

# eNewsletter

## Corporate

### **Law Modernising German Limited Liability Company Law and Combating Abuse (MoMiG) - Simplification and Liberalisation, but also New Risks for Founders and Investors**

On November 1, 2009 MoMiG became effective and has reformed the German Act for Limited Liability Companies (GmbH) most comprehensively since its introduction in the year 1892. Compared to the earlier draft versions of MoMiG, the final version contains some amendments, which we will outline in more detail in the following.

The GmbH reform is the German legislator's response to the admission of UK Limiteds in Germany. In particular, MoMiG is to facilitate and accelerate the formation of new businesses (as set out by the Federal Ministry of Justice in its current statement). This is expected to be achieved by simultaneously liberalising GmbH law and combating existent abuse.

It is obvious that these goals cannot be wholly congruent. By and large, the legislator has managed to achieve a practice-oriented compromise, which should help facilitate managing businesses in the future, especially in regard to cash pooling and other questions of capital protection. As compared to former drafts, some of the simplifications originally intended have been diluted in the final version.

To a certain degree, some of the amendments effected by MoMiG are retroactive. For example, the new provisions regarding the fulfilment of capital contribution requirements also apply to contributions made in the past on which no final court decision has been taken yet.

#### **I. Simplification of Provisions on Raising and Preserving Capital**

##### **1. Contributions in Lieu of Equity**

If the company is in distress, shareholders often prefer to add liquidity by way of shareholder loans instead of contributing further equity. They wish to continue the company, but, at the same time, to keep open the option of repayment by the company. If this were allowed without restrictions, the shareholders would be able to control the company but, on the other hand, have the same rights as other creditors when it comes to repayment.

The German Federal Supreme Court felt this was inappropriate. Therefore, it developed case law for contributions in lieu of equity supplementing the statutory provisions. According to these rules, loans and other contributions by the shareholders were to be treated as quasi-equity, and are prohibited from being repaid if they were given or retained in a situation in which the company would have been unable to obtain credit from third parties at market conditions. In order to avoid any circumvention, these rules

apply not only to shareholders, but also to any of their affiliated companies. Further, they applied to other contributions by the shareholder besides loans. The complex regulations led to uncertainties, which increased risks for investors.

The legislator saw this problem, and created exceptions for small participations up to 10%, and for shares acquired for the purpose of restructuring the company (restructuring privilege). However, investors still considered the improved provisions to be too unclear to give comfort. Since the provisions do not apply to foreign companies, the legislator felt it was necessary to improve the position of the GmbH as compared to foreign companies.

In the future, shareholder loans and other contributions made or retained in a crisis of the company can be paid or called back like other loans. Shareholder loans only become last-ranking in the insolvency of the company. Repayments made within one year before the insolvency can be challenged by the insolvency administrator. Even though shareholder loans are last-ranking in an insolvency as a matter of law, it was decided at the last minute that the shareholders must nevertheless, as before, issue a declaration subordinating such loans to those of other creditors in order to avoid the loans being balanced as liabilities in an over-indebtedness balance sheet.

The new provisions apply to both GmbH and stock corporations (AG). In particular, the privilege for small participations of non-executive shareholders up to 10%, which continues to be relevant in insolvency proceedings, applies uniformly to GmbH and AG. The restructuring privilege will also continue to exist.

In contrast to earlier plans for abolishment, special provisions will continue for non-cash contributions by shareholders of insolvent companies. When a shareholder has made contributions in kind which are important for the company prior to insolvency, the shareholder cannot separate these assets from the insolvency assets for a year. The company may continue to use the assets, but the shareholders will receive financial compensation for such use. This is meant to ensure that the company will not be stripped of assets which it needs to continue its business, and to achieve a successful reorganisation.

The new provisions will make it easier to continue businesses and groups in times of crisis, e.g. with respect to cash pooling within a group of companies, since the GmbH will now be able to make payments to its shareholders also in times of a crisis.

The new provisions also give more comfort to investors who considered the restructuring privilege as too uncertain. Most investments made for the purpose of restructuring are covered by the restructuring privilege even under the previous legal provisions. The new provisions, however, are more favourable in that they generally allow payments to shareholders during a crisis, independently of whether the participation was acquired for restructuring purposes. This should encourage new investments.

