# Shareholder Loans in Corporate Insolvency – A New Approach to an Old Problem

*By Dirk A. Verse*[*]

## A. Introduction

The treatment of shareholder loans in corporate insolvency is a controversial issue in many jurisdictions. On both sides of the Atlantic, lawmakers and courts have struggled to answer the question if and under what circumstances shareholder loans should be treated differently from loans granted by outsiders. In particular, the difficulties turn on three issues: (i) whether shareholder loans should rank *pari passu* with the claims of outside creditors or whether they should be subordinated; (ii) whether the repayment of shareholder loans should be subject to specific restrictions, particularly in the vicinity of insolvency; and (iii) whether specific restrictions should apply to secured shareholder loans.

In the U.S., the first issue is addressed by the doctrine of equitable subordination and, more recently, by the doctrine of recharacterization of shareholder loans.[1] The second and third issues are addressed by the general provisions on preferences and fraudulent transfers. In Germany, the answers to all three issues are contained in the rules on *Eigenkapitalersetzende Gesellschafterdarlehen* (equity substituting shareholder loans) or, more generally, *Eigenkapitalersatz* (equity substitution). According to these rules in their current form, a shareholder loan or an act equivalent to a shareholder loan is deemed to "substitute for equity" if it was granted or not immediately terminated at a time when the company was in a financial "crisis". In this case the loan will be subordinated in the case of insolvency as if it were equity. In addition, repayments of such equity substituting loans are subject to tight restrictions, and the same applies to the grant of security interests.

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[1] *See, e.g.*, James H.M. Sprayregen, Jonathan P. Friedland, Jo Ann J. Brighton, & Salvatore F. Bianca, *Recharacterization of Debt to Equity: An Overview, Update and Practical Guide to an Evolving Doctrine*, ANNUAL SURVEY OF BANKRUPTCY LAW (2004); David Skeel, Jr. and Georg Krause-Vilmar, *Recharacterization and the Nonhindrance of Creditors*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW (EBOR) 259 (2006).

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Similar to the development in the U.S.,[2] in Germany these rules were initially judge-made law developed and refined in a long line of cases dating back to the late 1930s.[3] In 1980, in an attempt to codify the existing case-law, the parliament intervened and introduced several provisions in the Private Limited Companies Act (*GmbH-Gesetz*, §§ 32a, b GmbHG) and the insolvency legislation. These provisions were meant to replace the previous case-law, but the *Bundesgerichtshof* (BGH – Federal Supreme Court) soon held that they were to be construed as a mere supplement to the judge-made rules.[4] Since then there have been two competing sets of rules that have a common core but are nonetheless different. This is one of the reasons why this area of the law is notorious for its complexity.

In the wider context of a general reform of the law governing the Private Limited Company (GmbH - *Gesellschaft mit beschränkter Haftung*),[5] the German parliament now has undertaken a second attempt to codify the rules on shareholder loans. This time the reform is aimed at all companies with limited liability, and not just at the GmbH.[6] The reform bill provides for a fairly radical change and simplification of the current rules. Since shareholder loans are very popular in practice, it is fair to say that the amendments in this area belong to the most important issues of the whole GmbH reform.

This paper seeks to outline the new rules brought before the *Bundestag* (Federal Parliament) on 26 June 2008.[7] If the new law passes the *Bundesrat* (Federal Council of States) as expected, it will enter into force in late 2008. Part B of this paper will be devoted to the issue of subordination, while Part C will focus on repayments of shareholder loans and their potential avoidance. The particular rules for secured shareholder loans will be considered in Part D. Finally, part E will address the increasingly important issue of whether the rules on shareholder loans also apply to foreign companies operating mainly or exclusively in Germany.

[2] *See* Taylor v. Standard Gas & Electric, 306 U.S. 307 (1939) (on equitable subordination).

[3] Reichsgericht (RG— Court of the German Empire), 67 JURISTISCHE WOCHENSCHRIFT (JW) 862 (1938); Reichsgericht, 68 JURISTISCHE WOCHENSCHRIFT (JW) 355 (1939). The precedent in the jurisprudence of the BGH is ENTSCHEIDUNGEN DES BUNDESGERICHTSHOFS IN ZIVILSACHEN (BGHZ) 31, 258.

[4] BGHZ, 90, 370.

[5] Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG — Act to Modernize the Law Governing Private Limited Companies and to Combat Abuses).

[6] *E.g.*, stock corporations (*AG*), limited partnerships which do not have an individual as their general partner (*GmbH & Co. KG*) and foreign companies operating mainly in Germany. On the latter, *see infra* Part E.

[7] The final version is published in BTDrucks 16/9737.

