Recharacterization and the Nonhindrance of Creditors

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RECHARACTERIZATION AND THE NONHINDRANCE OF CREDITORS

David A. Skeel, Jr. and Georg Krause-Vilmar*

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ABSTRACT

Using a 1977 article by Robert Clark as the starting point, this article attempts to shed new light on the question of whether and when shareholder loans to her company should be either equitably subordinated or, as courts have done in a few recent cases, recharacterized as equity. In its emphasis on the particular issue of shareholder loans, the article has a narrower compass than Clark’s article, which uses a four-part typology to explore the relationship among fraudulent conveyance law, equitable subordination, veil piercing and dividend restrictions. But the article also expands Clark’s analysis in several respects. The most important adjustment involves the general Nonhindrance ideal, which we use to identify a crucially important form of interference with the rights of creditors that Clark does not himself consider directly.

Part 1 of the article very briefly describes the 1939 Supreme Court case that served as a well-spring for equitable subordination doctrine in general, and for subordination of shareholder loans in particular. Part 2 then focuses on a series of recent decisions that have wrestled with the question whether shareholder loans should be recharacterized as equity contributions. Recharacterization doctrine is closely related to equitable subordination, but most courts view it as a separate development. Part 2 suggests that much of the confusion in the cases could be eliminated by disentangling two issues, whether the status of a loan is ambiguous (which raises issues of Truth, in terms of Clark’s typology) and whether it was likely to destroy value that would otherwise go to creditors (the Nonhindrance concern); and by distinguishing bankruptcy recharacterization from the tax characterization cases that seem to have spawned the new doctrine. Part 3 then concludes by briefly considering the German

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and Austrian approaches to these same issues, which focus on capitalization and creditworthiness.

The most important, and initially counterintuitive, implication comes in Part 2: whereas US courts have treated security interests as a badge of legitimacy in assessing shareholder loans, secured loans are actually the most worrisome form of shareholder investment. These security interests, we argue, should be disallowed.

Keywords: corporations, corporate reorganization, fraudulent conveyance, recharacterization, bankruptcy, secured debt, shareholder loans, priority.

1. Introduction

When a company fails, the judicial autopsy that ensues often reveals that its shareholders were far more than shareholders alone. Particularly when there is a controlling shareholder or the company is enmeshed in a parent-subsidiary framework, one or more shareholders may have made loans to the company, or supplied goods on credit, or leased property. Other shareholders, creditors who are not sure they will be repaid, and the courts to whom these shareholders or creditors take their complaints have long worried that the transactions are not entirely on the up-and-up. Since the controlling shareholder stands on both sides of the transaction, there is always a risk that she will charge too much for the goods she supplies, make dubious loans, or simply siphon assets out of the corporation.

Over the years, a wide variety of doctrines have been invoked, and new doctrines created, by US courts and legislatures to address the threat of insider manipulation. Under veil-piercing doctrine, creditors can ask a court to hold shareholders personally liable for obligations of the company. Equitable subordination can be used to lower the priority status of an obligation owed to an insider or other creditor. If the company has overpaid for benefits provided by the insider, creditors can challenge the transaction under fraudulent conveyance law. And so on.

Long ago, before his illustrious career as dean of the Harvard Law School, Robert Clark wrote a seminal article arguing that many of the doctrines just mentioned can be understood as fitting a single, coherent pattern.1 The Ur-doctrine, the doctrine from which the others flow, he argued, is fraudulent conveyance law.2 Broadly understood, the argument continued, fraudulent conveyance law is designed to assure that a debtor honors four related moral obligations in its dealings with creditors. The first is Truth, which forbids the debtor from

2 Most States have adopted some form of the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act. Although these provisions are incorporated into bankruptcy pursuant to 11 USC §544(b) (permitting creditors to invoke nonbankruptcy causes of action), the Bankruptcy Code also includes its own, very similar fraudulent conveyance provision. 11 USC §548. These provisions permit a debtor’s creditors to challenge, among other things, transfers for which the debtor did not receive adequate consideration if the debtor was at or near insolvency when the transfer occurred (constructive fraud) and transfers that were designed to hinder, delay, or defraud creditors (actual fraud).
lying to his creditors either by filing deceptive financing statements or in other ways. The second, Respect, prohibits the debtor from simply giving away money that might be used to repay creditors. Evenhandedness means he cannot pay some creditors rather than others. Finally, under Nonhindrance, which Clark views as a general category that subsumes the other three, the debtor is not permitted to take actions that are designed to stymie his creditors, such as converting liquid assets to illiquid ones to make it harder for creditors to collect.

Each of these ideals, according to Clark, is embodied in traditional fraudulent conveyance law. Other, seemingly separate doctrines are best seen as adjustments made through the years to fill in the gaps of the basic fraudulent conveyance framework. The biggest gap stems from the requirement in fraudulent conveyance law that creditors must point to a particular transaction or transactions that violate the debtor’s obligations to its creditors. If the debtor has engaged in numerous transactions over time, it may be difficult or impossible to prove on a transaction-by-transaction basis that the debtor has made fraudulent conveyances. Both equitable subordination and veil piercing plug this gap by substituting a “gestalt” approach for the transaction-specific requirements of fraudulent conveyance law.

Using Clark’s article as the starting point, this article attempts to shed new light on the question of whether and when shareholder loans to her company should be either equitably subordinated or, as courts have done in a few recent cases, recharacterized as equity. In its emphasis on the particular issue of shareholder loans, the article has a narrower compass than its classic predecessor. But it also expands Clark’s analysis in several respects. The most important adjustment involves the Nonhindrance ideal, which we use to explore a crucially important form of interference with the rights of creditors that Clark does not himself consider directly.

The article proceeds as follows. Part 2 very briefly describes the 1939 Supreme Court case that served as a well-spring for equitable subordination doctrine in general, and for subordination of shareholder loans in particular. Part 3 then focuses on a series of recent decisions that have wrestled with the question whether shareholder loans should be recharacterized as equity contributions. Recharacterization doctrine is closely related to equitable subordination, but most courts view it as a separate development. Part 3 suggests that much of the confusion in the cases could be eliminated by disentangling two issues: whether the status of a loan is ambiguous (which raises issues of Truth, in terms of Clark’s typology) and whether it was likely to destroy value that would otherwise go to creditors (the Nonhindrance concern); and by distinguishing bankruptcy recharacterization from the tax characterization cases that seem to have spawned the new doctrine. Part 4 then concludes by briefly considering the German and Austrian approaches to these same issues, which focus on capitalization and creditworthiness.

The most important, and initially counterintuitive, implication comes in Part 3: whereas US courts have treated security interests as a badge of legitimacy in assessing shareholder loans, secured loans are actually the most worrisome form of shareholder investment. These security interests, we argue, should be disallowed.

