

**AMERICAN COLLEGE OF BANKRUPTCY
INTERNATIONAL INSOLVENCY INSTITUTE**

**Joint Discussion Panel
Washington, D.C. – 17th March 2006**

**Comparisons Between D&O Liabilities between
German (GmbH) Companies and
English Companies in Germany**

Eberhard Braun, Schultze & Braun, Germany

Easy life and lucky escape for the director of a UK limited doing business in Germany

I) The differences and similarities between the liability of a director of a German limited company (GmbH) and a director of an English private limited company.

A) Introduction: The reason for incorporations of English private limited companies (Ltd.) in Germany

Today, names such “XX Limited” or “XX Ltd.” are a common sight in the business community and in trading circles, and not only in England and Northern Ireland, but also in Germany. Several years ago, a company with this addendum was only known by some professionals doing business with the UK. This status has now changed a great deal, a “Ltd.” in the German economic area is no longer an exotic type of company, instead, most of the people have a clear understanding of it. The number of incorporated “Ltd.” trading in Germany has increased tremendously.

The rise in incorporations of Limited trading solely in Germany was on such a scale that some lawyers in Germany believed that the era and existence of the most popular German type of company – the German limited liability company (Gesellschaft mit beschränkter Haftung, GmbH) – would be over.

Providing a basis for the option of having English Limited with head offices in Germany

The possibility to trade with a foreign type of company without any problems as far as recognition was concerned is relatively new. However, it required some rulings by the European Court of Justice.

Before 1999, at the time of the first rulings by the European Court of Justice in this matter, there had been legally sound way within the territory of the EU to incorporate one type of company in one Member State and use and trade with it only and exclusively in another Member State.

An English Limited moving to Germany and registering in the German commercial register (Handelsregister) had been out of the question. The Limited was not recognized as a legal entity (juristische Person) but was treated as an unlimited partnership (Personengesellschaft). As a result, the limited liability for the directors of such a limited trading in Germany was

ruled out entirely. These shareholders had always been liable personally and for the whole sum of the damages.

In 1999 the first ruling by the European Court of Justice in the “Centros”¹ case found that registering a branch establishment (Zweigniederlassung) cannot be denied if the company had been established with legal effect in a Member State where it had its registered office.

This ruling would also apply in case the company does not have any business operations in the Member State of its incorporation.

It is not deemed to be an abuse of the right of establishment (Niederlassungsrecht) if a citizen of a Member State wishing to establish a company selects a specific Member State which allows him the greatest possible freedom under its national corporation laws. Whether such citizen then wishes to establish branch offices in other states is deemed irrelevant.

The “Centros” case was opened because the Danish Central Administration for trading and companies (Zentralverwaltung für Handel und Gesellschaften) refused to register a branch of the Centros Limited (registered as a ‘private company limited by shares’ in England and Wales) in Denmark, although Danish national law in general permitted the registration of a branch of a foreign type of company.

The European Court of Justice also ruled in “Überseering”² that the rules of the Community law are violated if a company is regarded by the Member State in which it has its head office as neither capable of holding rights (rechtsfähig) nor capable of being a party to legal proceedings (parteifähig), although the company had been effectively established in the Member State of incorporation and is lawfully registered there.

“Überseering” came about because of the Dutch Überseering BV (Besloten Vennootschap met beperkte aansprakelijkheid, Besloten vennootschap, for short), which had been incorporated in the Netherlands and had relocated its registered office to Germany, wanted to file a claim in a German court. However, the German court dismissed the case, arguing that a Dutch type of company with offices in Germany could not be capable of being a party to legal proceedings.

Although this ruling led to a proper solution, its consequences did not go far enough because the question of liability remained unanswered. The capability of holding rights and the capability of being a party to legal proceedings were ensured by this ruling, but the issue of whether a limited liability of the foreign company should be recognized or not remained unanswered.

At this point in time the Second Division for Civil Matters of the German Supreme Court (Bundesgerichtshof, BGH) did not accept a limited liability for these foreign types of

¹ Ruling by the European Court of Justice of 03/09/ 1999; Rs. C- 212/97.

The wording of the ruling is published on the following official internet page of the European Court of Justice: www.curia.eu.int.

² Ruling by the European Court of Justice of 11/05/ 2002- Rs. C- 208/00)

The wording of the ruling is published on the following official internet page of the European Court of Justice: www.curia.eu.int.

companies trading in Germany, but characterized them as partnerships, more precisely as an unincorporated civil-law association (Gesellschaft des bürgerlichen Rechts, GbR).

The breakthrough came in 2003 with the ruling referred to as “Inspire Art”(Ruling of 09/30/ 2003- Rs C- 167/01)³:

In these proceedings, the European Court of Justice examined the Dutch corporate law creating obligations for formal foreign types of companies located in the Netherlands. For such foreign companies, special rules applied in the issue matter of liability.

Inspire Art was incorporated in July 2000 as an English “private company limited by shares” in accordance with English corporate law. Its sole director has resided in the Netherlands and has been operating a branch in the Netherlands since 2000. The local chamber of commerce (Handelskammer) argued that Inspire Art as a formal foreign company needed to be registered in the Dutch commercial register.

The European Court of Justice again ruled that it is not an abusive action if the company does not carry on its business in the Member State where it was incorporated. It would constitute a violation of the right of establishment (laid down in Article 43 and 48 EC law) if the shareholder of a foreign company faces a special form of liability in the Member State where he carries on its business. The creditors of such a foreign company are already well protected by the addendum of the legal form, in this case “Limited”. The creditors are aware of the legal form of the company and are in the position to assess the risks and issues resulting from the foreign legal form.

According to the ECJ and its Inspire Art ruling, restricting the right of establishment by national rules or measures is allowed only under strict conditions:

- First, provided that the restriction does not cause any kind of discrimination
- Secondly, if there are strong and urgent reasons under public interest for the restriction
- And, finally, the restriction must be appropriate and necessary.

Effects of ‘Inspire Art’ in Germany today

Being a Member State of the European Union in Germany, it is possible to incorporate an English Limited company in England and carry on business only in Germany.

This Limited is fully recognized in Germany and is seen to be capable of holding rights as well as capable of being a party in legal proceedings while operating in Germany and under German law. There is no need for the Limited with its head office in Germany to have any engagement in England.

