Subordination of Shareholder Loans from a Legal and Economic Perspective

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Introduction

In closely-held corporations, the owners of a significant amount of shares sometimes try to avert an impending bankruptcy by informally extending a loan, in the hope of financing a successful rescue attempt. For creditors, the continued operations of the company may result in a dissipation of even more liquidation value due to perpetuated and increased risk. For various reasons, courts and legislators are sometimes inclined to subordinate such loans in bankruptcy, or to require their treatment as equity.

While some legal systems, such as those of the UK, France or the Netherlands, provide for no specific rules and regulations on loans granted by shareholders to their companies in distress, the treatment of such loans varies significantly among countries using such a concept, which include Germany, Austria, Italy, Spain and the US. The basic idea can be outlined as follows: When the financial situation of a company deteriorates, third party loans may become unavailable at some point. If business operations cannot be continued without immediate cash supply, shareholders basically see themselves confronted with a double set of alternatives: First, they have to decide whether or not to liquidate their company. If they decide to continue their business, the second choice concerns the question whether to provide funds in form of equity or to grant loans. If they decide to grant loans and the company goes bankrupt nonetheless, statutory subordination excludes them from equal participation in the proceeds of the estate. In practice, they normally suffer a total loss. In turn, third party creditors, whose interests were not taken into account in the decision to continue operations, but who very well bear its consequences, profit twofold: Ex post, their quota in the proceeds increases inasmuch as the shareholders' claims are subordinated. Ex ante, they may benefit from the negative incentive deriving from imminent subordination to the extent it prevents shareholders from granting loans to companies that are potentially not capable of surviving. Under certain conditions, however, the incentive may be too weak or even counterproductive.

This paper proceeds as follows: The next section gives a comparative overview of how shareholder loans are treated by the law in a number of European jurisdictions and in the United States. Afterwards an economic perspective on subordination and its incentive effects on the basis of a model written by one of the authors is presented. It will be explained why the effects of subordination may sometimes be counterproductive. The last section offers some reflections on legal policy and possibilities of reform relating to the field.

Comparative overview

Extension of a loan during crisis

According to the traditional judicial understanding of German "Kapitalersatzrecht", a shareholder loan will be requalified if it was granted in the course of a crisis. This criterion implies that the company was either insolvent (illiquid[1] or over-indebted[2]) or at least "unworthy" of credit. The latter is assumed when no third party creditor is willing to extend credit at market conditions, so that the company would have to be dissolved immediately.[3] Though more useful than the statutory definition given by the German GmbHG,[4] defining the crisis as a financial situation in which a shareholder, acting like a responsible business man, would provide equity, this reference to market conditions is problematic, as there is more to the credit market than standard products. The creditworthiness rather depends on the borrower's capacity to pay the interest rates a (standard or non-standard) lender would deem ade-

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[1] E.g. BGH, 14.12.1959 – II ZR 187/57 ("Lufttaxi"), BGHZ 31, 258, 271 et seq.; BGH, 23.2. 2004 – II ZR 2007/01, ZIP 2004, 1049.
[2] BGH, 14.12.1959 – II ZR 187/57 ("Lufttaxi"), BGHZ 31, 258, 271 et seq.
[3] E.g. BGH, 24.3.1980 – II ZR 213/77, BGHZ 76, 326, 330 = ZIP 1980, 361, 362; BGH, 13.7.1981 – II ZR 256/79, BGHZ 81, 253, 262 f. = ZIP 1981, 974, 978; BGH, 12.7.1999 – II ZR 87/98 = ZIP 1999, 1524; BGH, 23.2. 2004 – II ZR 207/01 = ZIP 2004, 1049.
[4] § 32a (1) GmbHG [German Act on Limited Liability Companies].