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3 The ideal of Truth is described in Clark, loc. cit. n. 1, at p. 509. The other three ideals are described at pp. 509-513.
4 Clark later relabeled this attribute, calling it “Primacy.” Clark, op. cit. n. 1, at p. 53.
5 Under equitable subordination doctrine, which is now codified in 11 USC §510, a court can subordinate the claim or interest of a creditor or shareholder who has acted inequitably. When a court pierces the corporate veil, it holds shareholders or affiliated entities liable for the obligations of a corporation. See, e.g., Clark, op. cit. n. 1, at pp. 71-85 (analyzing veil-piercing doctrine).
6 It should go without saying that Clark himself may not agree with our appropriation of his four-part typology. Whether he would view our analysis as an adaptation or a distortion, we cannot say.
2. In the beginning: *Deep Rock* and its legacy

The subordination of shareholder loans in the United States dates back to a famous 1939 case that has long been viewed as an object lesson of the potential abuses of a parent-subsidiary framework. It is useful to describe the case in some detail in order to understand where equitable subordination came from and how far it has developed in the ensuing decades.

In *Taylor v. Standard Gas & Electric,* generally known as the *Deep Rock* case for reasons that will soon become clear, Standard Gas & Electric Company, the parent corporation, acquired control of an oil company whose name it changed to Deep Rock Oil Corporation from its owner, C.B. Shaffer, in 1919. Shaffer initially shared voting control with Standard, but within two years Standard lost confidence in Shaffer, bought back his stock and pushed him out. Over the next decade, during which Deep Rock was invariably only “two jumps ahead of the wolf,” as a Standard officer later testified, Standard ran an open account consisting of thousands of transactions between itself and Deep Rock. By the time the wolf finally caught up with Deep Rock in 1933, Deep Rock’s debt to Standard included $31,804,145.04 for cash contributions by Standard, $1,219,034.83 for management and supervision fees, $4,819,222.07 in interest charges, and $4,525,000 for leasing oil properties owned by another Standard subsidiary. These and other debits totaled over $52,000,000. After deducting credits of roughly $43,000,000, Standard filed a claim for $9,342,642.37 in Deep Rock’s bankruptcy.

Both the bankruptcy trustee and two preferred stockholders objected to Standard’s claim. “Many transactions entered in the account were attacked as fraudulent,” as the Supreme Court later put it, “and it was asserted that as Standard had made Deep Rock its mere agent or instrumentality it could not transmute itself from the status of proprietor of Deep Rock’s business to that of creditor.” The Court was persuaded that Standard’s behavior over the decade it controlled Deep Rock substantiated these complaints. From the beginning, Justice Reed wrote, “Deep Rock was insufficiently capitalized, was top heavy with debt and was in parlous financial condition. Standard so managed its affairs as always to have a stranglehold upon it.” Despite its precarious finances, Deep Rock paid over $3 million in dividends between 1926 and 1929, largely financed by borrowing from Standard.

Under traditional fraud conveyance law, the plaintiffs would have been forced to identify each of the improper transactions they intended to challenge, and indeed it appears that they attempted to do just this. Giving the difficulty of documenting the flurry of exchanges, however, many of the transactions might have slipped through the cracks. The Supreme Court did not let this difficulty stand in the way of recovery. Based on the “equitable principle that the doctrine of the corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice,” the Court reversed the lower courts’ approval of a reorganization plan that would have fully honored much of Standard’s claim. “No plan ought to be approved,” the Court held, “which does not accord the preferred stockholders a right of participation in the equity in the Company’s assets prior to that of Standard, and at least equal voice with Standard in the management.

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7 *Taylor v. Standard Gas & Electric,* 306 US 307 (1939). *Taylor* was decided the same year as another important decision subordinating a shareholder’s claim, *Pepper v. Litton,* 308 US 295 (1939). These two cases are generally viewed as the fount of equitable subordination doctrine in the United States.

8 Ibid., at p. 310.

9 Ibid., at p. 312.
Anything less would be to remand them to precisely the status which has inflicted serious detriment on them in the past.  

*Deep Rock* has laid the groundwork for decades of decisions wrestling with the question whether a shareholder loan or other claim should be subordinated. From time to time, courts and commentators have argued that subordination doctrine should be converted into a *per se* rule when the transactions in question involve a controlling shareholder or other insider. Judge Jerome Frank took this position in a series of cases starting in the late 1940s, arguing that the risk of manipulation by a controlling shareholder is so high that automatic subordination is justified, but he gave up this quest a few years later. In 1978, Congress codified equitable subordination as part of a sweeping reform of the American bankruptcy laws, quietly dropping a provision in the original proposal that would have provided for automatic subordination of insider claims. As it turns out, this codification has helped to spawn a new set of questions about the proper treatment of shareholder loans.

3. **Recharacterization: to praise or bury insider loans**

In recent years, the *Deep Rock* concern with obligations to a controlling shareholder has spawned a new doctrine that is closely linked to, yet at times subtly different from, equitable subordination. In these cases, the bankruptcy court is asked to recharacterize debt owed to an insider-shareholder, and to treat it as equity rather than debt. Recharacterization is said to differ from ordinary subordination in two respects: it does not require a showing that the shareholder acted inequitably; and rather than simply being subordinated to other creditor claims, the shareholder’s contribution is treated as equity.

Courts have wrestled with recharacterization both on doctrinal grounds and as a matter of policy. Some have concluded that bankruptcy courts do not have the authority to treat debt as if it were equity. In other cases, including many of the most recent decisions, courts have concluded that they have the power to conduct this reverse alchemy, but they seem uncertain how to determine when debt should be recharacterized. A useful gauge of the uncertainty is the steady proliferation of factors courts try to take into account. After surveying the previous case law, the leading case compiled a list of eleven factors; a subsequent case concluded that eleven was not enough, and added two more.

This part begins by describing the recharacterization case law and arguing that much of the doctrinal uncertainty stems from the fact that several different kinds of issues are subsumed under the label “recharacterization.” The doctrine has been further confused by courts’

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10 Ibid., at p. 324.
11 In determining whether to equitably subordinate a claim or interest, either of a shareholder or of an ordinary creditor, courts tend to require (1) inequitable conduct; (2) injury to creditors or an unfair benefit to the challenged claimant; and (3) that subordination not conflict with other provisions of the Bankruptcy Code. The inquiry is derived from *Matter of Mobile Steel Co.,* 563 F.2d 692 (5th Cir. 1977), which was decided shortly before equitable subordination was incorporated into the 1978 Bankruptcy Code.
12 These cases, and Judge Frank’s sympathy for a rule of automatic subordination, are described in Clark, op. cit. n. 1, at p. 537, n. 89.
14 *In re Autostyle Plastics, Inc.,* 269 F.3d 726 (6th Cir. 2001). The eleven factors are listed and critiqued in section 3.4 *infra.*
15 *In re Outboard Marine Corp.,* 2003 WL 21697357 1, 5 (N.D. Ill. 2003) (adding “(12) the ratio of shareholder loans to capital and (13) the amount or degree of shareholder control”).
reliance on an older, superficially similar body of tax recharacterization case law. After disentangling the issues, we explore them in more detail in the second and third sections, and offer a proposed solution to the treatment of shareholder loans. The final section then revisits the multi-factor test that has emerged in the case law.