But recognition does not mean adoption of laws. Rather, the foreign company is recognized as it is incorporated with all necessary consequences.

³ The wording of the ruling is published on the following official internet page of the European Court of Justice: www.curia.eu.int.

The rules stipulating the minimum capital of that Member State in which the company will carry on business cannot be imposed on the company. But the rules regarding the capital structure of that Member State in which the incorporation was made always apply.

In addition, imposing disclosure requirements (Publizitätspflichten) or duties of publication of financial statements (Offenlegungspflichten) on a foreign legal form which are stricter than for domestic companies is not permitted. Since foreign legal entities are recognized, they must also be treated equally.

Since it is now possible to operate a business in Germany under the legal form of a Limited, this type of entity is meanwhile seen as a serious competitor to the German private limited company (GmbH). This has been a subject of heated discussions in Germany, particularly because of its alleged “advantages” such as

- The minimum capital of only £ 1 and
- The fast, unbureaucratic and low-cost incorporation which makes a Limited more attractive for those who want to set up a new business.

Current trends in Germany: some figures

Today, the incorporation of a limited is widespread in Germany and is not confined to some specific region or specific industry. It is estimated that around 25,000 Ltds. are operating in Germany today.

It is not only young start-ups who decide in favor of incorporating a Limited, but to an ever-increasing degree also ‘older’ and experienced entrepreneurs who see a Limited as the better and more advantageous type of company.

This is endorsed by the following figures (*base for the percentage figure as the sum of all incorporations of ‘Ltds’ with a head office in Germany in 2004*)⁴.

Most of the ‘Ltds’ were incorporated in 2005 in the region of North-Rhine Westphalia (19 percent), followed by Bavaria (14 percent) and Hesse (11 percent).

The ‘Ltd’ has been chosen throughout the whole business community:

- Commercial enterprises are leading in incorporations with 22 percent
- Followed by the service sector with 15 percent
- The building industry and trade are also on a high level with 13 percent
- In management consultancy / telecommunications and IT the number of incorporated ‘Ltd’ also increased by 9 cent
- Statistics show that financing / real estate chose the ‘Ltd’ with 7 percent.
- In the field of media and marketing, 6 percent of the incorporations were ‘Ltds’.

The suspicion that the ‘Ltd’ is a new and trendy type of company, only chosen by young people aged between 20 and 30 (in the statistic included with 15 per cent) has also been disproved.

Statistics show that founders aged between 40 and 60 – especially those between 41 and 50 - chose the ‘Ltd’ in greater numbers than just one year before: in 2004, this group accounted for

⁴ Figures taken from the article “Deutschland im Ltd.- Gründerboom”, internet page: <http://www.finanzenchannel.de/articles65.html> of February 9, 2006.

10 percent, not far behind the younger age group. It has been shown that there is no longer a relevant discrepancy.

These statistics demonstrate that the company type of a 'Ltd' is known in Germany and is seen as a favorable choice for a company incorporation.

Critical issues arising from this situation

This trend does not seem to abate, on the contrary: incorporations in the Eastern part of Germany continue to increase steadily.

These new developments are not all advantageous for business in Germany; there are also risks and critical issues, for instance, how to manage an insolvent Limited that has its head office in Germany.

The crucial issue arising at this point is the question of which national insolvency law applies to an English type of company trading in Germany. And, following on from there, which corporation laws apply.

Combining both issues, the question is: which liabilities exist for a director of such a Limited in Germany and which national law does it govern?

Ultimately, one needs to focus on the creditors and their protection, or if the Limited in Germany entitles the representatives of the company to certain privileges at the expense of the creditors losing some protection.

This article is designed to address some critical aspects of this issue.

In order to better understand the mixed form of a Limited with head office in Germany and trading solely within Germany, a comparison is called for with the

- The pure form of a German limited company registered and trading in Germany and
- The pure form of an English private company registered and trading in England.

It is fairly evident that both aspects will in a certain way be relevant for the discussions involving the Limited with head office in Germany.

B) The German limited liability company (Gesellschaft mit beschränkter Haftung, GmbH)

1) Overview of its structure, incorporation and bodies

Ever since the German limited company (Gesellschaft mit beschränkter Haftung, GmbH) was established in German corporate law⁵ in 1892, this type of company has become widely accepted in Germany, especially for small and medium-sized businesses.

⁵ The term "corporate law" in relation to a German limited company (GmbH) in this document always refers to the corporate law applicable to the GmbH referred as to "GmbH-Gesetz", GmbHG); The term "director" if used in the context of a German limited company (GmbH) in this document always refers to the director of a German limited company = "Geschäftsführer".

The following statistical figures are available:

- At the end of 1989 there were 401,687 limited companies registered in Germany with a total volume of share capital of approx. Euro 92 billion (*US \$ 109bn*).
- At the end of 1996 there were an estimated 770,000 limited companies registered in Germany with a total volume of share capital of approx. Euro 155 billion (*US \$ 185bn*).
- In 2001 there were approx. 850,000 registered limited companies in Germany.
- At present, it is estimated that there are 900,000 registered limited companies in Germany.

The advantages of this type of company are seen to be the following aspects:

- High adaptability because of the freedom to stipulate the optional provisions and conditions in the articles of association (Gesellschaftsvertrag) and
- The exclusion of personal liability (Ausschluss der persönlichen Haftung) because the GmbH is an incorporated entity; in general, only the corporate assets are liable for any creditors' claims.

These two positive aspects are partly offset by the long and protracted process of formation – it can take as much as six to eight weeks - and includes several steps which will be outlined below.

a) Intention of foundation a GmbH (Gründungsentschluss)

The formation begins with the declared intention of foundation (Gründungsentschluss) by the future shareholders (Gesellschafter).

This intention may be a merely formal agreement, but can also be laid down in a written agreement in what is known as pre-formation agreement (Vorgründungsvertrag) and then results in a pre-formation company (Vorgründungsgesellschaft).

The articles of association (Gesellschaftsvertrag) do not exist at this point; pre- formation company is therefore treated as an unlimited partnership.

Because of their commitment entered into at this stage of the foundation, the shareholders are personally liable. The foundation of the limited company completed in future will not automatically change anything in the personal liability relating to these commitments.

If the future company with its corporate assets is to be liable for these obligations, it needs to conclude a contract regarding the transfer of these obligations from the shareholders to the established company.

b) Notarization of the articles of association (Gesellschaftsvertrag)

The next step is the notarization of the articles of association (Gesellschaftsvertrag, die Satzung) by the shareholders.

