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DIRECTORS' LIABILITY IN GERMAN LAW

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Abstract:

This article provides a comprehensive overview of the legal responsibilities and liabilities of directors under German law. It explains the distinctive features of Germany's dual-tier corporate governance system and outlines the duties and obligations imposed on directors. Key aspects covered include the Business Judgment Rule, duties of care and loyalty, and the liability of directors in cases of insolvency and actions brought by minority shareholders and creditors.

Keywords: German Corporate Law, Dual-Tier System, Duty of Care, Duty of Loyalty, Derivative Claim, Minority Shareholder Rights.

Under German corporate law, companies operate within a two-tier system comprising the managing board and the supervisory board as separate entities. In stock corporations (Aktiengesellschaft/AG), the supervisory board appoints the directors of the managing board, while in limited liability companies (Gesellschaft mit beschränkter Haftung/GmbH), this is done by the shareholders[1]. The supervisory board's role is to oversee and regulate the management, and it also represents the company in disputes involving the management board's directors. This structure plays a crucial role in defining the scope of directors' liability in Germany.

Directors' duties in German law

Like in other jurisdictions, directors in German companies are obligated to act in the company's best interest and with due diligence. They owe the company fiduciary duties, including a duty of care, and face liability for any breach of these duties. The extent of the duty of care is contingent upon each director's individual skills, knowledge, and experience, requiring them to act as a prudent and diligent manager according to their capabilities[2]. In German law, the concept of directors' liability extends to include *de facto* directors, also known as shadow directors. This encompasses individuals who perform the roles and responsibilities typical of directors without having been formally appointed to the position[3]. The "Business Judgment Rule" in Germany, established in 2005, applies to members of the management board and is also significant for supervisory directors. It mandates that directors make decisions based on adequate information and with the sincere conviction that their actions serve the company's best interests[4]. The rule asserts that a director is not in violation of their duty if they make a business decision under the reasonable belief that they are operating with sufficient information and in a manner that aligns with the company's best interests[5]. In accordance with §93 (1) of the German Stock Corporation Act (AktG), it is expected that managing directors have solid grounds for believing they were making decisions based on sufficient information and in the company's interest at the time they undertook entrepreneurial actions[6]. This stipulates that managing directors should concentrate on enhancing the company's value and profitability, as well as boosting its competitiveness. They will be deemed to have violated their duties if they make an erroneous risk assessment in an entrepreneurial

[1] Katharina Haehing VON LANZENAUER, Oliver SIEG, "Germany", in Edward SMERDON, *Directors' liability and Indemnification (Second Edition)*, London, Global law and Business, 2011, pp. 181-196, p. 181.

[2] §93 (1) of AktG. Andreas CAHN, David C. DONALD, Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, Cambridge University Press, 2010, pp. 369-370.

[3] Dr Christoph SCHOTTE, "Germany", in J. WILLIAM BOONE, Alston & Bird LLP (Eds.), International Insolvency: Jurisdictional comparisons (Third edition), London, European Lawyer Reference Series, 2012, pp. 183-203, p. 192.

[4] In this sense, Andreas CAHN, David C. DONALD, Comparative Company Law…, op. cit., p. 392.

[5] Paul DAVIES, Klaus J. HOPT, Richard NOWAK, Gerard VAN SOLINGE (Editors), Corporate Boards in Law and Practice: A Comparative Analysis in Europe, op. cit., p. 321.

[6] §93 (1) of AktG.

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decision, leading to irresponsible action[7]. In line with §116 of the AktG, the duty of care standard set out in §93 of the AktG is also applicable to supervisory directors for assessing whether they have acted within their scope of competence. As noted earlier, the primary responsibility of supervisory directors is to oversee the company's management. This duty of care entails scrutinizing the accounting books, records, and the company's assets[8]. They are obligated to stay updated on the authenticity of the company's critical information and ensure the proper maintenance of corporate capital and other assets.

Additionally, under German Law, managing directors have a duty of loyalty to the company. This duty originates from the good faith provisions in the BGB (German Civil Code) and forms the foundation for managing conflicts of interest between the directors and the company[9]. The duty of loyalty involves protecting the company's interests, which means that managing directors are bound by stringent non-compete agreements both during and after their tenure. This duty compels them to prioritize the company's potential gains and refrain from exploiting corporate opportunities for personal gain. Additionally, managing directors must avoid unlawful distributions from the company's assets. This often happens in scenarios where indirect reimbursements or the distribution of concealed dividends to shareholders occur[10]. Furthermore, regarding accounting, the duty of loyalty mandates that managing directors are responsible for maintaining accurate accounting records, while supervisory directors are tasked with verifying the authenticity of these documents' contents[11].

