Modernising the Companies Act

Christian Tönies and Marco Eickmann of P+P Pöllath + Partners discuss the German Private Limited Companies Act reform and its effects on the German M&A market

The German limited liability company (GmbH) is by far the most commonly used legal form in Germany. According to current statistics, around one million commercial entities are organised as GmbHs. Despite this popularity, the debate on deregulating and modernising the Private Limited Companies Act (GmbHG) gained momentum after the German legal market was opened for foreign legal entities by the European Court of Justice. A competitive disadvantage was often believed to exist for the GmbH as compared to foreign legal forms, in particular to the UK limited liability company, since the requirements in many EU member states regarding the establishment and raising of minimum nominal capital are less strict.

On November 1 2008, the Act to Modernise the Law Governing Private Limited Companies and to Combat Abuses (*Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen* – MoMiG) entered into force, amending significant parts of the GmbHG. The MoMiG constitutes by far the most comprehensive reform of the Private Limited Companies Act ever, since the GmbHG has survived more than a century with only a few amendments. As the MoMiG's name implies, the German legislator is pursuing two principle objectives with this reform. The first is to increase the competitiveness of the GmbH by providing a modern, uncomplicated legal structure suited to small and medium-sized enterprises. Therefore, the MoMiG aims to facilitate and accelerate the establishment of businesses and to deregulate the GmbHG, which was regarded to be too complicated and in some areas overprotective, in particular due to constructs and concepts created by German case law. The second aim of the reform is to increase protection against fraudulent use of the GmbH structure, especially regarding fraudulent liquidation and insolvency of the GmbH.

Setting up a GmbH

Model protocols

Simplifying and accelerating the incorporation of a GmbH was one of the major goals of the reform. While the notarisation requirement was retained, the MoMiG introduced an annex to the GmbHG which includes model protocols for the incorporation of a GmbH. Such model protocols are meant to be used for straightforward standard set-ups (involving, inter *alia*, formation by cash subscription and a maximum of three shareholders). The legislator holds that setting up a private limited company is easier when a model protocol is used because three documents – the shareholders' agreement, the appointment of the company director and the list of shareholders – are combined in just one document. However, it is doubtful whether founders will make much use of such standard documents that do not allow flexibility and customisation according to the founders' individual situation and interests.

Public approvals

The MoMiG eliminated the requirement to submit public approvals to the court of registration. This means that the application for registration with the commercial register can be filed and the company may be entered into the register before public approvals have been granted by other authorities. In other words, the speed of the registration process is no longer determined by the slowest procedure. Furthermore, it was made clear that the court of registration may only demand deposit receipts or other documentary evidence that the capital has been duly paid up in cases of substantial doubt regarding the payment. The MoMiG further abolished the requirement to furnish special security if only one person founds a private limited company. There is no doubt that these deregulations will accelerate and simplify the incorporation process, in particular with respect to setting up special purpose vehicles.

Limited liability entreprenunial company

The government's first draft of the MoMiG intended to reduce the minimum share capital of a GmbH from €25,000 to €10,000. However, the legislator decided to maintain the previous minimum capital. For new businesses that have a limited amount of nominal capital at the start of operations and need a small amount of capital, the MoMiG introduced an alternative to the established form of the GmbH called an entrepreneurial company with limited liability (*Unternehmergesellschaft*). Such company can theoretically be founded with share capital of only €1. However, distributions of profits are restricted in order to enable the company to save the minimum capital required for the established form of a GmbH. Given these restrictions, the entrepreneurial company will most likely remain attractive for start-up entrepreneurs.

Nominal amount of shares

Previously, each shareholder was only permitted to subscribe to one share in the company. Each share was required to have a minimum amount of €100 and be divisible by 50. The MoMiG grants shareholders much greater flexibility regarding the amounts of their contributions. Shareholders are now enabled to subscribe to as many shares as they wish and such shares will have to be denominated in an amount of at least €1. This makes modifying contributions according to the shareholders' needs and financial circumstances much easier. There is also greater flexibility in respect to shares, in particular it is now much easier to split and combine shares. This new flexibility will particularly simplify the purchase of shares if a shareholder intends to sell only a part of his stake, as well as joint ventures and management participation programs.

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Raising capital

Hidden contribution in kind

In principle, German law requires shareholders to make the contributions for their shares in cash. Contributions in kind are regarded as an exception for which the GmbHG contains specific complex rules. The shareholders have to draw up a report on the value of the contributed assets and submit documents to the commercial register to prove that the contributed assets' value matches the amount of the respective

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shares. To avoid these rules, shareholders often agree upon cash contributions and the company then uses the cash to acquire assets from the shareholder. In this case, from an economic perspective, the shareholder has made a contribution in kind. Such circumvention is known as a hidden contribution in kind (*verdeckte Sacheinlage*).