These articles of association must comply with the following minimum stipulations in terms of their content under § 3 Section 1 Corporation Law (GmbHG) and must include the following points:

- Registered office (Gesellschaftssitz),
- Name of the company (Firma),
- Purpose objects the company (Gegenstand des Unternehmens); the articles of association must clearly show the focal activities of the business,
- Amount of the share capital- minimum Euro 25,000- and the amount of the initial contributions (Stammeinlage) paid by each shareholder.

Beyond these minimum requisites, the shareholders have the option of establishing rules and conditions within legal limits which create the best environment for their business operations. As mentioned above, this is one major aspect for opting for the GmbH as company type.

However, § 64 of the law (GmbHG) stipulates that the director must file for bankruptcy without undue delay, but at the latest after three weeks if the company is overindebted on its balance sheet or is illiquid. It is not possible to waive or even to modify the director's

statutory duty to file for insolvency proceedings to open in accordance with § 64 Corporation Law (GmbHG). And: Three weeks mean three weeks and not one day later. Violating this duty is not only a civil law (damages) problem but also a criminal offence.

When discussing the liability of the directors of a German limited company with head office in Germany, it is helpful to keep in mind that under German corporation law this duty of a director serves as security for the creditors and is indispensable.

Once the articles of association have been drafted, the so called pre-limited-company (Vor-GmbH) is founded which is a type of company sui generis. The company law applies to it only to the extent that the foundation is completed.

As long as the foundation of the company is not completed, the persons acting externally on behalf of the company are personally liable for their commitments.

Unlike at the stage of a pre-formation company, once the company is effectively founded, their liability will automatically transfer to the company without any additional agreement or stipulation. After the foundation has been completed, only the company assets are therefore liable even for the commitments made at the pre-company stage.

c) Appointment of the directors (Geschäftsführer)

The directors must be appointed. More than one director may be appointed for the company.

There are two ways in which directors may be appointed:

- The appointment can be laid down in the articles of association or
- The director will be appointed during the first meeting of shareholders (Gesellschafterversammlung); in general, this meeting will take place in connection with the conclusion and approval of the articles of association.

d) Payment of the share capital

Before a company can be successfully registered in the commercial register, each shareholder must pay up at least one quarter of his initial contributions according to the articles of association.

In total, these payments must add up to at least half the minimum share capital of Euro 25,000, i.e. the minimum contribution must be Euro 12,500.

e) Filing an application for registration in the commercial register (Handelsregister)

After payments have been made, all shareholders must file an application for registration in the commercial register (Handelsregister).

This application must be accompanied by the documents listed in § 8 Corporation Law (GmbHG), i.e. the notarized articles of association and the minutes of the first shareholders' meeting.

In general, the commercial register will review only if the application includes all the documents required.

f) Registration in the commercial register

The last step involves the registration of the company in the commercial register. The registration completes the foundation and the company has come into existence as a legal entity; §§ 10, 11 Corporation Law (GmbHG).

From that point forward in time, the liability is limited to the company's assets.

g) The two bodies or organs of the company

A German limited company acts through its two bodies:

- Shareholders' meeting (Gesellschafterversammlung) and
- Its director(s) (Geschäftsführer)

(1) Shareholders' meeting (Gesellschafterversammlung)

The shareholders' meeting is the body having the power to change the structure and the intention of the company.

In general, the competence of the shareholders' meeting is laid down in the articles of the association, but some major matters are indispensable and must always be addressed and dealt with at the meeting of shareholders. These include:

- Changes and modification of the articles of association (§ 53 Section 1 Corporation Law, GmbHG)
- Requests for additional contribution (Einforderung von Nachschüssen) (§ 26 Corporation Law, GmbHG) applicable only in certain cases.
- Decision on liquidation of the company (§ 60 Section 1 No. 2 Corporation Law, GmbHG).

Unless different provisions are stipulated in the articles of the association, the shareholders' meeting also has the following powers besides a few others in case of doubt (§ 46 Corporation Law, GmbHG):

- Appointment and dismissal of the directors
- Creating the annual accounts and taking resolutions on the appropriation of profits
- Establishing measures for examining the management of the company.

(2) Director(s) (Geschäftsführer)

A director runs the business of a German limited company and represents the company both externally and internally.

A company may have more than one director. The director can also be a non-shareholder (Fremdgeschäftsführer).

h) Conclusion

This brief outline shows that the foundation of a GmbH is relatively time consuming and a rather protracted and complex process. Even if a company founder wishes to establish a GmbH without the assistance of a lawyer, a notary public must eventually be involved because the articles of association must be notarized. Notarization is also required if shares in the GmbH are to be transferred⁶.

Also, the minimum share capital Euro 12,500 must be paid up.

These requirements mean that a great deal of thought must be given to the feasibility of setting up a company, in particular in terms of funding the company.

In brief, this type of company does not allow business ideas or concepts to be realized within a short time. Unremarkably, it also requires a sound financial basis.

These protracted and complex foundation process is seen as a handicap in this type of company. Not surprisingly, this has resulted in the impressive number of newly incorporated Ltds. acting in and from Germany as promoted by the so-called Limited Dealers.

2) Liability of the directors (Geschäftsführer) in the event of insolvency

General and express duty of the director to file for insolvency

Pursuant to § 64 Corporation Law (GmbHG), the request to open insolvency proceedings must be filed within three weeks after the reasons for the insolvency arise under German Corporation Law (GmbHG).

Failure to comply with this duty constitutes what is known as insolvency procrastination which may result in criminal prosecution and claims for damages under civil law (see below).

⁶ Notarization in Germany is a much more technical, more time consuming and a much more expensive regulation than in the U.S., for example. A notary public is a separate profession, governed by a professional body, strictly regulated and highly supervised by the ministry of justice.

A director is therefore expressly responsible and liable for the timely filing of the request to open insolvency proceedings if the company becomes illiquid or overindebted.

Liability also attaching to a so-called shadow director?

A shadow director is a person who has not been officially appointed as corporate agent but manages the corporate business in fact like an executive officer with power of representation.

Although the wording of § 64 Corporation Law (GmbHG) does not expressly define the liability for insolvency procrastination, it is nonetheless assumed for a so-called shadow director. The liability of a shadow director has been endorsed in a number of rulings.

