

SCHULTZE & BRAUN INSOLVENCY LAW

The liability of the GmbH director (limited liability company) in insolvency scenarios – Part 1

Introduction

The law imposes extensive duties on the director of a German GmbH. These become even more stringent when the company is in crisis. These diligence requirements in a corporate crisis can turn into a tightrope walk for director, because he is torn between safeguarding the interests of the company and being exposed to a wealth of liability risks which affect him personally. Many directors are insufficiently aware of these liability risks. Yet they may have far-reaching effects on the director, even jeopardising his existence, because it is not only the director's property which is under threat, the law also provides for severe sanctions under criminal law. The most important regulations will be outlined in this paper.

Sanctions under criminal law

Insolvency filing duty

(§ 64 Section 1 GmbHG [Law on Limited Liability Companies])

Pursuant to § 64 Section 1 GmbHG, the director must, without culpable delay, apply for insolvency proceedings to be instituted at the latest three weeks prior to the occurrence of the inability to pay. According to Section 3 of the same paragraph, this also applies if the company is over-indebted. Similar regulations exist for stock corporations (AGs) and for GmbH & Co. KG.

Pursuant to § 17 Section 2 InsO, the debtor is insolvent if he is no longer capable of meeting his payment obligations. Over-indebtedness under § 18 Section 2 InsO prevails if the debtor's assets no longer cover his liabilities. When evaluating the debtor's assets, the continuation of the company is to be taken as a yardstick if, under the circumstances, the survival of the company is considered likely. Over-indebtedness is not to be deduced simply from the balance sheet; instead, it must be established by way of an over-indebtedness status. Some capitalisation prohibitions do not apply in this status. As soon as the over-indebtedness is determined by way of the balance sheet, the corporate crisis becomes manifest and the director is under the obligation to answer the question whether there is over-indebtedness as defined by the insolvency law.

This is the regulation which is often ignored in practice. Directors often display an astounding hard-headedness when it comes to drawing the consequences from the recent insolvency or over-indebtedness. Quite often, they also fail to see that the law requires them to file for insolvency without undue and culpable delay. The three-week period applies only if the director pursues promising avenues for reorganising the company. If, once the insolvency or indebtedness has occurred, the chances of reorganisation are considered to be slim, the application must be filed at once. If the rescue attempts are unsuccessful within three weeks after the occurrence of the insolvency or over-indebtedness, the application must also be filed.

Also, the internal allocation of duties does not relieve the director from his filing duty. Each and every director is under the same obligation.¹ Under § 64 Section 1 GmbHG, the de facto director is also liable.²

¹ BGH (Federal Court of Justice), ruling dated 1 March 1993, GmbHR 1994, 460

² Scholz/Karsten Schmidt, GmbHG § 64, mn 6f.

If the director infringes his insolvency filing duty under § 64 Section 1 GmbHG, he becomes criminally liable under § 84 Section 2 GmbHG. The offence can carry a prison sentence not exceeding three years or a fine if it was committed intentionally, i.e., if the director has been aware of the insolvency or over-indebtedness.

It should be noted, however, that negligence is also a punishable offence, which means that the objection of not having been aware of the insolvency or over-indebtedness will not be admitted. The law imposes the duty on the director to permanently observe the financial situation of the company and to gain an insight into the company's property status by preparing an interim balance sheet or a property status as soon as the first signs of a crisis loom.³ If there are signs of a corporate crisis or if the crisis is already evident, the director is therefore well advised to recruit the help of a neutral third party which prepares an over-indebtedness status, and to have the insolvency examined and investigated with the help of a budget account. If the examination arrives at the result that there are reasons for insolvency, the application must be filed.

Another factor the director should consider is the fact that, as a matter of routine, the files of the insolvency application are submitted to the public prosecutor's office which will examine whether the insolvency has been filed in good time.

Elements of § 283 StGB (Criminal Code)

Punishable offences are: hiding assets⁴, entering loss-making or speculative business transactions, selling assets below value, and not keeping proper books and records. The untimely preparation of commercial books or any other conduct grossly contravening the requirements of proper business management are also punishable offences under criminal law. It should be kept in mind that § 283 StGB also applies if the director has been negligently unaware of the over-indebtedness or the pending or existing insolvency.

Bankruptcy (§ 283 StGB)

§ 283 StGB encompasses an extensive catalogue of diligence requirements for business merchants which not only need to be observed when over-indebtedness or insolvency has already occurred, but which apply already when insolvency or the inability to pay is threatened or pending. Compared with the above §§ 64, 84 GmbHG, criminal liability therefore sets in at an earlier point in time. § 14 StGB defines the director's liability for meeting his diligence requirements.