3.1 Recharacterization: disentangling the concerns

As part of a proposed bankruptcy reform that became the starting point for the Bankruptcy Act of 1978, the National Bankruptcy Review Commission proposed that equitable subordination be codified after forty years of development in the courts in the wake of the Deep Rock and Pepper v. Litton cases. Under the provision drafted by the Commission, the claims of insiders would have been automatically subordinated, and the bankruptcy court would have had discretion to subordinate other claims as circumstances warranted. The automatic subordination provision (a concept we will revisit below) disappeared with little fanfare, but discretionary subordination remained in the legislation that was eventually enacted. It is the terms of this codification, as it turns out, that have raised questions about bankruptcy courts’ authority to recharacterize debt as equity.

The provision itself is quite simple. “[A]fter notice and a hearing,” it reads, “the court may … under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest.” The dilemma, in the view of some courts, is that this provision instructs courts to look to “principles of equitable subordination” as the basis for subordinating a claim. Yet the case law on recharacterization does not seem to rely on principles of equitable subordination at all. In most of the recharacterization cases, a shareholder or other insider supplies cash to a struggling company in the form of a loan. In some of the cases, the loan is poorly documented (or not documented at all) and the shareholder does not insist on regular payments. The question courts have often asked, as summarized by a group of prominent bankruptcy lawyers, is “whether the transaction bears the characteristics of an arm’s length bargain.” In the equitable subordination context, by contrast, the principal issue – and thus a key principle – is whether the shareholder or creditor has engaged in inequitable conduct. In effect, then, recharacterization seems to achieve the effect of equitable subordination without requiring any showing of inequitable conduct. The cases that have questioned their own authority to recharacterize a loan have pointed to this tension between the recharacterization remedy and the language of the equitable subordination provision. “Where there is a specific provision governing these determinations,” the most prominent of the cases concluded, “it is inconsistent with the Bankruptcy Code to allow such determinations to be made under different standards through the use of a court’s equitable powers.”

Courts that conclude they have the authority to recharacterize have gently accused their more diffident peers of making a category mistake. Recharacterization and equitable subordination, they argue, are entirely different remedies. “The effect of a bankruptcy court’s recharacterization of a claim from debt to equity may be similar to the court’s subordination of a claim through equitable subordination,” as the Sixth Circuit put it, “but there are

17 11 USC §510(c)(1).
18 Sprayregen, et al., loc. cit. n. 13, at p. 12.
19 In re Pacific Express, Inc., 69 Bankr. 112 (9th Cir. BAP 1986) at p. 115.
important differences between a court’s analysis of recharacterization and equitable subordination issues. Not only do recharacterization and equitable subordination serve different functions, but the extent to which a claim is subordinated under each process may be different. 20 The question in a recharacterization case “is whether a debt actually exists.” 21 With equitable subordination, by contrast, the validity of the debt obligation is not in question. The issue is “whether a legitimate creditor engaged in inequitable conduct;” if so, the principal remedy is to subordinate the creditor’s claim to the claims of other creditors, not to treat the claim as equity.

There is an intuitive logic to the argument that recharacterization is simply a different creature than equitable subordination, and it seems to be prevailing in the case law. Nearly all of the most recent cases have concluded that courts do indeed have the power to recharacterize. But the line between equitable subordination and recharacterization is not quite so pristine as the cases suggest. Inequitable behavior is not a prerequisite for recharacterization – in theory, the question is simply: was the shareholder’s capital infusion a loan or a contribution to capital? – yet courts’ sense of the propriety of the shareholder’s behavior seems to influence their decision whether to recharacterize. 22 The question whether the company was adequately capitalized at its inception also seems to figure prominently in both contexts. And courts – Deep Rock itself is a prime example – do not always assume that the obligations they subordinate in the equitable subordination context are legitimate claims. 23

If this tendency to draw overly sharp distinctions between recharacterization and equitable subordination only affected courts’ determination whether they have authority to recharacterize claims, it would be relatively unproblematic. Although courts have exaggerated the differences, the reasoning would go, their basic conclusion that recharacterization is not prohibited by the Bankruptcy Code is sound. But the effect is not as simple as this. The effort to identify an analytically distinct doctrinal foundation for recharacterization seems to have caused courts to confuse two different issues that arise when shareholders pump cash into a troubled enterprise. The first problem is shareholder contributions that are ambiguous in form. Although structured as loans, the contributions sometimes are not treated like ordinary loans; they may lack documentation or be repaid more erratically than other loans. Second is the question whether and on what terms loans from an insider should be encouraged when a business has encountered financial distress. Courts’ reliance on tax recharacterization doctrine has further confused the analysis. Disentangling these considerations may help us to develop a new perspective on the recharacterization cases.

3.2 The ambiguous loan problem

20 In re AutoStyle Plastics, 269 F.3d at p. 748 [emphasis in original].
21 In statutory terms, a “creditor” is an “entity that has a claim against the debtor,” 11 USC §101(10) and a “claim” is a “right to payment.” 11 USC §101(5). The question is whether the shareholder is a creditor who has made a loan and thus has a claim, or whether the contribution is simply an “interest.”
22 In In re Micro-Precision Technologies, Inc., 303 Bankr. 238 (Bankr. D. N.H. 2003) at p. 247, for instance, the Court described the recharacterization doctrine as applying to claims by corporate insiders and those who have dealt with the debtor in a potentially inequitable fashion.
23 As evidenced by the fact that the Supreme Court did not simply subordinate the controlling shareholder’s claim; it also insisted that control of the reorganized company needed to be shared with the company’s preferred stockholders.
A natural inclination of the principal shareholders of a floundering business is to look in their own pockets (and often the pockets of friends and relatives) for cash to plug the leaks. They see the problems first, and they may conclude that arranging an outside loan would be too time-consuming and uncertain. Better that those who know the business best provide the funding themselves.

The problem is that, while these cash infusions from insiders are usually described as loans, they sometimes are not treated like ordinary loans. There may not be any formal loan agreement, for instance, or the documentation that exists may omit key terms like the interest rate or repayment schedule. In one recent case, four of the five promissory notes called for in a purported secured lending transaction were never drafted, and the original loan was never properly perfected. The imaginary notes were subsequently assigned to another entity (which, like the first, was controlled by shareholders of the debtor) but no assignment document was ever executed. In other, less egregious cases, no payments are made at all between the time of the capital infusion and the time the company files for bankruptcy. The absence of any payments to the shareholder is not necessarily inconsistent with the contribution being a loan – after all, demand loans have precisely this quality – but this makes it look as though the insider is trying to treat the contribution as a loan if the company performs either very well (and thus can repay it) or very poorly (winding up in bankruptcy), while treating it as a contribution to equity while the company’s finances remain in a precarious state.

In Clark’s terms, the key issue here is whether the ambiguous loan violates the debtor’s obligation of Truth. These loans do not interfere with the expectation of Respect, since the shareholder is not giving the company’s money away; and Evenhandedness is not at issue. The problem is that a shareholder’s ambiguous loan may create an obligation that other creditors do not even know exists. A supplier who checks Dun & Bradstreet or another credit reporting service to assess the company’s overall debt situation may not see any reference to the shareholder’s purported loan. The misleading picture of the company’s finances could, among other things, cause the supplier to provide credit it otherwise would have withheld.