To qualify as a shadow director, the total squeeze-out of the statutory directors is not necessary. On the other hand, the mere internal impact on the charter-appointed director is insufficient.

These rather general statements have been specified by the courts in greater detail:

A shadow director is a person who meets at least six of the following eight criteria:

- (1) Determining the corporate policy
- (2) Corporate organization
- (3) Recruitment/ employment and dismissal of staff
- (4) Design of the business relationships with contract partners
- (5) Negotiations with lenders
- (6) Design of wages and salaries
- (7) Decisions involving tax matters
- (8) Control of accounting and bookkeeping

The potential liability of shadow can be ruled out if fewer than six of the above items apply to him.

Direct filing right for the shadow director?

The question whether the shadow director's filing duty also entails a direct filing right is as yet not settled with ultimate clarity.

If the conditions of a shadow directorship are fulfilled, the attempt should be made to bring the formal director to file once the reasons for the insolvency exist, because a connected right of request is not always unanimously and unequivocally recognized. The formal director's refusal should be recorded, if necessary.

The reason being is that it will be doubtful in legal practice whether the court will admit the self-filing by the shadow director. A self-filing is admissible only if the filing person's legal position, which grants him the right to file, is absolutely beyond doubt in the court's considered opinion. Furnishing prima facie evidence is not sufficient.

To be satisfied, the court will rely on the commercial register (Handelsregister) relevant for the debtor's legal structure. If a legal situation differing from the register entry is invoked, the material burden of proofs rests with the applicant and the court will typically dismiss as inadmissible a filing by a director who is not entered in the register.

Legal consequences in terms of civil law and criminal law

In the event of insolvency procrastination, the (shadow) director is personally liable to the company and / or the insolvency administrator and to the creditors for the damage resulting from of the insolvency procrastination.

If insolvency proceedings are opened, the insolvency administrator will regularly try to investigate and clarify the liability issues and to assert the resulting claims in order to include these in the insolvent estate.

The liability under criminal law of the person obliged to file the request to open insolvency proceedings in the event of failure to comply with its duty is laid down in German corporate law. This dereliction of duty is a criminal offence, carrying a prison sentence of less than three years or a fine pursuant to § 84 Section 1 No. 2 Corporation Law (GmbHG).

Negligent failure to act is also a criminal offence punishable by law (§ 84 Section 2 Corporation Law, GmbHG).

C) The English private company limited by shares – (Ltd.)

The entity corresponding to a German limited company in Germany is the English private company limited by shares in England and Northern Ireland, referred to below simply as Ltd. Similar to the GmbH in Germany, the Ltd. is the most common type of company in England and Northern Ireland. The Ltd. is also especially suited for small and medium-sized businesses.

Although the frequency of the Ltd in England, Wales, Scotland and Northern Ireland seems to be comparable with the German GmbH, you will see below that the foundation of the Ltd is much easier with less intermediate steps than the foundation of a GmbH in Germany.

1) Overview of its structure, incorporation and bodies

The foundation of a Ltd is easy, costs less money and will take less time.

The two major aspects are

- A notary is not necessary because no deed or notarized document is needed.
- There is no minimum capital share to pay in; a Ltd. can be established with as little as £1.

To incorporate a company, all that is needed is the following documents together with the registration fee (standard registration fee is £ 20) to the Registrar of Companies:

a) Documents to file with the Companies House

Memorandum of Association

The Memorandum of Associations which defines the external relationship of the company and the base of the company. The minimum details this document must contain are:

- The company's name,
- The registered office,
- Its purpose and the,
- Amount of the nominal capital.

The company's memorandum delivered to the Registrar must be signed by each subscriber in the presence of a witness who must attest the signature.

Articles of Association

The Articles of Association set out the rules for the running of the company's internal affairs such as:

- Rights of the different classes of shareholders,
- Rights and duties of the management of the business,
- Rules regarding the execution of a meeting of shareholders,
- Rights to vote,
- Transfer of shares and limitation of the transfer.

Form 10

Form 10 contains details of the first director(s), secretary and the intended address of the registered office. Each officer appointed and each subscriber (or their agent) must sign and date the form.

Form 12

Form 12 is the statutory declaration of compliance with all the legal requirements relating to the incorporation of a company. It must be signed by a solicitor who forms the company, or by one of the persons named as a director or company secretary on Form 10. It must be signed in the presence of a commissioner for oaths, a notary public, a justice of the peace or a solicitor.

b) Examination by Companies House and grant of the 'Certificate of Incorporation'

After these documents have been filed with the Companies House, the Registrar will examine the application of incorporation only cursorily.

The application will be rejected only in the following cases:

- If the name of the company is improper or is already used by another company or
- If the purpose of the company violates the law.

If none of the above situations prevails, the Companies House will issue the ‘Certificate of Incorporation’.

The issue date of this certificate is the date of foundation of the company. With effect from that date, the Ltd. is deemed to be founded begins to exist as a legal entity, and the liability is limited to the corporate assets.

This whole procedure will take only between 5 and 10 working days; for an additional fee (premium service, cost £ 50) it is possible to obtain the registration within 24 hours.

c) Bodies of the company

The Ltd. has the following bodies:

(1) General Meeting

The general meeting has the power of decision-making on behalf of the company. It is the top level body of the company.

(2) Board of directors; the directors

The directors constitute the board of directors which conducts the affairs of the company and represents it.

(3) Secretary

A Secretary has no power of decision-making and cannot decide anything regarding the business operations. The Secretary’s duty is to manage the administrative side of the company, i.e. to take care of the company register or to take minutes during the meetings or preparing the annual account report.

2) Liability of the directors in case of insolvency proceedings

In general, the director of a Ltd. has a fiduciary duty in relation to the company. However, neither the English insolvency law nor the English corporate law know an express duty of the director to file for insolvency in the same wording as that stipulated in § 64 of the German Corporation Law (GmbHG). This does not mean, though, that the director’s personal liability does not attach at all if he fails to file for insolvency at a certain point in time.

To protect the creditors and to safeguarding the constancy of the estate, the English Insolvency Act 1986 has established the following measures:

- Fraudulent Trading, Section 213 Insolvency Act 1986 as amended by the Insolvency Act 2000,
- Wrongful Trading, Section 214 Insolvency Act 1986 as amended by the Insolvency Act 2000,
- Liability in insolvency proceedings in accordance with Common Law.