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## B. Subordination of Shareholder Loans

While some legal systems, such as the U.K. and France, provide for no specific regulations on shareholder loans to distressed companies, many other jurisdictions (including the U.S., Italy, Spain, Austria and Germany) have specific rules, which, under certain circumstances, provide for the subordination of shareholder loans to the claims of other creditors.[8] Despite this fact, the current rules in Germany on the subordination of equity substituting shareholder loans have increasingly come under attack in recent years. While some authors have pleaded for narrowing down the scope of the existing rules,[9] others have gone so far as to call for abolishing subordination in general.[10] The reform, however, takes neither of these routes. It extends the scope of subordination to (almost) *all* shareholder loans.

### *I. The Current Law: Subordination of Loans Deemed to "Substitute Equity"*

In order to fully understand the reform, it is necessary briefly to recall the German position. Under the current law, a shareholder loan will be deemed to "substitute for equity" and hence be subordinated in the insolvency of the company if it was granted in the course of a "crisis" of the company.[11] The same applies to a shareholder loan granted before the onset of a crisis if the shareholder did not withdraw the loan as soon as the crisis began.[12] Both cases have in common that the

[8] For a comparative overview, see Martin Gelter, *The subordination of shareholder loans in bankruptcy*, 26 INTERNATIONAL REVIEW OF LAW AND ECONOMICS 478, 479-482 (2006); Martin Gelter and Jürg Roth, *Subordination of Shareholder Loans from a Legal and Economic Perspective*, 5 JOURNAL FOR INSTITUTIONAL COMPARISONS 40, 40-45 (2007); Ulrich Huber and Mathias Habersack, *Special Rules for Shareholder Loans: Which Consequences Would Arise for Shareholders if the System of Legal Capital Should be Abolished?*, *in* LEGAL CAPITAL IN EUROPE, 308, 308-321 (Marcus Lutter ed., 2006).

[9] *See, e.g.*, Gelter, *supra* note 8, at 479-482; Gelter and Roth, *supra* note 8, at 40-45.

[10] *See, e.g.*, Andreas Cahn, *Equitable Subordination of Shareholder Loans?*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW (EBOR) 287 (2006); Peter O. Mülbert, *A Synthetic View of Different Concepts of Creditor Protection, or: A High-Level Framework for Corporate Creditor Protection*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW (EBOR) 357, 397-399 (2006); Horst Eidenmüller, *Gesellschafterdarlehen in der Insolvenz*, *in* 2 FESTSCHRIFT FÜR CLAUS-WILHELM CANARIS 49 (Andreas Heldrich ed., 2007); SIMON M. BECK, KRITIK DES EIGENKAPITALERSATZRECHTS (2006). For a contrasting view, see Karsten Schmidt, *Vom Eigenkapitalersatz in der Krise zur Krise des Eigenkapitalersatzrechts?*, 96 GMBH-RUNDSCHAU 797 (2005).

[11] Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG — Private Limited Company Act) § 32a (1); Insolvenzordnung (InsO – Insolvency Code) § 39 (1) n. 5. Until 1998, GmbHG § 32a (1) even provided that the claim be disallowed.

[12] For details, *see* Mathias Habersack, *§§ 32a, b*, *in* GMBH GROSSKOMMENTAR, margin numbers 43-51 (Peter Ulmer ed., 2006).

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shareholder makes a decision to financially support the company despite the crisis, whether by actively granting a loan or by abstaining from withdrawing it. A company is deemed to be in crisis if it is either insolvent (illiquid or overindebted) or at least "unworthy" of credit, meaning that a third party other than a shareholder would not grant a loan such as the one actually given.[13]

In contrast to the equitable subordination doctrine in the U.S.,[14] German law does not require proof of any kind of inequitable conduct on the part of the shareholder towards the company or its creditors. The mere fact that the shareholder has granted (or has not withdrawn) a loan in a situation where a third party would not have taken a similar risk is considered sufficient for subordinating that shareholder's claim. Furthermore, different from the recharacterization doctrine in the U.S.,[15] subordination under German law also applies if it is properly documented and perfectly unambiguous that the parties intended to agree on a loan rather than an equity contribution.

### *II. The New Approach*

#### *1. Subordination of All Shareholder Loans*

In contrast to the current rules, the new law will no longer turn on the distinction between equity substituting shareholder loans and other shareholder loans. Rather, subject only to the two exceptions explained below, the subordination will automatically apply to *all* shareholder loans.[16] The inquiry whether or not the loan was granted (or not withdrawn) in the course of a crisis of the company will thus become redundant. This approach is apparently inspired by the position of a Spanish law that also subordinates all shareholder loans.[17] A similar automatic

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[13] *Id.* at margin numbers 62-66.

[14] *See* the three-prong test developed in *In re Mobile Steel Co.* 563 F.2d 692, 700 (5th Cir. 1977), requiring (1) inequitable conduct, (2) injury to creditors or an unfair benefit to the challenged claimant, and (3) that subordination may not conflict with other provisions of the Bankruptcy Code.