Since the principal issue with an ambiguous loan is one of Truth, this objective should guide the initial decision whether it is treated as debt or equity. If there is little or no documentation, or there is other evidence that the company’s creditors were or might have been misled about the existence of the claimed loan, recharacterization may be appropriate. The fact that a loan is clearly documented or shows up in the company’s credit reports, by contrast, would weigh strongly in favor of treating the cash infusion as a loan.

Notice that the focus is quite different from the tax law jurisprudence on recharacterizing debt as equity. The tax cases are most worried about low priority obligations that function like a class of stock but are treated like debt in order to give a shareholder the tax benefits of debt. Convertibility is worrisome from a tax perspective, since debt that can be converted into voting stock enables the company to treat the interest payments on the debt as a (deductible) business expense, while giving the security holder the option of converting to stock for the purposes of voting control. Convertibility has not been at issue in the bankruptcy

\[24\] Bunch v. J.M. Capital Fin. Ltd (In re Hoffinger Indus., Inc.), 327 Bankr. 389 (Bankr. D. Ark. 2005). The Court had no difficulty finding that recharacterization was appropriate on these facts. “This simply is not debt,” the Court concluded. “The purpose of the JM Capital transaction was not to incur debt necessary to the debtor’s operations; its purpose was to pay interest on equity and to judgment-proof the debtor.” Ibid., at pp. 410-411.

recharacterization cases, and, even if it were, the existence of a right to convert would tell us little about whether the initial characterization as debt should be honored. Similarly, and more importantly, if the contribution is structured as a traditional secured loan, it poses no problems from a tax perspective. But secured shareholder loans are quite worrisome in the bankruptcy context, for reasons discussed in detail in the next section.

Where the status of a loan is ambiguous, courts would do well to focus directly on the real problem with this ambiguity – the danger that other creditors will be misled. The ideal in question is Truth, and the concern is that sloppiness or deception by the shareholder will interfere with collection by creditors of their claims.

### 3.3 Ill-founded loans that hinder other creditors

The second, more subtle, issue is whether shareholder contributions to a faltering enterprise may interfere with creditors’ collection of their claims even if there is no sloppiness or deception whatsoever. The ideal in question here is not Truth so much as a more general concern, as Clark puts it, “of Nonhindrance of the enforcement of valid legal obligations against oneself, in connection with transfers of one’s property.”

Clark illustrates the ideal of Nonhindrance by imagining a debtor who sells readily marketable stock for illiquid assets in order to make it difficult for her creditors to collect the amounts they are owed. A shareholder loan seems quite different from loading up on illiquid assets – indeed our initial inclination is often to applaud the shareholder loan – but the effect may often be quite similar.

To appreciate how a shareholder loan can hinder the company’s creditors, even when it is done in the light of day, consider a company that owes its creditors a total of $100, and whose assets are worth a total of $80. If the principal shareholder contributes $10 in cash to the company, the cash can be used to pursue a project that has a 50 percent probability of being worth $15 after a year’s time, and a 50 percent probability of being worth $0. Because the project has a net value of negative $2.50 ($7.50 expected value minus $10 cost), pursuing it will reduce the recovery available to the company’s creditors. Yet if the shareholder structures her contribution so that she is promised, say, $15 in a year’s time on the principal and accrued interest for the contribution, she has a financial incentive to make the loan despite the consequences for the company’s creditors.

Shift now from the artificial numerical example to the real world of financially troubled companies (particularly the small- and medium-sized businesses that figure in many of the recharacterization cases). Will troubled firms often have business projects that fit the profile of the project described above? The answer is almost certainly yes. For many troubled businesses, continuing the business for another month or year, rather than shutting down today, is, in effect, a net negative present value project. Injecting additional cash may simply prolong the inevitable demise, using up assets whose value might otherwise have gone to creditors. In theory, creditors could take matters into their own hands under these circumstances and throw the company into bankruptcy involuntarily. But the shareholder loan may itself prevent creditors from filing an involuntary bankruptcy petition. To sustain an involuntary petition, creditors must show that the debtor is not paying its debts as they come due. If the loan enables the company to pay its current creditors for a few more months, the creditors will not be able to make this showing.

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26 As hopefully is clear, both concerns can be implicated by the same shareholder loan. But it is essential to keep the analysis separate.
27 Clark, loc. cit. n. 1, at pp. 512-513.
28 11 USC §303(h).
If every shareholder loan fit this pattern – good money, badly spent – a simple prohibition of shareholder loans would be in order. But sometimes shareholder loans make both creditors and the company better rather than worse off. If there is a 50 percent probability the project described above will return $15, for instance, and a 50 percent probability of $7, the $10 investment suddenly has a present value of $11 and is worth pursuing. In a world where shareholder loans may destroy value that would otherwise go to creditors, but may also fund valuable projects, how should courts respond to a request that a shareholder loan be recharacterized or subordinated?

An elegant new article that carefully explores the effects of recharacterizing shareholder loans both when a company is solvent and when it is insolvent concludes that courts should assess the quality of the project that the loan was used to finance. “A shareholder loan would fail the test,” on this view, and should thus be treated as equity “when the accepted value of total assets after a rescue attempt results in a reduction” in the value of the company’s assets. “If an increase in the going concern value after the rescue was to be expected, the shareholder-creditor should be treated like a third-party creditor in bankruptcy.”29 The beauty of this approach is that it neatly distinguishes between shareholder loans that benefit the company and those that impair creditors’ recoveries by inappropriately postponing the company’s bankruptcy. The obvious problem is that courts (and the experts whose testimony would inform a court’s decision) are not well positioned to make these calculations. In addition to the complexities of the basic analysis, the scrutiny would be prone to the kinds of hindsight bias that make courts reluctant to inquire into business judgments in other contexts.

Before we can offer any conclusions about the ill-founded loan problem, we need to add one more essential variable. The analysis thus far has assumed that the shareholder is lending to the company on an unsecured basis. But a substantial proportion of shareholder loans are made on a secured basis. In these cases, the question is not simply whether shareholder loans should be honored and thus encouraged. There is the added issue of whether the shareholder should be permitted to claim priority for the loan.

Once again, we should begin by asking whether these loans inappropriately hinder creditors. The basic trade-off is the same: as with unsecured loans, secured lending can be used to finance projects with either a net positive or a net negative value. But the stakes are in a sense higher with secured lending. Because the promise of collateral leapfrogs the secured lender ahead of other creditors, giving her the equivalent of a seat in first class, lenders may be willing to provide credit on a secured basis even if the financing will be used for projects whose value is much less than their cost. Yet the prospect of security can also facilitate financing for a valuable project that no lender would fund on an unsecured basis, due to the fact that the lender’s claim would simply be lumped together with all of the debtor’s other obligations. In economic jargon, collateral sometimes leads to overinvestment, but it also can be used to solve an underinvestment or debt overhang dilemma.30

29 M. Gelter, *The Subordination of Shareholder Loans in Bankruptcy*, John M. Olin Center for Law, Economics, and Business, Harvard Law School, Fellows’ Discussion Paper No. 4 (January 2005) p. 32. Gelter’s analysis suggests that, if the company is insolvent, recharacterization will never preclude an efficient investment and will discourage some but not all inefficient investments. If the company is insolvent, recharacterization will have a wide variety of effects, some beneficial and some harmful, depending on the size of the difference between the expected value of the project and the liquidation value of the company’s assets. The analysis considers only uncollateralized loans. As will become clear in the text below, secured loans are, in our view, the most important and worrisome form of lending by shareholders.