Fraudulent Trading, Section 213 Insolvency Act 1986 as amended by the Insolvency Act 2000

Explanation

Fraudulent trading exists if, in the course of the winding up a company, it becomes apparent that some business of the company has been carried on with intent to defraud creditors or for other fraudulent purpose.

Fraudulent trading is also a criminal offence.

Legal consequences

The legal consequences not only affect the appointed directors, but also the so-called shadow director, Section 214 (7) Insolvency Act 1986.

A shadow director under English company law is a person who, without being formally appointed, gives instructions upon which the directors of a company must act.

A director / a shadow director of a company who has been involved in fraudulent trading:

- May be disqualified from acting as a director for between 2 and 15 years under the Company Directors Disqualification Act 1986 as amended by the Insolvency Act 2000. Disqualification means that the person is no longer allowed to hold a leading role in any company. A disqualified person must obtain permission by the court to act as a director or to be involved in the promotion, formation or management of a company.
- Must make unlimited contributions from personal funds as the court sees fit. This is to enable compensation and also to punish those concerned. The amount of the contribution lies in the court's discretion and the court orders the amount as it thinks proper.

Practical impact

The practical impact of fraudulent trading is relatively unimportant, because the court demands stringent proof that the director has acted with a fraudulent intent. According to the so-called 'sunshine doctrine' non-fraudulent intent is assumed if the director is able to prove conclusively that he really thought the financial crisis was not permanent but could be overcome soon.

As a consequence, this rule provides insufficient protection for the creditors. Recognizing this fact, a new rule was added to the Insolvency Act 1986 on 28 April 1986 with Section 214: wrongful trading.

Wrongful Trading, Section 214 Insolvency Act 1986 as amended by the Insolvency Act 2000

Explanation

Wrongful trading exists if the company has gone into liquidation and some time before the director knew, or ought to have concluded, that there was no reasonable prospect that the company could avoid insolvent liquidation and yet continued to trade.

In terms of Section 214, a company is 'insolvent' if

- The company cannot pay its debts when due
- The value of its assets is less than the amount of its liabilities
- Both.

The moment when the director becomes liable - referred to as 'moment of truth' – is the point in time when there are no rational prospects for avoiding bankruptcy.

Possibility of exculpation

The option open to the director is that of exculpation. He rules out his liability by proving that he 'took every step to minimize the losses' in accordance with Section 214 (3) Insolvency Act 1986.

The criterion for the required duty of prudence is defined in Section 214 (4) Insolvency Act 1986. According to that provision, he is bound to exercise the care of a prudent business man. If he breaches this duty, he will be liable.

Legal consequences

The legal consequences for a wrongful trading are:

- Disqualification for between 2 and 15 years under the Company Directors Disqualification Act 1986 as amended by the Insolvency Act 2000.
- Paying unlimited contributions from personal funds as the court sees fit. This is to enable compensation and also to punish those concerned. The amount of the contribution lies in the court's discretion and the court orders the amount as it thinks proper.

Liability in insolvency proceedings under Common Law

Besides wrongful trading, the law in England has developed a separate liability for insolvency procrastination under common law. The underlying element of this liability is the director's duty to act to the benefit of the company.

This duty depends on the company's individual situation, i.e. if the company is financially sound, the director needs to act to benefit of the shareholders, but if the company is in financial crisis or already insolvent, the director must act to benefit of the creditors.

If insolvency proceedings have been opened, the creditors are entitled to assert claims against him, e.g. preservation of capital. In consequence, a breach of duty exists if the director continues running the business and so puts the creditors at a disadvantage.

His actions must be negligent, i.e. he fails to exercise the care of a prudent director or businessman.

Legal consequence:

If a director is personally liable under common law, he must make compensation payments to compensate for the damage resulting from his default.

Unlike the payments to be made in case of wrongful trading, the payment is only equal to the actual amount of the damage incurred. The actual amount does not lie in the court's discretion, but is equal to the actual damage.

Conclusion:

Although there is no express statutory duty for an English director to file for insolvency, the above fraudulent and wrongful trading and the liability under common law establish the liability for a director to ensure that he acts to the benefit of the creditors of the company in case of a financial crisis.

One of the more severe sanctions in the event of fraudulent trading and wrongful trading is the possibility of disqualification. Disqualification is not unknown in other European insolvency laws when it comes to unfit directors worsening or aggravating the financial crisis of the company; Spanish insolvency law, for instance, also knows this legal consequence.

In fact, German law provides for an explicit duty for the directors to file for insolvency at a certain point of time, but the legal consequence by way of a disqualification does not exist expressly for breaching this duty.

This does not mean, however, that German law does not provide for any sanctions at all for the directors of a GmbH. German law knows the sanction of the "Berufsverbot" (prohibition of pursuing a trade or profession) which, however, does not exist as a legal consequence if the duty to file for insolvency (§ 64 GmbHG) is infringed.

A director may be prohibited from pursuing a trade or profession if he has been convicted of a criminal insolvency offence under §§ 283– 283 d Criminal Code (Strafgesetzbuch, StGB). The same holds for the conviction for a similar criminal offence by a criminal court abroad.

A convicted director cannot hold a director's office for a period of five years after the judgement has become final. During that period, he is disqualified from holding office, expressly stipulated in § 6 Section 2 sentence 3 GmbHG.

At the time the application for entry of the GmbH in the commercial register is made, the future directors must warrant and assure that there are no circumstances which may prohibit their appointment as directors. Pursuant § 8 Section 3 GmbHG they are under the obligation to disclose a conviction under §§ 283- 283 d Criminal Code (Strafgesetzbuch, StGB). If such

assurance cannot be delivered or granted, the GmbH cannot be entered in the commercial register.

Untruthful warranties and assurances are punishable by law and may incur a prison sentence not exceeding 3 years (§ 82 GmbHG) and damages (§ 9 a GmbHG, shareholder's liability).

The legal consequence of disqualification appears to have a pronounced preventive effect. This consequence is seen as ideal on a European level. The EC Commission said in its working paper regarding the modernization of the company law of July 2003 that it will initiate a general personal liability in case of delays in filing for insolvency, also referred as to 'insolvency procrastination' and establish the legal consequence of disqualification on a European level⁷.

