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by Wolfgang Kessler and Rolf Eicke

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Germany passed legislation on September 19 that modifies the GmbH Act (GmbH-Gesetz), the Insolvency Act (Insolvenzordnung), and the Stock Company Act (Aktiengesetz). The legal measure, called MoMiG (Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen), will enter into force on November 1.

Background

In 1892 Germany created a legal form that not only turned out to be very successful, with almost 1 million companies in Germany today, but also influenced and shaped the nature of limited liability companies in Austria, Switzerland, and even Japan. The GmbH (Gesellschaft mit beschränkter Haftung, literally translated as ''company with limited liability'') is the legal form of choice for both midsize domestic companies and subsidiaries of multinational foreign companies that operate in Germany.

After decades of the GmbH being unchallenged, the European Court of Justice opened the floodgates and enabled foreign legal forms such as a U.K. limited to set foot in Germany. The ECJ found that not accepting a company that was established in an EU member state violates EC law. In the aftermath of the famous *Überseering* (C-208/00) and *Inspire Art* (C-167/01) decisions, the U.K. limited and other legal forms received a lot of attention in German corporate and tax law. Interestingly, one of the first foreign legal forms to operate in German territory without losing its legal identity was the so-called Delaware corporation, as stipulated in the Treaty of Friendship between the United States and Germany in 1954.

In the meantime, more than 65,000 U.K. limiteds were founded in the United Kingdom and transferred to Germany. This legal form is popular with craftspeople, butchers, and hairdressers, but also is popular as a subsidiary for multinational companies. Obtaining a limited liability for only £1 minimum capital is for most of them very tempting compared with the €25,000 minimum capital stock that is necessary to establish a German GmbH. Moreover, a U.K. limited can be ordered via the Internet and is set to go within a few days, and therefore is much more convenient than the lengthy formation process for the GmbH. In addition, international start-up companies and Anglo-American investors like this legal vehicle to do business in Germany. The U.K. limited is more familiar for them and therefore easier to deal with than the unknown GmbH.

MoMiG Reform

It took some time, but Germany finally reformed the GmbH in a way that enables the GmbH to fight back on its home base. The MoMiG constitutes nothing less than the biggest GmbH reform in 115 years. Earlier reform attempts failed in 1937 and 1971-1973, because they pursued a regulation approach by adapting principles of the Stock Company Act to the GmbH Act. In contrast, the MoMiG follows a deregulation approach, making the formation and the day-to-day business easier and faster. It also uses tougher legal measures in times of crisis and in cases of abuse.

Therefore, one of the main goals is to offer a faster and cheaper formation of a GmbH, establishing a level playing field with the U.K. limited in Germany. The other key goal of the reform is to protect business partners and creditors against abusive behavior by GmbH directors and GmbH shareholders.

Model Protocol

The new regime provides for a model protocol to facilitate the formation of a GmbH, lower the notary costs, and accelerate the formation process. The model protocol is an annex to the GmbH Act and combines the shareholder agreement, the assignment of a director, and a list of shareholders in one document. However, the model protocol can be applied only to standard formations with a maximum of three shareholders and one director. A notary must certify the protocol. A previous draft provided for a model shareholder agreement that required only the notarization of the signatures of the GmbH founders.

Moreover, the control rights and duties of the registry courts are reduced regarding the valuation of cash and property contributions. Also, a GmbH can be registered regardless of any administrative approvals. The same will apply for future registrations of stock corporations (Aktiengesellschaft).

Raising Capital

The treatment of hidden contributions of property often has been a bone of contention in practice. Currently, a hidden contribution of property results in the cash contribution being considered not performed and the acquisition of property being deemed null and void. The new regime simplifies this subject matter by introducing a credit approach. It provides that the hidden contribution of property will be credited against the cash contribution duty of the shareholder after the GmbH is registered in the commercial register. Thus, the contribution is valid and the shareholder is only liable for the difference in value. Yet the shareholder bears the burden of proof regarding the value of the contributed property. The crediting itself will be executed automatically by law.

A similar problem is the ''back-and-forth payment'' when a cash contribution is agreed on and performed but the company pays back the money by making a loan to the shareholder. Currently, the cash contribution is deemed as not performed. Under the new regime, the contribution is valid as long as the GmbH obtains a valid, valuable, and liquid receivable against the shareholder in return. The new framework could affect cash pool systems, which suffer from the detrimental legal consequences of the current regime.

It is important to note that the new regime does not compromise the duty to raise capital, but instead follows a more balance-driven approach.

Shareholder Loans

The reform will have a major impact on shareholder loans. Currently, a GmbH is prohibited from granting a loan to the shareholder if the capital is not derived from free reserves or profit carryforwards. A violation of this rule leads to a redemption of the loan.

Under the new regime, the transaction will be valid if the GmbH obtains a valid and valuable receivable against the shareholder. This also facilitates the implementation of cash pool systems.

Moreover, the new regime abandons the legal figure of the debt/equity substitution of shareholder loans. It provides that if a shareholder grants a company a loan in times of crisis in a situation in which a prudent businessperson would have contributed equity the loan is treated like equity. The payback of such a loan is not permitted.

