Shareholders’ and creditors’ entitlements on insolvency: who wins where?

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If shareholders are treated as outside creditors, there will be less to go around for other creditors, particularly if the shareholder loan is secured. There is no *communis opinio* that one should provide shareholder loans with a less favourable treatment on a global level. The issue of shareholder loans has divided different legal systems with Germany and England at opposite ends of the spectrum and Austria and the US somewhere in between.

**Introduction**

In order to engage in business activities, companies need finance. From a corporate finance perspective, there are only two basic types of finance: debt and equity. Companies can be financed either by shareholders by means of equity contributions or by means of debt provided by creditors. The money lent by creditors has as its most important characteristic, a return independent of the success of the company, usually in the form of a fixed interest rate. The return on equity, on the other hand, is dependent on the success of the company. If the company makes a profit, this profit flows to the shareholders, either by means of dividends or, in case no dividends are paid, by an increase in the share value. In the case of failure of the company, shareholders are last in line. This can be seen as a principle of both corporate law and corporate finance and is usually referred to as “equity is wiped out first”.

Companies are commonly financed by a mix of equity and debt and the creditors and shareholders are usually not the same person. Both from a corporate finance and legal perspective, the interesting question is what happens if debt and equity are combined because the equity provider is also a creditor. By large and there are no legal rules that actually prevent or prohibit a shareholder from financing the company by way of loans. The main issue from a legal perspective is how to treat these loans on insolvency of the company. Are the shareholders allowed to claim repayment of their loans like normal outside creditors and demand a pro rata distribution? Or does the fact that the loan was provided by a shareholder warrant that the loan be subordinated to the claims of other creditors, meaning that payment on the shareholder loans will only be made after the creditors have been paid in full? And what about secured shareholder loans? Are shareholders allowed to invoke security rights granted to them and rank above outside creditors? Can they enforce their security by ignoring the insolvency payment waterfall procedure of “their” company?

There are strong arguments in favour of regulating shareholder loans, ranging from basic distributional fairness considerations to more economic efficiency arguments. There is, however, no *communis opinio* that one should provide shareholder loans with a less favourable treatment than loans from outside parties. Nor can one say that regulating shareholder loans is common practice in different jurisdictions. Critics and opponents of shareholder loans either argue that they do not find the argument in favour of a different treatment compelling, basically arguing that shareholders’ money is as green as any other money. Or they argue that there is a real risk of negative side effects, that can turn against creditors, and therefore against those whose interest the subordination rules might seek to protect. The key argument is that the downside of giving shareholder loans an unfavourable treatment in insolvency could deter shareholder finance in times of crisis, and could unnecessarily precipitate insolvency proceedings and ultimately harm creditors.

**Economic Effect of Financing by Way of Loans**

The clearest impact of shareholder loans is, of course, at the stage of distribution in insolvency. If the shareholders are allowed to share as outside creditors, there is less to go around for the other creditors. This effect will be stronger in the case of secured shareholder loans.

Where a company is not financed by capital, but by shareholder loans, the shareholder loans regularly make up more than 50% of the outstanding debt. This is the case in all jurisdictions. Subordinating shareholder loans will increase the percentage payout to normal creditors and the issue of subordination is key for jurisdictions that do not have clear rules on the subject.

See for example the US court decision in *Herby*, where the court analysed the impact on outside creditors of whether or not to subordinate:

> “While these deceptive practices were being perpetrated, the aggregate sums owed by Herby’s to its trade creditors increased by 3.7 million dollars. According to the record before us, the total amount distributable from Herby’s estate will approximate 2.1 million dollars. If the claims of the Insiders are allowed a ranking equal to that of the unsecured trade creditors, the Insiders would receive approximately 75% of Herby’s estate. This cannot be

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**Feature**

**KEY POINTS**

- If shareholders are treated as outside creditors, there will be less to go around for other creditors, particularly if the shareholder loan is secured.
- There is no *communis opinio* that one should provide shareholder loans with a less favourable treatment on a global level.
- The issue of shareholder loans has divided different legal systems with Germany and England at opposite ends of the spectrum and Austria and the US somewhere in between.