With fraudulent trading and wrongful trading and its drastic legal consequences under English law, directors are as much forced to act to the benefit of the company as they are to act to the benefit of the creditors. The drastic legal consequences appear to be an encouragement to conduct one's business properly.

D) The English private company limited by shares with head office in Germany

As outlined above, the English private company limited by shares (Ltd.) is beginning to be a serious competitor for the German GmbH in Germany.

Before discussing the issues involving a foreign type of company being established in Germany and which actions to take in the event of insolvency proceedings being opened over its assets. First a brief outline of the steps required to establish a Ltd.

1) Overview of its structure, incorporation and bodies

As general rule, an English Ltd. is to be established under English law even if its head office is to be located in Germany.

During the incorporation, it is not the rules relating to the future location (situs) of the head office, but the rules relating to the type of company which must be observed.

Although the head office may be located in Germany, the company still remains a typical English company with the typical bodies of general meeting, director and secretary.

The incorporation must therefore follow the steps outlined above under C 1 a) to b).

2) Comparing a GmbH and a Ltd with head office in Germany

	GmbH	Ltd with head office in Germany

⁷ See www.eu-kommission.de/pdf/dokumente/com2003_0284de01.pdf = German version, page 19; seen on 16 February 2006.

Body of company	- shareholders` meeting (Gesellschafterversammlung) - Director (Geschäftsführer)	- shareholders` meeting - Director and - Company Secretary
Required form of the Articles of Association	Notarized deed	Signed in one`s private capacity: - Memorandum of Association (for external relationship) - Articles of Association (for internal relationship)
Time required for incorporation	Several weeks or months	Up to 10 working days; possible within 24 hours
Registration in the commercial register (Handelsregister) in Germany	Must be registered in accordance with § 7 Corporation Law (GmbHG)	The German-registered branch (Zweigniederlassung) must be registered in the German commercial register (Handelsregister)
Accounting	Must comply with the rules of the Commercial Code (HGB)	Must be done in accordance with English corporation law, i.e. annual accounts must be submitted to the Companies House; Violating this duty has serious consequences: - payment of a substantial fine - worst case scenario: liquidation of the Ltd.
Taxes	Corporate income tax	In accordance with the territoriality principle, also corporate income tax
Transfer of shares	Notarized deed	Signed in one`s private capacity and Entered in the Companies House

3) Liability of the directors in case of insolvency proceedings

a) First issue: Which kind of insolvency law applies to a Ltd. which has its head office in Germany?

If insolvency proceedings are opened over the assets of an English Limited which has its head office in Germany and which operates solely in Germany, there is no immediate answer as to the governing insolvency law because there are two options:

Is the location of the establishment and the legal form the defining element for the governing law, or is it the territory (jurisdiction) in which the company operates?

Since EC Regulation No. 1346/ 2000 of 29 May 2000 has come into force on 31 March 2002, the application of the insolvency law in the territory of the EU and among the Member States of the EU (excluding Denmark) has been regulated and codified.

The general rule is laid down in Article 4 Section 1 EC Regulation which states that the ‘law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which such proceedings are opened’; this State is referred to in the EC Regulation as the ‘State of the opening of proceedings’.

The reference in Article 4 EC Regulation relates both to the applicable procedural law and to substantive law. In compliance with this regulation, the issue of the applicable insolvency law in general is regulated for cross-border cases within the EU.

In accordance with Article 3 Section 1 EC Regulation, ‘the courts of the Member State within the territory of which the center of a debtor’s main interests is situated shall have jurisdiction to open insolvency proceedings’.

As practical experience with the EC Regulation shows, it is quite a problem to identify and specify the center of a debtor’s main interests (COMI). There have already been a number of law suits on this matter among the courts of the Member States.

But ‘in the case a company or legal person, the place of the registered office shall be presumed to be the center of its main interests in the absence of proof to the contrary’, as stated in Article 3 Section 2 EC Regulation.

This assumption is not helpful in the present situation, i.e., when the company does not operate at all in its State of incorporation but only in another state. In this constellation, the registered office and the head office are at different locations.

As a rule, the head office in this constellation is the pertinent office and is seen as the center of the main interests in accordance with Recital (Erwägungsgrund) No. 13 to the Regulation:

‘The center of main interests’ should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties’.

Applying the above criteria to an English Limited with its head office in Germany, its COMI is in Germany because it is there where the company carries on its business and where its administration is located. The company is ascertainable by third parties in Germany and not in England.

As a result, the ‘classical’ English Limited with its head office in Germany is subject to German insolvency law, i.e. both under procedural law and in terms of substantive law.

The situation may be somewhat different if business is also carried on at the registered office in England and / or decisions are made for the company. Then one needs to review where the COMI is situated – either in England or in Germany, with the effect that either English or German insolvency law applies.

b) Second issue: The legal qualification of the liability of a director in case of insolvency proceedings

The main issue is the question of which law applies to the director of a Ltd. with its head office in Germany if the company runs into financial crisis: is he under the duty to file for insolvency in accordance with § 64 German Corporation Law (GmbHG), or does his liability attach under English law?

It seems certain that, for corporate matters, English corporate law applies, and German insolvency law applies if insolvency proceedings are opened over a Ltd. which has its head office in Germany.

The reason this matter causes such difficulties arises from a collision between corporate and insolvency law:

- the duty of a director of a company is a classical matter for corporate law
- the request to open insolvency proceedings belongs to insolvency law.

The core of the problem is the different qualification of the director's duty to file for insolvency under § 64 Corporation Law (GmbHG). The outcome of this qualification also answers the question if this law applies to a director of a Limited with its head office in Germany or not. If § 64 Corporation Law (GmbHG) could be qualified as an insolvency order, it also would apply to the director.

There are two different qualifications:

- qualification under corporate law
- qualification under insolvency law

Qualification under corporate law

There are valid arguments to qualify § 64 as Corporate Law (GmbHG).

The first indicator for this point of view is the simple reason that the duty to file for insolvency is not an order by the German Insolvency Code (Insolvenzordnung, InsO), but is part of the German Corporate Code.

The second and even stronger indicator of this point of view is the aim of this rule. This rule is designed to create preventive protection for future creditors. The directors are to be encouraged to constantly control and review the financial situation of the company.

The duty to file for insolvency at a certain time is seen as a duty to act and react for the director in a certain economic situation⁸.