Table 1

Treatment of shareholder loans

	Personal requirements		Factual requirements	Concept: ▪ Dependence on fault: y/n ▪ Corporate/Insolvency law ▪ Statut. law/Court practice	Description and extent of effect	Exemptions subject to quality of rescue attempt	Relevant provisions
	Borrower	Lender					
GER	*Current:* AG, GmbH, GmbH& Co KG *MoMiG:* Independent of legal form	*Current:* Managing shareholder or non-managing shareholder with capital share >10% (GmbH, GmbH& Co KG); capital share >25% (AG); incl. indirect interest and group companies. *MoMiG:* Capital share >10% share quota also for AG; rest unchanged.	*Current:* ▪ Granting or non-withdrawal ("Stehenlassen") of loans or securities, assignment of goods or rights for use in a crisis (incl. economic equivalents); ▪ Crisis: Insolvency (illiquidity or overindebtedness) or lack of creditworthiness / unworthiness of assignment ("shareholder, acting like a responsible business man, would provide equity" – "no credit available at market conditions"). Exception: "Finanzplankredit". *MoMiG:* ▪ Abandonment of creditworthiness criterion → extension to all shareholder claims; ▪ "Stehenlassen" becomes obsolete.	*Current:* ▪ Independent of fault; ▪ Corporate and insolvency law concept; ▪ Statutory ("GmbH-Gesetz", GmbHG/"Insolvenzordnung", InsO) and parallel case law. *MoMiG:* ▪ Independent of fault; ▪ Insolvency law concept; ▪ Statutory (InsO).	*Current:* *Corporate law concept:* ▪ Retention in the amount of negative equity; ▪ Restitution if withdrawn in excess; limitation period: 10 years. *Insolvency law concept:* ▪ Full subordination in insolvency; ▪ Special claw-back action for withdrawals within last year before insolvency. *MoMiG:* ▪ Subordination of all shareholder claims; ▪ Claw-back unchanged; ▪ Reassignment for use: limiting of subordination to outstanding fees (current: outstanding fees and continued use).	*Current and MoMiG:* Prerequisites (ex ante): ▪ It must seem possible to restructure the company; ▪ Planned restructuring measures must seem adequate; ▪ Shareholders must be willing to complete the restructuring; ▪ Acquisition of shares in the company within the restructuring.	§§ 30, 31, 32a, 32b GmbHG §§ 135, 143, 144 InsO
AUT	AG, GmbH, GmbH& Co KG, limited liability cooperative, SE	Essentially shareholders with controlling influence or >25% of share capital; incl. indirect interests and group companies.	▪ Granting of loans or securities (without "Stehenlassen") and fee moratorium for rights to use granted in a crisis; ▪ Insolvency (illiquidity or overindebtedness) or need for reorganization (rebuttably presumed if equity ratio <8% and hypothetical debt redemption period >15 years).	▪ Independent of fault; ▪ Combination of both concepts; ▪ Statutory ("Eigenkapitalersatzgesetz", EKEG).	Full retention as long as the crisis lasts. Restitution if withdrawn before; limitation period: 5 years (40 years if withdrawn with knowledge of crisis).	Prerequisites (ex ante): ▪ Acquisition of shares in the company within the restructuring; or ▪ Granting of loan in the context of a reorganization according to the "Unternehmensreorganisationsgesetz", URG (§ 23 URG).	EKEG § 23, 24 URG
ITA	SARL; other types only within groups; otherwise at best per analogy	Shareholder irrespective of capital share, incl. indirect interests and group companies.	Granting of loans (incl. economic equivalents) under conditions of material undercapitalization or if the provision of equity would have been reasonable. If granted earlier, subordination is possible only if in line with the hypothetical will the parties, determined according to the circumstances existing on the day of granting or later ("versamento in conto capitale").	▪ Independent of fault; ▪ Insolvency law concept; ▪ Statutory ("Codice Civile", CC).	Full subordination in bankruptcy. Special claw-back action for withdrawals within last year before bankruptcy.	No such exemptions in the CC	Art. 2467, 2497quinquies CC

(Table 1 continued)