A more detailed discussion of all modalities of § 283 StGB would go beyond the scope of this paper. In summarising, one can say about the catalogue in § 283 StGB that business transactions which carry an increased risk or which are not in agreement with the duties of a properly acting merchant will entail sanctions under criminal law if insolvency proceedings are eventually instituted (see info box).

The fact that § 283 StGB does not presuppose actions to the advantage of the director or the partners should also be taken into account. If this feature is added, this may involve a particularly

³ BGH ruling dated 21 March 1988, BGHZ 104, 44; BGH ruling dated 28 June 1966, BGHSt 21, 191 (103)

⁴ BGH ruling dated 20 May 1981 GmbHR 1982, 131

aggravated case of bankruptcy, punishable as a criminal offence under § 283 a StGB. The punishment for “simple” bankruptcy is a prison sentence not exceeding five years or a fine, prison sentence of as much as ten years can be imposed for particularly aggravated bankruptcies.

Punishment will be meted out only if the company has ceased payments or if insolvency proceedings have been opened over the assets of the company or if such proceedings have been dismissed for lack of assets. In other words: If the company is eventually rescued, these actions are exempt from punishment.

Preference of creditors (§ 283 c StGB) and preference of debtors (§ 283 d StGB)

Pursuant to § 283 c StGB, preferring creditors is deemed to be a punishable offence if a person, knowing that it is insolvent, grants a creditor a security interest or satisfaction which the recipient is not permitted to claim or not permitted to claim in the manner and in the time in which it was granted, and if the recipient is so intentionally or knowingly placed better than the remaining creditors. What is meant here is the conduct of a director whereby assets of the company, after insolvency has occurred, are given without need to individual creditors who were not entitled to these claims. The director is permitted to meet due liabilities; he is not permitted, however, to give things to individual creditors after insolvency has set in without these creditors as yet being entitled to such things. For instance, it is quite common for a bank, once insolvency has been established, to exert pressure on the director with the effect of strengthening the bank’s security interest position without the bank actually injecting new money into the enterprise. If the bank has no due claim for strengthening its security interest (which is often the case), the director yielding to this pressure may become liable to prosecution for preferential treatment of creditors. In practice, the banks often do not realise that this conduct can be construed as incitement to give preferential treatment to individual creditors.

The punishment envisaged by § 283 c StGB is either a prison sentence not exceeding two years or a fine.

For the sake of completeness, preference of debtors should also be mentioned. Preference of debtors is punishable under § 283 d StGB if a person, knowing that insolvency of another person is pending or that payments are discontinued, in insolvency proceedings or in proceedings to bring about the opening of insolvency proceedings of another, removes or conceals parts of the other’s assets belong to the bankrupt estate in case of the insolvency proceedings being opened, acting with the consent of that other person or acting to said person’s advantage, or destroys, damages or incapacitates such assets in contravention of the requirements of proper business management. This can be the case, for instance, if the director removes parts of the GmbH’s assets.

Retaining and misappropriation of pay (§266 a StGB)

Any employer who unlawfully retains the employer’s contribution to social security insurance funds or to the Federal Labour Office commits a criminal offence under § 266 a Section 1 StGB.

The duty to pay the total social security contribution into the health insurance fund arises from §§ 28 d, 28 e, 28 h SGB IV (Code of Social Law). this is another regulation which is often contravened, for instance when the director of a company in crisis pays out the employees’ wages and salaries net without at the same time paying the employees’ contributions. All directors are liable in this case; the internal allocation and assignment of duties does not constitute an

exonerating element. Particular in times of corporate crises, the law assumes that the director who is not in charge under the internal assignment of duties must make sure that the social security payments are made properly and in good time.⁵

The punishment envisaged by § 266 a StGB for these offences is a prison sentence not exceeding five years and/or a fine.

Summary

This brief outline of the potential sanctions against company directors underlines what was said in the introduction. On the one hand, the director is expected to respond quickly in crises and to take quick actions, on the other hand, he is always at risk to become liable under criminal law. As indicated by the punishments quoted, the sanctions taken against director under criminal law can be massive indeed.

(The director's property liability will be outlined in the next issue).

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⁵ BGH ruling dated 15 Oct 1996, BB 1996, 2531, OLG Frankfurt am Main, ruling dated 9 Dec 1994, ZIP 1995, 213ff.