The implications of over- and underinvestment are initially quite counterintuitive. One might think that secured loans should always be discouraged if a company is insolvent. In reality, however, the more deeply insolvent a company is, the more serious the underinvestment problem will be; absent security, lenders will not finance even gold-plated projects if the debtor is drowning in debt.\(^{31}\) The state of the company’s solvency is thus a very imperfect measure of whether a secured loan should be applauded or condemned.\(^{32}\)

If a shareholder’s decision whether to lend money to her company were generally based on an objective assessment of the prospects for the investment, courts could simply honor both the loan and the shareholder’s priority treatment. But shareholder decision making is anything but objective as a company sinks into financial distress. To be sure, shareholder-managers know the business better than anyone else. But they tend to view its prospects through the rosiest of glasses. They also have a huge human capital investment in the company. The shareholder’s decision to make a loan therefore may be anything but objective.

Another set of concerns arises once the loan has been made, and applies even to loans that are not infected by the distortions we have just described. Because the shareholder who makes the loan is also likely to be managing the business itself, there is a risk that she will take steps that increase the amount of collateral subject to her security interest to the detriment of other creditors. The shareholder can build up the company’s inventory, for instance, if the security interest includes inventory. This general pattern of behavior is common enough to have a name: it is known as “feeding the lien.”

One can imagine using either of two approaches to address these concerns, an ad hoc approach or a per se rule. Under a particularized, ad hoc approach, courts might look for evidence that the shareholder had in fact taken steps to feed her lien, and disallow the security interest only if evidence of manipulation could be found. But manipulation not only may be difficult to detect: it also is only a small part of the problem of secured shareholder loans. More serious and pervasive is the risk that the secured shareholder loan will prolong the travails of a troubled company at the expense of its creditors. Lending on a collateralized basis enables a shareholder to have her cake and eat it too: to keep the hope of a turnaround alive, while using a security interest to limit her exposure under the new loan. The risk that this will simply delay the failure of an unviable company, and that value will be destroyed in the interim, is so high, in our view, that it calls for a per se response: courts should automatically disallow the shareholder’s security interest and treat the loan as a general, unsecured claim.

One obvious objection is that at least a few of these loans may be justified. If the company is drowning in debt, but has a valuable business opportunity, a rational shareholder might be reluctant to lend unless she were given priority, since the value of any new, unsecured loan would be diluted by the other competing claims against the debtor’s assets. This is simply another way of saying that collateral may be necessary to solve an underinvestment (or debt overhang) problem. But this objection is not especially persuasive on inspection. If the company, unlike most in these circumstances, has a valuable prospect but needs to borrow on a collateralized basis to pursue it, the company still could look to an outside creditor for the loan. Moreover, if the company does find itself in bankruptcy, the generous provisions for post-petition financing make it likely that a company which truly does have good future

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31 See, e.g., Triantis, loc. cit. n. 30, at p. 920.
32 Indeed, to the extent one focused entirely on the company’s solvency or insolvency, it would make more sense to subordinate any loan made while the company was solvent and to honor loans made after it sinks into insolvency.
prospects will be able to obtain financing – and the financing arrangement will be overseen by a truly objective decision maker: the bankruptcy judge.\(^3^3\)

A second objection arises from precisely the opposite intuition to the first. To the extent one is persuaded (as we are) that eve-of-insolvency secured loans are more likely to lead to overinvestment than to counteract underinvestment, one might go still further and subordinate even those secured loans that are made by a third party if they are made when the company is in financial trouble.\(^3^4\) In our view, this view has much more to recommend it than is usually assumed, but we would be reluctant to extend the *per se* subordination this far. One reason to distinguish third-party loans from shareholder loans is that third parties are less likely to be in a position to “feed the lien” or otherwise manipulate the company’s affairs to protect the new secured loan at the expense of other creditors. In addition, when a shareholder lends money to the company, she is preserving the “option value” of her equity interest in the company. The loan is in a very real sense designed to keep her interest as a shareholder of the company alive. Loans by a third-party lender are not subject to the same conflict and are somewhat less worrisome as a result.

Each of these explanations is only partial at best, however. There still remains the nagging suspicion that secured loans to financially troubled companies will often simply prolong the inevitable demise. A more compelling explanation comes from the perspective third-party lenders generally bring to their decision whether to lend to a troubled company. If these lenders simply focused on the loan in question, eve-of-bankruptcy secured loans by a third party might often lead to overinvestment. But lenders generally are not focusing simply on their initial loan. They are more likely to view the loan as the first step toward an ongoing lending relationship with the debtor. As a result, lenders are much more likely to lend to a company they expect to survive, than to make the last loan to a company that is on its way down.\(^3^5\) This does not suggest there is no reason to worry about third-party secured loans to a troubled company. But it does suggest that these loans are far less troublesome than loans by a shareholder.

If secured loans by the shareholders of troubled companies are worrisome, some might be inclined to go even further than we have suggested, and disallow even unsecured shareholder loans. Under this view, every loan by a shareholder would be subordinated to all other creditors or recharacterized as equity in order to address the overinvestment concerns we have discussed. Although we believe that this position has much to recommend it, we are not inclined to go quite so far. In part, our reluctance stems from the fact that the shareholder cannot manipulate an unsecured loan quite so easily as a secured loan. If the shareholder induces the company to repay her rather than other creditors on the eve of bankruptcy, for instance, the trustee may be able to invoke bankruptcy’s prohibition of preferential payments as a basis for retrieving the payments.\(^3^6\) In addition, shareholders may sometimes be a better source of loans than a third party, because the shareholder loan saves the transaction costs of


\(^3^4\) Although he has not explicitly endorsed this view, Barry Adler has hinted at such a position. See, e.g., B.E. Adler, ‘A Re-Examination of Near-Bankruptcy Investment Incentives’, 62 University of Chicago Law Review (1995) p. 575 at p. 605.

\(^3^5\) See, for example, Skeel, loc. cit. n. 33, at pp. 1924-1925 (discussing the importance of ongoing lending relationships in the debtor-in-possession financing context).

