Subordination of Shareholder Loans between Creditor Protection and Rescue Culture: An Escapable Tension?

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Introduction

This paper provides a critical overview of the different legislative frameworks which have been traditionally regarded as the most comprehensive models addressing the widespread practice of loans granted by shareholders to their company in the vicinity of insolvency. Rather than having its scope solely narrowed to what could be purely defined as a "comparative overview"[1], this paper revolves around the underlying foundational issues that an unregulated practice of shareholder loans may bring about, especially, having regard to the harm it invariably causes to claims of the external creditors of the company in the context of its insolvency. To this extent, the legislative models should be conceived, primarily, as specific attempts to cope with such issues in a particular jurisdiction. In this respect, the solution generally envisaged is ultimately branded in the rule commanding the subordination of shareholder loans to the debt provided by external creditors, if not, as it will be outlined, in the outright recharacterization of such loans into equity, with all the practical consequences such a treatment entails.

Against this backdrop, this paper argues that an unselective subordination of shareholder loans should not be considered as the "panacea" to all the issues a company invariably suffers from as it gets closer to its end. On the contrary, more room should be left in the legal analysis to the arguments which focus on the valuable part shareholder loans could perform in rescuing the company.

For purposes of adequately carrying out such a wide-ranging analysis and understanding what is at stake beneath the different rules, it is essential to "set the scene" by outlining the distinct roles that debtholders, or creditors, and shareholders accomplish within the company, and the respective legal functions debt and equity have in relation to its capital structure, in what has been effectively described as "the battle for value in financially distressed firms".[2] As set out in Section 2, the focus is on the different entitlements shareholders and creditors have on insolvency with respect to the different kinds of investment they make in relation to the company and the corresponding economic expectations of return they can legitimately claim in consequence. Following these footsteps, the universally accepted rule of corporate finance and corporate law in the context of the failure of the company is referred to as "equity is wiped out first".[3] Having this rule as a background will allow the opportunity to appreciate the shareholders' tendency of dressing their investment to the company in the form of a loan rather than as a contribution to capital. Further, it will also make it possible to explore the underpinning function of Insolvency Law, which has typically been described as "creditor law"[4] . The distortion to such function is as a result of the reckless acceptance of the practice of shareholder loans, the fundamental part that the rule of subordination serves in restoring it.

As a follow-up to these essential premises, Section 3 delivers an assessment of the legislative models which functionally stand as two different means to regulate the practice of shareholder loans: US law and German law. While the statutory provisions of German Insolvency Law in this area were subject to fundamental reform in 2008,[5] the US rules still consistently date back to the case-law of the Supreme

[1] For a comparative overview, M Gelter and J Roth, "Subordination of Shareholder Loans from a Legal and Economic Perspective" (2007) Harvard Law and Economics Discussion Paper No. 13, Journal for Institutional Comparisons, Vol. 5, No. 2, 40-47; U. Huber and M. Habersack, "Special Rules for Shareholder Loans: Which Consequences Would Arise for Shareholder if the System f Legal Capital Should Be Abolished?" (2006), Legal Capital in Europe 308-321.

[2] RJ de Weijs, "Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt–Equity Divide" (2018) 15 European Company and Financial Law Review 405.

[3] RJ de Weijs, "Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt–Equity Divide" (n 2) 414.

[4] Ibid 414.

[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) <http://www.bgbl.de/xaver/bgbl/start.xav?startbk=Bundesanzeiger_BGBl&jumpTo=bgbl108s2026.pdf> (accessed 3 June 2019).

Court and set out a marked distinction between the Doctrine of Equitable Subordination and the Doctrine of Recharacterization with respect to purported loans in the context of insolvency.

Having explored the underlying corporate law tensions and the rules provided by the most assertive legal frameworks, Section 4 raises the question as to the possible connection which may be established between the existing economic models on the subject and the legal rules in order to make the point that shareholder loans could efficiently serve as an essential medium to rescue the company in the vicinity of its insolvency.[6] Finally, Section 5 concludes.

Debt and Equity: the "battle for value" between shareholders and creditors and the lost function of Insolvency Law

Money is not just money: the struggle for creditors

As a matter of fact, companies need finance in order to engage in business activities and, at the outset, it could be obtained either in the form of equity contributed by shareholders or debt provided by creditors, *tertium non datur*. From a corporate finance perspective, if one were to argue about the criterion companies should adopt to choose between these two mediums of finance to manage its financial structure, it would be necessary to fall back, at least as a starting point, on the Modigliani and Miller's classic article on the cost of capital. In their "Irrelevance Theorem", Modigliani and Miller stated that the value of a firm does not depend on the composition of its financial structure, assuming that capital markets are efficient and competitive and that there are no taxes and bankruptcy costs.[7] In other words, under these conditions, once finance, either in the form of debt or equity, is injected into the company, the value of the company only depends on the value of the assets in question, that is to say, that, after all, money is just money and nothing more.[8]

While it is not the intention of this paper to debate this model, it is indispensable to clarify that a corporate law perspective should also and primarily be adopted to address the topic at stake, whereby it could paradoxically, and maybe pretentiously, be affirmed that money is not just money once channelled into the capital structure of the company.[9] From this perspective, alongside the traditional distinction in finance between debt and equity, there is also the sharp distinction in law between the duties a corporation owes to its creditors and shareholders and vice-versa. Accordingly, it shall be established that the provisions of finance provided by each of these categories stand as something more than just money being granted to the company, but as a convoluted tangle of liabilities and corresponding economic expectations to which their investment is ultimately grounded.

Generally speaking, the most important characteristic of the money lent by creditors is a return independent of the success of the company, usually in the form of a fixed interest rate, while, on the other hand, the return on equity for the shareholders is dependent on the success of the company.[10] Consequently, this relational framework submits that if the company makes a profit it goes to the shareholders either by way of dividends or by the increase of the share value, whereas, in the case of failure of the company, shareholders are last in the insolvency's line.[11] As already mentioned, from the shareholders' perspective, this latter principle is usually referred to as "equity is wiped out first".

