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The subordination of shareholder loans in bankruptcy

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Abstract

Bankruptcy and corporate laws in several countries allow or require courts to subordinate loans by shareholders to corporations. Examples include the German *Eigenkapitalersatzrecht* and the equitable subordination and recharacterization doctrines in the US. I use a model to show the incentive effects of subordination when a controlling shareholder attempts to rescue a closely held corporation by extending a loan. Even though subordination has some beneficial effects, it deters some desirable rescue attempts and is an insufficient deterrent for some undesirable ones. Legal reform should thus focus on narrowing down the scope of application to undesirable shareholder loans, where more severe penalties than subordination should apply.

JEL classification: G32; G33; K22

Keywords: Close corporations; Bankruptcy; Subordination; Recharacterization; Equity substitution; Capital structure

1. Introduction

In closely held corporations, the owners of a significant amount of shares (who may be managers at the same time) sometimes try to avert an impending bankruptcy by informally extending a loan, in the hope of financing a successful rescue attempt. However, for creditors,

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the continued operations of the company may result in a dissipation of even more liquidation value due to perpetuated and increased risk. Courts are therefore sometimes inclined to penalize shareholders by subordinating such loans in bankruptcy, or by treating them as equity. This paper analyzes the effects of the subordination of such loans on social welfare by using a formal economic model. Even though its motivation comes mainly from the German and Austrian discussion on the doctrine of equity substitution (*Eigenkapitalersatzrecht*), subordination is an issue also in the law several other countries, including the US, which face similar or the same policy issues.

The paper proceeds as follows: After a brief comparative overview on the law in Section 2, and a summary of previous literature in Section 3, I set up a simple model in Section 4 in order to explore the underlying incentive structure and its effects on desirable and undesirable rescue attempts under the circumstances described above. Section 5 interprets the results of the model and discusses ex ante effects on interest rates. Section 6 discusses the effects of particular risk preferences. In Section 7, I try to identify criteria for the limits of subordination and find that an alternative approach may be preferable. Section 8 concludes.

2. Comparative overview

In German and Austrian legal literature, there is an extensive discussion on the so-called "law of equity substitution", which is considered an important building block of creditor protection in corporations. The development of this doctrine in Germany began in the late 1930s in a number of decisions by the then *Reichsgericht* ("imperial court") concerning both stock corporations (*Aktiengesellschaften*) and private limited companies (*Gesellschaften mit beschränkter Haftung*)[1] and was continued after World War II by the *Bundesgerichtshof* (BGH; Supreme Federal Court)[2], which developed the doctrine over the decades. In 1980, the doctrine, as far as it applied to limited liability companies (*GmbH*), was codified by statute.[3] However, the courts continued to apply the principles developed by the Supreme Federal Court parallel to the statutory rules.[4] A long line of case law and academic legal literature has developed since then. The Slovenian corporate law of 1993 largely copied the German provisions.[5] The Austrian Supreme Court (*Oberster Gerichtshof*; OGH) followed the German case law in 1991.[6] Only in 2003, the Austrian parliament passed an act,[7]

[1] RG 16.11.1937, JW 1938, p. 862; RG 3.12.1938, JW 1939, p. 355; RG 22.10.1938, RGZ 158, p. 302; RG 13.1.1941, RGZ 166, p. 51. Even before the cases, legal scholars and some legislative drafts had already considered the issue. For a historical overview, see Koppensteiner (1998): pp. 308–309, Schummer (1998): pp. 7 et seq.

[2] The earliest case is the "Lufttaxi" decision, BGH 14.12.1959, II ZR 187/57, BGHZ 31, p. 258.

[3] Gesetz zur Änderungen des Gesetzes betreffend die Gesellschaften mit beschränkter Haftung und anderer handelsrechtlicher Vorschriften vom 4.7. 1980, BGBl. I, pp. 836 et seq. (introducing provisions §§ 32a, 32b GmbHG).

[4] Most importantly, see the "Nutzfahrzeug" opinion, BGH 26.3.1984, II ZR 14/84, BGHZ 90, p. 370. cf. Koppensteiner (1998): p. 309, Hommelhoff (2002b): comment 1.2.

[5] Zakon o gospodarskih družbah, §§ 433, 434. See Bruckmüller (2004).

[6] OGH 8.5.1991, 8 Ob 9/91, SZ 64/53.

[7] Bundesgesetz über Eigenkapital ersetzende Gesellschafterleistungen (Eigenkapitalersatz-Gesetz–EKEG), Art. I Gesellschafts- und Insolvenzrechtsänderungsgesetz 2003–GIRÄG 2003, BGBl I 2003/92.