Under the new regime, the loan can be paid back even in times of crisis, eliminating the practical problem to determine whether there actually was a ''time of crisis'' when the loan was paid. In the future, all shareholder loans, not merely those considered as a substitute for equity, can only be redeemed as a subordinate claim in the insolvency proceedings.

> **A key goal of the reform is to protect business partners and creditors against abusive behavior by GmbH directors and shareholders.**

Regarding the figure of usage/equity substitutions, the lawmaker developed a solution that has been derived from the Austrian Insolvency Act. If a shareholder grants the company the right to use an asset, the shareholder cannot claim a special selection of the assets in case of insolvency for no more than one year if the asset is necessary to continue the business operations. During that time the shareholder will be compensated on the basis of the remuneration paid in the year before the beginning of the insolvency proceedings.

The reform also allows the creation of authorized capital stock, thereby increasing the capital flexibility of the GmbH. It provides that the shareholders can authorize the director for a maximum of five years to increase the capital stock in the amount of 50 percent of the capital stock present at the time of authorization.

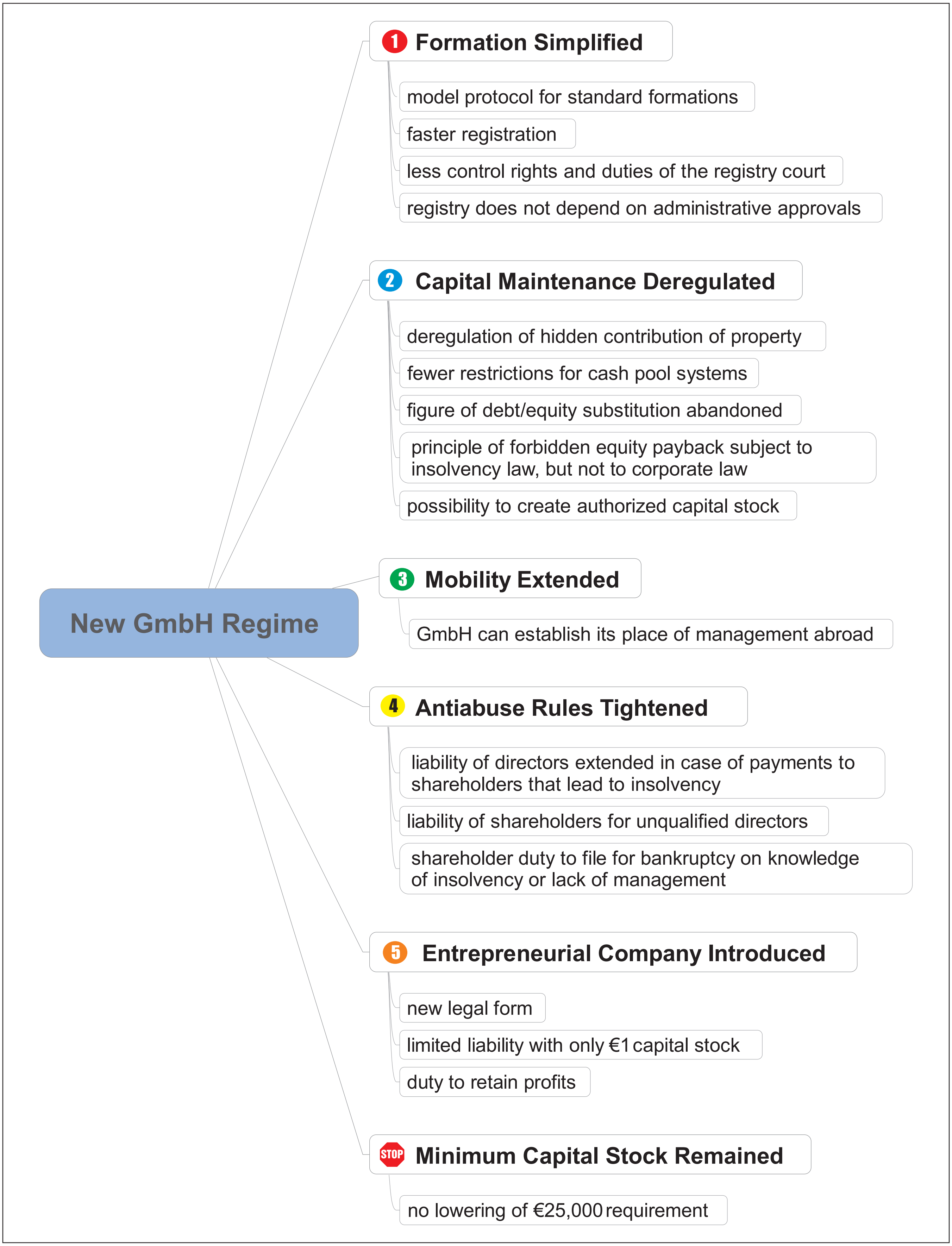
The new rules on capital maintenance and shareholder loans show that some of the key legal framework of the GmbH will be governed by insolvency law instead of corporate law in the future.