In specific situations, supervisory directors also have a duty of loyalty to the company. For instance, the management board is required to keep confidential all vital business matters, trade secrets, or other proprietary information of the company, and these obligations are similarly applicable to supervisory directors[12].

Additionally, the duty of loyalty entails that supervisory directors must appropriately determine the remuneration of managing directors in line with their competence. Failure to do so may result in supervisory directors being held accountable for any damages arising from a breach of this duty of loyalty[13].

The duty of care and the duty of loyalty form the fundamental fiduciary responsibilities of directors to the company under German law. Consequently, if members of either the managing or supervisory board act in contravention of these fiduciary duties, they should be held collectively and individually responsible[14]. Under French Law, a company contesting a director's behavior must show that the company incurred specific harm due to the director's misconduct. On the other hand, in German law, directors are required to establish that they acted with the care of a prudent businessperson and that any damage the company suffered did not result from their managerial actions in order to be exonerated[15].

Under German Law, which employs a dual-tier board system, there are two mechanisms for initiating a corporate action. One approach allows supervisory directors to take action against members of the managing board for their misconduct[16]. Alternatively, managing directors also have the capability to initiate a corporate action against members of the supervisory board who have engaged in unlawful activities[17].

A derivative action filed by minority shareholders or creditors

When neither the managing nor supervisory board initiates a corporate action, shareholders have the option to file a derivative claim in the company's name. In a stock corporation (AG), an individual shareholder is not entitled to sue the managing or supervisory

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[7] Katharina Haehing VON LANZENAUER, Oliver SIEG, "Germany", loc. cit., pp. 185-186. Mads Tønnesson ANDENÆS, European Comparative Law, Cambridge, Cambridge University Press, 2009, p. 271.

[8] §111 of AktG.

[9] International Business Publications, German Company Laws and Regulations Handbook: Strategic Information and Basic Regulations (Volume I), Washington, International Business Publications, 2012, p. 39.

[10] §93(3) of AktG and §43(3) of GmbHG. Alexander LOOS, "Germany", in Alexander LOOS (Editor), Directors' Liability: A Worldwide Review, The Hague, Kluwer Law International, 2010, pp. 379- 388, pp. 381-384.

[11] §91 of AktG, and §41 of GmbHG. Frank DORNSEIFER, "Germany", in Frank DORNSEIFER (Ed.), Corporate Business Forms in Europe: A Compendium of Public and Limited Companies in Europe, München, Sellier/European Law Publishers, 2005, pp. 211-294, pp. 252-253.

[12] §116 (2) of AktG.

[13] §116 (3) of AktG.

[14] §117 (2)(1) of AktG.

[15] §117 (2)(1) of AktG, Theodor BAUMS, "Personal Liability of Company Directors in German Law", pp. 1-20, p. 11. The article is available on the website: http://www.jura.uni- frankfurt.de/43029388/paper35.pdf.

[16] Petri MÄNTYSAARI, Comparative Corporate Governance: Shareholders as Rule-maker, Berlin/Heidelberg/New York, Springer, 2005, p. 321.

[17] §§ 77 and 78(1) of AktG.

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directors on behalf of the company[18].

Per §147 of the AktG, a minority group of shareholders, collectively owning at least 10% of the company's capital or shares amounting to a total value of 1 million euros, have the right to designate specific representatives to pursue such a claim[19]. Nevertheless, if the company is unsuccessful in the lawsuit, these minority shareholders are obliged to compensate the company for its losses and cover the legal expenses. Hence, due to the potential risk involved, minority shareholders rarely exercise this provision in legal proceedings[20].

Contrasting with §147 of AktG, where minority shareholders must appoint a representative to bring a claim against directors, §148 of AktG, introduced in the 2005 reform, allows minority shareholders to directly file a derivative claim themselves against directors. Minority shareholders who collectively possess shares amounting to 1% or more of the company's capital, or a minimum of 100,000 euros in value at the time of filing the petition, are authorized to assert a claim on the company's behalf for any incurred damages[21]. To safeguard against frivolous lawsuits by minority shareholders and ensure only valid claims are pursued, German law empowers courts to assess the admissibility of such derivative claims. In this context, certain factors must be demonstrated for a claim to be considered: the shares must have been acquired before the alleged duty breaches occurred, the company must have suffered a loss due to serious legal violations or breaches of bylaws, and there should be no prevailing interests of the company that could invalidate the claim[22].

