, or repayments of paid-in amounts or other violations of the maintenance of share capital rules. They are, in principle, however, not liable for any losses generated by the *GmbH* in the course of operating its business.

So-called "Economic Re-Incorporation" of a *GmbH*

The doctrine of "economic re-incorporation" has been created by the German courts. It has its roots in the following scenario: a *GmbH* is formed (see above) but stops doing business after a certain period of time. Its operations simply may have turned out not to be as successful as planned. Its initially paid-in share capital is more or less lost. The *GmbH* is, however, still registered in the commercial register and it is not being liquidated. At this point in time, the shares in the *GmbH* are sold and transferred to an acquiror. He deems it advantageous to acquire the existing *GmbH* for a purchase price of, say, Euro 1,000.00, instead of having to form a new *GmbH* with the obligation to pay in Euro 25,000.00. So, he acquires the shares, replaces the managing directors, amends the articles of association and uses the *GmbH* for operating a new business. This is basically what German courts call "economic re-incorporation". The legal consequence is that the (new) managing directors are obligated to disclose to the commercial register, in the application letter reporting the aforementioned changes, the economic re-incorporation and, even more importantly, they have to confirm anew

that the share capital of the *GmbH* is at their unrestricted disposal. This means that, at the time of the economic re-incorporation, if the share capital had already been lost, the *GmbH* has to be provided with new funds in a manner such that the amount of net equity of the *GmbH* corresponds to the amount of the registered share capital. If the aforementioned requirements are not met, the shareholders are personally liable. One of the topics which had been in debate until the *BGH's* new ruling discussed herein is the extent of such liability. Are the shareholders only liable for the shortfall between the net equity and the registered share capital at the time of the economic re-incorporation? Or are the shareholders liable for all and any losses of the *GmbH* until its eventual insolvency? This is where the new judgement of the *BGH* comes in.

The New Ruling of the *BGH*

The *BGH* has now clearly stated that the shareholders are only liable for the amount by which the net equity of the *GmbH* falls short of its registered share capital at the time of the economic re-incorporation. The *BGH* expressly says that the liability does not extend to losses generated afterwards. Several authors and also some German courts had advocated the latter so that there had been considerable liability risks and uncertainty before the new judgement. This has now been clarified.

The new judgement is convincing. This follows from the fact that even in a standard formation scenario of a *GmbH* the business partners of the *GmbH* can only expect that the share capital is fully paid in once, not paid back to the shareholders and that it is properly maintained within the capital preservation rules. They cannot expect the *GmbH* not to make any losses. If losses are made, the shareholders may either elect to inject fresh money into the *GmbH* or to let the company go into insolvency. In both scenarios, the business partners of the *GmbH* have, generally speaking, no claims against the shareholders for compensation of losses. Why should it be otherwise in economic re-incorporation cases? It is only logical to have the same principles govern this concept, as the concept has been created in analogy to the (standard) incorporation rules applicable to a *GmbH*.