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The doctrine of subordination of shareholder loans as safeguard of creditors' rights and its development in Lithuania

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Abstract

The crisis and post-crisis situation of the global economy in the recent years had a significant influence on more cautious decisions of company creditors making them to consider their investment possibilities with a more stringent approach. As it is known, in the context of various business transactions, creditors who have received a painful lesson of the economic crisis, nowadays request serious and robust safeguards for their rights. There is also another, a weaker, group of non-voluntary creditors, however, who are not linked by any contractual relations with debtor companies (e.g. third persons who have suffered from bad-faith actions of companies). Therefore, in addition to contracts, which are not effective for non-voluntary creditors, other ex ante safeguards for lender rights are necessary to protect the interests of not only voluntary but also of non-voluntary creditors, in particular when debtor companies have insolvency problems. For the purposes of securing creditors' interests effectively, the doctrine of subordination of shareholder rights has been acquiring a special importance in some of the EU member states recently. The purpose of this study is to analyse the doctrine of subordination of shareholder loans as an alternative safeguard of creditors' rights and to provide an assessment of its effectiveness for the protection of creditors' rights. The research has shown that subordination of shareholder loans is considered an effective safeguard of the rights of voluntary and non-voluntary creditors and is the right alternative for other measures of protection (e.g., contractual) of creditors' rights. At the end of the research, the authors provide specific recommendations to the Lithuanian legislator on the improvement of legislation in this area.

Keywords: Credit / Loan Agreements, Creditors' Protection, Liability, Subordination, Shareholders

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1. Introduction

The overall economic crisis that started in 2008 has shown that small and medium-sized business is in particular sensitive to any financial obstacles at the start-up of business. An increase in the number of bankruptcy proceedings of companies and frequent failures to satisfy financial claims of company lenders witness that the safeguards of lender rights should be treated with special emphasis in the legal framework of states. With decreasing investments into business and slowing down economic growth, investors who make contributions to their commercial projects consider the risk they have as creditors more rigidly and reconsider various safeguards of lender rights – both statutory, e.g. obligatory capital maintenance requirements, and contractual, e.g. additional guarantees of shareholders, assurances, etc. It is not a secret that many practising lenders are disappointed in the safeguards afforded by statutory capital maintenance rules and seek to protect their interests by contractual measures (i.e. by ex post safeguards of lender rights) when creditors may themselves define the measures to protector lender interests with borrowing companies.

It is also important, however, that due to the existing differences of debtor groups (conflict of interests of lenders) only contractual *ex post* measures cannot be considered as sufficient and universal safeguards of lender rights because their benefit is not the same for voluntary and non-voluntary creditors.

Therefore, apart from contracts as safeguards of lender rights, which are not effective for non-voluntary creditors and in particular when debtor companies have insolvency problems, there is also a need for another safeguard of lender rights – the doctrine of subordination of shareholder loans, which is gaining special importance in some EU member states in order to protect lender interests effectively. The purpose of this study is, therefore, to analyse the doctrine of subordination of shareholder loans as an alternative safeguard of creditors' rights and to provide an assessment of its effectiveness for the protection of creditors' rights.

2. Concept and types of subordination

Subordination is a legal relationship where one of the parties (a senior creditor) has the right to request the other party, i.e. the debtor, to discharge its obligation to the senior creditor earlier than the obligation held to the third party, i.e. the junior or subordinated creditor (Wood, 2007).

Although subordination by its essence is a contractual relation, by the form of its implementation it is classified to (1) contractual subordination and (2) structural subordination. Contractual subordination is, in its own turn, divided into general contractual subordination and special contractual subordination, depending on who are the parties of subordination as a legal relationship (Lamon, 2005).

General contractual subordination is a legal relationship between the senior creditor and the debtor: the senior creditor has the right to request the debtor to perform its obligation held in respect to the senior creditor earlier than the obligation held in respect of any other existing or future creditor (subordinated creditor) and the debtor must perform its obligation in this manner.

Special contractual subordination is a legal relationship between the senior creditor and the subordinated creditor: the senior creditor has the right to request the debtor to perform its obligation held in respect to the senior creditor earlier than the obligation held in respect of the subordinated creditor and the subordinated creditor must ensure that the debtor performs the obligation in this manner. Special contractual subordination is formalised by an Intercreditor Agreement. Such agreement may also be referred to as a Subordination Agreement, Priority Agreement, Standstill Agreement. Structural subordination is expressed in a corporate structure consisting of a holding company and a subsidiary company (Miller, 2008).