According to §93(5) of the AktG, if a stock company's assets are insufficient to cover all its debts, creditors have the right to file a claim against the directors for breach of their duties[23]. It's important to note that a derivative claim in this context is not intended to establish a direct liability framework for creditors against directors. Instead, its purpose is to recuperate losses that the company itself has sustained[24]. The compensation from such a claim is directed to the company, not to the creditors. However, creditors may indirectly receive compensation through the process of insolvency proceedings.

A personal action filed by individual shareholders

Under German law, as directors owe fiduciary duties solely to the company, shareholders individually cannot file a claim against directors based on their directorial role. Consequently, personal claims are generally not permissible under company law. However, general tort law, as outlined in §§823 (1) (2) and §826 of the BGB, offers a liability framework for individual shareholders against directors. This is based on the violation of specific protective statutes and permits compensation for purely economic losses[25]. Such claims, however, are only viable when managing directors commit an act of tort that does not stem from their role as directors and directly impacts individual shareholders. In situations like these, claims for indirect damages resulting from the devaluation of shares are not considered admissible[26].

However, in exceptional cases, individual shareholders are permitted to directly file a claim against managing directors[27]. For instance, §31 (6) of the GmbHG stipulates that managing directors who are culpable in relation to such repayments are collectively and individually liable to shareholders for the reimbursement of these repayments[28]. Additionally, as per §117 (1) and

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[18] Theodor BAUMS, "Personal Liability of…", loc. cit., p. 12.

[19] §147(1) and §147(2) of AktG, A. J. BOYLE, Minority Shareholders' Remedies, op. cit., p. 47.

[20] Hans C. HIRT, *The Enforcement of Directors' Duties in Britain and Germany –A Comparative Study with Particular Reference to Large Companies*, Bern, Peter Lang, 2004, p. 302. Xiaoning LI, "On the Recent Reform of the German Stock Companies Act Concerning the Shareholders' Derivative Action", *Journal of Hunan University (Social Science)*, Vol. 23, No. 3, 2009, pp. 136-141, p. 138.

[21] §148(1) of AktG.

[22] §148(1) of AktG. Katharina Haehing VON LANZENAUER, Oliver SIEG, "Germany", loc. cit., pp. 187-188.

[23] §93 (5)(1) AktG. Thomas STOHLMEIER, German Public Takeover Law: Bilingual Edition with an Introduction to the Law, The Hague, Kluwer Law International, 2002, p. 15.

[24] Jean J. DU PLESSIS, Bernhard GROßFELD, Claus LUTTERMANN, Ingo SAENGER, Otto SANDROCK, Matthias CASPER, German Corporate Governance in International and European Context (Second Edition), Berlin/Heidelberg/New York, Springer, 2012, p. 84.

[25] §§ 823 (1) (2) and § 826 of BGB. In this sense, Katharina Haehing VON LANZENAUER, Oliver SIEG, "Germany", loc. cit., p. 184.

[26] Fernando Marín DE LA BÁRCENA, La acción individual de responsabilidad frente a los administradores de sociedades de capital (art. 135 LSA), Madrid, Marcial Pons, 2005, p. 55.

[27] Frank MONTAG, Klaus HEINEMANN, "The European Community", in Christian CAMPBELL (Editor), International Liablity of Corporate Directors [2007]II, New York, Yorkhill Law Publishing, 2007, pp. 339- 360, p. 353.

[28] §31 (6) of GmbhG. Frank MONTAG, Klaus HEINEMANN, "The European Community", loc. cit., p.

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(2) of the AktG, an individual shareholder has the right to claim compensation for losses incurred when other shareholders or third parties deliberately induce directors to act in violation of the general standard of a board member's duty of care, resulting in harm to the company. In such instances, the individual shareholder may initiate legal action against both the board members and those who influenced them[29].

Furthermore, in accordance with some special rules in relation to securities market, directors may be held liable for a loss sustained by individual shareholders. For example, the failure to release *ad hoc* notices[30], or the publication of false information on the current financial status of the company will be one of the reasons for the shareholders to incur liability to directors[31].