[6] J Armour, G Hertig and H Kanda, "Transactions with Creditors" (2009), in Kraakman RH, Armour J, Davies P et al (eds) The anatomy of corporate law: a comparative and functional approach, Oxford University Press 115-151.
[7] F Modigliani and MH Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment" (1958) 48 The American Economic Review 261-297.
[8] RC Clark, "Corporate Law" (1986) Little Brown, Boston, 67-70.
[9] RJ de Weijs, "Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt–Equity Divide" (n 2) 422.
[10] CP Normandin; with discussion by RT Peters and RE Scott, "The Changing Nature of Debt and Equity: A Legal Perspective" (1989) Conference Series, Federal Reserve Bank of Boston, vol. 33, 50.
[11] RJ de Weijs and M Good, "Shareholders' and creditors' entitlements on insolvency: who wins where?" (2015) Butterworths Journal of International Banking and Financial Law 642.

Conversely, from the creditors' perspective, a fixed rate of return is agreed upon for a priority right to payment over shareholders on insolvency or liquidation of the company. Ultimately, this "battle for value" between creditors and shareholders is indeed capable of affecting the choice as to how to invest in the company at a given point in time of its life cycle, having regard to the trade-offs with the company that each form of investment entails.

As it has been suggested, for purposes of dealing with this twofold relational network within a corporation, all the relevant rules regulating the legal position of creditors and shareholders could be usefully understood through a "contractual approach".[12] From this perspective, a distinction could be drawn between two different contractual paradigms: complete contingent contracts, or discrete contracts, and relational contracts. On the one hand, one could describe debt contracts as discrete contracts where, at the time of contracting, the parties are assumed capable of agreeing on all the relevant terms governing their relationship. In this context, the law assists the contracting parties by providing them with default rules which are deemed as applicable unless explicitly opted out by them. On the other hand, the relationship between shareholders and the company can be viewed as a relational contract where conditions of uncertainty prevent the parties from drafting in detail all the relevant terms at the time of contracting.[13] This is due to the complexity that characterises the equity claims as ongoing relationships, whereby it is not feasible for the parties to anticipate all future contingencies and assign the corresponding risks. In this context, the law assists the shareholders by imposing, as a default rule, a general fiduciary obligation to the directors of the company according to which they must act so as to promote the success of the company and thus maximise the interests of both contracting parties.

Additionally, the position of creditors can also be evaluated efficiently in light of the notion of "non-exclusivity"[14], which in turn gives the opportunity to introduce the issue creditors invariably struggle with every time the company contracts a new form of debt. More specifically, "non-exclusivity" refers to the circumstance that a borrower, such as the company, may theoretically be able to borrow from a second set of creditors without having obtained the consent of the first set of creditors. As new debt gets piled onto the old one, the old creditors' expected payoff is affected since the probability of default increases and the recovery value of old debts in the event of a default reduces.[15] Ultimately, "non-exclusivity" turns out to be one of the major concerns creditors try to protect themselves from in insolvency or liquidation and, therefore, it tends to play a crucial part also in the context of loans being provided by the shareholders.

Attraction for debt financing in the shareholders' perspective

As previously mentioned, a company's capital structure may consist of a mix of debt and equity respectively financed by creditors and shareholders, which are normally conceived as separate persons. Both from a corporate finance and legal perspective, the traditional distinction between these two categories and their respective relationship with the company seems to get blurred if a shareholder goes beyond his role as an equity provider and becomes a creditor of the company.[16] While it is undeniable that the crucial question looms as to how such loans should be treated in an insolvency of the company, it is preliminarily worth looking at the legal and economic reasons whereby a shareholder may be attracted by the expectation of structuring its investment to the company as debt financing. From a legal viewpoint, while, on the one hand, the shareholder, as an equity provider, is subject to the core rule according to which "equity is wiped out first", on the other hand, as a debt provider by way of a loan, it escapes such rule and grants itself a more favourable position in the insolvency line together with the external creditors. Moreover, this dynamic is exacerbated in the event the shareholder attains to

[12] CP Normandin, "The Changing Nature of Debt and Equity: A Legal Perspective" (n 10) 75.
[13] CP Normandin, "The Changing Nature of Debt and Equity: A Legal Perspective" (n 10) 76.
[14] P Bolton, "Corporate Finance, Incomplete Contracts, and Corporate Control" (2014) 64 Journal of Law, Economics and Organizations 74 <https://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/6023/Bolton_corporate.pdf.> .
[15] DS Bizer and PM De Marzo, "Sequential Banking" (1992), 100 Journal of Political Economy 41–61.
[16] RJ de Weijs and M Good, "Shareholders' and creditors' entitlements on insolvency: who wins where?" (n 11) 642.

structure its loan as a secured loan: on such an occurrence, whether the security is designed as a pledge, a mortgage, or a floating charge on the company's real estate and inventory, the shareholder, in the context of an insolvency or liquidation, could always invoke its security rights and thus receive back the whole of its investment ahead of other unsecured creditors.[17] In other words, as it has been effectively defined, the security enables the shareholders to "have their cake and eat it too"[18].

In the end, both in the case of an unsecured and secured loan, the economic advantage the shareholder acquires is significant, since, in the event of a downside scenario for the company, it would be able to present itself as a creditor and thus actively participate in the insolvency or liquidation distribution, whilst, in the case of a favourable scenario, it would still be entitled to profits, either in the form of dividends or shares, having also invested risk-bearing capital. In conclusion, it is convenient to categorise the behaviour of the shareholders and their tendency towards debt finance within the bigger picture of the above-mentioned "battle for value" against creditors in financially distressed companies as shareholders try to gain the upper hand acting as creditors rather than equity providers upon an insolvency proceeding.[19]

Against this backdrop, which aims to elucidate on the shareholders' position in this area, it is even more important to scrutinize the function that Insolvency Law should maintain when dealing with the practice of shareholder loans. In this respect, the focus is on whether Insolvency Law is, by itself, capable of upholding the principles upon which it is grounded, especially having regard to the position of creditors. Following this approach, a light on what the proper function of Insolvency Law should be is excellently shed by Thomas J. Jackson as he emphasizes that, upon insolvency, the primacy of shareholders, which transpires from the rule of limited liability, is replaced by that of creditors, and, consequently, "Bankruptcy Law" shall be presented as a kind of expropriation of the shareholders for the benefits of creditors.[20]