	Personal requirements		Factual requirements	Concept: ▪ Dependence on fault: y/n ▪ Corporate/Insolvency law ▪ Statut. law/Court practice	Description and extent of effect	Exemptions subject to quality of rescue attempt	Relevant provisions
SPA	Independent of legal form	Creditors associated with the company, especially managers, shareholders with a capital share ≥10%. (≥5% for listed companies, group companies and assignees, if the assignment occurred during the past 2 years).	▪ Granting of loan or security for pre-existing debt (or new debt replacing a pre-existing debt); ▪ No crisis required.	▪ Independent of fault; ▪ Insolvency law concept; ▪ Statutory (“Ley Concursal“, LC).	Full subordination in bankruptcy. Special claw-back action for withdrawals within last 2 years before bankruptcy, whereby the requirement of mass diminution is rebuttably presumed.	No such exemptions in the LC	Art. 71, 92, 93 158 LC
USA	Independent of legal form	*Equitable subordination:* Typically insiders, namely group companies or controlling shareholders (incl. indirect interests); Qualification as insider does not necessarily require capacity as shareholder (even the bank or auditor can be insider). Outsiders practically only in case of misrepresentation *Recharacterization:* Not necessarily shareholder	*Equitable subordination (cumulative test):* ▪ Claim of lender against the company; ▪ Inequitable conduct (for insiders) or gross misconduct (for outsiders); ▪ Injury to creditors or unfair advantage; ▪ Consistency with Bankruptcy Code. *Recharacterization (11-factor test):* ▪ Names given to instrument (if any) evidencing indebtedness ▪ Maturity date and payment schedule (if any) ▪ Fixed rate of interest and interest payments (if any) ▪ Source of repayments ▪ Adequacy or inadequacy of capitalization ▪ Identity of interest between creditor and stockholder ▪ Security (if any) for advances ▪ Ability to obtain financing from outside lending institutions ▪ Extent to which advances were subordinated ▪ Extent to which advances were used to acquire capital assets ▪ Presence or absence of sinking fund to provide repayments.	*Equitable subordination:* ▪ Dependent on fault (inequitable conduct); ▪ Insolvency law concept; ▪ Bankruptcy Code § 510 (c) codifies consequences, case law specifies requirements. *Recharacterization*: ▪ Independent of fault; ▪ Insolvency law concept; ▪ Case law based on equity power (Bankruptcy Code § 105 (a)).	*Equitable subordination:* Basically full subordination. However, if deemed proper, the court may limit the subordination within 3 dimensions: ▪ only pari passu (=same rank); ▪ only partial; ▪ only to the benefit of some creditors. *Recharacterization:* Financial contribution is identified as equity (instead of debt). Accordingly, it is subordinated in full (as capital contributions are to be repaid only after satisfying all other obligations of the corporation).	The requirement of inequitable conduct can produce effects similar to an exemption for desirable rescue attempts.	Bankruptcy Code§§ 101 (31), 105 (a), 510 (c), 547

Source: Compilation of the authors.

quate to cover his credit costs, to allow for an adequate yield and – most of all – to compensate the increased risk of default (risk premium) (Table 1).

Whereas *Austria* avoids these difficulties by replacing the creditworthiness criterion with the rebuttable presumption of a crisis if the equity ratio is below eight percent and the hypothetical debt redemption period ("fiktive Schuldentilgungsdauer") exceeds fifteen years,[5] the recent reform proposal issued by the German government[6] (the "MoMiG") considers abandoning the criterion of lacking creditworthiness following the example of *Spain.*[7] This would result in an extension of statutory subordination to all shareholder loans, irrespective of when and under what circumstances they were granted.[8] While the current German concept, due to the similar treatment of loans granted and loans not withdrawn in the crisis ("Stehenlassen"),[9] constitutes an incentive to timely withdraw loans in order to avoid their re-qualification, thereby accelerating the demise of the company and thus minimizing potential damages to third party creditors resulting from continued business of companies presumably not capable of surviving, the newly proposed concept would create an opposite incentive: In order not to provoke an immediate insolvency resulting in a total loss of all their claims due to their statutory subordination, shareholders would generally be induced to remain inactive, in the mere hope of an eventual recovery of their company. A similar revision was considered, but abandoned in the US during the 1970s.[10]

Italy, whose regulation explicitly rests upon the current German concept,[11] subordinates shareholder loans only if the provision of equity has been reasonable[12] or if – under due consideration of the business activity of the company – there is a significant mismatch between equity and debt (material undercapitalization[13]). With this reference, Italy comes closest to the US equitable subordination doctrine: According to the three part test developed by the Court of Appeals of the 5th Circuit in re Mobile Steel Co.,[14] equitable subordination requires:

- an inequitable conduct on the part of the creditor;[15]
- an injury to creditors or an unfair advantage caused by this conduct; and
- consistency of subordination with the provisions of the Bankruptcy Code.

Undercapitalization is one of the most important cases of inequitable conduct.