A personal action filed by creditors or other third parties

Like their relationship with shareholders, directors are also non-contractually linked with creditors and other third parties. Generally, creditors or third parties cannot directly initiate a personal lawsuit against directors for their misconduct; instead, they are expected to seek recourse from the company. However, §§823 (1) (2) and §826 of the BGB provide a pathway for creditors to pursue claims against directors based on external liability. Directors may be held accountable if they commit a tortious act outside the scope of their directorial role. To establish a tort-based claim, three elements must be present: an intentional wrongful injury, a breach of explicit statutory provisions where such violation justifies compensation, and wilful or negligent breaches of certain defined rights or protected interests, such as life, health, or property[32]. However, damages incurred by creditors or other third parties often do not become apparent until the company enters into insolvency[33].

In exceptional cases, managing directors of a GmbH (limited liability company) can be held directly liable to creditors. As per §311 (2) of the BGB, a managing director can be liable to a contractual partner of the GmbH due to a breach of a "culpa in contrahendo" (fault in conclusion of a contract) obligation. This applies if the partner relied on the managing director's specialized knowledge and trustworthiness, or if the managing director had a direct economic interest in the transaction in question[34]. Additionally, a breach of a "culpa in contrahendo" obligation may occur if directors delay filing for the company's insolvency and allow the company to enter into new contracts with creditors (often referred to as "new creditors")[35]. We'll proceed with this discussion in the following part.

Directors' liability in the insolvency proceedings

In a financially stable company, directors are expected to prioritize the best interests of the company and its collective body of shareholders. However, when a company faces bankruptcy, the primary goal of the insolvency proceedings shifts to distributing the remaining corporate assets among creditors and finalizing the company's closure. Consequently, the focus of interest moves from shareholders to creditors during these proceedings. As per §42 (2) of the BGB, directors are obligated to file for insolvency if the company is insolvent or over-indebted. Should they delay or fail to file for insolvency, directors may be collectively held responsible for any damages incurred by the company's creditors[36]. As it is understood, a director bears the ongoing responsibility to monitor the solvency status of their company. In this context, if a managing director fails to promptly undertake all necessary measures for either the rehabilitation or liquidation of the company, they would be accountable for breaching their obligations[37]. This obligation extends

353. Fernando Marín DE LA BÁRCENA, La acción individual…, op. cit., p. 54.

[29] §117 (1)(2) and §117 (2)(3) of AktG. Petri Mäntysaari, Comparative Corporate Governance…, op. cit., p. 324.

[30] Julia REDENIUS-HOEVERMANN, La responsabilité des dirigeants…, op. cit., pp. 102-112.

[31] Theodor BAUMS, "Personal Liability of…", loc. cit., p. 15.

[32] Theodor BAUMS, "Personal Liability of…", loc. cit., p. 14.

[33] Katharina HaehLing VON LANZENAUER, Oliver SIEG, "Germany", loc. cit., p. 188.

[34] Frank MONTAG, Klaus HEINEMANN, "The European Community", loc. cit., p. 353. Fernando Marín DE LA BÁRCENA, La acción individual…, op. cit., p. 313. Jesús Alfaro ÁGULA-REAL, "La llamada acción individual de responsabilidad o responsabilidad 'externa' de los administradores sociales", Indret, 1/2007, pp. 1-18, pp. 14-15.

[35] Jesús Alfaro ÁGULA-REAL, "La llamada acción individual de responsabilidad contra los administradores sociales", pp. 1-54, p. 54, this article is available on the website: http://www.estig.ipbeja.pt/~ac_direito/individual.pdf.

[36] § 42 (2) of BGB, Rafael ARENAS GARCÍA, "Suing directors in international litigation", in S. GRUNDMANN, Unternehmen, Markt und Verantwortung, Berlin/New York, Walter de Gruyter, 2010, t. I, pp. 321-335 (p. 331).

[37] Ulrich HUBER, Mathias HABERSACK, "Special Rules for Shareholder Loans: Which Consequences Would Arise For Shareholder Loans if the System of Legal Capital Should be Abolished?", in Marcus LUTTER (Ed.), Legal Capital in Europe, Göttingen, European Company and Financial Law Review (Special Volume), De gruyter, 2006,

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not only to formally appointed directors but also to *de facto* directors, those who effectively perform the role without official appointment[38].

