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A Worldwide Review
Third Edition

Edited by
Alexander Loos



the global voice of
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International Bar Association

The Global Voice of the Legal Profession



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The International Bar Association (IBA), established in 1947, is the world's leading organisation of international legal practitioners, bar associations and law societies. The IBA influences the development of international law reform and shapes the future of the legal profession throughout the world.

It has a membership of over 55,000 individual lawyers and 206 bar associations and law societies spanning all continents. It has considerable expertise in providing assistance to the global legal community as well as being a source of distinguished legal commentators for international news outlets.

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Germany

Alexander Loos

I BASIC PRINCIPALS FOR DIRECTORS' LIABILITY

Managing directors and managing partners of German companies (hereinafter collectively referred to as 'Directors') have different job titles depending on the type of their company: for example, *Geschäftsführer* (GmbH, partnerships), *Vorstand* (AG, eG, AöR, and even for GmbH), or *geschäftsführender Gesellschafter* (partnerships). Directors may become personally liable for any culpable violation of their duties. Such duties may originate from a contract (articles of association or Director's employment contract) or from law (civil, corporate, criminal, environmental, tax or insolvency law). A Director's liability may lead to damage claims from the company (so-called internal liability) or to damage claims of the company's creditors (so-called 'external liability'). The personal liability of a Director may be joint and several with his or her fellow Directors and/or joint and several with a parallel liability of the company, especially in cases of tort.

[A] Single-Body Companies or Two-Tier System

In companies under the single-body system the entire control over the management is in the hands of the shareholders or partners. The nomination, election, and termination of a Director is decided by the shareholders or by a committee formed and controlled among the shareholders.

In the two-tier system the controlling powers of the shareholders are split between a supervisory board (*Beirat* or *Aufsichtsrat*) and the shareholders. The supervisory board appoints the management and decides upon its employment terms and upon its removal. Furthermore, the supervisory board is competent for approving or not approving financial statements and important strategic, industrial, and financial decisions as specified by law and, in addition thereto, by the company's articles.

The two-tier system is compulsory by law for an AG (*Aktiengesellschaft* = German joint stock corporation) and for an eG (*eingetragene Genossenschaft* = an incorporated cooperative association specially designed for business with its shareholders, preferably used for development enhancement banks like *Volksbanken* or *Raiffeisenkassen*). All other types of German companies are subject to this single-body system, but may, and very often do, opt for the two-tier system.

In companies under the two-tier regime, the control of shareholders over day-to-day business is remote. Consequently, shareholders have less influence on the management and Directors can protect themselves less often against personal liability by obtaining shareholder approval.

[B] Management Structure and Chairman

The management board may consist of one or more Directors. Directors share their managerial responsibilities collectively, regardless of how areas of competence are allocated among them, be it by the articles, by shareholders' resolution, or by agreement between the Directors. Except for individual responsibilities under criminal law, any external liability is a joint and several one. Typically, the shareholders or the supervisory board when appointing the Director(s), elect one of them as chairman (*'Vorsitzender'*) or, if his or her functions are less dominant, as 'speaker' (*'Sprecher'*). In management boards comprising more than three Directors, it is customary to form committees (*'Ausschüsse'*), for example, for personnel, financial matters, audits, and so forth. Even if such committees within the management board may pass resolutions otherwise requiring a ballot from all Directors, any ensuing liability is a collective and therefore a joint and several one for all Directors.

[C] Delegation of Management Powers

Directors must be individuals and they may delegate their powers only in specific cases or transactions and not by way of a general power of attorney. Any such general delegation is deemed invalid. Even if a Director validly delegates his or her powers to another person for a specific transaction, any ensuing external liability of the delegating Director remains his or her own.

[D] Removal of Directors

Directors in the position of a managing partner of a partnership (civil law, limited or unlimited) can only be removed if the bylaws of the company so provide, for example, by partners' resolution with a qualified or simple majority. For Directors in corporations, the removal requires a resolution of the appointing body. In companies under the two-tier system, any removal prior to the end of a Director's term may only be resolved for cause or in consequence of a shareholders' resolution stating 'lack of confidence'. Any Director of a GmbH can be removed from his or her formal position at any time. Neither the articles of association nor any employment agreement of a Director may

validly stipulate otherwise. The law distinguishes between the formal position as Director and any existing employment relationship; one relationship may validly exist without the other, and termination of both (e.g., for cause) requires separate resolutions of the appointing body (shareholders' meeting or supervisory board) for each of them. The removal becomes effective immediately upon being communicated to the Director, even though subsequent registration may take longer.