A more recent, less settled development of US courts is the recharacterization doctrine, under which some bankruptcy courts have decided to treat debt owed to shareholders as equity.[16] Recharacterization does not require inequitable conduct on behalf of the creditor, but uses an eleven-factor test,[17] which includes, among others the inadequacy of capitalization and the corporation's inability to obtain financing from outside lenders.[18]

Exemptions

Basically, there are two types of conditions under which shareholder loans may be exempt from subordination:

- *Personal exemptions* based on limited participation in the company in terms of equity and management responsibility;
- *Factual exemptions* based on the prospects of success of the rescue attempt as part of which the loan is granted.

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[5] § 2 EKEG (Austrian Eigenkapitalersatz-Gesetz).
[6] Bundesregierung (2007).
[7] Art. 92 no. 5.° in connection with. art. 93 no. 2 and 158 of the Spanish Bankruptcy Code ("Ley Concursal", LC), entered in force on 1.9.2004; Huber & Habersack (2006), pp. 315–16, with further references.
[8] Cf. the proposed new wording of the §§ 39 and 135 of the German Insolvency Code ("Insolvenzordnung", InsO). The proposal is based on the consideration that due to the court practice regarding the so-called "Stehenlassen" (this section below) the point in time when creditworthiness sets in is of little practical relevance. In restrospect, all shareholder loans are qualified either as having been granted during crisis, or as having been left within the company after the onset of crisis (cf. Bundesregierung 2007, p 130).
[9] This section below.
[10] See Clark (1986), p. 69 [referring to the bills H.R. 31, S. 236, 94th Cong., 1st Sess. (1975) (Bankruptcy Commission's bill) and H.R. 32. S. 235, 94th Cong., 1st Sess. (1975) (Bankruptcy Judges' Bill)].
[11] Haas (2004), p. 562, at note 58, with further references.
[12] Cf. the statutory ordinance ("Decreto legislativo"), Gazzetta Ufficiale n. 6, 17.1.2003, Supplemento Ordinario n. 8 ("Riforma organica della disciplina delle società di capitali e società cooperative, in attuazione della legge 3 ottobre 2001, n. 366"), and art. 2467 of the (redrafted) Civil Code ("Codice Civile", CC).
[13] Tantini (2004), p. 798.
[14] In re Mobile Steel Co., 563 F.2d 692, 699–700 (5th Cir. 1977). Older seminal cases include Taylor v. Standard Gas & Electric ("Deep Rock"), 306 U.S. 307 (1939); Pepper v. Litton, 308 U.S. 295 (1939).
[15] "Inequitable conduct is that conduct which may be lawful, yet shakes one's good conscience." Cf. e.g. the opinions In re Beverages Int'l Ltd., 50 B.R. 273, 281 (Bankr. D. Mass. 1985), and In re Mayo, 112 B.R. 607, 650 (Bankr. D. Vt. 1990).
[16] E.g. In re Cold Harbor, 204 B.R. 904 (Bankr. E.D. Va. 1997); In re Fett Roofing & Sheet Metal Co., Inc., 438 F.Supp. 726 (E.D.Va.1977).
[17] Roth Steel Tube Co. v. Comm'r of Internal Revenue, 800 F.2d 625, 630 (6th Cir. 1986); In re Autostyle Plastics, Inc., 269 F.3d 726 (6th Cir. 2001); In re Outbound Marine Corp., 2003 WL 216973571 (N.D. Ill. 2003) (adding two more factors).
[18] An overview is provided by Skeel & Krause-Vilmar (2006), pp. 264 et seq.

Personal exemptions are provided for by the laws of *Germany*,[19] *Austria*,[20] and *Spain*.[21] *US* bankruptcy law distinguishes between insiders[22] and outsiders, depending on the respective degree of control, which is crucial for the criterion of inequitable conduct: While the subordination of outsider claims requires gross misconduct, this additional element is not required for insiders.

An exemption of the second type is provided by the laws of *Germany*[23] and *Austria*.[24] In the US, the requirement of inequitable conduct has similar effects.

