

Liability in Limited Liability companies

It might seem counterintuitive, but you may face unlimited liability in a German Limited Liability Company (GmbH and UG) – at least if you are its Managing Director (MD). In fact, MDs are exposed to countless personal risks of civil and even criminal liability. You can encounter anything from a modest fee to years of jail time. The least you may worry about is your company firing you as a MD. Certain criminal offences will ban you from regaining that post for a long time anyways.

Therefore, it is grossly negligent to take office as a Managing Director without knowing your basic duties, let alone knowing any German – since correspondence with authorities is at all times held in German, e.g. with the chamber of commerce, the trade office or the tax bureau. The main liability pitfalls are the company's representation (A), monitoring the finances (B) and the business organisation (C). Finally I will give you 6 tips on how to limit or even avoid personal liability (D).

Learn about managing director liability in this video

A. Flawed or abused representation

The basic idea is that as a MD you represent the company in legal relations and therefore stay out of liability yourself. Any action or declaration falls back to the company. In some cases though, the representation is flawed or abused and you are personally liable.

So whenever you represent the company, do so properly:

1. Make sure that the other side understands you are dealing on behalf of a Limited Liability Company and not as a private person.
2. Never mix up personal interests or affairs with your business dealings: your contracting partner may hold you liable if you abuse the personal trust he puts in you and your statements. This is especially true for investors' prospect statements. Likewise, he may claim any damages from you arising out of the contract if you have a personal interest in the contract's outcome.
3. If you are the MD of a UG (haftungsbeschränkt), you must call the company by its proper name and not refer to it as a GmbH. Otherwise, you may have to pay the difference in share capital in damages of up to 25,000 Euros out of your own pockets.
4. Likewise, the chamber of commerce may fine you if you make any wrong representations of the basic company data in business letters and other official documentation.

5. If you are not allowed to close a contract on your own but do so regardless, you will be personally accountable for any damages.
6. Any major abuse of your power of representation will be persecuted on top of all civil claims being made.

B. Trust violations

The MD's power to manage and represent the company stems from a mutual bond of trust. If he violates that trust, he owes the company damages and may be fired. For instance, it is forbidden to disclose any business secrets or to compete with the company even if there is no clause in the employment contract.

C. Duty violation, § 43 GmbHG

The downside to generally not being liable externally is the MD's all-encompassing internal liability: whenever he violates his duties, the company may claim damages. Even though the MD himself is usually in charge of enforcing claims this internal liability is of major importance: among several MDs any could raise claims against him and even if he is the sole MD the shareholders may charge you - sometimes they are even obligated to do so. Furthermore, even if you are the only MD and shareholder of the company, you are still at risk: if the company goes bankrupt the liquidator will not hesitate to claim damages from you. And many claims only lapse after 5 years time!

An integral part of running a business is taking risky decisions. Fortunately, courts leave those decisions to your discretion as a MD if you follow these Business Judgment Rules:

1. Make an informed decision,
2. weigh the pros and cons reasonably,
3. act only out of the company's interest and not your own, and
4. do not break the law.

If you make your decisions according to these principles, you will not be liable even if a decision had a bad outcome for the business.

Acting in the company's interest sometimes even means breaking contracts, e.g. by not paying a creditor in order to pursue a business opportunity.

At other times your shareholders will tell you exactly what the company's interests are by means of a shareholders' resolution. As a MD you have to comply with these resolutions at all

times – unless they are against the law. On the contrary, the MD must never break the law. The courts even presume that only lawful business can be in the company's interest and will grant the GmbH a claim against you – despite following their very shareholders' resolution! Therefore, adhering to the law is the core of the MD's duties. Let us cover the most important legal obligations:

D. Legal obligations: Financial Monitoring

As usual, it is all about the money. Accordingly, the main source for the MD's worries and troubles are the company's finances. Every MD has to keep an eye on them at all times and understand their impact on the company's liquidity. If you don't understand the numbers, get help quickly!

The main financial task is keeping the company's books which leads to drawing up the balance sheet and the annual financial statement. Be careful with the accounting: any negligent wrong-doing in the company's financial reports may lead to your personal criminal punishment.

The GmbH only guarantees liability up to its share capital of 25,000 Euros in most cases. Therefore, the legal system is very keen on ensuring that the company attains and keeps its share capital. When registering the company, the MD has to affirm to the commercial register that all share contributions have been paid – and he will be liable if that is not the case. Generally, he will be accountable for any false declarations and submissions to the commercial register.

Once the company is founded, the share capital may not flow back to the shareholders. Therefore, the MD needs to ensure that the company's assets will cover the share capital. If it does not, he will have to pay any amount he transfers to a shareholder that results in negative equity. Accordingly, he may never grant a loan to a MD with the same outcome. As soon as the company's assets cannot cover half of the share capital the MD has to convene a shareholders' meeting without any undue delay. Directors of UGs (mini-GmbHs) additionally have to convene it once insolvency may be imminent.

When things go really down for the company, the MD has to be extra careful: once the company is bankrupt, the MD has a maximum of 3 weeks time to file for bankruptcy, This is particularly critical since failing to do so will grant the company's creditors a direct claim

against the MD. And they will be very eager to enforce it since there is probably not much to get out of a bankrupt company anyways.

A bankrupt company is no longer able to pay its current expenses or its assets no longer cover its liabilities, unless it is predominantly likely that it can continue to stay in business. Therefore, the MD constantly needs to predict the company's liquidity when making payments.

Also, the MD may not authorise any payments that will lead to the company's bankruptcy. After entering bankruptcy, you may only authorise payments that are reasonable and just. Whether or not payments fall into that category is very crucial. For instance, payments to tax authorities and the social services are allowed, since failing to pay taxes will have the MD liable and failing to pay social security contributions is a criminal offense. Of course, other manipulations with the assets of the bankrupt company are penalized as well.

E. Legal obligations: Organization

Regarding the organization and management there is good news and bad news. The good news is: as a MD you are only liable for your own breaches of duty. If a fellow MD or an employee messes up, it will not be attributed to you legally. Here is the bad news: your duties include organizing the company in a manner that minimizes mistakes and that allows you to check and overview any relevant process. Indirectly, the employee's mistake may fall back to you after all. So whenever you delegate tasks, make sure you have a system of checks and balances in place. And the more dangerous your product or service is to anyone's protected legal interests, the higher the requirements for that system.

F. Top 6 tips on how to avoid liability as a Managing Director

1. Ask the company's shareholders for permission before taking risky decisions or upon implementing a new organization.
2. Ask the company's shareholders for an annual discharge from liability, especially for approval regarding accounting, balance sheet and financial statement.
3. Get a D&O insurance (Directors and officers) to cover all basic negligent risks. Include a clause in your employment contract that obligates the company to effect such an insurance.

4. Include a clause in your employment contract or the company's bylaws that limits your liability to intent and gross negligence. Alternatively include a cap that limits your maximum sum of liability.
 5. In your employment contract, set a period of limitation of a maximum of 2 years outside the mandatory scope of Sec. 43 para. 3, 64 GmbHG (Limited Liability Companies Act).
 6. Get professional financial and legal assistance (accountants and lawyers), especially regarding your financial statements and in times of crisis and bankruptcy.
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Any questions?

Then leave as a quick message under hi@streifflaw.de or call as under +49 30 8597 6915

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