II TYPICAL LIABILITY CASES

[A] Internal Liability towards the Company

Managerial duties of Directors in corporations exist towards the company and not towards its shareholders. The most frequent violations are breaches of compliance rules, of loyalty obligations (non-compete covenants during and after employment or the collection of kickbacks) and illicit disbursements from the company's equity (indirect refundment to shareholders/partners, distribution of hidden dividends).

[1] Violation of Compliance Rules

Directors have to protect first of all the company's interests and, as secondary obligation, the interest of the company's shareholders. As a basic rule the Directors must endeavour to conduct the company's business in full compliance with all applicable tax law, criminal law and every other pertinent legislation. Such legislation obliges the Directors to apply the proper diligence of an experienced business person e.g., when entering into a merger¹ or in public listed companies, when publishing ad-hoc reports² or generally when neglecting to supervise and enforce the compliant conduct of business by employees, so that in result administrative offences occur.³ Such administrative offences may be fined heavily with up to EUR 10 million or, if the illicit advantage expected by the company is higher, then the fine may get increased accordingly.⁴

[2] Violation of Non-compete

Directors are subject to strict non-compete obligations towards the company, regardless of whether such is explicitly stipulated in their employment contract, in the company's articles, or even by law. Such non-compete obligation applies during their employment for all types of companies⁵ and may be extended for a definite time

1. §25 Umwandlungsgesetz.

2. §§15.1, 37 b, 37 c Wertpapierhandelsgesetz; although any such violation will give rise to a liability of the company, the company may take recourse against the Director based on §93 Aktiengesetz.

3. §§30.1, 30 Gesetz über Ordnungswidrigkeiten.

4. §§17.4, 30.3 Gesetz über Ordnungswidrigkeiten.

5. §§112, 113 Commercial Code (HGB); §88 Joint Stock Corporation Act (AktG); BGH Wertpapier-Mitteilungen 1964, 1320.

thereafter by explicit agreement. Respective judicial practice is vague and therefore any post-contractual non-compete covenant should not extend beyond two years and must entitle the former Director to a compensation of no less than half of his or her former remuneration.⁶ Violation of the Director's non-compete obligation (be it post-contractual or not) does not require any competitive activity as such: It is sufficient that the Director owns a controlling interest in a competitor, be it direct or indirect or through a close relative. Directors holding a managerial position in more than one company of the same group ('group' means companies being ultimately controlled by the same shareholder) may need an explicit exemption from their non-compete obligation in order to work for several group companies at the same time. Such exemption requires an explicit phrase in the articles of association or a unanimous shareholder resolution. Without such exemption the factual or agreed allocation of market sectors among companies of the same group can be regarded a preference for a 'competitor' and hence may be a violation of the Director's non-compete and loyalty obligation; moreover it may be deemed a violation of arm's-length principles (see section II[A][4]).

[3] Poaching of Business from the Company

No Director may take over from the company any business opportunity in order to use it for his or her own benefit or for persons close to him or her. This includes illicit synergies, such as negotiating favourable business conditions for his or her own private good or for his or her family's procurement, while the company enjoys less favourable terms with the same supplier.⁷ Though the amount of damage suffered may be doubtful, the benefit obtained by such illicit arrangements must be refunded to the company, because judicial practice presumes that any such benefit was obtained at the expense of the company.

[4] Disbursements from Restricted Equity of the Company

The most frequently used types of German companies (GmbH, GmbH & Co. KG, AG, eG) are subject to rigid capital preservation rules, which, if violated by Directors, give rise to direct personal liability for restoring the full amount plus any ensuing damage.⁸ Such capital preservation rules were somewhat weakened⁹ in favour of cash pooling systems and upstream lending if and to the extent the company is subjected to a profit and loss assumption agreement if it is entitled to adequate receivables in return.¹⁰

6. Analogous to §§74 et seq. Commercial Code (HGB).

7. BGH *Wertpapier-Mitteilungen* 1967, 679; OLG Düsseldorf GmbH-Rundschau 1995, 227.

8. §§30, 43 Abs. 3 Limited Liability Company Law (GmbHG); §§57, 93 Abs. 3 Joint Stock Corporation Act (AktG); §172 a Commercial Code (HGB); §§ 22 Abs. 3, 34 Abs. 3 Cooperatives Act (GenG).

9. §57 Abs. 1 Joint Stock Corporation Act (AktG); §30 Abs. 1 Limited Liability Company Law (GmbHG), as revised by the so-called MoMiG of 23 October 2008 (BGBl. I S. 2026).