Legal consequences

Again, two major approaches can be identified:

- *Requalification:* The so-called "corporate law (or preventive) concept" treats shareholder loans as equity insofar as they must not be repaid to the extent the sum of the company's liabilities and stated capital exceeds the total value of its assets.[25] Excessive repayments must be refunded. Requalification takes effect before, and persists after the opening of the insolvency proceedings.
- *Subordination:* Claims for repayment of shareholder loans are subordinated in (but not excluded from) insolvency proceedings. Repayments obtained in a critical period before the opening of the insolvency proceedings must be reimbursed. Since subordination is subject to the opening of insolvency proceedings, it is sometimes referred to as the "insolvency law (or reactive) concept".

While in *Germany* both concepts exist in parallel,[26] the *Austrian* system qualifies as a combination of both.[27] *Spain*[28] and *Italy*[29] have implemented subordination.

In the *US,* a claim may be equitably subordinated *(as debt)* in accordance with the Mobile Steel Co. three point test only to the extent deemed necessary by the court to offset injury or damage caused to creditors by the debtor's inequitable conduct, while the (amended) eleven point recharacterization test is used to identify a financial contribution as *equity instead of debt.* Accordingly, a recharacterized loan is subordinated in full "as a proprietary interest because the corporation repays capital contributions only after satisfying all other obligations of the corporation".[30] Consequently, recharacterization of a claim precludes its equitable subordination.[31]

Loans granted before but left after the onset of the crisis

German case law subordinates not only shareholder loans granted in distress, but also those granted before, but not reclaimed immediately after the onset of the crisis, provided the creditor was (i) aware of it and (ii) able to either withdraw the loan or initiate liquidation (so-called "Stehenlassen").[32] These extra requirements do not apply if the loan was granted or promised before, but already with a view to a possible future crisis ("Finanzplankredit").[33] The *Italian* doctrine ("versamento in conto capitale") is somewhat similar, as it allows the requalification of funds designated as loans based on the circumstances existing on the day of their granting or even later.[34] As described above, *US* law can have similar effects. While *Spain,* due to the absence of a creditworthiness (or similar) criterion, has no need for any such special provision,[35] *Austria* explicitly limits requalification to loans granted during crisis.[36]

Further countries

Specific provisions regarding the subordination of shareholder loans granted in distress can also be found in *Greek, Portuguese, Slovenian* and *Polish* law.[37] By contrast, in *Switzerland,* there are no provisions to that effect. A reform proposal to add a sub-

[19] § 32a(3), 2nd sentence GmbHG; see also §§ 39(1) no. 5, 39(5) of the proposed revisions to the Insolvency Act (Bundesregierung 2007).
[20] § 5 EKEG.
[21] Art. 93(2) LC.
[22] Cf. the definition in Bankruptcy Code § 101(31).
[23] § 32a(3) 3rd sentence GmbHG; see also §§ 39(1) no. 5, 39(4) of the proposed revisions to the Insolvency Act (Bundesregierung 2007).
[24] § 13 EKEG.
[25] See e.g. Cahn (2006), p. 289.
[26] Requalification is based on § 30(1) and § 31(1) GmbHG; subordination follows from § 32a(1) GmbHG and § 135 InsO. The MoMiG draft (Bundesregierung 2007) abolishes the corporate law concept.
[27] § 14 EKEG. The full amount of the loan is locked in (not only to the extent needed to cover stated capital) immediately upon its granting in crisis, and must not be repaid before restructuring is completed. Earlier repayments constitute an immediate reimbursement claim. However, the effect in insolvency is only subordination (§ 57a(1) KO [Austrian Insolvency Act]).
[28] Art. 92 no. 5.° in connection with art. 93 and 158 LC.
[29] Art. 2467 CC.

[30] Nozemack (1999), pp. 689 and 719. Recharacterization cases "turn on whether a debt actually exists, not on whether the claim should be equitably subordinated" (Id. at p. 716); In re Autostyle Plastics, Inc., 269 F.3d 726 (6th Cir. 2001).
[31] In re Autostyle Plastics, Inc., 269 F.3d 726 (6th Cir. 2001).
[32] BGH, 26.11.1979 – II ZR 104/77, BGHZ 75, 334, 336 et seq. = ZIP 1980, 115. This case law practice would become obsolete if the MoMiG draft (Bundesregierung 2007) was enacted in its current version.
[33] E.g. BGH, 17.11.1997 – II ZR 225/96, ZIP 1998, 243.
[34] Cf. Haas (2004), pp. 560 et seq., with further references.
[35] See this section above.
[36] § 3(1)(3) EKEG.
[37] Huber & Habersack (2006), pp. 314–16; Haas (2004), p. 561; Wachter, pp. 717 and 725, all with further references.