The German Supreme Court (Bundesgerichtshof, BGH) recently confirmed the applicability of English corporate law in its ruling of 03/14/2005 (BGH *ruling of 14.03.2005; Az: II ZR 5/03*)⁹.

This ruling shows that the German Supreme Court (Bundesgerichtshof, BGH) qualifies the duty to file for insolvency as corporate law.

⁸ See among others Dr. Alexander Schumann, "Die englische Limited mit Verwaltungssitz in Deutschland: Kapitalaufbringung, Kapitalerhaltung und Haftung bei Insolvenz, in German law journal „Der Betrieb“ 2004, page 743 - 749 and Heribert Hirte/ Sebastian Mock „Wohin mit der Insolvenzantragspflicht?“ in the German law journal ZIP page 474 – 478.

⁹ This ruling is published among others in the following German law journals: NJW 2005, page 1648 - 1650; ZInso 2005, page 541 – 542.

In its ruling, the court stated as follows:

The liability for legal obligations of a director of a Limited with head office in Germany but incorporated and registered in England conforms to the law of the State of the incorporation. English corporate law therefore also applies to the question of liability for legal obligations. The courts also ruled that it would violate the right of establishment (Article 43 and 48 EC law) if a director is personally liable under § 11 Section 2 in analogy with German Corporation Law (GmbHG), even in case that the establishment of the Limited is not registered in the German commercial register (Handelsregister).

As a result, § 64 Corporation Law (GmbHG) is qualified as corporate law and does not apply to directors of a Limited with head office in Germany, because the rules of German corporate law do not apply to them.

Qualification under insolvency law

Some commentators qualify § 64 GmbHG as insolvency law because it aims to afford protection for the creditors. This rule is designed to encourage directors to file for insolvency at the earliest point in time and to avoid the continuing diminution of the insolvent estate¹⁰.

As a result, § 64 Corporation Law (GmbHG) is applicable to directors of a Limited with head office in Germany because German insolvency law applies.

Conclusion

§ 64 Corporation Law (GmbHG) is to be qualified as corporate law because this qualification is confirmed by a judicial ruling.

Qualification under insolvency law, on the other hand, is discussed and favored in academic discussions and papers.

This leads us to the question whether the qualification under corporate law does not result in a lack of liability, as argued by the supporters of a qualification under insolvency law.

At first glance, it seems that there is, in fact, a lack of liability:

- § 64 GmbHG qualified as corporate law does not apply to the director
- but fraudulent trading and wrongful trading also do not apply because these are qualified as insolvency rules under English insolvency law. But the Limited with head

¹⁰ See among others Johannes Holzer, „Rechte und Pflichten des Geschäftsführers einer nach englischem Recht gegründeten „limited“ im Hinblick auf das deutsche Insolvenzverfahren“ in the German law journal: ZVI 2005, page 457 – 468;
Volker Röhrich, “Insolvenzrechtliche Aspekte im Gesellschaftsrecht” in the German law journal: ZIP 2005, page 505 – 520.

office in Germany is subject to German insolvency law instead of English insolvency law.

Of course, there is still the possibility of liability under common law as a kind of catch-all element (Auffangtatbestand) for the liability of a director of a Limited with head office in Germany breaching the duty to file for insolvency at a certain point in time.

This liability is clearly assigned to the statute of corporate law and will always remain for the director of a Limited with head office in Germany.

But one should keep in mind that this liability under common law is merely a catchall element and does not carry such severe legal consequences as a disqualification or a criminal punishment. Compared with the director of a UK based Limited, the director in Germany is privileged.

Against this legal background it is interesting to examine if there are any other rules under German law which may close the liability gap for directors of a Limited with head office in Germany.

Maybe there are some other laws in Germany, e.g. criminal law, providing for the duty and liability for these directors to file for insolvency at a certain point in time.

c) Does any other German law apply to the Ltd.?

Although English corporate law applies to a Limited with head office in Germany in accordance with the statute of corporate law, it is possible and likely that German tort law applies according to Article 40 International Civil Law (EGBGB Article 40 Section 1).

International civil law states that the law of the state applies:

- in which the liable person acted (Article 40 Section 1 sentence 1 International civil law) – also called the *lex loci delicti* (Tatortstatut)

or

- in which the outcome– the damage - occurs (Article 40 Section 1 sentence 2 International civil law).

As far as a Limited with head office in Germany operating solely in Germany is concerned, the requirement of the *lex loci delicti* will always be fulfilled.

Similarly, the general rules of the German criminal law apply to the Limited with head office in Germany. The German international criminal law codified in § 3 Criminal Code (Strafgesetzbuch, StGB) states that German criminal law applies in the whole territory of Germany and therefore to all criminal offences committed within its borders regardless of the nationality of the offender.

The statute of the corporate law is therefore not relevant for the general German criminal law. The only important factor is whether the crime has been committed within the German borders. The question still remains: do we actually have a penal provision the director of the Ltd. is violating?

Special penal provisions involving the criminal liability of certain corporate forms and their organs, such as those stipulated in § 84 GmbHG for the director of a GmbH, are not defined for a Limited with its head office in Germany. For such penal provisions relating to a specific

type of company, it is again the statute of corporate law which becomes significant again because only the corporate form specified in the penal provision has the criminal offender quality stated in that provision.

In general, the criminal rules are characterized as protective laws under civil law. The consequence of this is that a crime or offense committed may at the same time also be an infringement of civil tort law and may cause civil liability beside criminal culpability.

The directors of a Limited with head office in Germany are personally liable under § 823 Section 2 Civil Code (Bürgerliches Gesetzbuch, BGB) in conjunction with § 263 Criminal Code (Strafgesetzbuch, StGB; German criminal rule against fraud) if the directors enter into an agreement and thereby mislead the contracting party about the true financial circumstances of the company.

The directors may also be held personally liable under § 826 Civil Code (Bürgerliches Gesetzbuch, BGB) which stipulates liability for damages in case of damage contrary to public policy (sittenwidrige Schädigung).

In practice, these rules under tort law raise the same problem as the rule of fraudulent trading, namely the difficulty to prove intent by the directors in their actions.

It is difficult to show the intent satisfactorily and to convince the judges of a fraudulent action.

