

Corporate Finance/M&A - Germany

'Phoenix' and 'Cuckoo' Businesses: Liability Risks Related to Business Transfers

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A recent Federal Court of Justice ruling highlights the risks of taking over and carrying on an existing business using a business name which is identical or similar to that used previously. Any party partaking in an asset deal involving the transfer of German business operations must be aware of several pitfalls in order to avoid liability.

General Risks Related to Asset Deals

It is acceptable under German law to establish a new company that takes over the failed business of an existing company and runs it under an identical or similar name. There are no so-called 'prohibited names' (as under UK law), and there is no particular liability of the directors. However, there are certain risks generally related to the transfer of a business through an asset deal:

- Where the consideration for the transferred business is unfair and the former owner becomes insolvent, an insolvency receiver or (if none has been appointed) the creditors may subsequently ask a court to avoid the transaction (Section 129 of the Insolvency Code);
- Where business units are transferred by way of an asset deal, the employees belonging to such units will be transferred to the new business owner by operation of law (Section 613a of the Civil Code. This provision is based on EU law); and
- Tax liabilities referring to the business will also be transferred to the new business owner, but limited to the value of the transferred assets (Section 75 of the Tax Code).

Liability of Transferred Businesses

Under Section 25 of the Commercial Code, the new owner of a business is subject to unlimited liability for all debts of the former owner arising from the former business activity, if: (i) the new owner acquires (by means other than inheritance) the essential assets forming the relevant basis of the former business or a standalone branch (the acquisition of an irrelevant division which accounts for only 10% of the total business operations is not sufficient);⁽¹⁾ and (ii) the new owner carries on the business under the same name as previously. It is sufficient that the new name is so similar to the previous name as to suggest an identical business enterprise (eg, the names 'Industrie-Böden Salur Ltd' and 'Fussbodenbau Salur Ltd' have been deemed to be similar due to the retention of the distinctive 'Salur' part of the name.)⁽²⁾

The reasoning behind this liability is not completely clear. In particular, it not only applies to new companies arising from the ashes of failed enterprises (so-called 'phoenix companies') but applies regardless of whether:

- the former owner was insolvent at the time of the transfer of the business or became insolvent thereafter;
- the new owner paid a fair consideration for the business taken over; or
- the business remains under the direction of the same director after the transfer.

It is sufficient that the general public may be induced by the similar name and the assets taken over to believe that they are still dealing with the same business owner. However, liability under Section 25 of the Commercial Code is sometimes referred to as *Dummenhaftung* ('fools' liability'), since it can be easily avoided.

Exclusion of Liability

There is no liability under Section 25 where the former owner and new owner of the

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business agree that such liability is to be excluded, and: (i) such agreement is registered in due time after the business transfer in the Commercial Register and published in the electronic gazette; or (ii) the creditors are given notice of such agreement.

Nevertheless, new owners often overlook the need to make an explicit agreement to avoid liability. In particular, three pitfalls must be avoided.

Acquisition from or by a foreign company

Whether the business is acquired or sold by a foreign company is irrelevant; German courts will consider only the place of the transferred business.⁽³⁾ If that place is Germany, a foreign company as the new owner will be liable in the same way as a German company. Such liability could come as a nasty surprise to a non-German company which is involved in a transaction which includes the transfer of German business operations.

Acquisition of a distressed business

There is no liability where the new owner acquires the business from a court-appointed insolvency practitioner.⁽⁴⁾ However, there may be liability where the seller is only a provisional insolvency practitioner. In this case an explicit agreement to avoid liability is strongly recommended. An explicit agreement is always required where the business is acquired from a party-appointed liquidator.

'Cuckoo' business transfer

Recently, the Federal Court of Justice ruled on a case in which the sole shareholder and director of a German company established a new company with a name similar to that of the previous company and carried out similar business operations.⁽⁵⁾ The newly formed company operated from the same business address using the same phone and fax numbers as the old company, and used a similar letterhead. Three employees of the newly formed company previously worked for the original company. In addition, the newly formed company advertised its professional expertise by referring to the original company's past performance. Thus, like a cuckoo, the newly formed company laid the eggs of its business in the original company's nest.

However, no other assets had been transferred from the original company to the newly formed company. In particular, the original company continued to trade actively for more than 12 months, after which it became insolvent. It appeared that the insolvency was not due to the parallel business activity of the newly formed company, since the original company's business volume remained almost unaltered. There had been no agreement whatsoever between the original company and the newly formed company for the transfer of assets and, therefore, there could be no explicit agreement to exclude the newly formed company from liability. Nevertheless, the Federal Court of Justice found that the newly formed company was liable for the original company's business liabilities, as the general public had been induced to believe that the newly formed company and original company's businesses were one and the same. By 'nesting' with the original company, the newly formed company had assumed its features.

Comment

The treatment of 'phoenix' companies under German law is quite distinct from that in other jurisdictions (eg, the United Kingdom). A new owner that carries on an existing business under an identical or similar name as that used by the original company may face unlimited liability for all debts arising from the business activity of the original company. Although this liability can easily be excluded, there are several pitfalls which must be avoided. In addition, the transfer of a business, bit by bit, over an extended period without any explicit transfer agreement (a 'cuckoo' business transfer) may also trigger unlimited liability for the debts incurred by the original business.

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Endnotes

(1) Dusseldorf Higher Regional Court, Decision I-18 U 36/08, October 28 2008 (further appeal pending).

(2) Federal Court of Justice, Decision VIII ZR 192/06, September 24 2008 (NJW-RR 2009, 820).

(3) Dusseldorf Higher Regional Court, Decision 6 U 93/94, May 4 1995 (NJW-RR 1995, 1184-1185).

(4) Federal Court of Justice, Decision VIII ZR 192/06, September 24 2008 (NJW-RR 2009, 820) and Federal Labour Court, Decision 6 AZR 215/06, September 20 2006 (NJW 2007, 942).

(5) Federal Court of Justice, Decision VIII ZR 192/06, September 24 2008 (NJW-RR 2009, 820).

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