\(^3^6\) 11 USC §547.
finding and negotiating with a third-party lender. We should acknowledge that we remain less than entirely convinced by these arguments against full subordination of shareholder lending.\footnote{As we discuss in more detail in Part 4.2.2, another argument sometimes advanced in favor of shareholder loans is that the loans counteract shareholders’ incentives to take excessive risks in order to preserve their stake in the company. This argument seems plausible to us with unsecured shareholder loans but much less so with a secured loan, since the secured loan may be protected against loss even when the shareholder gambles unsuccessfully with the company’s assets. Like us, Clark is agnostic about the question whether unsecured shareholder loans should automatically be subordinated. Clark, op. cit. n. 1, at pp. 538-539. Clark does not address the issue of secured shareholder loans.} But the more pressing concern is that shareholders not be entitled to claim a secured status for loans they make to the company.

Thus far, we have assumed that the shareholder was a shareholder before she lent money to the company. In the United States, this will generally be an accurate description of the chronology. But sometimes, particularly in the European context, an existing creditor acquires equity. How should this situation be treated? In our view, the acquisition of an equity interest by an existing creditor is less problematic than a shareholder loan, because it is less likely to have a dilutive effect on the interests of current creditors. We would make one major exception, however: if the creditor acquires a controlling equity stake in the company, the risk that the creditor will use its control to favor its own interests arises, just as with a secured shareholder loan.\footnote{Interestingly, Germany provides an exception to its equity substitution rules that can be seen as addressing the issue described in the text. This provision, §32a III 2 GmbHHG, reads: “These rules [on equity substitution] do not apply to a non-managing shareholder whose equity share does not exceed 10 percent.” §32a III 3 GmbHHG then adds: “If a creditor acquires equity in a crisis of the company in order to overcome this crisis, this does not lead to the application of the equity substitution laws on his existing or new loans.” As the discussion in the text suggests, this second exception is more problematic in the event the creditor acquires a controlling stake.} Under these circumstances, we would therefore apply the same principles as with a shareholder loan. At the very least, the secured portion should be disallowed.

Let us pause here to briefly consider an apparent tension between our starting point – a consideration of the moral obligations of debtors to their creditors – and the conclusions we have reached, which do not seem as obviously based on general moral intuitions. Indeed, the moral arguments might seem to suggest that shareholder loans, whether secured or not, should be applauded. A shareholder whose business is failing will naturally attempt to save it, the reasoning goes, and these rescue efforts should be praised rather than skeptically scrutinized. Notice, however, that this argument does not explain why shareholders should be permitted to lend on a collateralized basis. After all, security lets them have their cake and eat it too: leading a rescue effort without taking the risk of failure. Similarly but more importantly, our initial intuition that shareholders should be applauded for contributing to a rescue needs to be adjusted to consider the likelihood that the “rescue” will often destroy value and hinder creditors’ ability to collect what they are owed.

UK company law is a useful comparison here. When a UK company encounters financial distress, its directors are expected to accede to insolvency proceedings rather than continuing business as usual in the hope of digging out of the company’s hole. Under the United Kingdom’s “wrongful trading” rules, directors who violate this expectation are subject to a wide range of sanctions, including personal liability and the possibility of a fifteen-year prohibition from serving as a director at another company.\footnote{The wrongful trading rule is described in J. Armour, B. Cheffins and D. Skeel, ‘Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom’, \textit{55 Vanderbilt Law Review} (2002) p. 1699 at pp. 1746-1747.} The wrongful trading rule
reflects an assumption that directors who carry on with ordinary trading after the company begins to hemorrhage cash are hindering their shareholders and creditors. US corporate law takes a more optimistic view of the prospects for recovery and generally does not punish directors who try to postpone the day of reckoning. But with shareholder loans, a context where the risk of undermining creditor recoveries is both systematic and high, the moral assumption that secured loans will have the effect of hindering creditors is fully warranted. To put the point slightly differently, a transaction transferring a security interest to one of the company’s shareholders is more like a fraudulent conveyance than an ordinary loan.

3.4 Applying the analysis: the eleven-factor Autostyle Plastics test

The previous two sections have argued that two different kinds of concerns may be implicated when shareholders make a loan to their own company. With ambiguous loans, courts should focus on whether the existence of the loan would be clear to an inquiring creditor. If not, and if the loan thus violates the ideal of Truth, it should be treated as a contribution to equity rather than as debt. Whether or not a loan is ambiguous, it also may hinder the company’s creditors, dissipating value as the company’s shareholders attempt to postpone liquidation. Here, the more general concern of Nonhindrance takes center stage. We have argued that this second concern should be addressed by invalidating any security interest that purports to secure the shareholder loan. As a doctrinal matter, courts would need to use equitable subordination rather than recharacterization as the basis for disallowing a shareholder’s security interest on Nonhindrance grounds, since our analysis does not call for recharacterizing the secured loan as equity. Rather, it would be treated as an ordinary unsecured claim.

Recent judicial opinions addressing the recharacterization issue have conflated the Truth and Nonhindrance concerns and also have been overly influenced by the seemingly similar tax recharacterization doctrine, which, as we have seen, is aimed at a very different problem. The case law that has resulted is, to put it charitably, muddled. As a result, we will argue, courts have been too willing to honor shareholder loans according to their terms. To see this, consider the eleven-factor test laid out in the leading recharacterization case. According to the Sixth Circuit, courts should consider each of the following factors:

1. the names given to the instruments;
2. presence or absence of a fixed maturity date and payment schedule;
3. presence or absence of fixed interest payments;
4. source of repayments;
5. adequacy or inadequacy of capitalization;
6. identity of interest (or not) between the creditor and shareholder;
7. security (or not) for the advances;
8. the corporation’s ability to obtain financing from outside lenders;
9. the extent to which the advances were subordinated to other creditors;
10. the extent to which the advances were used to acquire capital assets; and
11. the presence or absence of a sinking fund to provide repayment.41

Notice the variety of different concerns that seem to be proxied by the eleven factors. The first three factors focus squarely on the ambiguous loan issue. “The absence of notes or other

41 In re Autostyle Plastics, 269 F.3d at p. 750.
instruments of indebtedness,” as the Autostyle Plastics court put it, “is a strong indication that the advances were capital contributions and not loans.”42 The fifth and eighth factors offer related but independent standards for assessing whether a cash infusion should be seen as a loan (both of which, as we shall see, are standards that are used in Germany and Austria). If a company is undercapitalized, the fifth factor implies, new cash should be viewed as addressing the need for capital rather than as a loan. Under the eighth factor, the intuition is that shareholder financing should not be treated as a loan if no one else would make a similar loan on these terms. Most of the remaining factors deal with the Nonhindrance issue in one way or another, but in a fashion that is clearly influenced by tax recharacterization doctrine. Factors 7 (whether the shareholder has insisted on security), 9 (whether the obligation is subordinated) and 11 (whether the obligation has a dedicated source of repayment) can each be seen as influenced by the tax concern that shareholders will create a low priority debt security, rather than a class of stock, in order to take advantage of the deductibility of debt. Each of these factors overlaps with the Nonhindrance analysis.43 Factor 10 then addresses Nonhindrance directly, asking whether the funds will be used to acquire capital assets or to finance operations.

There are two intangible problems with this welter of factors. The first is that many are either unhelpful or used in precisely the wrong way. Second, the overall list has tended to distort courts’ analysis of what should and should not be honored as a loan.