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**Shareholders’ and creditors’ entitlements on insolvency: who wins where?**

This article considers how different legal systems treat shareholder loans on corporate insolvency, looking at the approach of Germany, England, the US and Austria.

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**INTRODUCTION**

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Companies are commonly financed by a mix of equity and debt and the creditors and shareholders are usually not the same person. Both from a corporate finance and legal perspective, the interesting question is what happens if debt and equity are combined because the equity provider is also a creditor. By large and there are no legal rules that actually prevent or prohibit a shareholder from financing the company by way of loans. The main issue from a legal perspective is how to treat these loans on insolvency of the company. Are the shareholders allowed to claim repayment of their loans like normal outside creditors and demand a pro rata distribution? Or does the fact that the loan was provided by a shareholder warrant that the loan be subordinated to the claims of other creditors, meaning that payment on the shareholder loans will only be made after the creditors have been paid in full? And what about secured shareholder loans? Are shareholders allowed to invoke security rights granted to them and rank above outside creditors? Can they enforce their security by ignoring the insolvency payment waterfall procedure of “their” company?

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Shareholder loans do not only change the outcome in insolvency cases, they also ... change the risk profile of the company by reducing its financial resilience.

German law

German law provides for the general subordination of shareholder loans. In order to understand German law, one needs to look at its development. Subordination was initially developed by the courts in the 1930s. Loans granted when a company became financially distressed were subordinated. This allowed the company to continue to operate, the benefits of which were reaped by the shareholders. Concurrently, the risk of corporate failure, borne primarily by the creditors, was reduced because of an increase in debt (which included the shareholder loans) and a further dissipation of assets. In the 1980s the rules were codified, although the courts held that the codified rules were a mere supplement to case law. Meanwhile the rules grew increasingly complex. One issue concerned how to deal with shareholder loans that became due at a moment of crisis but were not repaid. If the shareholder left these loans in place, these would also be subordinated. In 2009 there was an overhaul of German corporate law, in part, to make the German corporate form more attractive to investors. The overhaul included a revision of the rules on shareholder loans and provided that all shareholder loans were to be subordinated, regardless of their timing and whether or not the company was in distress. In addition the repayment of shareholder loans in the year prior to the filing for the opening of an insolvency procedure was made subject to transaction avoidance and shareholders cannot invoke security rights. Some exceptions to these rules are in place, most notably an exception for small shareholders that hold less than 10% of the capital and are also not involved in the management of the company.

Little theoretical thought has been given to the decision to subordinate all shareholder loans. One German author, Verse, writes: “The most plausible explanation is that subordination of all shareholder loans will simply ensure that the shareholders adequately participate in the entrepreneurial risk of the company.”

English law

English law stands at the other end of the spectrum. In the 1980s, English insolvency law was revised by the Cork committee which argued strongly in favour of subordination of shareholder loans. Although the proposal was not adopted (notably not because subordination would be at odds or incompatible with English law), the argument provided by the Cork committee is explained below. The committee pleaded the case in favour of subordination as follows:

“The strength of the case of those who seek a change in the law – and radical at that – can be seen if a simple and perhaps extreme example is taken. A wholly-owned subsidiary company is under-capitalised. It relies virtually wholly on moneys lent by the parent. Its affairs are conducted by and in the interest of the parent and they are mismanaged. There is a history of transactions between subsidiary and parent which, although not individually or collectively susceptible to attack at law, have, cumulatively, advantaged the parent and disadvantaged the subsidiary. All profits earned by the subsidiary have been paid up to the parent by way of dividend and the moneys needed by..."
The subsidiary to conduct its business lent back by the parent. The subsidiary, at the instance of the parent, has obtained substantial credit by relying on its membership of the group of companies headed by the parent. The subsidiary indicates its membership on all documents and billings by showing a device or logo distinctive of the group. The subsidiary becomes insolvent and goes into liquidation. The parent company declines all liability for its subsidiary’s debt to external creditors, and competes with them by submitting a proof in respect of its loan. The result is that, out of the total funds realised by the liquidator for distribution among the creditors, a substantial proportion goes to the parent company. We recognise that a law which permits such an outcome is undoubtedly a defective law.8

The proposal argued not in favour of blanket subordination, but for subordination of loans that functioned as capital.9 There is no legislation on subordination and no statute preventing shareholders from providing finance by means of secured loans.