Upon extending a credit to the subsidiary company, the creditor may be sure that in case of the liquidation of the subsidiary company he, as the creditor of the subsidiary company, will be the senior creditor in respect of all creditors of the holding company. It is so because in case of the liquidation of the company the lender has priority over the capital provider to get the company's assets. Thus, the creditor of a holding company is structurally subordinated to the creditors of a subsidiary company (Miller, 2008).

3. Subordination of shareholder loans is its application differs in different jurisdictions

Subordination of shareholder loans may be understood in a two-fold way (Ho, 2011). Firstly, subordination of shareholder loans in respect of the senior creditor may be one of the subject-matters of a credit contract or the object of a separate contract which defines the legal relations of subordination (such a contract may be called a Subordination Agreement, Priority Agreement or Standstill Agreement). Such subordination of shareholder loans is called contractual.

Secondly, subordination of shareholders may be imperatively defined in legal acts, i.e. compulsory subordination. Normally, compulsory subordination is applied in case of insolvency/bankruptcy of the company.

The doctrine of compulsory subordination means that the loans of shareholders granted to the company until the institution of insolvency or bankruptcy proceedings against the company are subordinated (i.e. it is prohibited to return them to the shareholders) in respect of other priority loans extended by other creditors. A different variant of this doctrine is also possible – the loans of the company's shareholders are redefined as the company's equity in the context of insolvency from which lenders' claims are satisfied. The doctrine, in principle, is justified by the fact that the shareholder is obliged to take relevant actions: to liquidate the company or provide additional funds to it in case the company encounters financial difficulties (Bork, 2007). If the shareholder chooses the latter option, he has to "revive" the company, however, he should have no possibilities of diversifying in this risk with creditors.

Thus, if the shareholder has an opportunity to recover all contributions before the institution of bankruptcy proceedings by taking risky decisions, the rights of the creditors would be grossly violated (Verse, 2008). The shareholders, as insider lenders, are usually the first to whom it becomes known that the company will not avoid bankruptcy proceedings, therefore, they may influence company heads in order to recover the loans and interest granted to the company (Verse, 2008). In order to protect the interests of the creditors who are outsider lenders *per se* in the cases referred to above, the legislators and jurisprudence of

some states offer the doctrine of subordination, ensuring that shareholders would be sufficiently motivated in case the company encounters difficulties to take care of the restoration of its financial welfare.

The institute of subordination of shareholder loans in case of the company's insolvency or bankruptcy is controversial and dealt with by many jurisdictions (Verse, 2008). Law-making and case-law on both sides of the Atlantic try to answer the question when and in what circumstances shareholder loans may be held to be contributions into the company's equity and subordinated in respect of other creditors.

The U.S. subordination doctrine of shareholder loans is attributed exclusively to the subject-matter of bankruptcy law regulation (Sprayregen et al., 2004; Cahn, 2006).

In Germany, this doctrine is known as the institute of *Eigenkapitalersatz* (redefinition into equity) (Verse, 2008). In Germany, the doctrine of redefinition of shareholder loans and any other assets (e.g., lending rights of premises) into equity was also historically developed in the case-law on the basis of provisions on insolvency (i.e. it was possible to redefine any contribution of a shareholder into the company's equity, if the contribution was made at the time of economic crisis of the company) (Seibert, 2007). After the reform of the German company law in the area of GmbHG, shareholder loans are subordinated automatically, if all objective prerequisites exist: the loan issued to the company by a GmbH member holding not less than 10 per cent of the capital is subordinated in respect of the loans (priority) granted by other creditors, if the company becomes insolvent within the period of one year after the granting of the loan and it is irrelevant whether the company was solvent or not at the time of issuance of the loan (Beurskens and Noack, 2009; Muller, 2009). It is also important that the doctrine of subordination is applicable to all shareholder loans. The only exceptions are related to minority shareholders who hold less than 10 per cent of the capital and to shareholders who extend a loan to the company, if such loan has been given by acquiring shares in the company and the loan is considered to be a part of the acquisition transaction of the target company (Verse, 2008).

Interestingly, a similar doctrine is applied in Spain where, in case of a set of objective circumstances, shareholder loans are also subordinated automatically (Huber and Habersack, 2006). In France, Estonia (Vutt, 2008 – this scholar is also in favour of introducing the doctrine of subordination in the positive law of Estonia), Lithuania, the doctrine of subordination is not applicable.

