

MEMORANDUM

From: P+P Pöllath + Partners Rechtsanwälte und Steuerberater mbB
To: Future Managing Directors of a German GmbH
Re: Your Obligations and Potential Liability
Date: 2 November 2017

Congratulations! You plan to become managing director (*Geschäftsführer*) of a German limited liability company (a “GmbH”). Before you accept your appointment as a managing director, you may want to read the small print, *i.e.*, inform yourself on the obligations and potential liability of a managing director under German law.

I. Introduction

Before speaking about the obligations and potential liability of a managing director, let us say a few words about the basic corporate governance of a GmbH: Every GmbH must have at least one managing director. Only a natural person can become a managing director. It is not possible to appoint a legal person as a managing director. A managing director is appointed by the shareholder meeting of the GmbH. If the shareholder meeting appoints several managing directors, the managing directors together are still usually referred to as the ‘managing directors’ and not as the ‘board’ even though their governance works like the governance of a board of managing directors. All managing directors are executive directors. A managing director cannot be non-executive. If a person is appointed as managing director with the idea of being a non-executive director, he can, as a practical matter, of course abstain from participating in the affairs of the company. But as a matter of law, he is under the same obligations as every other managing director.

In addition to the managing directors, the shareholder meeting can introduce a board of non-executive directors that is usually referred to as a supervisory board (*Aufsichtsrat*), advisory board (*Beirat*) or shareholder committee. The shareholder meeting is relatively free to define the rights and obligations of the board. In many cases, the board is given the authority to control the managing directors. The board can even be given the authority to appoint and dismiss the managing directors. The board must not have executive functions. Except for few exceptions, the executive functions of the company are reserved for the managing directors. If requested by the employees, companies with more than 500 employees (in Germany) must have a supervisory board whose members are partly elected by the employees. We call that ‘co-determination’ of the employees (*Mitbestimmung der Arbeitnehmer*).

If the shareholder meeting introduces a board or committee, the managing directors cannot be members of the board and *vice versa* at the same time. It is not possible to merge the managing directors and the board into a single corporate body or committee.

II. Obligations

We have set out the most important personal and organizational obligations of a managing director in the below. While some of the obligations are self-explaining and of a more general nature, we have described certain obligations in more detail that are of greater importance in terms of the liability of a managing director.

Most of the obligations derive from German corporate law, particularly, from the German Act on Limited Liability Companies (*GmbHG*) and its interpretation by German courts. Other important sources for the obligations of a managing director are the articles of association, by-laws, shareholder resolution(s) and, if applicable, board resolutions of the respective company and, of course, in the service agreement of the managing director that commonly specifies certain (additional) obligations.

1. Manage the day-to-day business of the company with the care of a prudent businessman (*Sorgfalt eines ordentlichen Geschäftsmannes*)

This basic obligation includes: **financing, sales, marketing, distribution, sourcing, back-office functions, R&D, HR, internal organization, risk management** and of, course the **company's strategic direction**. The before mentioned list indicates that the managing director is responsible for any executive management task of the company. In fulfilling this role, the managing director has to take into account (i) potential limitations (such as the company's scope) as set out in its articles of association, by-laws etc. or (ii) instructions from the shareholder(s) of the company or, if applicable, instructions from a supervisory or advisory board of the company. In addition, the articles of association or by-laws may provide for tasks that require the prior (written) consent of the shareholder(s) or any board.

A managing director is relatively free to delegate certain of his obligations and tasks to other managing directors or even employees (save for any provisions in the articles of association to the contrary). However, the managing director remains responsible for overseeing and monitoring the fulfillment of the delegated obligations and tasks.

2. Comply with the law / Compliance with the company's statutes

One of the most important obligations of a managing director in Germany is to **comply with the laws** and the company's statutes and to ensure that the company and its employees comply with the laws and the company's statutes (*Organisationspflicht*). However, this obligation does not stop at the level of the company itself. **Compliance** must also be **monitored and ensured** at the level of any **direct or indirect subsidiary**. German courts held that a managing director is responsible for establishing a reporting chain that allows monitoring

compliance on any level of the company (and its subsidiaries) from “bottom to top”.

Act in the interest of the company

Every managing director has to be loyal towards the company. Such **fiduciary duty** does not only include a managing director’s obligation to promote the company but also, and more specifically, it does include the obligation to **treat the company’s affairs confidential** and to **not engage in competition** in any business field of the company. If a **conflict** arises between the managing director’s and the company’s **interest**, the managing director is held to act to the advantage of the company even if this goes along with a personal disadvantage of the managing director.

3. Represent the company

The managing director(s) is/are authorized to **represent the company** in any respect (*i.e.*, both in and out of court). To the extent the company has more than one managing director, the company is validly represented by two managing directors acting at the same time. Deviations from this rule, in the meaning that a single managing director can represent the company alone (*Alleinvertretungsmacht*) are quite common in Germany but have to be addressed in the company’s articles of association. Further, the articles of association can allow the managing director(s) to represent several legal entities at the same time. The latter exception is quite important in scenarios where the managing director needs to represent affiliates of the company at the same time (*e.g.*, group financings).