The new provisions also facilitate debt to equity swaps. A loan can only be swapped into equity as part of a capital increase in kind, contributing the claim and waiving repayment in return for new equity, if and to the extent the claim had an actual value, i.e. the claim must not only exist, but probability of its payment must be realistic. Under the previous law loans in lieu of equity were not deemed to be of value as long as the crisis lasts, as their repayment was prohibited for legal reasons even if the company had sufficient funds for repayment. The new provisions improve this situation, as the value will in future be determined in relation to the company's actual economic situation.

The corporate improvements regarding the value of shareholders loans could also facilitate restructuring within the group. Under the previous law many shareholders refrained from waiving claims to improve the balance sheet, as the waiver of claims without value can trigger tax revenue in principle.

## **2. Share Capital**

The minimum equity share capital for a GmbH remains at EUR 25,000, and will not be reduced to EUR 10,000 as originally planned. The retention of the minimum share capital is intended to help maintain the reputation of the GmbH, especially as compared to the UK Limited. However, the minimum amount of a single share is reduced to EUR 1, which makes it easier to allocate shares among different shareholders. In addition, a shareholder will be able to assume several shares when the GmbH is formed.

Payments infringing the share capital are still illegal, and can be reclaimed. However, back-and-forth payments agreed prior to contribution will now be permissible as long as the claim for repayment is of value and due, or can be declared due at any time, and the agreement regarding back-and-forth payments is disclosed in the application to the commercial register.

Further, the new provisions bring clarity as regards the limitation language in loan agreements. In order to protect the managing directors from personal liability when making repayments or giving collateral within the group, credit agreements normally stipulate that the managing directors shall be under no obligation to infringe capital protection rules. As a result of the amended laws, the rights and obligations of the managing directors will be easier to define. In addition, the legislator has also made provisions for specifying the admissibility of payments under domination and profit transfer agreements, lowering liability risks.

### 3. Entrepreneurial Company (with Limited Liability)

Special rules apply to entrepreneurs who can not or will not raise the minimum capital for a GmbH. There are now provisions for an "Entrepreneurial company (with limited liability)", i.e. German "Unternehmergesellschaft (haftungsbeschränkt) (UG)". The UG is not a new, independent form of company, but a GmbH which can be established without a definitive minimum capital. Future profits of the UG may not be fully distributed, but must be partially used for building up a statutory reserve, whose purpose it is to help save up for the full share capital, or to compensate for losses or losses carried forward. If the minimum share capital is reached by way of subsequent increases in capital, e.g. by converting the statutory reserves into equity, the special restrictions for UG cease to be effectual, and the company may continue as a fully-fledged GmbH. The limitation on liability must be indicated by use of the addendum "Unternehmergesellschaft (haftungsbeschränkt)" or "UG (haftungsbeschränkt)".

There are no special provisions as regards the insolvency of a UG, so a lower initial capitalisation can lead to insolvency more quickly as liabilities or losses pile up.

### 4. Contribution in Kind

Unlike many other European countries, Germany has provisions prohibiting the so-called hidden contribution in kind, which can revive the personal liability of a shareholder who has already made a contribution to the company in return for his shares, so that he has to make a new contribution. While an open contribution in kind requires an expert evaluation in order to ensure that the increase of the GmbH's share capital is covered by the value of the assets contributed, the hidden contribution in kind is meant to circumvent this requirement so that the company receives a contribution in cash, but uses it to acquire an asset from the shareholder who has made the contribution in cash. From an economic point of view, the asset acquired, not the cash contributed but soon afterwards paid back as compensation for the asset, is the real contribution.

The German Federal Supreme Court considered this as unlawful, and developed case law prohibiting hidden contributions in kind. In case of a hidden contribution in kind, the shareholder is deemed not to have made a valid contribution. He can reclaim his asset from the company, but must render his contribution again in cash.

Even under the previous legal situation, there were ways to remedy hidden contributions in kind to a GmbH, which, however, the legislator did not consider to be sufficient. Under the new provisions, the value of the (hidden) contribution already made is factored in so the shareholder will only have to pay the difference (if any) in cash once the new share capital has been registered in the commercial register. Nevertheless, hidden contributions in kind are in principle still considered impermissible. Should the managing director be aware that the contribution is really a hidden contribution in kind, he must not apply for registration of the capital increase with the commercial register.

### 5. Authorised Capital

Towards the end of the legislation process, the legislator introduced an authorised capital, which can be created in a GmbH as was previously only possible for AG, and which can be exercised (i.e. converted into an actual capital increase) for up to five years. This helps save notarisation costs for GmbH whose shareholder and director are identical, but might be of limited use for other GmbH. Unlike the management board of an AG, the managing directors of a GmbH are not necessarily controlled by a supervisory board. If the shareholders nevertheless want to create an authorised capital, they should provide for control mechanisms in the articles of association or rules of procedure as a precaution.

