Loans granted to shareholders? Managing directors watch out!

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In a recently issued decision the Federal High Court of Justice (-BGH-) has tightened liability with the granting of "detrimental" loans to shareholders of a private limited company. The liability now also applies to the (ignorant) managing director. This new point of view has considerable consequences for a private limited company regarding company and tax law. Serious consequences may result, especially for companies that are part of a group cash pooling. In connection with the new regulations on shareholder debt financing in accordance with Section 8a Körperschaftssteuergesetz (Corporation Income Tax), the lending or borrowing by shareholders of a private limited company must now always be checked in advance by a certified attorney at tax law.

The case decided by the BGH ended in disaster for the managing director - she was sentenced to pay EUR 511,291 (DM 1 million) although the loans had been paid out to the shareholders without her knowledge and through no fault of her own.
The facts of the case can be described as almost classic: two friends founded a private limited company in 1990. Apart from one shareholder, also the other shareholder's wife was appointed managing director; actually, however, she only acted as a "frontwoman" for her husband. In 1994 the other shareholder/ managing director saw to it that the private limited company granted him a loan of DM 150,000 and the other shareholder a loan of DM 850,000. The private limited company went bankrupt in 1997. The receiver not only demanded the loans back from the two shareholders, but he also held the managing director liable for the entire amount of the loan; the BGH agreed with him.

It is a matter of course that the shareholders are obliged to repay the loans. However, what renders this case remarkable is the managing director's (additional) liability for repayment. The managing director had defended herself, arguing that she had only be appointed as "frontwoman" and therefore had not known about the lending and would not have been able to prevent it. The BGH was not convinced by this argumentation: whoever is managing director has to fulfil the respective supervisory obligations. If they do not meet this obligation, they have only themselves to blame.

However, much more important is the BGH argumentation why the granting of the loans to the shareholders constitutes a breach of duty. Up to now it was the conventional wisdom that the granting of loans (to shareholders) per se cannot cause any adverse consequences since the company receives an equal claim for repayment of the loan in exchange for the lending. On the balance sheet this is an asset swap as it is termed, which has neither positive nor negative consequences for the company. The BGH, however, has now dismissed this point of view:
If the company has an adverse balance, any real capital drain to shareholders without actual consideration constitutes a violation of the capital maintenance provisions of Section 30 GmbHG (Act on Private Limited Companies). The BGH expressly declares that it is not a matter of whether the shareholder is creditworthy, i.e. the claim for repayment of the loan has an intrinsic value. In the state of adverse balance the managing director must not provide the shareholders with liquid funds if the nominal capital is not sufficiently covered. This decision could also cause problems for cash pooling systems across groups for in general the participating companies receive an equal claim against the parent company in return for the transfer of liquidity to the parent company – as the BGH now sees it, this is a possibly inadmissible approach.

The BGH decision has considerable effects on the relationship between the managing director and the shareholders. If the managing director allows that loans are granted to shareholders without checking it, he runs the risk of being held liable for repayment later on. The managing director is thus personally liable for the repayment of the loan apart from the shareholder concerned – and in the event of insolvency at the latest the company will have no scruples about asserting this claim against him.

The BGH decision contrasts with the other trends in Europe. Whereas the European Court of Justice declares the possibility of transfer of domicile of foreign companies (e.g. British Ltd) to Germany legal (Centros decision, Inspire Art decision) thus paving the way for foreign "cheap private limited companies", the BGH tightens the requirements placed on a private limited company. That can only be interpreted in such a way that the German courts want to positively differentiate the value of a private limited company from "cheap private limited companies": those who enter into business relations with a private limited company, should rest assured that the statutory (minimum) nominal capital is actually available.

For the shareholders and managing directors, however, this leads to problems regarding liability, which must not be underestimated. The pivot is the problem of when there is an adverse balance as defined by the BGH decision. This question must be answered by including regulations regarding company and insolvency law, which calls for an attorney's advice.
Attorneys will also have to deal with the opposite case, namely the granting of loans to the private limited company by its shareholders. In this case it may result in a similar problem in the event of repayment of the loan to the shareholders. If the loan is repaid to the shareholder despite adverse balance, the shareholder may be held liable for (re)payment even years later; a problem that can be coped with – even retrospectively – if an attorney is consulted.