In Jackson's words:

> In bankruptcy, the unsecured creditors of an insolvent debtor can be viewed as the new equity owners of the debtor and hence entitled to what the debtor was entitled to outside of bankruptcy.[21]

In light of the above, there is a manifest distortion caused by the practice of shareholder loans to the role of Insolvency Law. Once again, the point shall be stressed that the corporate finance and law distinction between debt and equity is not merely descriptive and Insolvency Law shall therefore be capable of upholding such partition. Ultimately, in this area, the foundations of Insolvency Law appear to be disregarded as much as the presumption that shareholders are the ones to be entitled to profits because they have invested in risk-bearing capital. As a radical outcome, it could also be claimed that such distortion casts a long shadow on the corporate form of limited liability, for it is grounded on the presumption that shareholders have, at least, some "skin in the game" as they invest in the company.[22]

The final question that results out of this picture is why a shareholder, having originally contributed equity to the company, should keep on being an equity contributor when it could be accorded the same rights and economic expectations in insolvency as an external creditor by way of simply lending to the company. In other words, it doesn't seem unfitting to emphasize that Insolvency Law would completely

[17] RJ de Weijs, "Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt–Equity Divide" (n 2) 418.
[18] DA Skeel and G Krause-Vilmar, "Recharacterisation and the Nonhindrance of Creditors" (2006), 7 European Business Organization Law Review 283.
[19] RJ de Weijs, "Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt–Equity Divide" (n 2) 405.
[20] Ibid 414.
[21] TH Jackson, "The Logic and Limits of Bankruptcy Law" (1986), Harvard University Press, Cambridge, 21.
[22] FH Easterbrook and DR Fischel, "The economic structure of corporate law" (1991), Harvard University Press, Cambridge, 67-70.

misplace its foundational function as debt-collection law, and thus as creditor-law, in the event the shareholders were entitled to stand in such a "win-win" state of affairs with no limitations whatsoever.

Why fretting over the subordination rule?

Having presented the matter which could be hereafter referred to as the "lost function of Insolvency Law" in the context of shareholder loans, it is now time to introduce the rule that has long been claimed as the most effective medium to restore it: the principle of subordination of shareholder loans in insolvency proceedings. While a detailed assessment and description of this rule and its applicability is subject to the comparative legal analysis referred to in Section 3, it is preliminarily worth back-tracking to ask the simple question: why should a jurisdiction fret over such rule? Or, in other words, does the principle of subordination of shareholder loans *really* make a difference in the way companies are financed by their investors? Since such an evaluation necessarily involves an empirical analysis, the answer must be a firm "yes" given the impact shareholder loans regularly have on the stage of distribution. In particular, a reference shall be made to the extensive work carried out by Professor R.J. de Weijs on the topic[23]. Following the examination of several insolvency proceedings in many jurisdictions, he ultimately concluded that, in all the cases, companies are financed by shareholder loans rather than by capital, as shareholder loans amount to more than 50% of the outstanding debt. As a follow-up to such considerations, he was eventually able to show the difference that the application of the rule of subordination makes to the pay-out percentage ordinary creditors would be entitled to compared to that, lower one, they would be entitled to if shareholder loans were treated as ordinary external debt.

In conclusion, a detailed regulation under Insolvency Law of the practice of shareholder loans is capable of substantially affecting the way companies are financed. In particular, there is a strong preference toward the capitalisation of the companies by way of equity provided by the shareholders and it, notably, suggests a clear-cut emphasis on the function of Insolvency Law as "creditor law", thus upholding the debt and equity divide. From this perspective, the legal disciplines hereafter assessed shall be conceived as particular ways of tackling the problem, having regard to the different corporate policy choices that each jurisdiction aims to pursue, and which are reflected in the legal norms.

Shareholder loans under US and German law: the long-claimed lever of creditor protection

The capital versus loan question

Having presented the issue of "the lost function of Insolvency Law", one cannot leave aside the following question: do we call an advance made by a shareholder a loan rather than a capital contribution? Such enquiry is pivotal to introduce the topic at stake and understand the material implications that the application of the different rules infers.

As a mere example, there is a sharp distinction between the US and the German rules commanding the subordination of shareholder loans. On one side, the US Doctrine of Recharacterization, on the other, the conditions required by the respective courts for their applicability. In particular, while the first sets of rules require the subordination of the loan granted by a shareholder to the claims of external creditors without questioning the legal qualification of the advance made by the shareholder, i.e. a loan, the Doctrine of Recharacterization involves a process whereby an advance apparently presented as a loan by a shareholder is subsequently treated as equity (with all the substantial consequences such a qualification implies) thus determining whether a debt actually exists.[24]

[23] RJ de Weijs and M Good, "Shareholders' and creditors' entitlements on insolvency: who wins where?" (n 11) 642-643.
[24] Sprayregen, Friedland, Brighton, Bianca, "Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine" (2004) Annual Survey of Bankruptcy Law 2.

Accordingly, as much as the loan versus capital question is concerned, the touchstone for many of the cases[25] is undoubtedly *Pepper v. Litton.*[26] Although there are several other cases that deserve to be considered in this area[27], this one stands amongst all because of its famous dictum[28] stating that a shareholder loan's claim may be treated as capital investment and thus disallowed.[29] Furthermore, this judgment was also the first one to encompass the combination of the terms "equity" and "subordination", infusing a huge influence amongst the bankruptcy courts in the years that followed.[30] Above all, this judgment provided the bankruptcy courts with a criteria that could be applied to detect which debt advanced by a shareholder could be treated as equity. Always bearing in mind that different decisions consider and stress different criteria, depending on the facts of the case, it could be stated that a decisive criterion in answering the capital versus loan question often lies in the circumstances of a corporation especially where a corporation is undercapitalised.

