Liability of executives in limited companies

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Directors, members of executive boards and members of supervisory boards are considered to be executives of companies limited by shares, in particular in the case of private limited companies (GmbH) and public limited companies (AG). By law, they bear liability for certain circumstances, irrespective of whether they are also the proprietors (shareholders) of the relevant company. The executives themselves are frequently unaware of these circumstances, but the result is still direct, personal and unlimited liability, independently of any consideration of fault.

A number of cases which occur frequently and prove on review to be an almost certain source of liability are to be examined here. Mostly, it is only a receiver who makes claims on the basis of such liability, in order to recover assets. An executive should therefore never rely on promises by the shareholders not to make claims themselves. The applicable laws oblige executives to safeguard the rights of the company, often in opposition to the shareholders, if they are not to become liable themselves. The term "director" as used in this article covers not only directors of private limited companies, but also members of the executive and supervisory boards of public limited companies. In this connection, it must be mentioned that liability incurred does not lapse by limitation for very long periods, in some cases up to 30 years.

On foundation of a limited company, the director gives an assurance before a notary that the equity capital is finally available and at his disposal. In spite of the best possible intentions, this is frequently untrue. At the time of entry in the register of companies, usually around three months later, the equity capital is normally no longer available in full. This being so, the director is liable for the difference between the promised capital (mostly EUR 25,000 in the case of a private limited company) and the capital available. If the company has considerable debts at the time of registration, these are to be settled and a further EUR 25,000 paid in. The director’s liability in this case results from Article 11, para. 2 of the German Companies Act (GmbHG), which covers liability resulting from actions. To avoid this, the director has to prove that the capital was available, but the old bank statements are often missing and therefore the director, whether a shareholder or not, has no option but to pay in the equity capital again from his own pocket.
Increases in capital are always to be conducted in such a way that the company actually receives the funds for such an increase. The funds must be freely available to the directors. Problems repeatedly occur in these circumstances. Capital increases are often performed in response to pressure from banks. In such cases, the sums for the increase are paid into an account which is in deficit or into an account which is subject to a right of offsetting on the part of the bank. If the director is unable to prove that the funds for the capital increase were nevertheless at his disposal, he is liable for the capital increase, and in effect pay the sum concerned once again to the receiver. The same problem arises when advance payments of

funds are made to the company's account for a planned capital increase, although no shareholders' resolution to increase the capital is as yet available.

In current business operations, especially where the law relating to groups of companies is applicable, payments are often made in contravention of Article 30 of the Companies Act. Article 31 of the Act requires such sums to be repaid, and the director is personally liable for this repayment under the terms of Article 43, paras. 2 and 3 of the Companies Act.

Cash pooling contracts are a typical example of this. Liquid funds are creamed off from current account and paid to the holding company financing the venture. Companies engaged solely in research or the provision of services often have no substantial value of their own, and therefore any diminution of liquidity constitutes an infringement of Article 30 of the Companies Act. If the limited company also has a high equity capital, huge sums can be accumulated rapidly. It is incorrect to believe that subsequent payments from the holding company are automatically assigned to the settlement of the subsidiary's claims resulting from Article 31 of the Companies Act. Precisely that earmarking is absent in cash pooling agreements.

Intercompany prices within groups also present problems. When a subsidiary has purchased raw material at an inflated price from the parent company in response to considerations of liquidity in the group management, the performance and consideration are no longer in balance. Payments to the parent company then frequently fall under the prohibition of Article 30.

A profit transfer agreement or control agreement do not provide exemption from the liability outlined above, as such agreements may be terminated and do not remove the fundamental liability.

Liability on the part of a director often results from fiscal circumstances: this topic is always relevant when a company has become insolvent. The director's liability for tax obligations is enshrined in Articles 69 ff. in conjunction with Article 34, para. 1 of the Fiscal Code, and applies even if he is merely a purchasing director or similar. The law makes no distinction between directorships of varying degrees. There is as good as no possible exculpation when the actions required were delegated to staff. A director employed by the company cannot therefore simply trust a group accounting system, but must himself exercise continuous and careful supervision or arrange for this to be done by competent persons. The controller cannot normally fulfil this function.

Directors are liable in full for the payment of income tax. This even applies in the face of the defence that there were sufficient funds available to pay wages at the end of the month, but by the 10th of the following month liquidity had, surprisingly, been so depleted that the income tax owing could not be paid. There is no excuse in such circumstances: the income tax was retained, and the director is therefore responsible for paying it. There is certainly also no excuse for failure to pay income tax for longer than one month. Then, not only liability but also the possibility of criminal actions or negligence come into consideration. A similar situation applies to national insurance contributions.

In the case of Value Added Tax, directors are liable according to the principle of proportional repayment, i.e. they must pay as much of the tax owing as they pay of debts to other creditors. Payments made to embarrassing small creditors during a liquidity bottleneck, which then however leads to insolvency, establish the precise conditions for liability for the tax owing in full. This also applies to taxes on corporate income, but in the case of insolvency there are frequently no such taxes owing.

Personal liability of the directors for all the debts of the company can result from the following circumstances. Insofar as the conditions for insolvency have been fulfilled, Article 64 para. 2 of the Companies Act prohibits the directors from making any further payments to creditors. Should they nevertheless do so, they are liable to the company. With the customary amount of capital available to companies, the conditions for insolvency are however more likely to be fulfilled than not, as overindebtedness is a basis of insolvency.

In the course of a skimming off of profits, many limited companies are reduced to an absolutely minimum level of net equity. They have never been anything other than overindebted.

Legal advice can bring about a repair of various circumstances giving rise to liability before the worst happens. This should never be put off for too long, despite the fact that these unpleasant topics are not, in our experience, received with enthusiasm by anyone at group level.