[15] According to the analysis in *In re Autostyle Plastics*, 269 F.3d 726, 750 (6th Cir. 2001), courts should consider eleven factors when deciding on recharacterization. The first three of these factors focus on whether or not the loan was properly documented. *See* Skeel and Krause-Vilmar, *supra* note 1, at 277, 279 (noting that "[i]f the loan is properly documented, courts are loath to interfere").

[16] InsO § 39 (1) n. 5, as amended.

[17] *See* Huber and Habersack, *supra* note 8, at 315-316 (discussing the Spanish position). The new law borrows heavily from the ideas of these two authors, as is apparent from a proposal submitted by them in early 2006; *see* Ulrich Huber and Mathias Habersack, *GmbH-Reform: Zwölf Thesen zu einer möglichen Reform des Rechts der kapitalersetzenden Gesellschafterdarlehen*, 61 BETRIEBS-BERATER (BB) 1 (2006).

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subordination rule was considered in the U.S. in the 1970s, but was not enacted by Congress.[18]

There are two exceptions which already exist under the current law[19] and will continue to apply under the new rules.[20] The first exception relates to shareholders who (i) are not directors of the company and (ii) do not hold more than 10 % of the registered capital.[21] The subordination is thus confined to shareholders who, at least typically, have a significant influence on the management of the company. This is designed to help companies receive financial support in situations where a lender, for instance a bank, holds a small number of shares in the company. The second exception applies in the course of a rescue attempt by an investor who previously did not hold shares in the company (or only held a small number which fell under the first exception). If such an investor acquires shares in order to rescue the company from a crisis, any loans granted by him or her before or in connection with the acquisition of the shares will not be subordinated.[22] This exception shall serve as an incentive for rescue attempts from outside investors.

*2. Practical Consequences*

The new approach is based on the idea that its application in practice will be simpler than the current law, as the exact determination of when the company's crisis began will no longer be required. The official notes on the new rules further argue that the practical consequences of the new approach will not materially differ from the current position, since under the current law shareholder loans outstanding at the date of the insolvency filing already were regarded as equity substituting loans in the vast majority of cases.[23] Indeed, as we have seen, shareholder loans are already deemed to substitute for equity as soon as the crisis begins if the shareholder does not immediately withdraw the loan. Therefore, since virtually every insolvency is preceded by a crisis, a shareholder loan still outstanding at the date of the insolvency filing will, in almost all cases, be regarded

[18] *See* ROBERT C. CLARK, CORPORATE LAW 69 (1986).

[19] *See* GmbHG § 32a (3) n. 2-3.

[20] In the future they will be found in InsO § 39 (4), (5), as amended.

[21] InsO § 39 (4), as amended. Note that the 10 % threshold will henceforth not only apply to the *GmbH*, but also to a stock corporation (*AG*). Up to now, the relevant threshold in an *AG* was 25 % of the registered capital.

[22] InsO § 39 (5), as amended.

[23] BTDrucks 16/6140.

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as an equity substituting loan and will be caught by the subordination. The only (rather theoretical) exception would be the case of a formerly prosperous company, as a result of an exogenous shock, falling into insolvency so suddenly that the shareholder did not have time to react to the crisis prior to the insolvency filing. In this exceptional case, the shareholder did not make a financing decision while the company was in crisis, so his loan would not be regarded as an equity substitute under the current rules. In contrast, under the new approach, this would be irrelevant and the loan would be subordinated nonetheless. Leaving this case aside, the results of the new approach to subordination will indeed be no different from those under the current law.[24]

*3. A New Theoretical Basis?*

The question remains, of course, how such a wide-reaching subordination of shareholder loans can be explained on policy grounds.

The rationale for the current rules was explained by the Federal Supreme Court as follows:[25] When a company is facing a financial crisis shareholders have to make a decision whether they wish to liquidate the company or maintain it by granting financial support. If a shareholder chooses the latter option and thereby enables the precarious business to continue, then he or she must be prevented from speculating at the expense of the creditors. A shareholder could easily speculate at the expense of the creditors if he or she could act in the belief that, due to his or her insider status, he or she will be able to withdraw the loan early enough before the insolvency. In order to avoid this, the loan is treated as equal to equity with the twofold effect that (i) it may not be withdrawn until the financial difficulties have been resolved[26] and (ii) it will be subordinated in the insolvency of the company. The same is sometimes summarized by saying that the shareholder shall bear the full responsibility for the consequences of his or her financing decision made while the company was experiencing a crisis (*Finanzierungsfolgenverantwortung*).

While it is sometimes contended that the same rationale underlies the new approach,[27] the better view is, arguably, this is not the case. As we have seen, in the

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[24] Note, however, that the new approach triggers considerable practical consequences in other areas, particularly as regards the repayment restrictions on shareholder loans; *see infra* Part C.