In turn, the undercapitalisation of the corporation is usually spotted considering the ratio of the shareholder loans to their invested capital, whereby high ratios of debt to equity have usually resulted in decisions that the advances made by the shareholders were capital.[31]

Alongside the undercapitalisation criterion, the practice of shareholder loans tends to stand on another crucial and factual circumstance: whether the shareholder was a controlling member capable of exploiting the information it could possess as an "insider" when granting a loan instead of a capital contribution. As it has been mentioned in Section 2, a shareholder of this status is capable of masking its intention to the company as a debt to avoid the "equity is wiped out first" rule, circumventing the principle Insolvency Law stands to uphold. While such circumstances could indeed trigger and fall foul of the Doctrine of Equitable Subordination. It could also be regarded as an "inequitable conduct", as it is explored in Section 3.2. This was illustrated in the landmark case of *Taylor v. Standard Gas & Electric Co*.[31] The case dealt with a parent company (the Parent) that had completely dominated the affairs of its subsidiary (Deep Rock) managing its business at the Parent's own advantage and interest and having no regard to the good concern of the subsidiary and its creditors.[32] Crucially, the Court stated that Deep Rock had found itself in financial difficulty because of the Parent's mismanagement determined by the large sums the latter had advanced to the subsidiary and because of which it had requested the approval of a compromise in a reorganisation proceeding against Deep Rock. Consequently, the Court announced what came to be known as the "Deep Rock Doctrine",[33] rejecting the reorganization plan and condemning both the undercapitalisation of Deep Rock and the mismanagement which both resulted from the domination by the Parent. Finally, this judgment is key for one more thing. While before the announcement of the "Deep Rock Doctrine", in analogous circumstances, the courts had sought to totally exclude the claim of a parent company in the proceedings against one of its subsidiaries, after the judgment they began, more simply, to subordinate such claim to the other unsecured claims. Importantly, this goal was not achieved by way of piercing the parent's veil as had been done previously, but by proving the domination and the mismanagement of the parent toward the subsidiary. [34]

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[25] JS Cohen, "Shareholder Advances: Capital or Loans" (1978) 52 Am. Bankr. L.J. 259-275.
[26] *Pepper v. Litton*, 308 U.S. 295 (1939).
[27] E Everett, "Subordinated Debt – Nature and Enforcement" (1965), The Business Lawyer 20, no. 4, 953- 987 <https://www.jstor.org/stable/40684025?seq=1#page_scan_tab_contents>.
[28] "And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations, but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations being furnished by the stockholder as a loan*"*.
[29] JS Cohen, "Shareholder Advances: Capital or Loans" (n 25) 259.
[30] DG Carlson, "The Logical Structure of Fraudulent Conveyances and Equitable Subordination" (2002) Cardozo Law School, 50 Working Paper Series 24.
[31] Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1939).
[32] JS Cohen, "Shareholder Advances: Capital or Loans" (n 25) 260.
[33] "No plan ought to be approved which does not accord the preferred stockholders a right of participation in the equity in the debtor's assets prior to that of the inequitable parent/creditor, and at least equal voice with the parent/creditor in the management".
[34] A.S. Herzog, J.B. Zweibel, "The Equitable Subordination of Claims in Bankruptcy" (1961) 15 Vand. L. Rev. 105.

The Doctrine of Equitable Subordination

Following the landmark decisions of the bankruptcy courts concerning the issue of capital versus loans, the landmark Doctrine of Equitable Subordination will now be approached. As has been pointed out above, as a starting point in an equitable subordination analysis a court may examine whether a legitimate creditor is engaged in inequitable conduct. If this is the case, the remedy which has been developed consists of the subordination of that creditor's claim to that of the other creditors, but only to the extent necessary to remedy the inequitable conduct. This is exactly the conclusion reached in the landmark case *Benjamin v. Diamond* (*In re Mobile Steel Co.),*[35] which brought clarification to the Doctrine. Hence, at the outset, courts developed the doctrine by applying their equitable powers in order to ensure that a claimant in a bankruptcy proceeding, who had engaged in "unfair or fraudulent conduct" to the detriment of the debtor or other creditors, was sanctioned in a just and fair manner.[36]

Following from the *Mobile Steel Co* decision, the Doctrine was finally endowed with a test capable of marking the limits and the conditions for its applicability. Essentially, the application of the Doctrine depended on three essential conditions which have been left unchanged ever since: (1) the existence of inequitable conduct on part of the creditor/claimant; (2) a causal link between such conduct and the detriment suffered by other creditors or, alternatively, unjust enrichment or advantage on the creditor/claimant; and (3) that the subordination of the claim by way of equity was not inconsistent with the provisions of the Bankruptcy Code. Moreover, as an equitable remedy, the subordination could only operate to compensate the prejudice suffered by the other creditors,[37] with the burden of the proof with respect to the existence of such conditions being imposed on the plaintiff.

With respect to the third condition, it is now possible to state that it does not constitute an effective restriction to be evaluated anymore, since the introduction of § 510(c) of the U.S Bankruptcy Code in 1978 which ultimately codified the power of the bankruptcy courts to subordinate claims on grounds of "principles of equitable subordination". As a matter of fact, the confirmation of such power in the Bankruptcy Code, although completely leaving the task to shape the principles in question to the established and forthcoming case law, at least resulted in the self-evident consistency of equitable subordination with the provisions of the Bankruptcy Code.[38]

Notwithstanding the "new order" established by Mobile Steel Co. and the coeval introduction of § 510(c) in the Bankruptcy Code, the Doctrine was still left with a lot of uncertainty. Specifically, there were still many doubts surrounding the definition of "inequitable conduct of the creditor", which, in turn, made the enforceability of the Doctrine itself very nebulous. Since the Code had been left silent with respect to the criteria to be used to define what inequitable conduct could be, it was once again up to the courts to provide the Doctrine with the right tools to operate effectively. It is thus now reasonable to draw the connection between the findings referred to in Section 3.1 and the doctrine at stake. In particular, amongst the criteria mostly used, the undercapitalisation of the debtor corporation has always been critical.