10. See Altmeppen 'Cash Pooling and Raising of Capital', NZG 2010, 361, 441 seq.

[5] Violation of Arm's-Length Principles

Directors are obliged to treat shareholders, fellow Directors, and third parties who are closely related to shareholders at arm's length. Any culpable breach of these loyalty duties will cause unlimited personal liability for restituting to the company any disadvantage suffered. Such liability is joint and several with any shareholder/fellow Director, who has enjoyed the preferential terms.¹¹

[6] Knowing Disregard of Avoidable Risk

Fuelled by the so-called financial crisis since 2008, public prosecutors increasingly indicted Directors for tortuous breach of fiduciary duties.¹² Such tortuous breach of fiduciary duties is both a criminal offence and a tortuous breach of the Director's civil law obligations vis-à-vis his or her company.¹³ Any risk knowingly accepted, when making a managerial decision, may, if causing subsequent damage at the expense of the company, cause respective responsibility of the Director under both criminal law and civil law on restitution of damages. Directors of an AG bear the burden of proof for establishing that the risk perceived for the company was acceptable for a diligently acting manager.¹⁴ Their personal internal liability towards the company may be waived by prior shareholder approval, not, however if the company's claim for restitution of damage is required for compensating the company's creditors. In a GmbH, however, Directors, when asking for shareholder approval in preparation of risky business decisions, may get justified by such shareholder approval except if criminal offences such as, for example, incorrect tax filings or the omittance to file for insolvency in due course are concerned.

Directors, i.e., member of an executive board in an AG may justify their business decisions under a concept of a 'business judgment rule'. Even a risky business decision by a Director can be justified under this rule if it is 'based on reasonably sufficient information as reasonably suitable for obtaining beneficial effects for the company'.¹⁵ However, except for the damage suffered by the AG, the burden of proof for all other facts of the 'business judgment' applied is on the Director regardless whether still holding such position or already retired.

[B] External Directors' Liability

Directors' personal liability towards external third parties requires a culpable violation of mandatory law (e.g., tax law, criminal law, insolvency law, environmental law). In

11. §43 Limited Liability Company Law (GmbHG); §93 Joint Stock Corporation Act (AktG); §34 Cooperatives Act (GenG).

12. §266 German Criminal Act, sentencing such breach with up to five years of imprisonment or respective fine.

13. §823 Abs. 2 German Civil Code.

14. §93 Abs. 2 Joint Stock Corporations Act (AktG).

15. *Ibid.*

addition, Directors may become liable for tort. Except for tort the external liability of Directors is only a secondary one supplementing the company's primary liability. Such secondary liability for Directors therefore has special importance, where the company later gets into bankruptcy.

[1] Gross Negligence to Pay Taxes and Public Levies

Directors are obliged to see to it that the company pays its taxes and public levies.¹⁶ Any grossly negligent or intentional violation of this duty gives rise to personal liability, which can be enforced by the tax administration directly.¹⁷

[2] Illicit Non-payment of Social Security Contributions

Social security contributions in Germany are shared by the employer and by the employees, while the collection and payment of both shares must be effected and accounted for by the company. Non-payment of the employee's portion within the security contributions, as it may happen in times of financial crisis, leads to direct personal liability on the part of the Directors.¹⁸ This obligation continues even after the Directors will have filed for bankruptcy as long as their managerial powers are not substituted by the appointment of an insolvency receiver holding appropriate managerial powers.

[3] Late Filing for Insolvency

Directors are obliged to file for insolvency proceedings within three weeks, once the liabilities of the company exceed its assets or once the company has stopped or interrupted its payments for lack of liquidity. Payments made from the accounts of a company, even though the filing for bankruptcy became due, oblige Directors to refund such payments to the bankrupt estate unless every single payment can be justified as necessary or as preventing further and higher damage to the company's estate.¹⁹ In this context the most crucial question is, at which point in time the filing for bankruptcy was due. During the last two decades judicial practice continuously has intensified respective duties of care for Directors. Judicial practice has focused on the issues:

16. §34 Tax Code (AO).

17. §69 Tax Code.

18. §§14 Abs. 1, 266 a Criminal Code (StGB); §823 Abs. 2 Civil Code (BGB).

19. §92 Abs. 2 Joint Stock Corporation Act (AktG); § 64 Abs. 1 Limited Liability Company Law (GmbHG); Directors bear the burden of proof for justifying, item by item, any outgoing payments effected.