[25] BGHZ 90, 381, (388-389).

[26] For details *see infra* Part C.

[27] Reinhard Bork, *Abschaffung des Eigenkapitalersatzrechts zugunsten des Insolvenzrechts?*, 36 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 250, 257-258 (2007).

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future the subordination will also apply to cases where a shareholder never made any financing decisions while the company was in crisis. Under those circumstances, it will be impossible to base subordination on the rationale described above.[28]

It follows that a new rationale is required to explain and legitimize the new rules. Such an explanation is, however, not easy to find. The most plausible explanation that has been offered so far is that subordination of all shareholder loans will simply ensure that the shareholders adequately participate in the entrepreneurial risk of the company. This, in turn, will prevent the shareholders from taking excessive risks to the disadvantage of the creditors. It is argued that the rules on raising capital and capital maintenance, taken on their own, are insufficient to accomplish that aim since the registered capital is often very low. Therefore, these rules need to be supplemented by a rule that extends the entrepreneurial risk of the shareholders to the whole amount of financial support granted by them to the company regardless of whether it was granted as equity or debt.[29]

This explanation, however, is controversial. As stated above, the current rules are subject to fierce criticism. *A fortiori*, the same objections are now raised against the new approach. In particular, the argument has been made that subordination may deter shareholders from granting loans in situations where loans would be used for projects that are *ex ante* efficient (projects that have a positive present value). Subordination should therefore be restricted to shareholder loans that fail this *ex ante* efficiency test.[30] An obvious objection to this approach is, however, that courts are ill-equipped to make these calculations and their judgment would probably be prone to hindsight bias.[31]

A second, possibly more convincing, argument against subordination is that the fear of excessive risk-taking at the expense of the creditors is already sufficiently counteracted by prohibiting the repayment of loans during a certain period prior to insolvency. If a shareholder is unable to withdraw the loan in the vicinity of insolvency and thus bears the risk of only receiving the insolvency quota, that

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[28] For a concurring view, see Mathias Habersack, *Gesellschafterdarlehen nach MoMiG: Anwendungsbereich, Tatbestand und Rechtsfolgen der Neuregelung,* ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 2145, 2146-2147 (2007); Ulrich Huber, *Finanzierungsfolgenverantwortung de lege lata und de lege ferenda*, FESTSCHRIFT FÜR HANS-JOACHIM PRIESTER 259 (Peter Hommelhoff, Peter Rawert & Karsten Schmidt eds., 2007).

[29] Huber, *supra* note 28, at 275-278.

[30] Gelter, *supra* note 8; Gelter and Roth, *supra* note 8; Ulrich Haas, *Das neue Kapitalersatzrecht nach dem RegE-MoMiG*, ZEITSCHRIFT FÜR DAS GESAMTE INSOLVENZRECHT (ZINSO), 617, 624-625 (2007).

[31] Skeel and Krause-Vilmar, *supra* note 1, at 271; Cahn, *supra* note 10, at 294.

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shareholder already has a strong incentive to avoid excessive risks and to make a careful assessment of the chances of the company's survival before granting the loan. This argument is supported by insolvency quotas for unsecured creditors in Germany, which are notoriously low.[32] In more than 40% of all company insolvencies, proceedings are not even commenced because the assets are insufficient to cover the expenses.[33] If rules are in place to ensure that shareholders are barred from abusing their insider status to withdraw loans in the vicinity of insolvency, shareholder loans are subject to the same risks as unsecured third-party loans. Against this background, there is much to be said for the view that shareholder loans should rank *pari passu* with the claims of other unsecured creditors.[34] Be that as it may, the lawmakers' decision is clearly to the contrary. The mere fact that the shareholder-lenders are "closer to the business" of the company will suffice to make them bear a higher risk than the ordinary creditors.[35]

## C. Repayment of Shareholder Loans

Shareholders will often be the first to know if and when the company is approaching insolvency. In this situation, they will be inclined to terminate the loan and cause the company's directors to effect its repayment. To allow such behavior would, however, enable shareholders to speculate at the expense of the creditors. Moreover, allowing shareholders to exploit their insider status in order to recover their loan in full, while loans from outside lenders will only be satisfied in the amount of the insolvency quota undermines the basic principle of *par condicio creditorum*. For these reasons, different from the controversial issue of subordination, it is clear that the law should impose certain restrictions on the repayment of shareholder loans in the vicinity of insolvency.[36]

[32] Empirical data from 1994-1998 suggests that, on average, unsecured creditors receive quotas of less than 5 % in the insolvency proceedings; *see* Joachim Bauer, *Ungleichbehandlung der Gläubiger im geltenden Insolvenzrecht*, DEUTSCHE ZEITSCHRIFT FÜR WIRTSCHAFTS- UND INSOLVENZRECHT (DZWIR) 188, 189 n. 21 (2007).

