Legal Update
Corporate and Tax, Mergers & Acquisitions

Liability of Shareholders Following Reactivation of Dormant Private Limited Companies – New Ruling of Federal Court of Justice Limits Liability

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Frankfurt am Main, 10.01.2013

Introduction

The principles elaborated by the Federal Court of Justice in its case law on the reactivation of dormant private limited companies and the resultant increase in the liability of shareholders of such dormant companies have in recent years resulted in a series of decisions by lower courts that have not always sufficed to handle situations encountered in actual practice and have resulted in excessive liability on the part of shareholders who intentionally opted for a form of incorporation that limited their liability in order to shield their personal assets against claims of creditors of the company. These various rulings have in the meantime caused a virtual deluge of scholarly debate in the legal literature that defies oversight and in some cases reveals the existence of diametrically opposed positions. The upshot has been a noticeable increase in uncertainty among practitioners, especially as regards the extent of the potential liability incurred in the case of the reactivation of a dormant company.

This unfortunate development was encouraged by the previous case law of the Federal Court of Justice, which either completely neglected to address certain aspects involved in the application of the principles governing liability following the reactivation of dormant companies or provided misleading information. In its judgment of 6th March 2012, II ZR 56/10, which has been published in DStR 2012, p. 974 et seq. and elsewhere, the Federal Court of Justice has fortunately taken the opportunity not only to confirm the validity of its principles regarding the liability of shareholders in the case of the reactivation of dormant private limited companies in the past, but also specifically addressed the issues of the duration and extent of the liability of shareholders and set limits for both.

Confirmation of Previous Pronouncements

a) The recent case law of the Federal Court of Justice has first of all confirmed the previous definition of what is meant by reactivation of a dormant company. Reactivation

of a dormant company is taken to mean the acquisition of a shelf company or a shell company as well the resumption of the business operations of a dormant private limited company with no change in the shareholders.

b) The Federal Court of Justice considers cases that fall into the above category to represent the equivalent of the legal incorporation of a new private limited company and as a result would apply those provisions of law accordingly that govern the creation of an artificial person that did not previously exist. In order to protect creditors, these provisions governing the establishment of companies require that the capital required by law and the articles of association be actually paid in as of the commencement of the existence of the company since that is ultimately what justifies the limitation of the liability of the shareholders to the existing corporate assets in the first place.

Application of these provisions in the case of the reactivation of a dormant company means that the managing director of the reactivated entity must notify the court of registry of the reactivation and submit a statement of compliance pursuant to section 8(2) of the Private Limited Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung* – GmbHG) concerning the contributions pursuant to section 7(2) and (3) of the Private Limited Companies Act in respect of the shares and the unhindered availability of these contributions. In the event of failure to comply with this duty to disclose the reactivation of the dormant company, the shareholders are personally liable for the debts of the company.

c) Finally, the Federal Court of Justice confirmed that failure to disclose the reactivation of a dormant company not only affects the liability of those shareholders who were directly involved in the reactivation of the company, either by virtue of the purchase of a shelf or shell company or by virtue of the resumption of business operations of a company; shareholders who acquire shares in a reactivated dormant entity, i.e., from a company that has resumed business operations, are also liable regardless of whether they had positive knowledge of such reactivation.

Limitation of Liability

a) Due to the previous case law of the Federal Court of Justice, it was commonly thought up to now that shareholders would not only be personally liable for the integrity of the share capital in the case of the reactivation of a dormant company, but that this liability would also be of indefinite duration since the amount of personal liability was to be determined as of the time of the disclosure of the reactivation of the dormant entity to the court of registry and be equal to the difference between the amount set by law or the company's articles of association and the actual value of the company's assets. However, in the event of failure to make such disclosure, the liability of shareholders would be indefinite and also include losses that result in a reduction in the assets of the company after resumption of business operations, i.e., after reactivation of a dormant company.

This broad construction of liability in connection with the reactivation of a dormant company in the event of a breach of the duty of disclosure is logical in the case of the literal application of the provisions of law governing incorporation, which originally pertained to initial incorporation of a private limited company, and the corresponding case law of the Federal Court of Justice for this means that the shareholders are completely liable for all liabilities when the company is initially created – and then as shareholders of the company prior to entry in the register of companies – and to be sure for any losses incurred up to registration as well as for excessive debt thereafter. In the event a company has already incurred liabilities by commencing business operations prior to its entry in the register of companies, the shareholders are

personally liable for the difference between the share capital and the value of the company's assets as of the time of registration (*liability for deficit balance*). In the event of failure to register a private limited company, the shareholders are personally liable for debt not covered by the company's assets (*liability for uncovered losses*).

b) In its decision of 6th March 2012, the Federal Court of Justice clearly rejected this far-reaching liability model. In the case of the reactivation of a dormant company that is not entered in the register of companies, the Federal Court of Justice now limits the liability of shareholders to the deficit balance as of the time the reactivated dormant company first makes its public appearance. That point in time is determined either on the basis of the time of registration of any changes in the articles of association made in connection with the reactivation of the company or the commencement of business operations. The possibility of indefinite liability for uncovered losses, which is possible in the case of the initial establishment of a private limited company, will in the future be excluded in the case of the reactivation of dormant companies.

The Federal Court of Justice correctly justifies this limit to liability by referring to the fact that the liability model originally developed specifically for initial legal incorporation is not necessarily completely applicable in the case of the reactivation of dormant companies since there are serious differences between initial incorporation and reactivation of a dormant entity that call for and justify a difference in liability. For example, as regards the liability of a shareholder of a reactivated dormant company, it is necessary to take into account the fact that the entity in question is already entered in the register of companies when it is reactivated, which is not the case when a company is registered for the first time, and already exists as a legal entity that is separate from its shareholders such that its liability is limited to its corporate assets pursuant to section 13(2) of the Private Limited Companies Act. The required entry of a reactivated dormant company in the register of companies cannot be equated with initial entry in the register of companies, which is what gives rise to the legal existence of the company and limits its liability in the first place.

c) The Federal Court of Justice considers any further shareholder liability to be unnecessary despite the fact that unlimited liability for an indefinite period could exert a disciplinary influence on shareholders, who might otherwise ignore the duty to disclose the reactivation of a dormant company with virtual impunity. According to the court, preferential treatment of a company's creditors as compared with the situation in the case of proper disclosure would in any case not be warranted.

Conclusion

In its decision of 6th March 2012, the Federal Court of Justice put a welcome stop to the burgeoning liability of shareholders of private limited companies due to its previous case law by adapting and limiting the scope of the liability model it created for cases involving reactivation of dormant companies in the interest of greater legal certainty. However, since the Federal Court of Justice consistently insists upon application of the provisions of law governing incorporation, including the principle of liability for deficit balances, in the case of the reactivation of dormant companies, some basic doubt remains as to the validity of this ruling in respect of its constitutionality on the one hand and other possibilities for the protection of a company's creditors on the other hand. One need, for example, mention only prohibition of dividends and the principles governing liability for the destruction of the existence of a company.

Note

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