Legal Update Corporate

Potential Liability Upon (Re)Activation of Dormant Companies

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Important 2012 German court decisions clarified the scope of liability where a German company is repurposed and undertakes new business activities, or is otherwise reactivated after a period of dormancy. Where no notice of "economic reincorporation" is filed with the company's commercial register, the shareholders may ultimately be held liable for the difference between the company's nominal share capital amount and its actual assets (so-called "negative equity") at the time that the company (re)commences business activities.

The court decisions highlight several concepts that are sometimes not well understood by foreign businesses with German holdings. The decisions also underscore the importance of certain procedural steps where a dormant business is repurposed and recommences business.

I. Background

1. Nominal share capital

German companies (limited liability *GmbH* companies or stock corporations – *Aktiengesellschaften*) have nominal share capital (*Stamm- or Grundkapital*); these amounts are typically required to be paid in at incorporation (at least half of the total amount and at least one quarter of the nominal amount of each share) and in any event, the shareholders of the company are liable to the company for these amounts as of incorporation. The statutory minimum nominal share capital for a GmbH company is EUR 25,000 (EUR 50,000 for a stock corporation); it is not uncommon to find German companies with significantly higher nominal share capital amounts, e.g. EUR 500,000 or EUR 1 million. This is a very different regime from typical limited liability companies in common law jurisdictions, which can issue shares for penny values or shares without par value.

German corporate law places considerable importance on the nominal amount of a company's share capital.[1] At incorporation, management is obliged to certify that the company's nominal share capital is paid in[2] and at the company's disposal; the registering court may request proof of such payment where it has doubts, including a valuation of any contributions in kind. Traditionally, a company's nominal share capital amount is regarded as a symbol of the company's ability to pay creditors and fulfil other obligations. Even though German corporate law now permits the "enterprise company" (*Unternehmergesellschaft*), which can be incorporated with a nominal share capital amount of EUR 1, this original significance still informs German corporate law and court decisions.

Note that the purchaser of a share that has not been fully paid in or in respect of which contributions are otherwise owing (e.g. due to a repayment) is also liable for the contribution pursuant to § 16 (2) of the Limited Liability Companies Act (*GmbHG*). Corporate due diligence in respect of German companies closely assesses whether nominal share capital amounts were originally properly paid in or have been repaid in the meantime.

2. Dormant companies and (re)activation

German corporate law permits companies to cease their business activities and remain dormant for extended periods of time (i.e. without deregistering or otherwise filing as "inactive"). Dormant companies are typically found in two circumstances. Primarily, shelf corporations may be incorporated and then held dormant until such time as these are needed.[3] Dormant companies are also frequently found within larger company groups, e.g. where a holding company has sold an operative business and is kept dormant in the event that liability claims are asserted in future. Eventually, these dormant companies may be repurposed by equipping these with new assets and pressed back into service. In doing so, it is common to amend the articles of the company to modify the company's original business purpose to cover the new activities undertaken.

The activation of a dormant shelf company and the reactivation of a dormant company by providing it with a new purpose and new assets will commonly result in a so-called "economic or deemed reincorporation" (*wirtschaftliche Neugründung*). Consistent court decisions have established that when a "deemed reincorporation" takes place, the management of the company is obliged to register this with the commercial register court which maintains the public business records of the company. In particular, management must recertify to the register court that the company's nominal share capital amount has been fully paid in and remains available to the company.

Prior to 2012, some legal uncertainty existed in respect of the consequences of a failure to register a deemed reincorporation. In keeping with the policy of regarding the company's nominal share capital amount as a public assurance of an ability to fulfil obligations to creditors, where the company failed to register a deemed reincorporation, liability attached to the shareholders for so-called negative equity, namely the difference between the company's nominal share capital amount and the company's actual equity (which could be less than zero in the event that the company was over-indebted).

II. 2012 court decisions clarify liability scope

Court decisions issued last year, including by Germany's Federal Supreme Court (*BGH*), provided important clarifications on the scope of such liability. In doing so, the courts have reinforced the practical necessity of register-

ing a deemed reincorporation whenever a dormant company is activated or repurposed.

1. BGH Decision

The limited liability GmbH company at issue in this decision[4] was incorporated in 1993 with the nominal share capital amount of DM 50,000 (approximately EUR 25,000). By 2003, the company no longer had any assets and realized no revenues. In 2004, the shareholders repurposed the company, renaming it, relocating its registered office and appointing new management. The company subsequently undertook different business activities. No deemed reincorporation was registered with the commercial register.

In 2005, the company was acquired by a new shareholder, which paid EUR 7,500 for the DM 50,000 share. In 2007, the company filed for insolvency. The insolvency administrator claimed against the new shareholder, asserting – among other things – an entitlement to the "negative equity" of the company, namely the difference between the company's nominal share capital amount and the company's net value, which was less than zero.

The BGH found that the repurposing of the company in 2004, in particular the amendment to the company's purpose permitting it to undertake wholly new business activities, constituted a deemed reincorporation.

Two critical issues were at stake in this decision, namely, whether the new shareholders were liable for the company's negative equity at the time of the deemed reincorporation (2004) or – potentially – at the time the company became insolvent,[5] and whether the shareholders were required to prove that at the time of such reincorporation the company's assets were not lesser than its nominal share capital amount.