Accordingly, in cases where the controlling shareholder or the parent company granted a loan, their debt could be subordinated if the corporation which benefited from the loan proved to be manifestly undercapitalised at the time the loan was granted, having regard to its corporate objectives. The same outcome would result when, at the time the loan was advanced, a well-informed external creditor would have not contributed the same amount of debt.[39] Despite the elaboration of certain criteria to determine the extent necessary for the undercapitalisation to qualify a loan being granted as an inequitable

[35] Matter of Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977).
[36] Sprayregen, Friedland, Brighton, Bianca, "Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine" (n 24) 4-5.
[37] RC Clark, "Corporate Law" (n 8) 61.
[38] JW Dickens, "Equitable Subordination and Analogous Theories of Lender Liability: Towards a New Model of "Control" (1987) 65 Texas L. Rev 814.
[39] D Vattermoli, "La Subordinazione "Equitativa" (*Equitable Subordination*)" (2009) 6 Rivista delle Società 1408.

conduct, such as the debt-to-equity ratios referred to in Section 3.1., there has never been a commonly accepted standard. Consequently, such circumstances have always infused the judges with a high degree of discretion when deciding on the existence of inequitable conduct.[40]

On the other hand, one issue seems not to be controversial: the existence of inequitable conduct consisting of the behaviour of shareholders granting loans instead of capital contributions is not dependent on the subjective will of the lender. In other words, where the corporation is undercapitalised, the debt in question will be subordinated both in the case the shareholder truly intended to grant a loan and in the case where the shareholder sought to camouflage a capital contribution as debt.[41]

However, despite its relevance, it is the opinion of the majority of the scholars,[42] as much as of the bankruptcy courts, that the sole undercapitalisation of the debtor corporation is insufficient to constitute the ground for the subordination, thus requiring the coexistence of other inequitable conducts. As it is set out in Section 3.3., this feature, concerning the weight undercapitalisation has in the analysis the courts carry out in this area, is essential to study the differences and the interactions between the Doctrine of Equitable Subordination and the Doctrine of Recharacterization. In a recharacterization analysis, unlike in an equitable subordination one, undercapitalisation may be enough to prompt the recharacterization of debt into equity, without the need to spot any other inequitable elements. Likewise, it is feasible to envision the occurrence of an inequitable conduct in the absence of an undercapitalisation's situation, especially in the context of corporate groups, where the conduct resulting from the domination of the parent over its subsidiaries could be regarded as inequitable *per se*.[43]

Moving on to the second condition required for the applicability of the Doctrine of Equitable Subordination, namely the detriment suffered by other creditors or, alternatively, an unjust enrichment or advantage on the creditor-claimant, there seems to be less confusion. Generally, this condition is satisfied when the competing creditors receive less out of the bankruptcy proceedings than what they would have received if the inequitable conduct had not taken place. Notably, the correct assessment and measurement of this damage suffered by the creditors is essential to determine those ones to whom the debt of the claimant will be subordinated, as much as the exact amount of the claim that will need to be subordinated to remedy the inequitable conduct. Ultimately, it is thus correct to state that equitable subordination is subject to a "double limitation", both with respect to which competing creditors and the maximum amount of the claim to be subordinated.[44]

The Doctrine of Recharacterization

When delving into recharacterization in the context of the capital versus loan, it is common sense to think of the situation of debt being recharacterized into equity, and consequently being treated as such upon a bankruptcy proceeding. From this perspective, it is correct to introduce the Doctrine of Recharacterization as a judicial development whereby a bankruptcy court causes debt that has been granted to a corporation, or at least something the parties to the transaction characterised as such, to be converted into equity.[45] While it is fundamental to understand the consequences such doctrine determines toward a given bankruptcy claim and appreciate its relationship with the Doctrine of Equitable Subordination, it is preliminarily worth looking at its origins.

At the outset, the Doctrine originated from some bankruptcy courts which started subordinating claims by way of recharacterizing purported debt transactions as equity contributions by using their general

[40] R Schlesinger, "Acceptable Capital Structures: How Thin Is Too Thin?" (1952) 5 Florida L. Rev. 355 ss.
[41] Note, "Subordination of Stockholder Loans on the Ground of Corporate Undercapitalization" (1963) 23 Md. L. Rev. 260 ss.
[42] R Posner, "The Rights of Creditors of Affiliated Corporations" (1976), 43 U. Chi. L. Rev. 518; M. Nozemak, "Making Sense Out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510
(c) Equitable Subordination?" (1999) 56 Wash. & Lee L. Rev. 700.
[43] JM Landers, "A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy" (1975), 42 U. Chi. L. Rev. 622 ss.
[44] D Vattermoli, "La Subordinazione "Equitativa" (*Equitable Subordination*)" (n 40) 1410.
45 Sprayregen, Friedland, Brighton, Bianca, "Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine" (n 24) 2.

equitable powers.[46] This time, unlike equitable subordination which had been expressly codified in §510(c), the courts were not bestowed with the power to recharacterize by a specific provision of the Bankruptcy Code, but they derived it indirectly from §105, which grants bankruptcy courts the authority to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the Code.[47] It is the lack of a specific code provision on the recharacterization of bankruptcy claims that has always fuelled the debate amongst the courts with respect to the factors to consider for the application of the Doctrine.

In this context, the landmark case is *AutoStyle Plastics*.[48] This case, beyond settling the debate with respect to the authority to recharacterize claims in favour of those courts that had derived such power from § 105, is mostly cited for the adoption of an eleven-factor test for the applicability of the Doctrine. Although it is not the purpose of this paper to analyse each of these factors in detail, since such scrutiny would inevitably overlap with those carried out by leading and way more exhaustive papers on the topic,[49] it shall be pointed out that no one factor is decisive alone and that their assessment is fact-sensitive on the circumstances of the case.

Against this background, once again, a connection should be established between the discussion referred to in Section 3.1 and 3.2 with respect to the undercapitalisation factor. In fact, it is submitted that the occurrence of an undercapitalisation situation constitutes the ideal playing field to draw a comparison between the doctrine at stake and the doctrine of equitable subordination. Generally, it has been reported[50] that courts scrutinise the undercapitalisation question in a recharacterization analysis just as they would normally do in the context of equitable subordination. This means, building on the criteria referred to in Section 3.1., that the courts would look at the amount of capital in the debtor corporation at the time of the transaction as much as to the amount of control shareholders exercise.