ordination provision in the course of a recent revision was abandoned,[38] while the Swiss Federal Court has recently held that the legal concept of requalification is unknown to Swiss law. Whether or not subordination could take place instead has been left open.[39] Roughly spoken, the prevailing Swiss doctrine, however, acknowledges a legal subordination under conditions similar to those in Germany.[40]

An economic perspective

The policy rationale behind subordination of shareholder loans has been disputed for several years. The German discussion has gained some fierceness recently and has been fuelled by the recent reform proposal.[41] From an economic perspective, the incentive effects created by the doctrine stand at the core of the debate.[42] In fact, most economic analysis has emphasized that subordination creates a disincentive against legitimate rescue attempts, as shareholders will not obtain an insolvency quota if the rescue attempt financed by the shareholder loan fails.[43] The economic intuition in favour of subordination is that shareholders will often gamble for resurrection, resulting in a high risk of dissipation of the remaining corporate funds.[44] Hence, legal consequences should deter such conduct. However, rescue attempts financed by shareholder loans are not necessarily negative. From an ex ante perspective, a rescue attempt has a certain probability of success, the benefits of which are in part borne by the firm's original creditors, who will obtain full repayment.

The first comprehensive model of subordination of shareholder loans in bankruptcy that measures the doctrine against an efficiency gauge was proposed by Gelter (2006). The model assumes that the company has entered into an unforeseen crisis, when its shareholders must decide either to let the company go into liquidation or to add more capital to the firm in the form of a shareholder loan, which is used to finance a rescue attempt. This project may either result in success, in which case the total value of the company – composed of the total of both the creditors' claims and shareholder value – increases, or it may result in failure, which means that the firm still has to be liquidated, but at a potentially lower liquidation value.

The model takes the normative perspective that the relevant legal doctrine should maximize the total expected wealth of shareholders and creditors combined. However, because of the debt overhang problem famously described by Myers (1977), the interests of shareholders and creditors strongly diverge in a near-bankruptcy situation. In other words, shareholders have the incentive to take risks from which they benefit to a larger degree than creditors, or that are outright detrimental to creditors. The reason for this divergence is that if the rescue attempt succeeds, most of the benefits will typically accrue to shareholders, whose profits (from the increased value of the firm) are not constrained by an upward boundary. By contrast, creditors' gains in expected value are limited by their fixed claim. It follows that a shareholder who has the opportunity to increase the risk of the firm by prolonging its existence by means of a shareholder loan often will have an incentive to enact such a rescue attempt, although it may not be efficient for shareholders' and creditors' expected wealth combined.

It is intuitive that subordination of shareholder loans exerts a numbing effect on this incentive. However, whether the doctrine creates such a disincentive has nothing to do with whether the rescue would be ex ante efficient. Gelter's (2006) model is the first to show mathematically under what circumstances the results yielded by the incentives modified by subordination diverge from the first-best solution. A closer investigation reveals that there are essentially the four possible effects shown in Table 2.

Table 2

Possible effects of subordination of shareholder loans on rescue attempts

efficient rescue attempt prevented by subordination (type II error)	**inefficient rescue attempt** **prevented by subordination**
efficient rescue attempt **not prevented by subordination**	inefficient rescue attempt not prevented by subordination (type I error)

Source: Compilation of the authors.

[38] Art. 697i and 807c of the pre-draft for the revision of the LLC law ("Vorentwurf für die Reform des GmbH-Rechts"); cf. Böckli et al. (1996), pp. 32 and 82.
[39] BGer., 2.3.2006 – 5C.230/2005, E. 3.
[40] Böckli (2004), § 13, N 779.
[41] Bundesregierung 2007.
[42] By contrast, one of the leading academic advocates of the doctrine has rejected economic analysis and stated that the purpose of the doctrine was "to create an equilibrium of financial freedom and responsibility in view of creditor protection", and "on this basis, rules of the game for legitimate measures of funding and restructuring – and truly not for their obstruction" (Schmidt 2006, p. 1926 [own translation]).
[43] See Götz (2001), pp. 109 et seq.; Engert (2004), pp. 826 et seq.
[44] See Klaus (1994), pp. 360 et seq.; Engert (2004), pp. 821–22.