In the past, according to German case law, all contracts regarding the transfer of the relevant assets were deemed to be void and the shareholder's obligation to pay the contribution in cash was deemed not to be fulfilled. Therefore, particularly in cases of insolvency of the company, the shareholder ran the risk of being obliged to pay his contribution twice. The MoMiG has considerably reduced this danger by clarifying that all contracts in connection with a hidden contribution in kind are valid and that the value of the asset is credited against the shareholder's duty of payment. However, hidden contributions in kind are still illegal and may result in civil liability of the managing directors. Furthermore, the shareholder who received his cash contribution back is obligated to furnish proof of the value of the contributed asset.

Pay-in and pay-out

Prior to the MoMiG, cash payments to a shareholder were, in principle, illegal within six months after the shareholder has made a cash contribution in the course of the foundation of the company or a capital increase. In case of such pay-outs, the shareholders' obligation to pay the contribution was deemed not to be fulfilled. This also applied to payments in connection with loans granted to the shareholders. Thus, it was almost impossible to raise capital if a company was integrated into a cash-pooling system and thus potentially obliged to make payments to the pool. The MoMiG relaxes these regulations by permitting payments to shareholders if the company has an economically valid and immediate due claim for repayment.

Maintenance of capital

The permissibility of cash-pool systems was further questioned by the provisions on the maintenance of the share capital. According to these provisions, a GmbH is not allowed to distribute any assets that are required to preserve the company's stated share capital. Distributions are only permissible if the remaining assets cover the company's share capital and its liabilities. In other words, only the free reserves and accumulated profits are allowed to be distributed to the shareholders and their affiliates. Payments that violate these provisions have to be refunded by the shareholders and lead to civil (and possibly criminal) liability of the managing directors.

In November 2003, the German Federal Supreme Court decided that this not only applies to distributions (without consideration) but also to upstream-loans, regardless of whether the company's claim for repayment is economically valid. By way of this judgment, the Court refused to follow the prevailing balance-sheet approach according to which the mere exchange of assets (cash against a full-value repayment claim) does not affect the company's net equity and thus cannot be prohibited. Due to unclear formulation and some exceptions considered by the Court, the decision was followed by a controversial debate in legal literature, in particular concerning the permissibility of cash-pooling systems and upstream securities in connection with leveraged buy-outs. Following a stringent interpretation, the Court's decision covered all payments made under a cash pool as well as all upstream securities.

One of the main goals of the MoMiG was to put cash pools on secure footing. The German legislator – regarding cash pooling as an economically reasonable instrument for balancing out liquidity between parts of a group – reinstated the balance-sheet approach. That means that upstream loans are permissible under the rules on the maintenance of the share capital if the repayment claim against the shareholder is of full value at the time of the granting of the loan, even if the loan is not paid out of free reserves.

Overall, the amendments to the provisions on the raising and maintenance of the share capital are major improvements providing legal certainty on the permissibility of upstream loans and cash-pooling systems.

Authorised Capital

Whereby the authorised capital is a commonly-used instrument to increase the capital of a German stock corporation, the former GmbHG did not provide a respective possibility for German limited liability companies. This was changed by the MoMiG which introduced the concept of authorised capital to the GmbH. According to Section 55 GmbHG, the articles of association may nowadays authorise the managing directors for a maximum of five years, following the registration of the company or the registration of the respective change of the articles of association, to increase the stated capital up to 50% of the existing capital by issuing new shares in one or several tranches against contributions in cash or contributions in kind. Making use of the authorised capital does not require another shareholder resolution. In this light, the authorised capital may be a flexible and cost-saving instrument for German limited liability companies to increase their share capital. However, besides Section 55, the GmbHG provides for no additional provisions. Therefore, the crucial question remains whether the respective provisions of the German Stock Corporation Act (AktG) shall be applied analogously. Nevertheless, the possibility to create authorised capital will give the management of a GmbH an instrument to obtain further financial means without convening general meetings or to set up management incentive programs.

Shareholder loans

Prior to the MoMiG, the GmbHG contained specific provisions regarding equity-replacing shareholder loans (*eigenkapitalersetzende Darlehen*). According to these statutory rules, claims for repayment of loans or similar claims granted by a shareholder or an affiliate of a shareholder were subordinated to claims of other creditors in case of insolvency, if such loans had been granted or left outstanding in a period of a crisis, like a situation in which the company was no longer able to borrow money from third parties on market terms. The whole concept had become more complex through judicial rules, which not only subordinated such loans but treated them as equity, so that any repayments of such loans constituted a violation of the provisions on the maintenance of the share capital.

This rather complicated concept of equity-replacing shareholder loans has been considerably simplified and fundamentally deregulated by the MoMiG. Therefore, the statutory rules have been reformed and incorporated into the law governing insolvency, whilst the judicial rules have been repealed. A distinction will no longer be made between equity-replacing and normal shareholder loans. All claims for repayment of downstream loans are now subordinated to other creditors' claims in case of insolvency, regardless of whether the loans were granted or left outstanding in a period of crisis. Despite this subordination, however, shareholder loans are still considered liabilities in the insolvency balance sheet. Therefore, to avoid over-indebtedness because of shareholder loans being classified as liabilities, contractual subordination clauses are still necessary. Repayments of shareholder loans within one year prior to filing for insolvency may be challenged by the insolvency administrator. As such challenge no longer premises that a loan was granted in a period of crisis, repayments should particularly be avoided previous to M&A transactions that lead to a loss of the seller's control over the company. Instead, shareholder loans should be sold and transferred to the buyer.