Nevertheless, as pointed out in Section 3.2, undercapitalisation, without inequitable conduct, is usually regarded as insufficient to justify equitable subordination, whereas, it may be sufficient to cause the recharacterization of a purported loan into an equity claim. This is due to the consideration that, notwithstanding the similarities as to their effect, debt recharacterization and equitable subordination amount to two distinct causes of action, whereby they could be regarded as mutually exclusive. Accordingly, it is important to remember that recharacterization cases focus on whether a debt actually exists, whereas equitable subordination cases deal with legitimate creditors and focus on whether an inequitable conduct has occurred. The difference is prominent since the result of the recharacterization of a claim in debt into a claim in equity is that the claimant is not satisfied until the bankruptcy estate pays all other creditors in full, in accordance with the pivotal "equity is wiped out first" rule. On the contrary, as pointed out in Section 3.2, in an equitable subordination's type of judgment, a debt gets subordinated to other creditors' claims subject to the abovementioned "double limitation" with respect to both the number of creditors to whom the claim will be subordinated (in accordance with the second condition of the Mobile Steel Co's "test of applicability") and the maximum amount of the claim that will need to be subordinated (due to the principle that the subordination must operate only to the extent it affords a remedy to an inequitable conduct).

In conclusion, one could truly state that the application of the Doctrine of Recharacterization tends to be way more severe from the standpoint of the claimant that has granted an alleged loan to a company. This ultimately results from the considerations that the analysis carried out by a court to recharacterize such claim does not need to prove the occurrence of inequitable conduct together with the circumstance

46 M Nozemak, "Making Sense Out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510 (c) Equitable Subordination?" (n 43) 690.
47 11 U.S.C § 105(a).
48 In re Autostyle Plastics, Inc., 269 F.3d 726 (6th Cir. 2001).
49 D Skeel, Jr and G Krause-Vilmar, "Recharacterization and the Nonhindrnace of Creditors" (2006) (n 18) 277-279; Sprayregen, Friedland, Brighton, Bianca, "Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine" (n 24) 14-18.
50 M Nozemak, "Making Sense Out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510 (c) Equitable Subordination?" (n 43) 710-711.

that the recharacterization into equity brings automatically the claimant to the very last level of the insolvency line.

For the sake of completeness, it is also important to focus the analysis on the position expressed by those courts situated at the opposite side of the spectrum with respect to the positive affirmation of the power to recharacterize debt. The reference shall thus be made to the decision of the United States Court of Appeals for the Ninth Circuit Bankruptcy Appellate Panel's (B.A.P.) in *Unsecured Creditors' Committees of Pacific Express, Inc.v Pioneer Commercial Finding Corp.* (*In re Pacific Express, Inc.*).[51]

This judgment stated that bankruptcy courts do not have the authority to recharacterize debt into equity, since this was not envisioned by the Code. In particular, such a conclusion was due to the refusal by the B.A.P. to adopt the analysis to distinguish between a loan or a capital contribution, which had originally been used by the tax courts and subsequently deemed by many bankruptcy courts as the one to implement also in a recharacterization scenario. As a drastic consequence, the B.A.P. thus ruled that all the actions resulting in the subordination of claims in bankruptcy proceedings necessarily had to be governed by § 510(c) and nothing else.[52] Such restrictive interpretation in relation to the courts' power to subordinate claims is revealing with respect to the underlying policy choice to the decision. In this respect, the tendency of the courts toward an easily realisable subordination of claims sends a clear signal to those insider creditors ready to make a loan to their troubled companies. As a matter of fact, those insiders, knowing that their claims could be subordinated regardless of the occurrence of an inequitable conduct on their part, would inevitably refrain from granting a loan, with the consequence that their troubled companies would potentially miss a great chance to resurrect.[53] Additionally, this dynamic is exacerbated by the fact that insider creditors are usually the only source of finance available to companies in the vicinity of insolvency.

Against this background, the decision projected in *Pacific Express* has the merit to reassure all lenders that their claims could not be subordinated where no inequitable conduct has occurred in accordance with § 510(c) of the Bankruptcy Code.[54]

Shareholder loans under German Insolvency Law

The argument relating to the legal treatment of shareholder loans under German Insolvency Law requires a preliminary admonition which is revealing of the underlying object of this paper. First of all, the following analysis, rather than being an outline of the German legislative framework on the subject, will serve as a significant point of comparison with the US one. Secondly, and as a consequence, the discussion will build upon the premise to introduce the topic referred to in Section 4 concerning the impact that policy choices made by the legislators may have on the practice of shareholder loans. Therefore, the German rules are here presented having been reformed in late 2008 by the Modernisierung des GmbH-Rechts und zur bekampfung von Missbrauchen (*MoMiG*) also known as the law on the Modernisation of the German Limited liability Company law.[55]

As a starting point, the core of the *MoMiG* consists of the extension of the rule of subordination to almost every kind of shareholder loan.[56] In order to appreciate the impact of such extension, it is important to recall the old law on the subject. Under the old law, commonly referred to as "law of equity substitution",[57] a shareholder loan could be subordinated if it was deemed to "substitute for equity" in

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[51] In re Pacific Express, Inc., 69 B.R. 112 (B.A.P. 9th Cir. 1986).
[52] M Nozemak, "Making Sense Out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510 (c) Equitable Subordination?" (n 43) 691-692.
[53] M Gelter and J. Roth, "Subordination of Shareholder Loans from a Legal and Economic Perspective" (n 1) 9.
[54] M Nozemak, "Making Sense Out of Bankruptcy Courts' Recharacterization of Claims: Why Not Use § 510 (c) Equitable Subordination?" (n 43) 715.
[55] 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) (n 4).
[56] There are two exceptions laid down by InsO § 39, which already existed under the old rules.
[57] M Gelter, "The Subordination of Shareholder Loans in Bankruptcy" (2006) JM Olin Center for Law, Economics, and Business Fellows' Discussion Paper Series, Harvard, Discussion Paper No 4, 3.

the case it was granted to a financially distressed company (in "crisis"). To the same extent, the rule of subordination was commanded in the case of a shareholder loan granted before the appearance of any indicator of the "crisis" if the shareholder did not withdraw the loan at its occurrence.[58] Under this framework, the "crisis" of the company was set out by reference to a standard of "unworthiness", whereby the company was deemed to be in "crisis" if a third party would have not granted the loan given by the shareholder at the same conditions. Against this background, the new rules didn't take the distinction between equity substituting loans and "normal" loans by the shareholders into account anymore, but were intended to apply automatically to all shareholder loans.[59] As a consequence, such generalisation implies that, since 1 November 2008, no enquiry has to be made to determine whether or not the company is in "crisis" at the time the loan is granted by the shareholder, since subordination applies anyway.[60]

It has been argued that the new rules have not substantially brought about the results that the old ones had already envisioned, at least as far as the applicability of the subordination rule is concerned.[61] In particular, it could be stated that both the old and the new rules substantially subordinate shareholder loans granted upon an imminent insolvency of the company.