The emphasis on undercapitalization falls into the unhelpful category. As noted earlier and discussed again in the next part, a company’s financial condition is not always a good barometer of whether a loan is justified: if the project is a good one, the loan should be encouraged even if the company is heavily indebted. Moreover, the emphasis on undercapitalization conflates the recharacterization question with the analytically distinct issue of whether the corporate veil should be pierced and the company’s shareholders held personally responsible for its obligations. Creditworthiness is a more defensible standard, but it too is flawed, since it may be difficult to determine whether an outside creditor would make a loan, and this willingness is itself an imperfect proxy for whether a loan would enhance or destroy value.44

Particularly misguided is the tenth factor (whether the advances were used to acquire capital assets). “Use of advances to meet the daily operating needs of the corporation,” according to the Autostyle Plastics court, “rather than to purchase capital assets, is indicative of bona fide indebtedness.”45 Although it seems sensible at first glance (at least to those who snoozed through the discussion in the last section), this distinction is very hard to defend; if anything, it gets the likely effect of a cash infusion exactly backwards. Pumping more money into the operations of a troubled firm will often simply prolong its deterioration – recall that unwarranted continuation is the most frequent form of “overinvestment” – whereas the acquisition a capital asset may (though, to be sure, it also may not) be tied to a profitable new business opportunity. Similarly, the factors that seem indebted to tax law privilege secured lending. Secured loans, as we have seen, are precisely the loans that pose the greatest danger of overinvestment, particularly when the lender is a shareholder rather than a third party.

What do courts do with all of this? Faced with a welter of factors, they seem to focus heavily on whether the infusion looks like a “proper” loan. If the loan is carefully

42 Ibid.
43 Unfortunately, however, as discussed below, tax recharacterization doctrine has led courts to apply these factors in almost exactly the wrong way in bankruptcy.
44 See, e.g., Gelter, op. cit. n. 29, at pp. 27-30 (noting that a hypothetical lender would base her loan decision on her prospects of repayment under the terms of the loan, rather than on whether the loan is value enhancing for the debtor).
45 In re Autostyle Plastics, 269 F.3d at p. 752.
documented, courts are loath to interfere. This stance makes perfect sense for addressing the ambiguous loan issue. It also can be seen as linking the ambiguous loan factors with the factors that show a preference for secured loans, since the security interest will generally be reflected in a public filing. But the ideal of Nonhindrance seems to get lost in the enthusiasm for form and security. As a result, properly documented secured loans are almost always upheld, as in the Autostyle Plastics case itself. Yet these are precisely the loans that pose the greatest risk of overinvestment and of manipulation by the shareholder-manager. While clear documentation addresses the ambiguous loan problem, the Nonhindrance ideal suggests that the security interests should be subordinated and the loans treated as general unsecured obligations.

4. **The German and Austrian alternatives: creditworthiness and undercapitalization**

4.1 **Overview of the rules**

The German doctrine on equity substitution law (Eigenkapitalersatzrecht) has its roots in the same era that saw the emergence of equitable subordination in the United States. In the late 1930s, the German Imperial Court (Reichsgericht) decided the first German cases on equity substitution.\(^{46}\) In the first case, the Reichsgericht viewed its decision as an individual correction of a special case of misconduct; but by the second case it had already established a more general rule regarding the subordination of shareholder loans.\(^{47}\) With its Lufttaxi decision in 1959,\(^{48}\) the German Supreme Court (Bundesgerichtshof, BGH) adopted this case law and developed the doctrine over the years.

The doctrinal justifications for the equity substitution rules have both changed and accumulated in the fifty years since the original cases. Among the stated rationales are: that companies should issue equity instead of debt in times of crisis; that it is inappropriate for the company to put the financing risk solely on outside creditors; that shareholder-lenders have informational advantages that could operate to the detriment of other creditors; that the shareholders should not be permitted to speculate at the expense of other creditors; and that shareholder loans may create a misleading perception that the company is adequately capitalized.\(^{49}\) In its BuM/WestLB decision, the BGH made it clear that it considers all of these concerns the basis for its doctrine, and the Court consolidated them into the term “responsibility for consequences of corporate finance.”\(^{50}\) The current doctrinal justification has been criticized,\(^{51}\) but seems to be firmly established in the BGH’s decisions since

\(^{46}\) RG JW 1938, 862; 1939, 355.

\(^{47}\) B. Gehde, *Eigenkapitalersetzende Gesellschaftserleistungen in Deutschland und den USA* [Equity Substituting Contributions by Shareholders in Germany and the United States] (Berlin, Duncker & Humblot 1997) p. 54.

\(^{48}\) BGHZ 76, 326.


\(^{50}\) ‘Finanzierungsfolgenverantwortung’, BGHZ 90, 381, 388.

\(^{51}\) See, e.g., Bezenzner, loc. cit. n. 49, at pp. 34-35; B. Grunewald, ‘Plädoyer für eine Abschaffung der Rechtsregeln für eigenkapitalersetzende Gesellschafterdarlehen’ [Plea for the Abolition of the
Legal scholars have added additional justifications for the doctrine, including the concern that shareholder loans circumvent the oversight of the financial markets\textsuperscript{53} and that they create a risk of overinvestment.\textsuperscript{54}

As in the United States, a rule calling for the subordination of all shareholder loans might seem like the best response to these concerns. Indeed, one of the Reichsgericht’s initial decisions seemed to endorse such a \textit{per se} rule.\textsuperscript{55} But, even more than in the United States, shareholder loans have long been an essential source of finance for small- and medium-sized German companies.\textsuperscript{56} It is of course possible that companies would begin to rely more on outside financing, and that outside lenders might step into the vacuum, if shareholder loans were automatically subordinated. But given the lower transaction costs of a shareholder loan, and the potential frictions that might interfere with efforts to obtain third party loans, we are hesitant to endorse a blanket rule that would subordinate all shareholder loans. As in the United States, we need a criterion that differentiates between those shareholder loans that should be subordinated and those that should stand as loans, as we discuss in more detail in the next section.

The German rules only subordinate shareholder loans which are deemed to “substitute equity.”\textsuperscript{57} The criterion used to determine an equity substitution is whether the company’s circumstances were such that a reasonable shareholder would make an equity contribution (\textsection 32a GmbHG defines such a situation as a “crisis of the company”). In order to clarify this standard, the criterion of creditworthiness is applied. The creditworthiness test asks whether a reasonable outsider would have given the same loan under the same conditions.\textsuperscript{58} If the answer is no, the shareholder loan is deemed an equity substitute.

The Austrian Supreme Court (\textit{Oberster Gerichtshof}) adopted the German rules in a case decided in 1991.\textsuperscript{59} In 2003, the Austrian Parliament codified these rules as well.\textsuperscript{60} The main difference between the Austrian doctrine that has emerged, as compared to its German counterpart, is that the Austrian rules focus more on undercapitalization and less on creditworthiness.