## II. Standardised Articles of Association

In the initial draft of MoMiG, a GmbH was to be formed in written form only as long as standardised articles of association provided by the legislator were used. This was strongly criticised due to its considerably higher potential of error in comparison with a notarised formation. In reaction to this criticism, the legislator has now provided standard articles of association for simple formations (cash formation, maximum of three shareholders and one managing director), which has to be notarised, but at very low cost.

From the point of view of aspiring entrepreneurs, this decreases the costs of formation. However, setting up a GmbH with a low share capital was inexpensive before. In practice, it will usually be preferable to use more sophisticated articles of association as are currently in use, which are different from the template provided by the legislator, but more suitable for making adequate provisions for the respective case at hand.

### III. Bona Fide Acquisition of Company Shares

According to the new provisions, a bona fide acquisition of shares in a GmbH is possible. Previously, the possibility of bona fide acquisition only existed with respect to AG. GmbH shares can now be acquired bona fide if the vendor is reflected as shareholder in the list of shareholders of the GmbH in the commercial register and such list of shareholders has been incorrect for more than three years at the time of acquisition. When the shareholder is responsible for false registration, a bona fide acquisition is possible within a shorter period of time. If the shareholders' list was incorrect even before MoMiG came into force, there is a transitional period of six months. If the shareholders are not responsible for false registration, the time period of three years applies. After the transitional period has expired, GmbH shares can be acquired bona fide. Therefore, existing shareholders' lists should be checked in order to make sure that they are correct.

### IV. Liability of Shareholders and Managing Directors of a GmbH

When drafting MoMiG, the legislator did not only intend to simplify GmbH law, but also to prevent its abuse. In particular, action has been taken against so-called "company burials", where shareholders and managing directors of insolvent companies actually sever themselves from these companies in order to avoid detriment to their reputation, and liability risks. Instead of taking responsibility, they appoint new managing directors, who are essentially unconnected to the company. The managing directors accept their appointment, mostly because they urgently need the financial compensation, yet do not exercise their office in practice.

The legislator wished to extend obligations to shareholders in such cases, and therefore introduced a duty to file for insolvency for shareholders of such unmanaged companies, with a criminal sanction for delay of insolvency proceedings. This duty exists unless the shareholders can prove that either the insolvency or absence of a management was not known to them.

When a shareholder applies for the opening of insolvency proceedings, he must furnish prima facie evidence that the company is insolvent. If it should turn out that the company was not insolvent after all, there is a risk of liability. The shareholder must therefore consider very carefully which course of action is the right one.

In principle, extending the obligation to file for insolvency to shareholders of companies which are being "buried" and are in effect without working management, is not inappropriate. However, the new provisions have already met with strong opposition. In particular, it was criticised that, in contrast e.g. to shareholder loans, there was to be no privilege for small shareholders. At least according to the wording of the provisions, it does not seem impossible that liability will be extended to minority shareholders with small shareholdings. On the one hand, the legislator mentioned in the explanatory statement to the new law that minority shareholders with small participations should not be affected by the new provisions, as they are not familiar with the internal affairs of the company. On the other hand, e.g. banks, which sometimes acquire small participations for reasons connected to German real estate transfer tax, can have information about the company as part of their financing commitment. In a crisis of the company, they should therefore bear in mind that they can have a risk of liability of their own in case the insolvent company has no acting management.

The legal liability of managing directors has also been made more strict. The prohibition on making repayments, which already existed under the previous legal provisions, has been extended. If the managing director arranges for repayments to the shareholders even though it is becoming apparent that this will make the company illiquid, he will be personally liable. On the other hand the liberalisation of the provisions on contributions in lieu of equity reduces the liability risk for managing directors.

The catalogue of criminal offences which prohibit an appointment as managing director has been further expanded by MoMiG, and now also comprises fraud, computer fraud, economic subsidies fraud and capital investment fraud. At a late stage of the legislative process, another provision was added, pursuant to which shareholders are liable under civil law when they have intentionally or through gross negligence left the management of the company's business affairs to someone who is legally prohibited from being validly appointed as managing director. In the future, shareholders must therefore check that there are no prohibitions on taking office for the managing director.