"The new possibility to create authorised capital will make it easier to attract new investors within a short timeframe"

Share purchases

Shareholder list

The relevance of the shareholders' list was enhanced by the MoMiG. Whereas before the reform, the shareholders' list was kept for informational purposes only and had no legally-binding effect, henceforth only those persons who are listed on the shareholders' list filed with the commercial register are considered to be shareholders of the GmbH and entitled to voting and dividend rights. Whenever there is a change in the persons of the shareholders or their shareholdings, the managing directors are obliged to submit an updated list to the commercial register without delay. Such shareholders' list has to identify first name, surname, date of birth, address or, in case of legal entities, the company name, the registered office, the commercial register where the company is registered, the respective registration number and the business address, respectively of each shareholder, as well as the nominal amount of each share. In case a notary public was involved in the changes which require the submission of an updated shareholders' list, the notary himself is obliged to file the list for registration with the commercial register immediately after the measure has become legally effective.

The reformed shareholders' list provides more transparency and legal certainty for the company and its shareholders. Especially within the context of M&A transactions, the new shareholders' list may help to retrace the title chain and examine the validity of shareholder resolutions. Furthermore, guarantees related to the correctness of the shareholders' list may be considered.

Good faith acquisition

Before the MoMiG came into force, the purchaser of a share in a GmbH was at risk that the shares concerned actually belonged to someone other than the seller. It took considerable time and effort during due diligence processes to verify the ownership of the shares through the complete chain of title and to review the validity of all share transfers since the company's establishment. The MoMiG introduced the possibility of acquiring shares in a GmbH in good faith. This regulation aims to provide greater legal certainty and reduce transaction costs. For this purpose, the shareholders' list serves as a point-of-reference. In principle, a purchaser can trust that a person entered in the list really is a shareholder in the company. However, this applies only if the respective entry has been incorrect for at least three years without objection. Therefore, it is questionable if the possibility of good-faith acquisitions will actually streamline current due diligence procedures.

Corporate mobility

One of the main goals of the reform was to strengthen the international competitiveness of the GmbH. In light of this goal, the MoMiG eliminated the requirement that the registered seat of a GmbH must be identical with its principal place of business. This allows a German limited liability company to relocate its principal place of business to a different jurisdiction from that of its registered seat, which must be – in any case – located in Germany. This amendment enables German limited liability companies to move their principal place of business to any other country without any corporate restrictions; this is not restricted to the EU as long as the third country recognises the applicability of German law to the GmbH. The possibility to operate abroad in the familiar legal form of a limited liability company might be an especially attractive option for German groups and their foreign subsidiaries. Furthermore, in January 2008, the Federal Ministry of Justice presented a draft private international law for corporations, which codifies the incorporation theory for all German corporations and partnerships. The implementation of this draft would mean a basic change in the system of German private international law.

Without doubt, these developments are a huge step forward, particularly with regard to the rather surprising decision of the European Court of Justice (ECJ) in the Cartesio case in which the ECJ held that Articles 43-EC and 48-EC are to be interpreted as not precluding legislation of a member state, according to which a company incorporated under the law of that member state may not transfer its principal place of business to another member state while retaining its status as a company governed by the law of the member state of incorporation. A transfer of the principal place of business might be a simple and effective way of engaging in economic activities in another member state without having to bear the costs and the administrative burdens inherent in first having to wind up the company in its state of origin and then having to completely resurrect it in the state of destination, in particular for smaller-sized companies. However, whether German corporations make use of this new corporate mobility opportunity may, *inter alia*, depend on the tax consequences of doing so. Therefore a question will be whether the transfer will result in a realisation of hidden reserves pursuant to Section 12 of the German Corporate Income Tax Act.

Conclusion

The MoMiG introduced major improvements in terms of modernisation and deregulation of the former formalities which were related to the foundation, administration and handling of a GmbH. Besides increased liability risks for managing directors related to actions in connection with a crisis of a GmbH, the MoMiG facilitates the use of a GmbH in connection with M&A transactions in light of financing structures. The enhanced possibilities to grant upstream or downstream loans without facing the uncertainties of the admissibility have been streamlined. Furthermore, the MoMiG allows for the acquisition of shares in a GmbH in good faith from persons registered in the shareholders' list. The new possibility to create authorised capital will make it easier to implement management incentive programs, to attract new investors within a short timeframe and to acquire other businesses by way of issuing new shares without involving a general meeting. Overall, the fundamental changes introduced by the MoMiG extinguished major uncertainties and therefore have positive consequences related to the use of GmbHs in connection with M&A transactions.