### 4.2 Critique of the German criteria

The German creditworthiness standard has the virtue of drawing a clear, intuitively attractive line between shareholder loans that are permissible and those considered a threat to the company’s other creditors. Its aim is to maintain a company’s minimum capitalization and thereby to protect the company’s other creditors. Although making a hypothetical, after-the-fact assessment of whether a third party would have made the loan in question may be
difficult, there is now an extensive body of case law to guide the inquiry. The problem with this standard is not so much with its difficulty in application, but with the focus on creditworthiness itself. It does not identify the proper claims for subordination. As we shall see, the weakness of the test is especially evident in the case of secured shareholder loans.

4.2.1 Inefficient results

The most obvious problem with the creditworthiness standard is that it leads to inefficient results. A hypothetical outside lender does not base her decision whether to extend a loan or not on efficiency concerns, but rather solely on the basis of her own chance of recovery. Her individual benefits, however, might not coincide with the best result for society as a whole, or even for other creditors of the company. As discussed earlier, the key question for many of the companies that rely on shareholder loans is whether keeping the company afloat is cost-justified, or whether it is more likely simply to delay an inevitable failure and destroy value in the process. Ideally, the court might address this question directly and subordinate loans that have a net negative present value. But, as noted earlier, courts are not well positioned to make this kind of determination.

4.2.2 Inability to properly deal with secured shareholder loans

The shortcomings of the creditworthiness standard are particularly evident when it comes to secured shareholder loans. As with recharacterization doctrine in the United States, the German creditworthiness standard treats secured shareholder loans as less worrisome than unsecured loans. The problem with this, as we have seen, is that the risk of overinvestment – of postponing default and diverting value from creditors as a result – is particularly high if the shareholder is able to lend on a secured basis.

In addition, because the loan is made by an insider-shareholder rather than a third party, the benefits that justify secured loans in other contexts are much less likely to be in evidence. Shareholder-lenders cannot be expected to monitor the debtor and its managers, for instance, if they themselves are the managers.

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61 For opposing arguments on the difficulty of assessing creditworthiness, see, for example, A. Goetz, "Juristische und ökonomische Analyse des Eigenkapitalersatzrechts" [Legal and Economic Analysis of the Equity Substitution Law] (Nomos, Baden-Baden 2001) p. 43 (difficult to apply); and Gehde, op. cit. n. 47, at p. 94 (fairly simple to apply).

While creditworthiness is the key criterion, German courts also look at capitalization to determine equity substitution. Lutter and Hommelhoff, op. cit. n. 57, at §32a/b, Rn. 33. As noted earlier, capitalization is also the main factor in Austrian equity substitution law. The shortcomings of the capitalization standard are quite similar to the shortcomings of creditworthiness discussed below. Most importantly, adequacy of capitalization is a poor proxy for whether a proposed loan should be encouraged or discouraged.

62 Gelter, op. cit. n. 29, at pp. 27-30.

63 Ibid., at p. 29.

64 Ibid., at p. 28.

65 “If the company gives a security from its own assets, which an outside creditor would have required, considered sufficient in the moment of issuing the loan and actually received, it is a factor against the qualification as equity substitution, unless special circumstances require a different judgment.” BGH ZIP 1999, 1524, 1526; BGH ZIP 2001, 839-840.

66 The role of secured credit as a mechanism for reducing agency costs is explored in detail in Renger, op. cit. n. 54, at pp. 96-98.
In the German context, shareholder loans are often defended as helping to align the shareholder-managers’ incentives with interests of the company’s outside creditors. Shareholders have incentives to engage in risks, the argument goes, since they are the ones who benefit from positive results, while being able to share the consequences of negative results with the creditors. The more highly leveraged the company is, the greater the shareholders’ incentives to take risks at the expense of their creditors. The conflict in incentives is reduced, however, if the shareholder lends money to the company and thus also acts as a creditor. Indeed, the shareholder may become affirmatively risk averse if her debt interest is sufficiently large.

While this alignment-of-incentives defense of shareholder loans is at least plausible if the shareholder lends on an unsecured basis, it loses nearly all of its force if the loan is secured. The shareholder/secured creditor does not bear the risk of default on her loan due to the security, but still receives the profits if the company succeeds. As a result, the security enables the shareholder to have her cake and eat it too. If anything, a secured loan may exacerbate the conflict between the shareholder’s incentives and the interests of the outside creditors and the company as a whole. It does not remove the shareholder’s incentive to take risks, and at the same time facilitates the financing that may make the risk taking possible.

In short, the creditworthiness standard is particularly difficult to defend as applied to secured shareholder loans. The threat posed by secured shareholder loans is even graver in Germany than in the United States because of differences in the respective insolvency regimes. The manager-displacing quality of German insolvency law creates even stronger incentives for overinvestment, that is, investments in a company that is not worth continuing. Because a managing shareholder knows that she will lose control of her company in the case of insolvency, she will try even harder to save it. A secured shareholder loan presents a relatively safe platform for a rescue attempt. This safety is gained at the expense of the unsecured creditors, however, as it creates the incentive to engage in enormous risks.

Given the threats posed by secured shareholder loans and their comparative lack of benefits for anyone other than the shareholder herself, a per se standard of subordination seems to us the most defensible strategy. Such a standard would greatly discourage secured

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68 Bezzenberger, loc. cit. n. 49, at p. 38.
69 Engert, loc. cit. n. 67, at p. 825, Goetz, op. cit. n. 61, at p. 167 et seq.
70 Engert, loc. cit. n. 67, at p. 831.
73 We are focusing principally on loans made by an existing shareholder. As noted earlier, we are inclined to subordinate the security interest of a creditor that later acquires equity only if the creditor acquires a large or controlling stake.
shareholder loans. At the same time, it would not interfere with the extension of unsecured shareholder loans and thereby would keep this measure of corporate finance relatively intact.

5. Conclusion

Both in the United States and in Germany, lawmakers and courts have long wrestled with the issue of whether to accord shareholder loans the same status as the loans made by outsiders. This article has suggested that courts have been right to worry about the potential effects of loans by shareholders to companies that later prove unable to pay their debts, but that their focus is misplaced in crucial respects. Using Robert Clark’s typology of a debtor’s moral obligations to its creditors as a starting point, we have considered whether and when shareholder loans should be subordinated or recharacterized as equity. Our most important conclusion is that secured shareholder loans so often and so thoroughly violate the obligation of Nonhindrance of creditors that they should always be subordinated.

One question the article has not yet addressed is why creditors do not seem to limit shareholder loans by contract. Creditors could use negative pledge clauses, for instance, to explicitly prevent some or all shareholder loans. We suspect one reason for the dearth of such clauses may be that it is difficult to distinguish good shareholder loans from bad ones—though, as we have argued, it seems likely that secured shareholder loans are rarely both good and necessary. Transaction costs may also discourage many creditors from addressing the risk of a value destroying shareholder loan by contract. It may also be the case that existing, general negative pledge clauses would in fact preclude shareholder loans in many instances. Whatever the explanation, our analysis suggests that, at least in the absence of an explicit agreement by creditors to give priority to a secured shareholder loan, secured shareholder loans should be subordinated.