- The Directors are responsible for anticipating the necessity of organizational and financial restructuring measures well in time. Any respective negligence will make them personally liable.²⁰
- After realizing that they must file for insolvency, the Directors may not reduce the equity/liquidity of the company until they get replaced by an insolvency receiver. This requires the Director to continuously monitor the availability of liquidity and, which seems more difficult, the valuation of liabilities and assets in order to avoid that liabilities exceed. In this context the valuation of assets under ‘going concern principles’ becomes the decisive criterion for ascertaining the point in time when the filing for bankruptcy becomes inevitable. Present judicial practice requires that the ‘going concern assumption’ must be based on a forecast covering the next two years. Furthermore, the going concern principles can no longer be applied if the company (though being able to pay the most part of its liabilities when due) comes into default with more than 10% of its liabilities for longer than three weeks; as soon as this shortage of liquidity becomes foreseeable, the three weeks commence to run. After such three weeks the management is liable to file for bankruptcy at the latest.²¹
- If Directors have filed for insolvency proceedings with delay, judicial practice awards different damage claims to ‘old’ and ‘new’ creditors. While ‘old’ creditors (i.e., creditors existing before the financial crisis) may only claim damages to the extent that their insolvency dividend would have been higher if the Directors had filed for bankruptcy in due time (*‘Quotenschaden’*), ‘new’ creditors are entitled to compensation as if they would have avoided any dealings with the company at all (*‘negatives Interesse’*).²²

Most recent judicial practice of appeal courts indicates that Directors shall be granted a widened scope of discretionary decision, how long they may see their chances for restructuring as still being realistic and for postponing the filing for bankruptcy; however, this new tendency still is lacking the necessary endorsement from the Federal High Court.

III LIABILITY ISSUES

[A] Enforcement of Director’s Liability

[1] *Who Can Sue?*

In corporations (GmbH, AG, eG) all managerial duties of a Director exist only towards the company as a legal entity. Consequently, shareholders are not entitled to damage

20. §43 Abs. 2 Limited Liability Company Law (GmbHG); § 93 Abs. 2 Joint Stock Corporation Act (AktG).

21. §15a Insolvency Act (InsO); Federal High Court (BGH) judgment of 24 May 2005, IX ZR 123/ 04 (= *Entscheidungen des Bundesgerichtshofs in Zivilsachen* 163, 134).

22. BGH Zeitschrift für Wirtschaftsrecht 1993, 763, 1543.

claims except in special cases where Directors have neglected to properly handle the collection of capital contributions. In partnerships, where managerial duties of Directors exist towards the community of partners as joint and several ‘employers’, any partner may sue on behalf of the partnership against a Director in a derivative action (*‘actio pro socio’*).

For all cases of internal Directors’ liability, the company is entitled to sue before the specialized chambers for commercial matters (*‘Kammer für Handelssachen’*) in the district court (*‘Landgericht’*) of the company’s place of registration. The claiming company needs to be represented by one or more partners if being a partnership or, if a corporation, needs to be represented by someone specially authorized by the shareholders’ meeting. Corporations under the two-tier system must be represented by the supervisory board.

Under the two-tier system the supervisory board has no discretion, but must enforce any existing claims against Directors in order to avoid its own liability²³ towards the company.

In cases of external liability (towards third parties), the damaged third party has the right to sue against the company as primary debtor and, if the company is unable to pay, against the Director as secondary debtor. Where ‘new’ creditors (being those who transacted business with the company without knowing its already imminent state of bankruptcy) sue for damage caused by late filing for bankruptcy, they may sue against every single Director for the full amount of their damage. In exchange for the Director’s compensation payment, such claimants must assign to the Director any claims they may have for a respective bankruptcy dividend.²⁴ For damages of old creditors, resulting from illicit reduction of the bankrupt estate, the bankruptcy receiver sues the Directors and subsequently distributes the proceeds among the damaged creditors.

[2] Costs of Litigation and Class Actions

According to the German loser-pays principle, plaintiffs are entitled to full reimbursement of court fees and of costs for counsel in the amounts defined by German fee regulations; actual costs may exceed such refundment claims, especially if a counsel bills time-based as opposed to the statutory standard of the German lump-sum system under the *Rechtsanwaltsvergütungsgesetz* (*‘RVG’*), which is related to the value of the dispute.

‘Class actions’ according to the American pattern are not possible under German law. However, as a first step towards class actions, Germany since 2005 has introduced²⁵ the option for securities actions to be put on hold when based on (nearly) the same facts and related to the same respondents until one or more exemplary pilot cases will be decided, thereby providing the parties with a lead ruling to be applied to all other pending cases. Such securities actions mainly deal with the issuance of

23. BGH *Neue Juristische Wochenschrift* 1997, 1926 (ARAG-Garmenbeck).

24. *Entscheidungen des Bundesgerichtshofs in Zivilsachen* 146, 264.

