Cash Pooling

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-Hidden risks for managers and partners-

With the introduction of the euro a kind of winding-up management has become topical which up to now has not been able to show its full advantages due to the different currencies in Europe: the cash pooling.

The new possibilities presenting themselves, however, should not obscure the problems which could arise in practice with the implementation of this model. Especially the decision of the German Federal High Court of Justice (BGH) regarding the liability of the managers of the associate companies in a crisis and the events concerning the acquisition of the Klöckner group by the English Balli group have perfectly shown the shortcomings and dangers of this model.

The idea of the cash pooling is as simple as its actual implementation is difficult: several companies, for the most part a parent company and its dependent subsidiaries, combine their entire financial resources on a master account in order to be able to manage the solvency of all companies centrally and in a cost-efficient and economic manner. Societies which are in the red receive a balancing from the master account and do not have to take out expensive foreign loans. The master account is managed by the parent company or with the outsourced treasury. Of course, the money paid in will not be lost for the companies; the former claim to payment against the bank (account) will be replaced by a repayment claim against the parent company or the treasury. The repayment claim, however, can only be asserted after the withdrawal from the cash pooling system.

Basically, nothing can be said against this system – however, as always, the real problems only become apparent in a (financial) crisis. The BGH has recently decided on such a case in a leading decision. In this case the parent company had obliged its subsidiaries to join the enterprise-wide cash pooling system. Some subsidiaries were situated in Eastern Germany and received hundreds of millions of Deutschmark in state subsidies, which were to be used for these companies only. This money, however, automatically poured into the cash pool and the bulk of it was used for the deficit subsidiaries in West Germany. Sometime it was clear that the master account would never be able to repay the paid-in sums to the East German subsidiaries. As a result, the master account had to file a bankruptcy petition.

In the following legal actions the individual directors of the parent company were personally sued for payments to an amount of 9.7 million DM <u>each</u>. After the lower courts had dismissed the action, the BGH as the court of last instance decided that there could basically be a claim for compensation against the directors and reversed the judgements of the trial courts.

The BGH used this decision as an opportunity to basically comment on the duties and liability of the managers and partners of the parent company <u>and</u> subsidiaries in such cases of enterprise crises – with far-reaching consequences for this group of people.

According to the decision, the controlling parent company has a two-stage duty of property management. In the first stage, the parent company has to make sure when managing the cash pool that the subsidiary will always and at any time have the means at its disposal which are necessary to cover the share capital. Thus an amount has always to be provided which fills the result of the subtraction “assets of the subsidiary minus its liabilities” to the fixed share capital. In the second stage, the parent company has to take care of the subsidiary’s property inasmuch as it has to make sure when it makes arrangements for the subsidiary’s assets that the subsidiary is still able to settle payable liabilities. This means in practice that despite the cash pooling the subsidiary must be solvent enough in order not to default. In this connection the BGH speaks of “ruinous interference” of the parent company. If this duty is not observed, the partners will be liable for the disadvantages arising from the fact that the company is deprived of the property which it actually needs to meet its liabilities. For such behaviour is a misuse of the legal forms of association, which allow for a limitation of personal liability. In this connection it is noteworthy that not only those partners will be liable who have received the repayment but also those who have contributed to the loss of property by giving their consent.

The BGH furthermore decided with regard to the duties of the parent company’s management. The latter has to inform the subsidiaries in the case of own crises or crises of other subsidiaries if this crisis endangers the subsidiary’s repayment claims against the master account/ treasury. The BGH has considered an omission of this notice a deception by omission committed by the parent company’s managers as defined by section 263 subsection 1 penal code (fraud). The responsibility of the managers under criminal law will additionally lead to their personal liability under civil law.

Furthermore, the subsidiary’s managers are subject to duties the non-observance of which will result in their direct unlimited personal liability. According to the capital maintenance stipulations they will personally be held liable for the fact that those amounts which the partners have paid in as share capital are not paid back to the partners. In the case of a cash pool, however, this danger typically exists and it is especially dangerous if the repayment claim against the master account/ treasury is no longer of intrinsic value. This is in particular the case if the parent company or other subsidiaries get into a crisis. Then the manager will face another duty, namely the duty of resistance against the partners` instructions! If the parent company is in a crisis, the subsidiary’s manager is obliged to immediately reclaim the paid-in money from the master account/ treasury. Any instructions of the subsidiary’s partners to the contrary must not be observed. This means for the subsidiary’s manager that in the case of a crisis he or she has to check each new instruction of the partners and the current agreements with the parent company for their economic consequences.

By doing so it additionally has to be taken into account that a manager is obliged to file for insolvency if their company is bankrupt. Any violation of this obligation is a criminal offence and will also result in personal unlimited liability of the manager.

In view of the risks and dangers accompanying the introduction and the practice of the cash pooling, the advice of an experienced lawyer at each level of organization is absolutely required. Especially the managers of a group situated in Germany must be able to assess the extent of their personal risk correctly.