Notwithstanding the considerations concerning the impact brought about by the new rules, this new approach deserves to be scrutinized with respect to its theoretical basis. In the first place, a flavour of it can be detected by comparing the newly reformed German rules with the US ones referred to in the previous paragraphs. Within such comparison, there transpires a marked difference between the kind of subordination envisioned in *MoMiG* and the Doctrine of Equitable Subordination, since the former does not require any inequitable conduct of the shareholder. Likewise, with respect to the Doctrine of Recharacterization, the German rule is different for it is not centred on whether or not the shareholder wanted to provide capital, with the consequence that subordination applies also in the case it is explicit that both the shareholder and the company genuinely wanted to contract a loan. Ultimately, it could be observed that the new German rules tend to bring the sanction of subordination one step further than the one reached by the Doctrine of Recharacterization, given its automatic applicability to all shareholder loans.

The final considerations concerning the comparison between the US and the German rules on shareholder loans, in turn, draw attention to the theoretical basis of the German rules from a closer perspective. Above all, building on the argument referred to at the end of Section 3.3, it is important to judge the rules from the shareholder's standpoint. It seems thus clear that the German rules seek to sanction to the maximum extent the shareholder who decides to provide finance while the company is in "crisis".[62] This is due to the configuration of the new rules which do not accord the shareholder any instrument to "justify" his decision to finance the company. By contrast, under the US rules, there is a getaway available to the shareholder both under the Doctrine of Equitable Subordination and the Doctrine of Recharacterization. As a matter of fact, under the former, the shareholder is always "excused" if the plaintiff is not able to provide the proof of the occurrence of an inequitable conduct, as much as of the other requirements laid down by the Mobile Steel Co.'s test, i.e. unfair advantage and

<http://www.law.harvard.edu/Programs/olin_center> (accessed 7 August 2019).

58 DA Verse, "Shareholder Loans in Corporate Insolvency – A New Approach to an Old Problem" (2008) 9 German Law Journal 1111.

59 H Tschauner and C Ede, "Shareholder Loans under German Insolvency Law" (2014), Financier Worldwide Magazine 5. <https://www.financierworldwide.com/shareholder-loans-under-german-insolvency-law> (accessed 7 August 2019).

60 DA Verse, "Shareholder Loans in Corporate Insolvency – A New Approach to an Old Problem" (2008) (n 59) 1112.

61 Ibid 1118-1221, according to which, while it is affirmed that the results of the new rules on subordination is not different from those under the old law, it is emphasized that the reform has substantially altered the previous restrictions on the repayment of shareholder loans. Under the new rules, subject to two exceptions left unchanged, the repayment of all shareholder loans is subject to avoidance if they were made within a one-year period prior to, or after the filing for insolvency, in accordance with InsO § 135.

62 Ibid 1115.

injury to other creditors. Similarly, under the latter, the shareholder loan is never recharacterized if it is unambiguous that the shareholder and the company genuinely wanted to agree on a loan.

However, it seems incorrect to describe the essence of the German rules as a "sanction", since subordination may apply also to those shareholders that have granted a loan before the crisis occurred. Consequently, it is more appropriate to conceive the German rules on subordination as an attempt to generate a preventive and deterrent effect toward shareholders every time they are about to provide finance to their company. In the shareholder's perspective, such effect is intensified also by the automatic application of the subordination rule, with no discretion exercisable by the German courts with respect to subordinating loans that squarely fall within the domain of the rules of German Insolvency Law.[63]

These conclusions prompt a final reflection. As a result of the application of the subordination rule under German Insolvency Law, shareholders are inevitably deterred to grant finance, by way of loans, even when it would be the most efficient medium to rescue the company. In this view, subordination turns out to be counterproductive and transcending the object to contrast excessive risk-taking by shareholders at the expenses of the creditors.[64] Accordingly, as it is further explored in Section 4, the argument has been made that shareholder loans should be subordinated only to the extent they fail an "efficiency test" aimed to predict those financial solutions that have a positive present value, and that the legislators should take the results of such test into account when framing the legal rules.[65]

Subordination of shareholder loans under the "rescue culture": an unescapable tension?

Corporate rescue beyond creditor protection

The legal models that have been assessed stand as regulatory responses to the issue that the unrestricted practice of shareholder loans would invariably bring about, and which has been labelled, in this paper, as the "lost function of Insolvency Law". In other words, the legal rules, despite their diversity depending on the legal system, all seek to safeguard the "equity is wiped out first" principle and the *par condicio creditorum*, thus upholding the nature of Insolvency Law as "creditor law", i.e., they are aimed at protecting the creditors.

Having said that, one is left with the question of whether "creditor protection" truly is the unique and ultimate goal Insolvency Law should pursue. Upon closer inspection, as estimated in Section 3, the principle of subordination embedded in the legal rules seems to leave no room at all for nearly any shareholder loan handed on the eve of insolvency, thus deterring those loans which could represent an indispensable source of finance for the company to avert its failure. This tension has been effectively described by Martin Gelter's words:

> *Thus, policymakers in the countries discussed here and elsewhere have to face the trade-off between creditor protection and the desirability of potentially successful rescue attempts in firms on a trajectory towards insolvency.*[66]

Therefore, it is critical to include the rescue of the company within the objectives of Insolvency Law and understand whether it could proficiently coexist with the long- claimed "creditor protection" objective. For these purposes, the meaning of "corporate rescue" needs to be outlined. Firstly, it should be clarified that "corporate rescue" does not necessarily stand at odds with the liquidation of the company, meaning