In German law, the duty to file an insolvency petition is considered a protective law matter, as outlined in §823 (2) of the BGB[39]. Additionally, according to §15 (a) of the InsO (German Insolvency Statute), directors are required to file for insolvency proceedings within three weeks of the company becoming insolvent or over-indebted. Failing to fulfill this obligation can result in directors facing both civil and criminal liabilities[40]. Additionally, under §92 (2) of the German Stock Corporation Act (AktG), §64 (1) of the Limited Liability Companies Act (GmbHG), and §823 (2) of the German Civil Code (BGB), directors are not only accountable for delays or failures to file for insolvency proceedings. They are also responsible for reimbursing any improper payments made by the company to third parties when the company's assets are insufficient to cover its debts[41]. This responsibility arises particularly when payments are made to shareholders after the company becomes insolvent or when its over-indebtedness is established[42].

However, a key aspect of the German liability framework is that directors are collectively responsible for any harm creditors suffer due to delayed or neglected filings for insolvency proceedings[43]. In this context, the responsibility falls not on the company alongside the directors, but squarely on the board members (directors) as a collective. Under such circumstances, creditors' ability to recoup losses is constrained to the shortfall experienced because of the filing delay. This loss equates to the discrepancy between the recovery rate achievable through prompt filing and the actual recovery rate achieved (termed "rate reduction loss")[44]. Therefore, establishing a direct link between the directors' mismanagement and the diminished corporate assets resulting from the delay or failure to initiate insolvency proceedings is essential.

As previously noted, the purpose of this liability is to provide restitution for losses incurred by creditors as a result of directors' wrongful actions[45]. This allows creditors to pursue legal action based on the directors' violation of a non-contractual duty. Nonetheless, according to §92 of the Insolvency Code (InsO), claims for compensation for damages suffered by creditors due to the devaluation of the corporate assets, either before or after the initiation of insolvency proceedings, can only be filed by insolvency administrators during these proceedings[46]. This stipulation does not alter the tort-based character of such claims.

In German legal theory, the concept of "new creditors" is notably discussed. These "new creditors" are those who have inadvertently provided additional credit to a company after the point when insolvency proceedings should have been initiated. Unaware of the company's insolvency, these creditors would not have engaged in transactions with the company under normal circumstances[47]. As previously explained, German jurisprudence acknowledges a 'culpa in contrahendo' duty that directors owe to these "new creditors". The Bundesgerichtshof (BGH, Federal Court of Justice of Germany) has ruled that "new" and "old" creditors must be treated distinctly, in line with the fundamental principles of damage and causation[48]. his means that "new creditors" can directly pursue claims against directors for the loss of their reliance interests, and such claims can be filed outside the scope of insolvency proceedings. Conversely, "old creditors" are limited to making claims through insolvency administrators during insolvency proceedings, specifically for losses pertaining

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pp. 308-324, p. 323.

[38] Dr Christoph SCHOTTE, "Germany", loc. cit., p. 192.

[39] Mattias CASPER, "Liability of the Managing Director and the Shareholder in the GmbH (Private Limited Company) in Crisis", German Law Journal, Vol. 9, No. 9, 2008, pp. 1125-1140, p. 1137.

[40] § 15 (a) (4) of InsO. Manuel LADIGES, "Criminal liability of directors of a private limited company seated in Germany", Criminal Law Forum (2013) 24, pp. 87-111, p. 98.

[41] § 92 (2) of AktG, § 64 (1) of GmbHG, and § 823 (2) of BGB.

[42] § 93 (3) (6) AktG, Martin SCHULZ, Oliver WASMEIER, The Law of Business Organization: A Concise Overview of German Corporate Law, Berlin/Heidelberg/New York, Springer, 2012, p. 33.

[43] §42 (2) of BGB, Rafael ARENAS GARCÍA, "Suing directors in…", loc. cit., p. 331.

[44] §823 (2) of BGB. Carsten GERNER-BEUERLE, Edmund SCHUSTER, "The Costs of Separation: Friction between Company and Insolvency Law in the Single Market", LSE Legal Studies Working Paper, No. 6/2014, pp. 1-44, p. 26.

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[48] BGH 6 June 1994, II ZR 292/91. Thomas BACHNER, "Wrongful Trading…", loc. cit., p. 317, and Nuria BERMEJO GUTIÉRREZ, Elena RODRÍGUEZ PINEAU, "Normas de protección de acreedores…", loc. cit., p. 15.

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to the insolvent estate[49].

In conclusion, German corporate law offers a comprehensive framework governing the duties and liabilities of directors. This framework ensures that directors act responsibly and in the best interest of the company, its shareholders, and creditors, with specific provisions tailored to address various scenarios, including insolvency and breaches of fiduciary duties. This structure serves to maintain a balance between enabling effective corporate governance and protecting the interests of all stakeholders involved.

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