[33] For details, *see* Jürgen Angele, *Insolvenzen 2006*, WIRTSCHAFT UND STATISTIK 352, 355 (2007). This figure used to be even higher in the past (up to 75 %).

[34] Cahn, *supra* note 10, at 295-298, 299-300. For further arguments against subordination, see Mülbert, *supra* note 10, and Eidenmüller, *supra* note 10, at 57-60 arguing, *inter alia*, that the risk for creditors does not stem from the loan as such but rather from wrongful management decisions taken by the directors in the vicinity of insolvency. Therefore, Eidenmüller argues that liability should be strengthened in the latter respect rather than penalizing shareholder loans by way of subordination.

[35] Habersack, *supra* note 28, at 2147.

[36] *See, e.g.*, Cahn, *supra* note 10, at 296-298; Mülbert, *supra* note 10, at 397; Eidenmüller, *supra* note 10, at 61-62.

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In the U.S., this would be a case for the general provisions on preferences and fraudulent transfers. In Germany, rules specifically designed for the repayment of shareholder loans apply. The reform considerably modifies these existing repayment restrictions. Compared to the existing rules, the new rules are partly stricter and partly more lenient for shareholders.

*I. The Current Law: Repayment Restrictions only for Loans Deemed to "Substitute Equity"*

The current repayment restrictions on shareholder loans are found both in the statutory law and the judge-made rules developed by the Federal Supreme Court. Both sets of rules have in common that only the repayment of loans which are deemed to substitute for equity is subject to restrictions.

The statutory regulations provide that any repayment of equity substituting loans made within a one-year period prior to the filing for insolvency is subject to avoidance by the insolvency administrator.[37] As a consequence of avoidance, the full amount of the repayment must be reimbursed to the company.[38] If no insolvency proceedings are commenced, then the right to avoid the repayment can be exercised by the creditors themselves.[39]

Further restrictions are contained in the judge-made rules. Courts developed these rules by drawing an analogy to the statutory provisions on capital maintenance.[40] The capital maintenance regime prohibits distributions made by the company to its shareholders for as long as the net assets of the company are lower than the company's registered capital. This barrier is also applied to repayments of shareholder loans deemed to substitute for equity. As a result, if the company's net assets fall short of the registered capital, the repayment of the loan is barred to the extent of such shortfall.[41] If the repayment is made nevertheless, the shareholder is liable to reimburse the barred amount.[42] This liability is of considerable practical

[37] InsO § 135 n. 2.

[38] InsO § 143 (1).

[39] AnfG §§ 6 n. 2, 11 (1).

[40] GmbHG §§ 30, 31.

[41] Example: The company has assets totalling 300 and liabilities (including the equity substituting loan) totaling 285, hence the net assets amount to 15. If the registered capital is 25, the repayment of the loan is barred in the amount of 10. *See* Habersack *supra* note 12, margin number 214.

[42] Habersack, *supra* note 12, margin numbers 214 and 221.

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importance since, unlike of the statutory avoidance rules, it also applies when the repayment was made more than one year prior to the insolvency filing.[43] If, for instance, the company was already in crisis two years before it filed for insolvency, any repayments made at that time can still be recovered under the judge-made rules. These repayments would, however, be out of reach under the statutory avoidance provisions. Another difference between the judge-made rules and the statutory provisions stems from the fact that, at least in theory, the company's claims for reimbursement under the judge-made rules can also be asserted outside of a company's insolvency proceedings. In practice, however, such claims are rarely asserted prior to the insolvency proceedings.

### *II. The New Approach*

#### *1. Avoidance of All Repayments in the Vicinity of Insolvency*

The reform will alter the existing restrictions on the repayment of shareholder loans in two ways. First, statutory avoidance provisions will be extended to apply to *all* shareholder loans and not just to loans deemed to substitute for equity. As a result, the repayments of *all* shareholder loans will be subject to avoidance if they were made within a one-year period prior to, or after the filing for insolvency.[44] Parallel to what has been said with regards to subordination, the questions of when the crisis began and whether or not the loan was granted or not withdrawn while the company was in crisis will no longer be relevant. This new approach is subject only to the two exceptions mentioned above for small shareholders and investors who acquire shares in an attempt to rescue the company. As described above, these exceptions are already a part of the current law and will continue to apply in the new law with the effect that neither the subordination nor the avoidance rules will apply to such cases.[45]

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[43] The limitation period is ten years; GmbHG § 31 (5).

[44] InsO § 135 n. 2, as amended. If no insolvency proceedings are commenced, the one-year period is to be calculated not from the date of the insolvency filing, but from the date on which the creditor obtained an enforceable title for his claim; *see* AnfG § 6 n. 2, as amended.