25. *‘Kapitalanleger Musterverfahrensgesetz’* (abbreviated ‘KapMuG’), BGBl 2005, IS. 2437.

information about public listed companies, be it either misleading information or be it the omission to publish important news in due time.

[B] Joint Liability of Directors

Since the members of the same management board are held collectively liable due to the collective responsibility of every single Director for all matters of the company, a team of Directors can be held jointly and severally liable towards the company and/or towards third parties. Despite such joint liability the Directors may, among themselves, have entered into agreements splitting specific areas of responsibility; consequently in their internal relationship some of the jointly liable Directors may be entitled to full indemnification in their internal relationships towards their fellow Directors.

[C] Indemnification

In order to protect against internal liability (as in section II[A] above), the management board may seek precautionary indemnification from the shareholders' meeting and/or from the supervisory board. In partnerships, respective resolutions require unanimous consent unless the bylaws request simple or qualified majority; for corporations the requirements differ: In a GmbH, shareholders' resolutions with simple majority are sufficient, unless the articles provide otherwise, whereas for an AG, the shareholders cannot provide indemnification beforehand, but at the earliest three years after the origination of the damage and only unless (at least) 10% of the voting stock file a protest in opposition to such indemnification.

External liability of Directors cannot be reduced or avoided by resolutions of shareholders, partners, or supervisory boards; however, a respective shareholder resolution may oblige the partnership or GmbH to hold the Director harmless against the claiming third party, while his or her external liability remains unaffected.

[D] Time Limitation

The company's damage claims against its Directors will become time barred within five years after the damage claim originated. Such origination will be deemed to have occurred as soon as the company can sue for a judgment on the merits. In public listed stock corporations time limitation will run for ten years. Time limitation for external creditors of damage claims differs according to the statutory cause of action applicable in the individual case. Claims for tort will become time barred within three years following the end of the calendar year when the damaged party got knowledge about the damage and the Director's responsibility, latest however ten years after the causation of the damage, regardless whether the damaged party had knowledge of its claim.

Special attention should be applied in order to adjust deadlines for coverage claims to the duration of time limitation (cf. the preceding paragraph) as time limitation usually is much longer. This applies even more so to policies for former Directors as

deadlines for notifying coverage claims to the D & O insurer usually extend to two years only after the Director's end of appointment.

IV DIRECTORS' AND OFFICERS' INSURANCE

Insurers offer D&O policies since 1995. Their general terms are based on printed conditions introduced in 1997.²⁶ Premiums typically are paid by the company as contractual counterpart of the insurer. The policies provide coverage against costs and fees for defending against claims ('*Abwehrdeckung*') and/or for compensating any damage ('*Schadensdeckung*'). In joint stock corporations, directors' and officers' coverage protecting Directors is limited by law²⁷ in order to maintain a basic risk exposure as a kind of incentive for compliant conduct; the residual risk that may not be covered by the directors and officers' (D&O) insurance is the lower of 10% of the damage or of 150% of the Director's annual remuneration. Insurers typically try to force claimants into a difficult two-step sequence in order to reduce options for cross-claims ('*Streitverkündungen*'): State court litigation against the Director and, in a second step, arbitration for the Director's recourse against the insurer. Cases where insurers have provided voluntary coverage for compensation of damage are rare, and D&O policies of German insurers should be carefully analysed with a view to their complicated clauses on excluded risks.

V LAWYER DIRECTORSHIPS

There are no restrictions for lawyers admitted to the Bar ('*Rechtsanwälte*') to become managing partners or managing Directors of companies. Once a free practicing lawyer has become a Director, he or she may not represent 'his' or 'her' company in state court litigation or in arbitration as counsel. Once a lawyer Director has worked on a case as counsel before he or she was appointed Director, he or she may not continue to work for and bill the company as counsel, even after having terminated his or her directorship.

VI THE EUROPEAN ACTION PLAN

Most issues of the European Action Plan dealing with Directors' liability already were part of German legislation before the European Union recommended respective legislation. For details, please see the contribution of Dr Thorsten Volz, "The European Action Plans of 2003 and 2012", Chapter [...] in this volume.

26. So-called Allgemeine Versicherungsbedingungen für die Vermögensschaden-Haftpflichtversicherung von Aufsichtsräten, Vorständen und Geschäftsführern, abbreviated 'AVB - AVG'.

27. §93 Abs. 2 Joint Stock Corporation Act (AktG).