SQUIRE PATTON BOGGS

Directors’ Duties – Germany

Considerations for Directors When a Company Is in Financial Difficulty

This quick guide summarises the duties that a managing director of a German GmbH (hereinafter “director”) is subject to, and how those duties change when the company is insolvent or at risk of being insolvent.

It also gives an overview of the personal risk to directors when the company is in financial difficulty.

This note is intended as an overview and should not be relied on as legal advice. Should you require legal advice in relation to your specific circumstances, please contact the Restructuring & Insolvency team member whose contact details are at the end of this note.

Directors’ Duties When Solvent

- Each director has a general obligation to act with the diligence of a prudent businessperson.
- Directors must exercise their duties in compliance with applicable laws, the company’s articles of association and bylaws, any instructions issued at shareholder meetings, and the obligations under their employment agreement.
- Directors are obliged to continuously monitor developments, which could endanger the continuation of the company’s existence, and to take appropriate countermeasures.

Financial Distress

Directors’ Duties When Insolvent, or at Risk of Being Insolvent

- In an insolvency or close-to-insolvency scenario, German Insolvency Law imposes various duties on directors, which are designed to protect the interests of the company’s creditors, including an obligation to file for insolvency in a timely manner.
- Directors are obliged to file for insolvency without undue delay and at the latest (i) within three weeks after the company is unable to pay its debts when due (other than in case of a temporary and minor liquidity shortage) (illiquidity); or (ii) within six weeks after the company has become over-indebted, combined with a negative going concern prognosis.
- After the company has become insolvent, directors may not make any payments unless they are in line with the diligence of a prudent businessperson even in an insolvency. During the permitted insolvency filing period, payments made in the ordinary course of business are deemed to be made with the diligence of a prudent businessperson provided that the directors pursue the insolvency filing or aim to overcome the insolvency.
- In case the company initiates restructuring proceedings under the newly introduced restructuring laws, the directors need to observe the interests of the rights of its creditors (shift of fiduciary duties).

It is important for directors to understand their directors' duties, as well as how their actions and the decisions the board makes when the company is in financial distress could expose them to personal liability, criminal sanction and risk.

Below is an overview of the potential claims and potential exposure for directors if the company is insolvent or at risk of insolvency.

Criminal Liability

Failure to file for insolvency in a timely manner constitutes a criminal offence; the same applies if the insolvency petition is not correctly filed. Directors may be sentenced to imprisonment up to three years (or up to one year in the case of negligence) or a fine. Furthermore, directors will be precluded from future director positions for a period of five years if convicted for failure to file for insolvency.

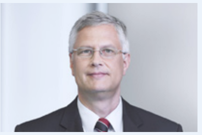
Personal (Civil) Liability

The insolvency administrator may hold directors personally liable if the company suffers damage as a result of violating directors' duties. There is a significant liability risk for directors arising from transactions at an undervalue or transactions detrimental to creditors, unless the insolvency administrator can successfully claw back the respective funds from the recipient under applicable claw back rules.

Directors may also be personally liable for:

- Payments made after the company became insolvent, which were not made with the diligence of a prudent businessperson even in an insolvency
- A failure to pay certain taxes and social security contributions
- Making payments to shareholders to the extent these payments result in the company becoming unable to pay its debts when due
- Repaying statutory share capital to shareholders in violation of statutory capital maintenance rules (including by way of upstream guarantees)

Contact



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Practical Tips to Mitigate Liability

- Directors should consider whether they can receive indemnification from the company or the shareholder.
- D&O insurance might be available for insolvency-related liabilities.
- Directors can mitigate their risk by acting upon resolution of the shareholders or if the shareholders ratify the directors' previous actions (although this may be ineffective against company claims).
- Properly document the basis for decisions.
- Avoid transactions at an undervalue or preferential treatment of specific creditors, unless these are justified by extraordinary circumstances (and such circumstances should be properly documented). Directors should also consider requesting shareholder approval for such transactions.
- Prepare and review short-term and mid-term liquidity forecasts to assess whether the company is illiquid and, therefore, obliged to file for insolvency and to help determine whether the company can survive the crisis.
- Consider appointing restructuring legal advisors, as well as auditors, to support the company to confirm the positive going concern prognosis, in case of over-indebtedness.
- If the company is insolvent but the directors do not file for insolvency immediately and want to use the three-week period (at the end of which they would otherwise have to file for insolvency) to come out of insolvency, any payment made by the directors during this time needs to be reviewed very carefully. There are multiple German court decisions, which have clarified the scope of allowed payments in a very restrictive manner, and the directors should seek legal advice as to which payments may be made.

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