Abuse and Liability

The implementation of a more liberal capital maintenance regime goes along with a tightening of liability rules. Once a shareholder gains knowledge of insolvency or a lack of management, there is a requirement to file for bankruptcy. The same duty will apply to the members of the supervisory board of a stock corporation (Aktiengesellschaft). Moreover, a director of a GmbH will be held liable for payments to shareholders that lead to insolvency. At last, the shareholders will be held liable if they deliberately or negligently authorized an incompetent director.

Mobility

To enable a GmbH to operate from abroad, the new regime permits a divergence between the statutory seat (Germany) and the place of management. The latter can be transferred abroad.



New GmbH Regime

- 1 Formation Simplified
  - model protocol for standard formations
  - faster registration
  - less control rights and duties of the registry court
  - registry does not depend on administrative approvals
- 2 Capital Maintenance Deregulated
  - deregulation of hidden contribution of property
  - fewer restrictions for cash pool systems
  - figure of debt/equity substitution abandoned
  - principle of forbidden equity payback subject to insolvency law, but not to corporate law
  - possibility to create authorized capital stock
- 3 Mobility Extended
  - GmbH can establish its place of management abroad
- 4 Antiabuse Rules Tightened
  - liability of directors extended in case of payments to shareholders that lead to insolvency
  - liability of shareholders for unqualified directors
  - shareholder duty to file for bankruptcy on knowledge of insolvency or lack of management
- 5 Entrepreneurial Company Introduced
  - new legal form
  - limited liability with only €1 capital stock
  - duty to retain profits
- STOP Minimum Capital Stock Remained
  - no lowering of €25,000 requirement

Entrepreneurial Company

The new regime provides for the legal background to create an unprecedented legal form that grants a limited liability with a capital stock of only €1 (Unternehmergesellschaft, or entrepreneurial company). The company must be labeled ''Unternehmensgesellschaft (haftungsbeschränkt)'' or ''UG (haftungsbeschränkt).'' This ''mini-GmbH'' takes away from the attractiveness of U.K. limiteds transferred to Germany. Yet one important difference will remain. The Unternehmergesellschaft has to comply with a duty to retain profits by establishing a statutory reserve, to which a quarter of the profit surplus of the previous year is added annually. The reserve can be used for an increase of capital (from company assets) or to balance out a loss or a loss carryforward of the previous year. The company escapes from the duty to retain profits once the capital stock is higher than €25,000. In that case, the company turns into a ''classic'' GmbH.

Minimum Capital Stock

An early goal in the legislative process that has not been realized was the lowering of the minimum capital stock. In fact, the draft version of the government proposed to lower the minimum capital stock from €25,000 to €10,000. The lower threshold was supposed to attract more small businesses for the GmbH and thereby offer an alternative to the U.K. limited. However, in the final stage of the legislative process, this proposal was dropped, so the minimum capital stock will remain at €25,000 for the ''classic'' GmbH. The reasoning behind this move was that the new regime already offers the formation of an entrepreneurial company, which is an attractive legal form for small businesses.

GmbH in International Tax Planning

Since many GmbHs are owned by multinational corporations with the purpose to organize and execute operations in Germany, the new legal framework will affect international tax planning. Because of the deregulation, the handling of the day-to-day business will get easier with fewer restrictions to comply with. If a GmbH or a stock corporation (Aktiengesellschaft) functions as a finance company, the less restrictive capital maintenance rules offer much more leeway for cash pool systems. Overall, the GmbH has become an even more attractive vehicle for international tax planning.

However, nothing has changed regarding the tax treatment and the tax burden. A GmbH (like a limited) is subject to taxation under the Corporate Income Tax Act (Körperschaftsteuergesetz, or KStG) and the Trade Tax Act (Gewerbesteuergesetz, or GewStG). Thus, the tax burden is at 15 percent corporate income tax, 14 percent trade tax (on average), and 0.83 percent solidarity surcharge on the level of the GmbH. For a profit distribution, the shareholders are currently either tax exempt (corporations), or partially tax exempt (partnerships and individuals). Beginning January 1, 2009, the flat and final tax (Abgeltungsteuer) will enter into force, taxing profit distributions to individuals at a final rate of 25 percent plus a solidarity surcharge and church tax.

Outlook

The reform of the GmbH regime is a major leap forward to take on the competition with the U.K. limited and other foreign LLCs. With the new offspring of the classic GmbH, the entrepreneurial company, Germany offers a legal vehicle for small businesses to limit the liability. A new competitor is on the horizon.

Following a recent European Commission announcement, there might be a European-GmbH or European-Limited (so-called Societas Privata Europaea) in the long run, mirroring the opportunities European stock companies already have when they transform into a European corporation (so-called Societas Europaea). However, a European-GmbH would likely focus on cross-border business operations and thus would not be a serious option for companies that operate purely domestically. For the sake of the diversity of legal forms, there is hope that the next evolutionary milestone regarding LLCs in Europe is not 115 years away. ◆

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