US law

US law does provide for rules on subordination, with two basic doctrines addressing the issue of shareholder finance. The first doctrine, applied by US bankruptcy courts since the 1980s, is recharacterisation.

The question of recharacterisation is mainly one of substance over form. Though not limited to circumstances involving shareholders’ contributions, recharacterisation frequently deals with how funds provided by a shareholder to a corporate entity are to be qualified from a legal point of view. The fundamental issue addressed by recharacterisation is: if a shareholder contributes cash to a corporate entity, is this contribution to be considered debt or equity?

The concept of recharacterisation is well-known in the US tax context, where it frequently arises in connection with a taxpayer’s effort to gain more favourable treatment for a particular transaction. In the insolvency context, it is frequently raised when creditors perceive an advantage in forcing certain claims to a lower position in the debtor’s capital structure. US bankruptcy courts have applied two varying legal theories to recharacterisation. One historically-applied approach, based on the court’s inherent equitable powers,10 evaluates transactions on a case-by-case basis to reach a determination of whether a particular transaction’s economic substance is more akin to the extension of credit, or to the taking of an equity position. A second, more recently developed approach looks instead to applicable state law (to the extent any exists) for guidance in discerning whether a given transaction should be characterised as debt or equity.11 As a practical matter, courts applying either approach tend to apply various multi-factor tests imported from tax decisions.12

Under a second doctrine, and even if the money provided by the shareholder qualifies as a loan and not as equity, such loan can still be subordinated equitably. The development of “equitable subordination” as a US legal doctrine very much resembles the manner in which a similar doctrine developed under German law.

Austrian law

Austrian law has a separate statute for the issue of subordination of shareholder loans, Eigenkapitalersatz-Gesetz or Statute on Capital Replacing Loans (EKEG). Austrian law has taken yet a different position and is important from a theoretical standpoint. Austrian law still holds the position that only loans granted when a company hits financial distress are to be subordinated.13 The rule is only applicable for shareholders holding 25% or more of the shares. The company is assumed to be financially distressed if it is either balance sheet insolvent or unable to pay its debts as they became due. The company is presumed (subject to proof to the contrary) to be financially distressed, if its solvency ratio falls below 8%.14
The Austrian solution is attractive since it seeks to distinguish between loans that only a shareholder would have granted and loans provided by a shareholder that might as well have been granted by a third outside party. The statutory thresholds prevent lengthy debates and court battles as to what third parties might or might not have done.

At the same time, the statutory thresholds can be said to be much lower than banks normally require from their debtors as a minimum solvency level for extending credit. Therefore, if anything, the Austrian rules should be deemed to be under inclusive rather than over inclusive if the aim is to subordinate those loans that would not have been granted by third parties. The Austrian threshold of 8% can therefore be said to be shareholder friendly.

**COMPARATIVE CONCLUSION**

Although the question as to whether shareholders are or are not allowed to assume the role of creditor in the case of insolvency can be regarded as the most important value driver for creditors in many insolvency cases, there is surprising little uniformity in the way different legal systems approach the issue. At one end of the spectrum there is English law, adopting a very much laissez faire approach. At the other end of the spectrum is German law, basically subordinating all shareholder loans. The US and Austria fall somewhere in between, with Austria providing for more hard and fast rules and thereby preventing lengthy debate. Although there might be some negative side effects to a strict subordination rule, simply allowing secured shareholder loans often leads to a situation where the shareholders can have their cake and eat it.

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