[45] *See supra* Part B.II.1. Note that while the exception for small shareholders can easily be explained on the ground that such shareholders will typically not have the same informational advantage as other corporate insiders, the merits of the second exception are dubious as far as repayments are concerned. It may be useful to give an incentive to investors who acquire shares in an attempt to rescue the company by exempting them from the subordination rule. It is difficult to see, however, why such an investor should also be exempt from the repayment restrictions, given that this enables him to abuse of his insider status by causing the repayment of his loan in the vicinity of insolvency.

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The second alteration to the existing rules involves abolition of the judge-made rules without substitution.[46] Taken together, both alterations will considerably simplify the application of the law. In the future, it will only have to be determined whether or not the repayment was made more than one year prior to the insolvency filing. If the answer will be yes, then the shareholder will be entitled to keep the repayment. If the answer will be no, with the two exceptions mentioned above, then the repayment will be subject to avoidance.

*2. Practical Consequences and Merits of the New Approach*

*2.1. Additional Risks for Shareholders*

The new approach is based on the assumption that, typically, the company will already have been in financial distress in the year prior to the insolvency filing and that, therefore, the approaching insolvency will have been discernible during that period. Obviously, this is a bright line approach that has its accompanying pros and cons. A clear advantage of this approach is that it produces predictable results and avoids the difficult inquiry of when exactly the crisis of the company began. The disadvantage is that this approach lacks the flexibility to do justice in each individual case.

It is undeniable that, compared to the current law, the new approach will at least partly deteriorate the shareholder-lenders' position. This is true for all cases where a company was not in crisis at the time of the repayment of the loan, but due to an exogenous shock or other unexpected events became insolvent within the next 12 months. Though such cases may be relatively rare,[47] they cannot be ruled out. Under the current law, the repayment would not be subject to avoidance in these circumstances since the company was not in crisis at the time of the repayment. In contrast, under the new rules, the repayment will be subject to avoidance merely because it was made within a one-year period prior to the insolvency filing.

It remains to be seen whether the courts will be prepared to soften the new approach by allowing certain exceptions in cases where it is obvious that the shareholder-lender was unable to discern the approaching insolvency and did not abuse his insider status. A good example would be the case of a shareholder who, at a time when the company was still prosperous, sold his shares to a new investor and had his shareholder loans repaid on that occasion. Let's assume the new

[46] GmbHG § 30 (1) s. 3 and AktG § 57 (1) s. 3, as amended.

[47] Empirical data suggests that most companies are in financial distress long before the insolvency petition is filed; *see* Haas, *supra* note 30, at 621.

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investor ran down the business and the company thereupon filed for insolvency within a one-year period after the sale of the shares. If the new rules are taken literally, the repayment of the loan would be subject to avoidance even if it is perfectly clear that it was the new investor who caused the insolvency of the formerly prosperous company. There is much to be said for the view that such a case should be exempt from the new rule since the underlying rationale evidently does not apply.[48] However, such exceptions will have to be construed narrowly, since otherwise the advantages of the bright line approach would be undermined. It is precisely the intention of the new law to render it unnecessary for the courts to dwell into the difficult issue of when exactly the company entered into financial distress and whether or not the approaching insolvency should have been foreseen. In any event, in such cases as the one described in the example, a shareholder-lender can best circumvent the problem by selling the loan along with the shares to the new investor, rather than having the loan repaid.[49]

*2.2. Safe Harbor for Repayments Made more than One Year Prior to the Insolvency Filing*

On the other hand, the new bright line approach gives the shareholders advantage by providing a safe harbor for loan repayments made more than one year prior to the insolvency filing. This differs markedly from the current law since, as noted above,[50] the judge-made rules were also applied to repayments made at a much earlier point in time. The new approach thus entails a significant gain in legal certainty.

A concern has been raised that the safe harbor rule will give an incentive to postpone the insolvency filing until the one-year period has expired. In order to prevent this, it has been argued that the one-year period should be calculated not from the date of the insolvency filing but rather from the date on which the company first became insolvent.[51] The objection to this proposal, however, is that it would re-introduce precisely the same sort of uncertainties which the reform seeks to avoid. Apart from that, delays in the insolvency filing are penalized by far-reaching sanctions.[52] Against this background, it appears preferable that the one-

[48] *See* Eidenmüller, *supra* note 10, at 64; Peter O. Mülbert, *Neuordnung des Kapitalrechts*, 60 WERTPAPIER-MITTEILUNGEN (WM) 1977, 1978-1979 (2006).

[49] *See, e.g.*, Eckhard Wälzholz, *Die insolvenzrechtliche Behandlung haftungsbeschränkter Gesellschaften nach der Reform durch das MoMiG,* DEUTSCHES STEUERRECHT (DSTR) 1914, 1920 (2007).

[50] *Supra* Part C.I.