The BGH found that shareholder liability is restricted to the negative equity at the date of the deemed reincorporation (i.e. did not extend indefinitely to the eventual insolvency). This date will be the date that the business is reactivated and undertakes business activities vis-à-vis third parties, for example, where it enters into agreements with third parties. In turn, the shareholders bear the burden of proof in showing that at this date, the company had assets equal to or exceeding its nominal share capital amount. In this decision, the shareholders were unable to provide such proof. The court confirmed as well that this burden also applies to subsequent shareholders, since shareholder liability for share capital contributions is transferred along with the share to subsequent purchasers.[6]

2. Munich and Düsseldorf court decisions

The Munich Regional Court applied the BGH's reasoning last August[7] to find that liability attached to the former sole shareholder of a stock corporation (*Aktiengesellschaft*) for the entire value of the nominal share capital amount of that corporation (EUR 50,000) as a result of a failure to notify that a deemed reincorporation had taken place.

Similar to the facts in the BGH decision, the claimant was an insolvency administrator. After the shareholder refused to make payment of the corporation's share capital amount, the administrator acted on behalf of the company and applied statutory rules in the Stock Corporations Act (AktG) to effect the exclusion of the shareholder.[8] The administrator's claim for repayment was based on the fact that several years prior to the insolvency, the corporation had ceased its business activities entirely, and was then repurposed and renamed, commencing entirely different business activities with new assets. This deemed reincorporation was not notified to the commercial register and the shareholder did not en-

sure that the corporation was able to dispose of assets in the amount of its nominal share capital amount at the time of the reincorporation.

The Munich decision differs from the BGH decision only in that the issue of the sum of liability outstanding was not at question. In using the statutory provisions to exclude the shareholder and retract the outstanding shares, the administrator's claim was already quantified by the corporation's nominal share capital amount. The decision illustrates the process that insolvency administrators will use in the case of a stock corporation where a deemed reincorporation in the past can be identified and no notification of this was made at the time.

Deemed reincorporation liability also played a role in a related decision by the Düsseldorf Higher Regional Court involving the purchase of a GmbH shelf company.[9] In a poorly-conceived arrangement between seller and purchaser, the purchaser used the (cash) share capital amount provided to it at purchase to effect payment for the shares themselves, stripping the company of its assets at the exact time of the deemed reincorporation. In the context of the 2007 purchase, the company was renamed and its purpose amended; subsequently it was equipped with financing. The managing director's certification that at the time, the company had the sum of its share capital available to it was incorrect.

The Düsseldorf court found that while the company did notify the commercial register of the "activation of a shelf company", this was insufficient notification of a deemed reincorporation. The shareholder was found liable for the repayment of the full deficit to the share capital amount at the date of the deemed reincorporation, namely EUR 25,000.

III. Practical implications

The decisions discussed above have important implications for practitioners:

- Care needs to be taken when acquiring or using a shelf company that the deemed reincorporation is properly notified.

- Due diligence on German corporate targets needs to carefully assess whether a deemed reincorporation took place in the past and if so, whether:

  – proper notice of the deemed reincorporation was made to the commercial register at the time; and if not

  – whether evidence of the company's assets at that time can be provided.

- Company groups that are considering using a dormant company to commence new business activities must ensure that any deemed reincorporation is properly notified to the commercial register and that confirmation of nominal share capital amounts is provided in the registration. Any "negative equity" existing at that time should be eliminated with top-up payments. An analysis of whether a deemed reincorporation takes place should be undertaken any time that the purpose and name of a business are amended, and any time that new assets are added to a dormant business.

- Shareholders of German companies need to be wary of permitting subsidiary companies to become insolvent without reviewing whether a past deemed reincorporation might provide an

insolvency administrator with grounds to assert shareholder liability. These decisions show that such claims are now a standard tool for administrators to increase the assets available for distribution to creditors.

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1 For example, the company's management is obliged to convene a meeting of shareholders where the company has exhausted 50 % of the nominal share capital amount (§49 (3) of the German Limited Liability Companies Act - GmbHG); repayments to shareholders of nominal share capital amounts are generally prohibited, § 30 (1) GmbHG, with management being personally liable for illegitimate repayments (§ 43 (3) GmbHG), with comparable provisions in the German Stock Corporations Act (AktG)

2 At a minimum in the amounts noted above

3 A variety of shelf company providers exist in Germany; shelf companies are frequently used for the quick purchase of a GmbH or Aktiengesellschaft vehicle

4 Federal Supreme Court (BGH) decision dated 6 March 2012, II ZR 56/10

5 A scope of liability extending to the latter of these dates would generally have been consistent with the court position that unlimited personal liability attaches to actions undertaken by the shareholders on behalf of the company prior to the incorporation and registration of the company, since the "limited liability" framework of the company is only created upon incorporation and public registration

6 Former § 16 (3) GmbHG, now § 16 (2) GmbHG

7 Munich Regional Court (LG), decision dated 30 August 2012, 5 HK O 5699/11

8 § 63 *et seq,* AktG

9 Düsseldorf Higher Regional Court (OLG), decision dated 20 July 2012, I-16 U 55/11

Note

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