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Coronavirus and civil procedure – Liability of a GmbH's management for and during the crisis?

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The coronavirus pandemic is sending shock waves through the business world. If a GmbH (German limited liability company) finds itself in financial distress, the management in particular will be under pressure and must fight for the survival of the business. At the same time, there are various scenarios in which managing directors could be held liable for not implementing crisis prevention measures or exercising the necessary diligence during the crisis.

Liability for inadequate crisis prevention

It is generally acknowledged that a certain degree of crisis prevention and risk monitoring is part of the duties of a GmbH's management. However, the details regarding numerous aspects are unclear.

While German public companies (Aktiengesellschaften) are explicitly obliged to set up an institutionalized risk control system, there is no such requirement for a GmbH. The legislative materials state that the aforementioned obligation has a "radiating effect" on the scope of duties of the management of other company forms. In the literature, some commentators analogously apply this obligation to all or only to particularly large or publicly traded companies. Others reject such an analogy. However, this does not mean that, according to their opinion, crisis prevention is not part of the duties of a GmbH's management. Rather, the obligation to perform a minimum amount of monitoring in order to detect a crisis early on and adapt in good time to changes in the economic environment is, according to this view, derived from the general duty of care and organization under sec. 43 para. 1 of the German Limited Liability Companies Act (GmbHG). Holders of this view likewise assume that this duty can be very demanding. In their opinion, this depends on the business's risk profile, size and complexity as well as its financial position.

To avoid liability risks and ensure a minimum degree of crisis prevention, the management should keep in mind the following duties:

- identifying potential triggers of a company crisis;
- analyzing the identified risks in terms of their likelihood of occurrence and the potential damage as well as early warning signs of the occurrence of the risks;

- taking risk prevention measures, developing procedures such as contingency plans to avert a crisis

The specific measures in question are business decisions that are covered by liability privilege (Haftungsprivileg) based on the business judgment rule (cf. sec. 93 para. 1 sentence 2 of the German Stock Corporation Act – AktG). No liability exists if the management could reasonably assume that it acted in a commercially justifiable manner on the basis of appropriate information for the benefit of the company and free of conflicts of interest and considerations that were irrelevant to the matter at hand. Hence, it is not necessary to detect and prevent every single extremely remote risk. However, obvious factors must be identified and addressed.

To what extent in particular the widespread streamlining of supply chains and their distribution across the globe should have been taken into account or weighed up – especially given potential sources of global turbulence such as a pandemic – is currently unclear. At least in the case of a GmbH, only in particular circumstances would this constitute a breach of duty by the management.

Liability for actions taken when the company is in distress

In contrast, the management's duties during a crisis that is already happening are more clearly outlined. The main priority here is to steer the business through the crisis as unscathed as possible.

- As at all other times, managing directors must exercise the due care of a prudent businessperson even – and in particular – when the company is in distress. Managing directors who breach this duty are liable to the company for the resulting damage.

- If the company makes losses amounting to half of the share capital, managing directors must inform the shareholders of this. If they fail to do so, they are making themselves liable to pay damages to the shareholders as well as to the company itself.

- In addition, managing directors of the company are obliged to refund any payments that were made after the firm became insolvent or was found to be overindebted and that thus breach the so-called prohibition on making payments.

The business judgment rule also applies to these measures – insofar as they are business decisions. Given that this rule only applies if sufficient information exists and that currently the legal situation in particular is changing continuously, the management is obliged to keep itself informed of these changes so that it can respond appropriately. This relates in particular to the following amendments:

Prohibitions on making payments in the event of insolvency relaxed by the German Act to Mitigate the Consequences of the COVID-19 Pandemic

Under the German Act to Mitigate the Consequences of the COVID-19 Pandemic under Civil, Insolvency and Criminal Procedure Law, the obligation to file for insolvency is suspended until 30 September 2020. However, this suspension applies only if the insolvency is attributable to the effects of the COVID-19 pandemic. This is presumed by law if the business was solvent as of 31 December 2019.

Click here to read the article by our colleagues Dr Tschauner and Dr Brackmann on the suspension of the duty to file for insolvency.

This new legislation makes it clear that special rules apply to D&O liability at present: under the currently applicable law, payments made in the ordinary course of business are consistent with the diligence of a prudent and conscientious manager. This applies in particular to such payments "that serve to maintain or resume business operations or to implement a restructuring plan". Therefore, managing directors are extensively released from their duties to compensate the company for payments under the prohibition on making payments pursuant to sec. 64 sentence 1 GmbHG. However, this release from liability applies only if the criteria for suspending the duty to file for insolvency were actually met.

Nevertheless, there are scenarios where liability applies even in the current situation of extensive releases from liability:

- If it subsequently transpires that the criteria for suspending the duty to file for insolvency were not met, managing directors will be liable to the company and its creditors for any damage and may be liable to criminal prosecution. In particular, the question remains as to whether the presumption that an insolvency is attributable to the consequences of the COVID-19 pandemic can be rebutted in practice.

- Furthermore, managing directors continue to be liable in general to the company for breaching their duty of care, e.g. in cases of unsuitable restructuring plans.

If you have any questions or need advice on this subject, you are warmly invited to **our webinar (in German) on coronavirus and the duties of management during the crisis on 20 May 2020** (click here to register), or feel free to contact us.

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