[51] *See, e.g.*, Gerrit Hölzle, *Gesellschafterfremdfinanzierung und Kapitalerhaltung im Regierungsentwurf des MoMiG*, 98 GMBH-RUNDSCHAU 729, 733 (2007).

[52] See the contribution by Matthias Casper in this issue of the GERMAN LAW JOURNAL.

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year period runs from the filing of the insolvency petition and not from the beginning of the insolvency itself.

## D. Secured Shareholder Loans

While the analysis thus far has only addressed unsecured shareholder loans, the reform also has repercussions on secured shareholder loans. Current law contains an avoidance provision that is specifically targeted at the grant of security interests for shareholder loans. It provides that the insolvency administrator is entitled to avoid and claim to any security interest for shareholder loans deemed to substitute for equity, provided that the security interest was granted within a ten-year period prior to the insolvency filing.[53] In line with the general approach of the reform, the new law will introduce the same rule not just for equity substituting loans, but for all shareholder loans.[54] However, as mentioned above, this is subject to the two exceptions: small shareholders and investors who acquire shares in an attempt to rescue the company.[55]

The fact that the avoidance of security interests is no longer confined to equity substituting shareholder loans substantially restricts the scope of secured shareholder-lending. Under current law, if a company falls into a crisis, the shareholder-lender is able to escape the requalification of his loan as an equity substitute by immediately terminating the loan. In this case, the shareholder's security interest will not be caught by the current rules and may thus be enforced by the shareholder. In contrast, under the new law, the shareholder's security interest will be subject to avoidance even if that shareholder responds to the crisis by immediately terminating the loan.[56]

The reason why the law seeks to avoid shareholders' security interests is fairly obvious: The subordination of shareholder loans could easily be circumvented if shareholders could simply rely on their security interests. This rationale also explains why the avoidance period of ten years for security grants is much longer

[53] InsO § 135 n. 1. If no insolvency proceedings are commenced, the creditors themselves are entitled to avoid and claim back the security interest under AnfG § 6 n. 1.

[54] InsO § 135 n. 1, as amended; *cf. also* AnfG § 6 n. 1, as amended.

[55] *Supra* Part B.II.1.

[56] For a critical analysis of the consequences of this approach in particular with regard to intra-group financing, *see* Michael Burg and Stefan Westerheide, *Praktische Auswirkungen des MoMiG auf die Finanzierung von Konzernen*, 63 BETRIEBS-BERATER (BB) 62 (2008).

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than the avoidance period of only one year for repayments.[57] It should be added that, even if there was no subordination rule, there would still be good reason for striking down the shareholders' security interests.[58] The reason is that lending on a collateralized basis would permit shareholders to finance excessively risky projects while at the same time limiting their exposure to a minimum. This is particularly worrisome in cases where shareholders' equity stake is low or widely dissipated and therefore no longer serves as an incentive to abstain from extremely risky transactions and transactions with a negative present value. Therefore, in order to prevent the shareholders from speculating at the expense of the creditors, it would appear well-founded to have a rule which avoids the shareholders' security interests even if no subordination rule existed.

**E. (Pseudo-) Foreign Companies**

Another important aspect of the reform deserves mentioning. As a result of the case-law of the European Court of Justice (ECJ) on freedom of establishment (art. 43, 48 EC Treaty), and specifically the landmark decisions in *Centros*, *Überseering* and *Inspire Art*,[59] the number of (pseudo-) foreign companies operating mainly or exclusively in Germany has increased dramatically.[60] It is, therefore, not surprising that the reform also addresses the issue of whether or not the abovementioned rules on shareholder loans are applicable to such foreign companies.

Under the relevant rules of private international law, the answer to this question depends on whether the rules on shareholder loans are to be regarded as a matter of corporate law or insolvency law. In the former case, these rules would be inapplicable to foreign companies, since the *lex societatis* is determined by the place of incorporation.[61] If, in contrast, these rules are classified as belonging to

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[57] Huber and Habersack, *supra* note 8, at 5-6, even suggest that the avoidance should not be subject to any deadline at all.

[58] *See* Cahn, *supra* note 10, at 298; Skeel and Krause-Vilmar, *supra* note 1, at 271-274; Andreas Engert, *Die ökonomische Begründung der Grundsätze ordnungsgemäßer Unternehmensfinanzierung*, 33 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 813, 830-831 (2004).

[59] Case C-212/97, Centros Ltd v. Erhvervs- og Selskabsstyrelsen, 1999 ECR I-1459; Case C-208/00, Überseering BV v. Nordic Construction Company Baumanagement GmbH, 2002 ECR I-9919; Case C-167/01, Kamer von Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 ECR I-10155.