Quite obviously, subordination would be most desirable if it led exclusively to incentives against all inefficient rescue attempts, but not against efficient ones. However, mathematical analysis shows that all four possibilities exist. Under certain circumstances, the deterrent power of subordination will be too small to prevent inefficient rescue attempts (type I error: no effect), while under others, it will deter efficient ones (type II error: counterproductive effect).

This has some important implications:

Regarding type I errors: Gelter (2006) shows that no general statement on the sufficiency of the deterrent effect of subordination can be made. As long as the conditions of a specific case are such that the potential subordination of the shareholders' claims is insufficient to neutralize their expected benefits from a risky rescue attempt, some inefficient rescue attempts will still take place. In cases with less potential for hazardous business continuation to the (potential) detriment of third party creditors, however, the incentive may be strong enough. Hence, the incentive deriving from the impending subordination cannot fully, but at least partly, discourage shareholders from inefficient continuation of their business or inefficient rescue attempts. It follows that the argument, according to which the large bulk of case law produced by the German "Kapitalersatzrecht" doctrine indicates that subordination has no deterrent effect,[45] is not compelling.

Moreover, as subordination is sometimes an insufficient deterrent, it will often be desirable to provide liability of management (or shareholders providing shareholder loans) for belated filing for bankruptcy in order to create an incentive against undesirable rescue attempts (ex ante) and to cover the third party creditors' damage resulting from continued operations of the firm.

Regarding type II errors: As Gelter (2006) shows, the possibility of type II errors supports the thesis that subordination can have a detrimental deterrent effect, as subordination as such does not achieve exclusively desirable results. From a theoretical perspective, shareholder loans should only be subordinated where they are used to finance inefficient rescue attempts, i.e. business continuations that reduce the expected total value of the firm. Hence, the delineation of the scope of applicability of the doctrine is of crucial importance. The answer to this need could be a well-designed reorganization exemption,[46] allowing for a distinction of efficient from inefficient rescue attempts.

Concluding remarks

The comparative overview has shown that there are basically two concepts to treat shareholder loans granted in distress. The so-called insolvency law concept, according to which shareholder loans are subordinated, is on the rise. As opposed to its counterpart, the corporate law concept, by which shareholder loans are re-qualified immediately after their granting in the crisis, it produces effects only after the opening of the insolvency proceedings. However, due to the anticipation of potential subordination, it produces similar incentives ex ante. The argument brought forward in some of the German legal literature in defense of the corporate law concept, according to which the retention of funds is superior to having to reclaim them, applies to (ex post) redistribution only.

Economic analysis suggests that, depending on the circumstances of the specific case, the potential subordination of shareholder loans may or may not be an effective instrument to prevent detrimental risk-enhancing conduct of shareholders near bankruptcy: While its numbing effect may discourage shareholders from socially undesirable rescue attempts in certain cases, the threat to subordinate the shareholder claims in bankruptcy may be too weak in others. This second group of cases calls for support through an additional, more severe sanction. A strict management liability for belated filing for bankruptcy could be such a sanction if it creates a sufficient deterrent effect on management against continuing business without a proper restructuring plan. The UK wrongful trading liability or the German liability for delays in filing for insolvency could serve as examples.[47] At last, there are situations in which potential subordination is over-inclusive. This third group of cases occurs if the deterrent effect prevents a socially beneficial rescue attempt. Such counterproductive effects can be avoided with a complementary restructuring exemption for ex ante promising rescue attempts.

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[45] Schmidt (2006), p. 1926.

[46] Previous section.

[47] In this context cf. e.g. the amendment to §§ 6(2), 64 GmbHG proposed in the MoMiG draft (Bundesregierung 2007).

Apart from the incentive effects ex ante, subordination may also be attractive to courts and legislators for its ex post reallocation effect. While veil piercing or management liability court proceedings involve considerable time and effort for an often uncertain outcome, subordination of loans may be an appealing alternative in legal systems not requiring the insolvency administrator to show fault on the part of the shareholder who granted the loan. This is of particular importance in cases of secured shareholder loans, which are particularly harmful to unsecured creditors.[48] In these cases, subordination renders the collateral invalid.

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[48] See Cahn (2006), p. 298–99.