It should be considered that the significance of the doctrine of subordination should increase in the future. It is more than evident that, for example, with the elimination of the requirements for the authorised capital of companies in the future, shareholders, acting as prudent businessmen, will most of all tend to finance the operations of companies by extending loans. Furthermore, *de facto* it is also likely that the shareholders may be the only potential creditors of companies because, for example, the financial situation of the debtor company makes it impossible to provide security for new loans under adequate market conditions. Consequently, it should be considered that the loans extended by the shareholders who are privileged creditors *per se* due to their special internal relation with the company, should be treated differently than the loans granted by outsider (i.e. less informed, privileged) creditors of the company in case of the company's insolvency. An undoubted benefit of the doctrine of subordination for the interests of shareholders is also proved by the fact that the protection it affords is applied both to voluntary and non-voluntary creditors.

4. Subordination of shareholder loans in Lithuania

As it has been already mentioned, the doctrine of compulsory subordination has not been established by the provisions of company law or bankruptcy law in Lithuania. On the other hand, smart and experienced creditors *de facto* apply contractual subordination of the shareholder loans of the debtor company as an additional security for their rights in the practice of commercial transactions of Lithuania.

It should be noted that historically there were proposals in Lithuania to satisfy shareholder claims under loan contracts only after the claims of other creditors of the company have been satisfied in case the bankruptcy of the company. These initiatives, however, have not been implemented in the law-making of bankruptcy law. Such position of the legislator should be treated with criticism – it is likely that the legitimisation of the doctrine of compulsory subordination of shareholder loans would significantly contribute to the protection of lenders' rights. Following the effective Article 35(4) of the Enterprise Bankruptcy Law of the Republic of Lithuania, the claims of creditors who are the shareholders are satisfied third in line for satisfaction. As the Enterprise Bankruptcy Law of the Republic of Lithuania imposes a ban on debtor companies to mortgage/pledge their assets to their shareholders (Article 15(1)(5) of the Law on Companies of the Republic of Lithuania stipulates that the shareholders shall have the right to lend to the company, in the manner prescribed by law, however, when borrowing from its shareholders, the company may not pledge its assets to the shareholders. When the Company borrows from a shareholder, the interest rate may not be higher than the average interest rate offered by commercial banks of the locality where the lender has his place of residence or business, which was in effect on the day of conclusion of the loan agreement. In such a case, the company and shareholders shall be prohibited from negotiating a higher interest rate), shareholder claims may not be satisfied in the order of the highest priority in the same way as the claims of, for example, mortgage creditors are satisfied.

Besides, following the latest amendments to the Law on Restructuring of Enterprises, third (i.e., the last) in line for satisfaction should stand claims of participants of the enterprise under restructuring who became creditors of the enterprise prior to initiation of the restructuring proceedings and who alone or together with other participants control the enterprise under restructuring (who became creditors of the enterprise both directly and indirectly through holding companies or subsidiaries or through legal persons of other legal forms, on the adoption of decisions of the meeting of participants whereof they may have an influence (hereinafter – holding companies or subsidiaries) not relating to employment relations. The legitimisation of this provision in the context of the institute of restructuring is assessed positively. Besides, it is also fair that an exception from such requirements is allowed for claims of related persons arising out of employment relations because the nature of these relations is different.

It should be noted that the legislator of the Republic of Lithuania, establishing a posterior order of satisfaction for the claims of the shareholders of company undergoing restructuring in relation to those of its other non-privileged creditors, has not detailed the time periods in relation to the loans extended. Therefore, it should be concluded that, within the meaning of the above-indicated provision, all existing shareholder

loans should be subordinated in respect of the loans of other creditors irrespective of the moment they have been granted. Such position may be considered as justified because the purpose of restructuring is to save and develop the company's operations, repay the debts and avoid bankruptcy by obtaining help from the creditors of the company, applying economic, technical, organisational and other measures (Article 2(3) of the Law on Restructuring of Enterprises of the Republic of Lithuania). Thus, a specific co-operation of creditors and participants of the company is necessary in this process. It should be noted that the creditors, rearranging the loans granted by them and often postponing the terms of loan repayment, expect that the members of the company will, at least, not expend the funds for the repayment of their own loans. Therefore, the subordination of all existing shareholder loans, irrespective of the moment they have been granted, is a proper measure to achieve this objective.