This burden of proof is even more difficult for an action causing damage contrary to public policy, because evidence must also be shown that the director has foreseen the kind and type of the damage he caused. Proving that the director has acted with intent is not sufficient; proof must also be provided that the director had knowledge of the consequences of the damage.

Proof must be provided that the director had knowledge of the kind of damages he caused as a result of his action and could foresee this damage.

The liability of the directors for insolvency procrastination under tort law will only cover situations in which the directors mislead the contract partners about the actual financial circumstances of the company. Or, under § 826 Civil Code (Bürgerliches Gesetzbuch, BGB), if the director enters into an agreement with a creditor knowing that this will only protract the insolvency of the company but will not really avoid it and therefore will diminish the insolvency estate after all.

It is therefore not possible under German tort law to establish a liability for insolvency procrastination because of violating the duty to file for insolvency at a certain point in time.

Such liability for insolvency procrastination because of a violation of the duty to file for insolvency could expressly exist only under § 823 Section 2 Civil Code (Bürgerliches Gesetzbuch, BGB) in conjunction with § 64 Section 1 Corporation Law (GmbHG) or in conjunction with § 84 Section 1 No. 2 Corporation Law (GmbHG) (intentional insolvency procrastination) or § 84 Section 2 Corporation Law (GmbHG) (negligent insolvency procrastination).

But, as outlined above, these rules do not apply to a Limited with head office in Germany because these rules are qualified as corporate law. And it is only English corporate law which applies to a Limited with head office in Germany.

The conclusion suggest itself that neither under the applicable tort law nor under the applicable criminal law is it possible to construe liability for the director of a Limited with head office in Germany for insolvency procrastination because of a violation of the duty to file for insolvency at a certain point in time.

These rules of civil and criminal law are designed to safeguard and protect the creditors of the Limited with head office in Germany and to ensure that the directors do not conduct their business in an unlawful and fraudulent manner.

The above appears to imply that the director of a Limited with head office in Germany would be only liable for insolvency procrastination because of violating the duty to file for insolvency at a certain point of time in accordance with English common law.

In addition, the director may be also liable under § 826 Civil Code (BGB) and / or § 823 Section 2 (BGB) in conjunction with § 263 Criminal Code (StGB) if proof of fraudulent action manifesting as fraudulent trading can be provided.

II) Conclusion

This brief outline of the English Ltd. with its statutes relating to the liability of the directors in comparison with the German GmbH shows that the Ltd. is seen to be much more advantageous and is chosen more and more as the legal form in Germany.

With respect to its incorporation requirements, it is true to say that establishing a Ltd. is much easier and cheaper, and it is also true that it could offer enough protection for the creditors of a company in case of insolvency proceedings with its instruments of wrongful trading and liability in insolvency proceedings under common law, but fully only if the Ltd is not operating exclusively in Germany. The UK system of protection in the Insolvency code does not apply, the German regulation is mainly corporate law orientated, in other words, not applicable. And: No damages from the director, no criminal offence is committed.

For cases involving insolvency procrastination resting on the infringement of the duty to file for insolvency at a certain point in time, there is a lack of liability for the director of a Limited with head office in Germany which, on the other hand, attaches fully to the director of a German GmbH.

Whereas the director of a German GmbH must also face criminal prosecution, such legal consequence does not exist for the director of a Limited with head office in Germany.

The impact and extent of a conviction under criminal law could be absorbed and compensated by the legal consequence of a prohibition of pursuing a trade or profession (Berufsverbot) because such prohibition constitutes an incisive measure.

However, the “Berufsverbot” does not exist as a legal consequence in the director’s liability under common law.

The conclusion may be drawn that the director of a Limited with its head office in Germany circumvents criminal prosecution and is privileged in comparison with the director of a German GmbH who is confronted with the express duty of filing for insolvency at a certain point in time. And the director of a Limited trading solely in Germany is also privileged in

relation to the director of an English-based Limited, with the latter being subject to the Insolvency Act regulations of fraudulent / unlawful trading.

The almost absurd consequence of these differences is that they also offer the director of a Limited trading exclusively in Germany an additional advantage besides the above-mentioned effects of circumventing the regular duties of a director, namely when it comes to the option of reorganization.

If the option of reorganization becomes available, the director of a GmbH has only three weeks within which he is allowed to attempt the reorganization, the director of a Limited with head office in Germany is under no time limit. He has plenty of time to take reorganizing actions and merely needs to explain and demonstrate that these reorganizing actions are for the benefit of the company. As long as a judge is certain of the positive effect of the reorganizing actions and believes that they are for the benefit of the company, the director would not automatically be held personally liable under common law.

Recognizing this (for German regulators unsatisfactory) situation, the debate now revolves around establishing a general duty to file for insolvency at a certain point in time for companies with limited liability under the insolvency law.

Maybe our corporate law will benefit from this discussion and receive new impulse and new and better modifications:

The German economy holds onto the GmbH, but also sees its problems and disadvantages in comparison with other European corporate forms and demands changes and modifications. The intention is now to simplify this establishment procedure.

According to some proposals, it should be possible to establish a GmbH with just some standardized documents, maybe similar to Form 10 and Form 12 used for the establishment of an English Limited.

The need for notarized documents is also questioned, and there are considerations of deleting notarization altogether from the wording of the company law.

Some economists and politicians go even further and call for the reduction of the minimum amount of share capital from Euro 25,000 to Euro 10,000.

But the requirement of a minimum amount of share capital is seen as protection for creditors and is still greatly appreciated.

It is therefore unlikely that the requirement of a minimum amount of share capital will be dropped completely for a GmbH. Even a reduction in the amount of the share capital would help this type of company to compete with the Limited and would still offer a high degree of trust and confidence derived from the existence of a minimum amount of share capital.

But all these proposals fail to address the above wide-ranging differences in obligations, in responsibility and risk for a director acting for a GmbH or a Ltd.

At least in formal terms, the liability duty of a director of an English Limited with head office in Germany appears to be more favorable as there is no express duty and therefore no express liability to file for the opening of insolvency proceedings at a certain point in time.

Under the aspect of civil law, the only sanction for this kind of insolvency procrastination is the catch-all element under the English common law, whereas liability under criminal law can be ruled out altogether.

This may one of the advantages prompting the would-be founder to go for a Limited, with one unfortunate effect that the establishment of a Limited is often given preference over the establishment of a GmbH by a special clientele for rather dubious reasons.