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63 A Cahn, "Equitable Subordination of Shareholder Loans?" (2006) 7 European Business Organization Law Review 292.
64 DA Verse, "Shareholder Loans in Corporate Insolvency – A New Approach to an Old Problem" (n 59) 1115.
65 M Gelter, "The Subordination of Shareholder Loans in Bankruptcy" (2006) (n 58); PO Müller, "A Synthetic View of Different Concepts of Credit Protection, or: A High-Level Framework for Corporate Creditor Protection'" (2006) 357 European Business Organization Law Review 397-399.
66 M Gelter, "The Subordination of Shareholder Loans in Bankruptcy" (n 58), 8.

that a rescue outcome could also be attained through a liquidation procedure.[67] This latter is designed for the winding-up of the company and involves ceasing its activities, realising its assets, and paying off debts and liabilities out of it.[68] Actually, in this process, when assets are being realised, a rescue could thus be achieved by selling the company's assets by way of a takeover or a bulk sale of the assets.[69] However, for the purposes of this paper, it is more relevant to consider the hypothesis of a corporate rescue which may be achieved as an alternative to a liquidation procedure. In fact, such an alternative could be the option of shareholder loans which could be granted for purposes of making the company better off, thus exceeding the sole benefit of creditors, which, by contrast, could also simply be accomplished by a rescue outcome attained through a liquidation procedure. In this perspective, the concept of "corporate rescue" is here intentionally restricted to the preservation of the distressed company itself.[70]

In light of the foregoing, the argument is made that "creditor protection" shall not be an "absolute imperative"[71] to be pursued up to the point that it is made inefficiently by neglecting other possible advantages, meaning that policymakers should not aprioristically discourage shareholders from investing into a failing business with the attempt to turn it around.[72]

An "efficiency test" for shareholder loans: is it too much for the courts?

The question concerning what standard should be used to select those shareholder loans which should not be subordinated has been studied by a few scholars[73], although no legislative model has been promulgated pursuant to them so far, neither in Europe nor in the US. At its core, the criterion developed consists of an "efficiency test"[74] entirely based on an economic model, whose analysis goes way beyond the purpose of this paper. Suffice to say, by way of a simplification, using Martin Gelter's words: "rescues financed by shareholder loans should not be penalized where the benefits to shareholders exceed the costs to creditors".[75]

For what it is worth, one should ask the question whether courts could potentially be well- suited to adopt such a test when deciding upon the subordination of shareholder loans.[76] In this respect, the answer to this question must necessarily be led by the introduction of legal standards capable of translating the results of the economic models available into enforceable rules. In doing so, policymakers would prompt discussion on the topic, which, in turn, may stimulate the courts to provide themselves with greater expertise when dealing with the practice of shareholder loans. From this perspective, it seems valuable to recall the US law's development with respect to the strong influence the case law elaborated by the bankruptcy court has always exerted on the legislation and vice-versa, which is still ongoing if one thinks about the debate on the factors required fortriggering the recharacterization of debt into equity.

67 B Xie, "Corporate Rescue – The New Orientation of Insolvency Law" (2006) Comparative Insolvency Law 5 <https://doi.org/10.4337/9781781007389.00008> (accessed 8 August 2019).
68 G McCormack, "Corporate Rescue Law: An Anglo-American Perspective" (2008) 3.
69 J Armour, "The Law and Economics of Corporate Insolvency: A Review" (2001) ESRC Centre for Business Research, University of Cambridge, Working Paper No. 197, 4 <http://www.econ.jku.at/members/Buchegger/files/Juristen/armour_2001_corporate%20insolvency.pdf> (accessed 8 August 2019).
70 B Xie, "Corporate Rescue – The New Orientation of Insolvency Law" (n 68) 5.
71 M Gelter, "The Subordination of Shareholder Loans in Bankruptcy" (n 58) 9.
72 A Cahn, "Equitable Subordination of Shareholder Loans?" (n 64) 294.
73 M Gelter, "The Subordination of Shareholder Loans in Bankruptcy" (n 58) 10-30; in the same vein SA Muro, "Economic Reasons for the Nonhindrance of Creditors Per Se Rule? A Reply" (2007) 8 European Business Organization Review 401-411.
74 According to Gelter (n 74), "A shareholder loan would fail the test when the excepted value of total assets after rescue attempt results in a reduction vis-à-vis the hypothetical liquidation value at the time when the loan was made. 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 bankruptcy. Otherwise, if the creditor is punished in bad states of the world, even where the rescue attempt was desirable, an inefficient disincentive is the result".
75 Ibid 32.
76 Ibid 33.

Conclusion

This paper proposes a critical view on the existing legal rules regulating the widespread practice of loans granted by shareholders to their company in the vicinity of insolvency. At the core of this paper lies the intention to raise the question as to what function Insolvency Law should try to attain when dealing with such practice. As has been outlined in Section 2, the foundation of such analysis stands on a contradiction underlying the practice of shareholder loans, according to which, shareholders, despite the deterioration of the financial conditions of their company, are willing to finance losses, damaging the position of the external creditors, such as the banks. From this perspective, the function of Insolvency Law to be restored is that of “creditor protection”, which, at the outset, is accomplished by introducing the principle of subordination.

Following the overview of the legal rules in Section 3, it can be reasonably affirmed that, at the “frontstage”, Insolvency Law succeeds in attaining its “creditor protection” function, but, at the “backstage”, it is somewhat overreaching, since, in doing so, it almost completely neglects to safeguard the non-opportunistic behaviour of those shareholders, which could efficiently provide debt finance with the intention of saving the company. In this respect, the function of Insolvency Law should be reconsidered as to encompass the rescue of the company before the formal opening of any liquidation procedure.

In light of the foregoing, the contemplation of the “battle for value” between creditors and shareholders in financially distressed companies as the core criterion for the interpretation of the legal rules should be disavowed. By contrast, the rules should be conceived on the outcome that “creditor protection” is not necessarily the “panacea” to all the issues instigated by the practice of shareholder loans. Accordingly, policymakers should start to consider the results which have been contributed by the economic models, where it is envisaged that the subordination of shareholder loans shall work “efficiently” for the interest of all the parties involved. Such change of direction in the legal rules could only be accomplished within a legal framework which would start embracing the attitude of the “rescue culture” when dealing with distressed companies.

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