When representing the company towards third parties, the managing director must **disclose that he acts on behalf of the company**. If he doesn’t and the relevant third party is not aware that he acts on behalf of a limited liability company, the managing director may be held personally liable.

4. Educate yourself!

We understand that no further explanation is required.

5. Always act with the care of a prudent businessman

As mentioned before, a managing director is held to act with the care of a prudent businessman. This means in practice that a managing director is granted discretionary power in assessing the risks and chances of a contract, transaction or other measure (so-called ‘**business judgment rule**’). If the managing director acts within the scope of his discretionary power the respective decision may even not be challenged by a court. Enjoying this privilege requires the managing

director to **obtain appropriate information and/or advice** before taking out the contract, transaction or measure. As a rule: the greater the importance, the more and granular information or advice have to be obtained.

6. Book-keeping and preparing annual financial statements

Each managing director is obligated to ensure **proper book-keeping** as a matter of law. This means that a managing director cannot be released from this obligation even if it has been shifted to another managing director of the company or a tax advisor.

Each managing director is further obligated to **prepare the annual financial statements** within three calendar months following the end of the relevant financial year.

7. Taxes

Pay taxes in full and in a timely manner.

8. Pay your debt or exit/Insolvency

If the company is in crisis special obligations arise for a managing director the breach of which may lead to a personal liability of the managing director (please see also below). In times of crisis, the managing director is obligated to **cater for a risk management** and to **monitor the company's ability to meet its payment obligations**. The managing director is further obligated to call for shareholder meetings and inform the shareholder of the status of the company and its stated share capital. He is also held to prepare for insolvency proceedings and assess available alternatives to insolvency proceedings (such as the self-administration (*Eigenverwaltung*)). If the company is (i) unable to pay its debts as they fall due (*Zahlungsunfähigkeit*) or (ii) over-indebted (*Überschuldung*), the managing director has to **file for insolvency** (the latest) within three weeks following the occurrence of such ground for insolvency.

9. Shareholder relations

Another important task of a managing director is the **communication and interaction with the shareholder(s)**. The managing director has to **call for shareholder meetings** (i) to seek for approval of the annual financial statements and to determine the appropriation of earnings, (ii) if half of the share capital has been lost and, more general, (iii) whenever it appears necessary in the company's interest.

In order to avoid legal implications resulting from a hidden distribution of profits (*verdeckte Gewinnausschüttung*) selected shareholder(s) must not be favored to the detriment of the company or the other shareholder(s). As a rule, **dealings between shareholder(s)** and the company should only be entered into **at arm's length basis**.

10. Coordinate and interact with the other managing directors

If the company has more than one managing director it is of great importance that the **managing directors coordinate the daily business affairs** amongst themselves **and interact** with each other. It is quite common in Germany that the articles of association or by-laws provide foresee regular meetings of the managing directors. Each managing director has the right to object to measures of other managing director(s). If a measure has been objected, the relevant measure must not be implemented until the shareholder meeting has taken a decision on it.

11. Illegal acts and measures (Risk of personal liability)

Certain acts and measures are **forbidden by law** and bear the risk of a personal liability of the managing director: Most of these illegal acts affect the **capital maintenance** and **liquidity protection** of the company. The details of the capital maintenance rules (and certain exceptions thereof) and liquidity protection rank amongst the most complicated topics in German corporate law and are subject of a variety of judgments and ongoing disputes in legal literature. Briefly summarized, the key facts are as follows: a managing director must not (i) grant loan(s) to a managing director or other representative to the extent the stated share capital of the company is affected and/or (ii) effect any payments (directly or indirectly) to a shareholder to the extent the payment (y) leads to or deepens an underbalance or over-indebtedness of the company (z) must lead to the insolvency of the company.

12. Filing obligations

The managing director is obligated to file, amongst others, the following documents with or give notice of the following events to the **commercial register** (*Handelsregister*), the **business register** (*Unternehmensregister*) and the **transparency register** (*Transparenzregister*) (as applicable): (i) articles of association and amendments thereof, (ii) capital increases/decreases, (iii) list of shareholders, (iv) annual financial statements, (v) resolution(s) relating to profit appropriations, (vi) liquidation of the company etc. In addition, the names, addresses and other personal information of the economic beneficiaries of the company have to be reported for purposes of combating money laundering.

Even more important (as this goes along with a personal and criminal liability) is a managing director's obligation to observe and to fulfil the company's obligations pursuant to German tax laws. The managing director is held to not only withhold and pay any tax in full and in a timely manner but to also **file** the relevant **tax declarations** on behalf of the company. The same importance applies to reporting and payment obligations towards the relevant **social security** authorities, employers' liability insurance association and others.