The liability of shareholders was originally supposed to only pertain to the appointment of managing directors prohibited from taking office. The wording was changed in order to take account of the fact that an appointment in infringement of legal prohibitions is void in any case. However, the broad wording now chosen poses the question of whether such liability can also refer to persons who lead the business affairs of the company with the consent of the shareholders on an actual basis without being formally appointed as managing directors. This could be e.g. holders of special powers under German law (Prokuristen) who exercise more management powers than is customary. Judging from the explanatory statement of the legislator, it seems more likely that the liability shall be limited to cases in which the shareholders have appointed an uneligible managing director. It remains to be seen what the courts will decide.

MoMiG has also clarified the question whether directors of UK Limiteds active in Germany are criminally liable for delaying insolvency proceedings in Germany, which had been in dispute before. Now both managing directors of German companies and directors of foreign companies will be criminally liable.

## **V. Transfer of Seat Abroad**

### **1. Statutory Seat and Actual Seat**

Also under the new law, the statutory seat of the GmbH must still be in Germany. Similarly to an UK Limited, however, the actual seat of the GmbH by means of its administrative center (administrative seat) and/or the location of its business premises can now be transferred abroad.

### **2. Uniform Group Structure**

As a result of the GmbH reform, subsidiaries located abroad can be incorporated as GmbH. This can facilitate restructurings within the group. For example, spin-offs pursuant to the Transformation Act (Umwandlungsgesetz) are, at least pursuant to the wording of the Act, only possible between companies which are incorporated under German law.

### **3. Co-determination**

It is questionable whether the use of GmbH abroad can have an effect on employees' representation in the supervisory board. The scope of co-determination by German employees inter alia depends on the legal form of the enterprise in question and the number of employees in Germany. The legislator mentioned in the explanatory statement that the effects of a transfer of the administrative seat abroad on co-determination had been discussed. One had come to the conclusion that a transfer of the administrative seat had no effect upon German co-determination. Hence, the use of a GmbH with an administrative seat abroad has no effect upon German co-determination as long as the employees concerned are abroad.

The legislator did not expressly comment on the question whether the use of a GmbH abroad will lead to a co-determination of the German holding company via attribution of the numbers of the employees within the group to the German holding company. However, after the legislator emphatically stressed in a general way that the new provisions were to have no impact on co-determination, any risk should be within a limited scope.

### **4. Cross-border Restructuring**

Recently, there have been cases in which German companies initiated insolvency or other reorganisation proceedings abroad because they felt they were more favourable and easier to control than German proceedings. In order to render this possible, German companies were restructured into foreign companies, and moved their seats abroad.

Unlike the applicable company laws, which are those of the law under which the company has been formed, the applicable insolvency laws are determined in relation to the company's actual residence and activities. Therefore, GmbH whose actual seat (as opposed to their statutory seat) is abroad can, in principle, start insolvency or other reorganisation proceedings in the jurisdiction of their actual seat. However, it must be established that the actual seat really is abroad, as there is a presumption within the EU that the country of the statutory seat is also the country of the actual seat. In practice, the requirements for rebutting this presumption are strict.

## **VI. Accelerated Entry into the Commercial Register**

The formation and amendment of articles of association of GmbH only become effective when they are entered in the commercial register. The introduction of electronic commercial registers in the beginning of 2007 has already significantly sped up the registration process.

MoMiG is intended to further reduce the time required for the registration of a newly formed GmbH. Unlike before, companies whose business requires approval by the authorities (e.g. handicraft businesses) can in future be registered before official approval is granted. In addition, if a GmbH with only one shareholder is established, the requirements for granting special collateral have

been abolished. When examining the formation, receipts of payment or other proof of contribution to the share capital will only be requested by the commercial register if there is substantial doubt whether the capital has been raised properly. Where contributions in kind are made, examination will be limited to determining if there is a substantial overvaluation.

## VII. More Efficient Service of Documents

Companies will in future be required to submit an address in Germany for registration in the commercial register, so that actions against them can be taken more easily. This requirement also applies to AG, sole proprietors, partnerships and branches of German and foreign companies. If no actual service is possible under the registered address, public service will be facilitated in Germany.

## VIII. Conclusion

The legislator has for the most part accomplished its goal of simplifying GmbH law, and making it more attractive. Liability risks will be significantly reduced, particularly with regard to contributions in lieu of equity and the raising and protection of capital. However, in the process of implementing measures to combat abuse, a reasonable goal in principle, new liability risks have also been created. These apply particularly, although not exclusively, to shareholders of GmbH which have no active managing directors.

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