[60] On the rise of the UK limited company in Germany, *see, e.g.*, Marco Becht, Colin Mayer & Hannes F. Wagner, *Where do Firms Incorporate? Deregulation and the Cost of Entry*, ECGI LAW WORKING PAPER N. 70/2006 (AUGUST 2007); Dirk A. Verse, *Company Law Reform in Germany – The Proposed New Private Limited Company Law –*, 4 KYOTO JOURNAL OF LAW AND POLITICS 1, 3 (2008).

[61] This "incorporation theory" has been controversial for many years, but is now the prevailing view also in Germany, at least with regard to E.U. and U.S. companies. For details, *see* Andreas Heldrich, *Anh. zu*

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insolvency law, the *lex fori concursus* will apply. For foreign companies operating mainly or exclusively in Germany this will be German law, since the insolvency proceedings of these companies are subject to the jurisdiction of the German courts.[62]

Under the current law, the issue of whether the rules on shareholder loans fall under the *lex societatis* or the *lex fori concursus* remains controversial. The official notes on the new rules suggest that the latter view should be preferred.[63] In order to underline this position, the new rules will be contained exclusively in the insolvency legislation whereas hitherto they were contained partly in the *GmbH-Gesetz* and partly in insolvency law.[64] There is indeed much to be said for the view that the rules on shareholder loans should be regarded as part of the *lex fori concursus*. German legislature, however, is probably not in power to decide this issue for companies from other EU member states. Rather, its outcome has already been decided by art. 4 (2) of the European Insolvency Regulation, which provides that, *inter alia*, the ranking of the claims in insolvency as well as the rules relating to the avoidance of legal acts detrimental to creditors are parts of the *lex fori concursus*.[65] It is hard to see why the rules on shareholder loans should not be caught by this provision.[66]

The argument has been made, however, that even if the rules on shareholder loans are subject to the *lex fori concursus*, they could still not be applied to (pseudo-) foreign companies from other EU member states because doing so would violate the freedom of establishment (art. 43, 48 EC Treaty). Although the more convincing view is probably that there is no such violation,[67] this is a difficult question which

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*Art. 12 EGBGB*, *in* BÜRGERLICHES GESETZBUCH, margin numbers 6, 23 (Otto Palandt ed., 67th ed., 2008). Note that the German government is currently preparing a reform of international company law which shall codify the incorporation doctrine for companies from all jurisdictions.

[62] *See* European Insolvency Regulation, art. 3 (1) § 1 and art. 4 (1), Council Regulation 1346/2000, 2000 O.J. (L160) 1 on insolvency proceedings.

[63] BTDrucks 16/6140.

[64] GmbHG §§ 32a, b will be repealed, and the new provisions will be found in InsO §§ 39, 135 and AnfG § 6 as amended.

[65] European Insolvency Regulation, art. 4 (2) (i), (m), Council Regulation 1346/2000, 2000 O.J. (L160) 1.

[66] For a detailed analysis of this issue, *see* Ulrich Huber, *Gesellschafterdarlehen in der Inlandsinsolvenz von Auslandsgesellschaften*, *in* EUROPÄISCHE AUSLANDSGESELLSCHAFTEN IN DEUTSCHLAND 131, 165-185 (Marcus Lutter ed., 2005).

[67] *See* Huber, *supra* note 66, at 185-188; *but see* Horst Eidenmüller, AUSLÄNDISCHE KAPITALGESELLSCHAFTEN IM DEUTSCHEN RECHT, § 9, margin number 44 (2004).

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may ultimately have to be resolved by the ECJ. For the time being, shareholders of (pseudo-) foreign companies should take into account that there is at least a considerable risk that the German rules on shareholder loans will be applied against them.

## F. Conclusion

The GmbH reform marks a paradigm shift in the treatment of shareholder loans in corporate insolvencies in Germany. While the current law turns on the distinction between shareholder loans granted or not withdrawn in the course of a financial crisis (equity substituting loans) and other loans, the new law will introduce an automatic subordination rule which, subject to few exceptions, will apply to *all* shareholder loans. The new rules will further provide that repayments of all subordinated shareholder loans made within a one-year period prior to the insolvency filing are subject to avoidance. The same applies to the grant of security interests by the company for all subordinated shareholder loans if the security interest was granted within a ten-year period prior to the insolvency filing.

While the German government praises the new rules for enhancing the competiveness of the *GmbH* in the international competition of company law regulators, the new rules are in fact partly stricter and partly more lenient for shareholders. In particular, the fact that the application of the new rules no longer depends on the requirement of a crisis has the effect that repayments of shareholder loans may be avoided merely on the ground that they were made less than one year prior to the insolvency filing. The reverse side of the coin, however, is that there is now a safe harbor for repayments made more than one year prior to the insolvency filing. This is a considerable gain in legal certainty as compared to the current law. Taken together, the new rules will markedly simplify the treatment of shareholder loans in corporate insolvency. In an area of the law which is notorious for its complexity, this is no little achievement.

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