On the other hand, consideration should also be taken of the fact that if all the loans extended by the shareholders are subordinated in all stages of existence of the company in the context of the company's bankruptcy, in case of the institution of bankruptcy proceedings against the company its shareholders would not be willing to lend to the company in general (and this, as it has been mentioned, often happens to be the only possible financing source for the company). In case the legislator imposed an unconditional subordination of effective loan transactions of the shareholders in case of bankruptcy proceedings of the company irrespective of the time when the loan has been given and of the shareholder's involvement to the cause of the company's insolvency, it may be assumed that the risk would be unreasonably transferred only on the shareholders of the company who would have only a hypothetical right to recover their contributions.

Furthermore, adequate consideration should also be taken of the institute of *actio Pauliana* on the basis whereof the creditors would also be able to dispute the transactions (including debt repayment actions) made by the debtor company with the relevant member that the company was not obliged to conclude if such transactions violate the creditor's rights and the debtor company was or ought to have been aware of that. In this case it is considered that the transaction violates the rights of the creditor if as a result the company becomes insolvent or, while being insolvent, grants priority to another creditor or if the creditors' rights are breached otherwise1.

The assets recovered on the basis of the transaction refuted under *actio Pauliana*, as in case of an indirect action, is included into the assets of the debtor company and used for satisfying the claims of all creditors of the debtor company. Moreover, *actio Pauliana*, as the institute of protection of creditors' rights, requires special judicial proceedings. That is why this institute cannot be considered equivalent to the doctrine of subordination of shareholder loans to the company whereunder the loans of the shareholders are automatically subordinated in respect of the claims of all other creditors in case of institution of bankruptcy

[1] Article 6.66(1) of the Civil Code of the Republic of Lithuania. The institute of *actio Pauliana* laid down in this Article is a special safeguard of lenders' rights whereby it is granted a possibility of eliminating the consequences of abuse by the debtor of its rights ensuring in this way the performance of the obligations assumed by the debtor to the creditor. The conditions of application of *actio Pauliana* specified in Article 6.66 of the Civil Code of the Republic of Lithuania and highlighted in the case-law of the Supreme Court of Lithuania: (1) the creditor shall hold an undoubted and valid right of claim; (2) the transaction disputed shall be in breach of the creditor's rights; (3) the period of prescription of one year for bringing an action should be unexpired; (4) the debtor was not obliged to enter into the disputed transaction; (5) the debtor acted in bad faith because it was or ought to have been aware that the transaction being entered into would breach the rights of the creditor; (6) the third party who has entered into a remunerative bilateral transaction with the debtor acted in bad faith.

proceedings. It follows that the institutes of *actio Pauliana* and compulsory subordination of shareholders' loans should be assessed as mutually complementary (co-existing) rather than interchangeable.

It should be considered that the introduction of the doctrine of subordination of shareholder loans in the positive law of Lithuania should not be radical – it should follow the progressive practice of foreign states and the Lithuanian legislator (in the context of restructuring) to the effect that subordination should be possible of the shareholder loans granted to the company within an explicitly defined period of time before the institution of bankruptcy proceedings. Furthermore, the examples of foreign law-making providing for that subordination should only be possible of the loans of the shareholders who can make real impact on the management of the company, should be assessed positively. It is also undoubted that subordination should not be applied to the shareholder claims arising out of the legal relations of employment.

It follows from the above that it should be suggested to lay down a provision in the Enterprise Bankruptcy Law of the Republic of Lithuania to the effect that the last in the line of satisfaction shall be the claims not related to employment relations made by members of the company under bankruptcy who have become creditors of the company not later than one year before the bankruptcy proceedings were instituted against the company and who control the company under bankruptcy either alone or together with other members (who have become creditors of the company either directly or indirectly through holding companies or subsidiaries or through legal entities of other legal forms that they can influence the decision-making in the meetings of their members).

5. Conclusions

The research has shown that subordination of shareholder loans is considered an effective safeguard of the rights of voluntary and non-voluntary creditors and is the right alternative for other measures of protection (e.g., contractual) of creditors' rights.

With reference to the conclusions above and the arguments and reasoning stated above, the authors make a suggestion to amend paragraph 4 of Article 35 of the Enterprise Bankruptcy Law to read as follows:

> *"Third in line for satisfaction shall be all claims other than those specified above, save for the exception specified in this paragraph. The last in the line of satisfaction shall be the claims not related to employment relations made by members of the company under bankruptcy who have become creditors of the company not later than one year before the bankruptcy proceedings were instituted against the company and who control the company under bankruptcy either alone or together with other members (who have become creditors of the company either directly or indirectly through holding companies or subsidiaries or through legal entities of other legal forms that they can influence the decision-making in the meetings of their members)."*

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