13. Additional obligations in regulated industries

As mentioned before, the obligations set out in this memorandum are of a more **general nature** and are to be observed by managing directors of any company conducting business in Germany. Depending on the relevant nature of business or business sector the company is engaged in **additional obligations** may arise, particularly in **regulated industries**. For instance, private equity companies (set up under German law) and their managing directors have to observe the obligations imposed by the German code on capital investments (*Kapitalanlagegesetzbuch*).

14. Foreign law

The list of obligations of a managing director set out above would be incomplete without (at the least) mentioning **obligations under foreign law**. As soon as the company conducts business abroad, additional obligations for the company and its managing director may arise, such as rules of the Foreign Corrupt Practices Act (FCPA) in the US or the rules of the Bribery Act 2010 in the UK.

Even a brief description of obligations under foreign law would exceed the scope of this memorandum. We therefore can only strongly encourage you to obtain information and to seek advice on the rules and regulations of any country and state in which the company conducts business.

III. Liability

1. Basic Principle:

As a rule, under German law a managing director **cannot be held liable personally** for the **debt incurred by the company** and its respective payment obligations. However, a managing director **can be held liable personally** (by the company or any of its creditors) for any damage caused by a **breach of his obligations** set out above and below. The liability may not only arise in case of willful intent but also at any level of negligence.

Further, the **burden of proof** is to a certain extent **reversed** and lies with the managing director: First, the company has to prove the breach of an obligation, and, if it overcomes that hurdle, then the managing director has to prove that he is not responsible for the damage caused.

In this context “personal liability” means that the liability is not limited to a certain amount. The managing director can be held liable with this entire private property.

2. Special liability provisions

A managing director can be held personally liable by the tax authorities to the extent he is in breach of his obligations under German **tax law** and acts with willful intent or gross negligence. The liability of a managing director towards tax and **social security** authorities can easily be avoided by effecting the respective payments in full and in a timely manner.

We would also like to stress once more that a managing director may be held personally liable if he violates **capital maintenance** and/or **liquidity protection rules** and effects any payment (i) after the company become unable to pay its debts as they fall due or after the company is deemed to be over-indebted, (ii) to the shareholder(s) to the extent the payment must lead to the insolvency of the company, or (iii) that qualifies as an (illegal) repayment of the stated share capital.

3. Criminal liability

In addition to the potential liability described above, a managing director may also be held criminally responsible in case of a breach of his obligations. The most **important criminal offences** are: **fraud** (*Betrug*), **embezzlement** (*Veruntreuung*), **unlawful appropriation** (*Unterschlagung*), **disclosure of business secrets**, **incorrect filings** (e.g., annual financial statements) and **delayed filing for insolvency** (*Insolvenzverschleppung*). You will be instructed on the relevant criminal offenses by the acting notary upon your appointment as managing director.

IV. Service Agreement

Managing directors who are paid by the GmbH for their service as a managing director must enter into a service agreement with the GmbH. As a practical matter, the service agreement must be made in writing. The service agreement is the contractual basis for the managing director’s salary, bonus, company car (very important in Germany!) or other benefits. Service agreements often include further provisions, including the job description, non-compete obligations, the obligation of confidentiality, obligations relating to IP rights and other obligations. From a legal perspective, the service agreement is independent from the appointment as a managing director and *vice versa*: If you are appointed as a managing director, you still need to enter into a service agreement. If your service agreement expires you do not automatically cease to be a managing director. The managing director and the

shareholder meeting therefore have to ensure that the appointment as managing director and the service agreement are synchronized.

Managing directors are sometimes not paid by the GmbH, *e.g.*, because they are paid by the parent company or because they are the sole shareholders. Managing directors who are not paid by the GmbH for their service as a managing director only rarely enter into a service agreement with the company.

V. Residence in Germany

Nationality is irrelevant for becoming a managing director. Residence is largely irrelevant for becoming a managing director. You do not need a German residence or residence permit to become a managing director. However, you must be allowed to visit Germany.

If the GmbH has a managing director that is not residing in Germany, the managing directors must analyze for tax purposes (1) whether the GmbH has a permanent establishment outside Germany or is managed from outside Germany or (2) establish adequate processes to avoid that the GmbH has a permanent establishment outside Germany or is managed from outside Germany.

VI. Minors, Mental Illness, Convicts

Minors and people with a severe mental illness cannot become managing directors. Convicts and former convicts cannot be managing directors for a time period of five years if they have been convicted for certain white collar crimes. If they are appointed as managing director, the appointment is invalid. Upon his appointment, the managing director has to confirm to the commercial register that he is not legally barred from becoming a managing director. Making a false statement in this regard is a criminal offense.

VII. Language

Managing directors who do not speak German sometimes ask the question whether they are obliged to learn German. The answer is generally no. However, a managing director's lack of speaking German will not be accepted as an excuse for anything of legal relevance. If a managing director does not speak German, he must organize his business life in a way that ensures that all German communication and documentation that requires his attention is translated.

VII. D&O Insurance

Managing directors are not obliged to take out D&O insurance. It may still be a good idea to do so.

Please do not hesitate to contact us with any questions you may have regarding the above.

Kind regards

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