Legal Update
Corporate and Tax, Mergers & Acquisitions

Recent Case Law on the Liability of Investors and Trustees Acting as Limited Partners of Collective Investment Vehicles Organized as Limited Partnerships

(e.g., Federal Court of Justice decision of 24th July 2012/ZIP 2012, 1706 et seq.)

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The German courts, including the Federal Court of Justice, increasingly find themselves called upon to deal with shares in investment funds held through trustees; such schemes enable investors to acquire shares in a fund, usually legally organized as a limited or general partnership, through a trustee. The purpose and benefits of this trust model are to some extent the subject of dispute in the scholarly literature. The model is, however, very popular, not only among operators of investment funds but also among investors, since it offers considerable convenience; for example, it is often possible to dispense with notarization of the acquisition of shares in such companies and entry of the names of individual investors in the register of companies. This also gives investors access to an investment vehicle that ensures maximum discretion since no trace can be found in public registration records. On the other hand, although this type of investment vehicle does seem to offer interesting benefits, it also presents investors with serious problems, especially if the fund company should find itself in financial difficulty.

According to the established case law of the Federal Court of Justice, investors who acquire shares in partnerships through trustees and are therefore not shareholders in the formal sense are nevertheless to be treated as such. They are therefore exposed to the same risks as actual shareholders, i.e., as though they also owned their shares in the company directly. In addition, they may not offset claims against the trustee, which can result in a total loss of their investment, especially in the case of insolvency on the part of the fund company.

1. Recent Decision of the Federal Court of Justice

In a recent decision (Ruling of 24th July 2012 – II ZR 297/11), the Federal Court of Justice ruled that investors that acquire shares in a fund company through a trustee cannot offset claims for damages against the trustee-shareholder in order to avoid recourse by the company's creditors.

a) Headnote

In the case of partnerships in which investors can hold shares under a trust agreement that is designed so that trustors enjoy the same status as other – direct – shareholders within the company, they may not offset claims for damages arising from prospectus liability that they have against the trustee-shareholder against pecuniary claims arising from the right of the trustee-shareholder to be held harmless from claims of the company's creditors.

b) Facts

The Plaintiff is the general partner of a closed real estate fund organized as a general partnership. Acting in the capacity of trustee, the Plaintiff administers the investments of Defendants 1 and 2, who have agreed to hold the Plaintiff harmless from any claims for repayment of their proportionate shares of a loan brought by creditors of the fund company. The trust agreement does to be sure stipulate that the trustee is a shareholder in its own name, but that the contribution to capital inures to the trustors. The rights and obligations assumed by the trustee for the account of and in the interest of the trustors under corporate law, including any obligations to make further contributions to capital, were to pertain exclusively to the trustors. The statements made by the Defendants in the applications they signed upon joining the fund company stipulate that the managing partner authorized to represent the company will enter into agreements with third parties in the name of the company only if it is explicitly agreed that the liability of the other shareholders will be limited to an amount corresponding to their respective proportionate shares of the capital of the company. The articles of association also stipulate that the liability of the shareholders – with the exception of the managing shareholder – vis-à-vis one another will be limited to an amount corresponding to their respective proportionate shares of the capital of the company. When financial difficulties arose, the Plaintiff asked to be released from any liability towards creditors of the fund company by the Defendants. The Defendants then responded to the request of the Plaintiff by presenting claims for damages due to various misstatements in the offering prospectus.

c) Decision

The Second Civil Senate confirmed the Plaintiff's right to be held harmless from the claims of the creditors of the fund company against the Defendants arising from the trust agreement in conjunction with sections 675 and 670 of the German Civil Code (*Bürgerliches Gesetzbuch* – BGB). The fact that the Plaintiff first assigned the right to be held harmless to a creditor of the company and this right was then assigned back to the Plaintiff does not in any way affect the Plaintiff's right of action. The court ruled that such reassignment does not impair any legitimate interests of the debtor and serves to safeguard the legitimate interests of the Plaintiff and the creditor of the company. The Federal Court of Justice considers the question irrelevant and therefore did not rule on whether the creditor's claims to payment would have been reconverted into rights to be held harmless after reassignment to the Plaintiff. In any case, according to the court, the Plaintiff's right to be held harmless was converted into a claim for payment through the serious and final refusal of the Defendants to make payment in the proceedings pursuant to sections 280(1) and (3), 281(1) and (2) and 250 of the German Civil Code .

Referring to its ruling on the right to be held harmless of a trustee acting as limited partner that had been assigned to an insolvency administrator, the Federal Court of Justice completely rejected the possibility of allowing the Defendants to offset any claims for damages, stating that the question as to whether the claims for damages due to breaches of a duty of disclosure even existed in the first place need not be addressed. The court held that the relationship between the company and trustors is a fiduciary relationship with superimposed commitments

governed by corporate law and that the Defendants agreed in their applications not only to make contributions to capital, but also to cover liabilities towards the company's creditors with their personal assets. The court stated that this ruling also applied to general partnerships and that the liability of a shareholder of a general partnership was comparable with reinstated liability in the case of a limited partner. The fundamental reason for not allowing offsetting is that trustors in companies may not be privileged nor discriminated against as compared with direct shareholders. According to the court, this would apply equally to both corporate forms.

The court also saw no need to make a distinction as compared with cases in which an insolvency administrator of a fund company brings the claims of the creditor since it would not seem proper for the liability of the trustors to become greater after insolvency proceedings are initiated than they were prior to such proceedings.

d) Practical Implications

The decision of the Federal Court of Justice describes the legal consequences of administrative trusts (referred to as "artificial trusts", in which case trustees do to be sure become shareholders in their own name, but hold the contribution to capital exclusively for the account of and in the interest of trustors) that adopt the legal form of a general partnership in a manner that is detrimental to trustors. The court's decision is consistent in that it accords trustors who hold shares the same financial status as direct shareholders. This will therefore facilitate the situation of trustees as regards their liability in the context of such administrative trusts since trustees previously had to deal with the question as to who was responsible for the liabilities of the respective fund company. This has now been conclusively clarified in favor of trustees, whose purely administrative function has been confirmed by the Federal Court of Justice.

2. Outlook

According to the established case law of the Federal Court of Justice, investors who hold interests in investment companies through trustees are not to be treated better or worse than investors who hold their shares directly (see Federal Court of Justice, Ruling of 22nd March 2011 – II ZR 215/09, BeckRS 2011, 09691, para. 29). They therefore bear the full risk associated with their investment. It can therefore be anticipated that trustees will also continue to require that trustors hold them harmless from that percentage of the company's liabilities corresponding to their interests in the event the fund company finds itself faced with financial problems. Investors are therefore advised to familiarize themselves thoroughly with the benefits and possible disadvantages of investments in investment companies through a trustee.

Note

This overview is solely intended for general information purposes and may not replace legal advice on individual cases. Please contact the respective person in charge with GÖRG or respectively the author himself: Dr. Yorick Ruland on +49 221 33660-444 or by email to yruland@goerg.de. For further information about the author visit our website www.goerg.com.

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