SUBORDINATION OF SHAREHOLDER LOANS

For some time there has been a discussion in the Netherlands regarding the nature of a shareholder loan as compared to other claims of creditors against a subsidiary of such shareholder in the context of that subsidiary being declared bankrupt. Several legal authors have advocated that such loans (under certain conditions) should be subordinated, while others assert that such subordination is inconsistent with, *inter alia,* the principles of freedom of contract and equality amongst creditors as developed under Dutch law. In the case below, the District Court of Breda, the Netherlands, has ruled on the nature of a shareholder's loan in such a context.

Facts

A parent company (the **"Parent"**) provided staff, equipment and materials to its subsidiary (the **"Subsidiary"**) for its business operations. Consequently, the Parent had a claim against the Subsidiary, which was recorded in a current account relationship. Following the Subsidiary's bankruptcy, the Parent's representative presented its claim to the Subsidiary's liquidator, which was then disputed by the Subsidiary's liquidator during the creditors' meeting.

Dispute

The Subsidiary's liquidator did not dispute the existence of the claim, but considered the claim to be subordinated. The subordination was of great importance to the Subsidiary's other creditors. If this claim was indeed subordinated, the unsecured creditors would have received full payment on their claims, instead of only 40–50% if the Parent's claim was also considered to be an unsecured debt.

The Subsidiary's liquidator relied on the so called 'Carrier I decision' of the Court of Appeal in Amsterdam, the Netherlands. In that case, the Court of Appeal ruled that unequal treatment of creditors may be justified under certain circumstances. The Court of Appeal further held that the shareholder loan furnished in that case should be considered a capital injection. Therefore, in the instant case, unequal treatment of the shareholder could be justified.

It is not entirely clear what criteria the Court of Appeal applied in characterising the shareholder loan as a capital injection. The Court of Appeal could have referred to the decision at first instance, in which the District Court had found that the fact that the loan had been furnished at a time and under conditions which a random third party would have never accepted was decisive, but it did not.

Decision of the District Court of Breda

The District Court concluded in this case that the current-account relationship between the Parent and the Subsidiary should be considered 'informal capital'. The fact that the Parent had continued to provide financing to the Subsidiary whilst the Subsidiary's activities were incurring losses was the primary basis for this decision. Additionally, the very close connection between the Parent and the Subsidiary was considered to be relevant in assessing whether the claim should be subordinated. The close connection mainly pertained to the Parent exercising actual and operational management over the Subsidiary, as well as the Subsidiary being dependent on the Parent for its continued existence.

The District Court found that under those circumstances it was reasonable to consider the Parent's claim against the Subsidiary to be subordinated. The District Court felt that it would be unreasonable if a controlling shareholder who had incorporated the company, had absolute control within the company, and had kept the company going through a current-account financing was to be able to share in the proceeds of the estate in an equal manner with the unsecured creditors.

Conclusion

This decision implies that a shareholder loan should be considered subordinated if that loan (i) can be characterised as informal capital; and (ii) was furnished by a controlling shareholder.

However, the District Court of Breda seems to adopt a stricter approach in determining the nature of a shareholder loan compared to the Court of Appeal in the Carrier I decision. Specifically, in the Carrier I decision the unequal treatment of creditors was already accepted if a loan could be considered informal capital. The mere determination that a shareholder loan constituted informal capital could not convince the District Court of Breda, which concluded that there was only reason to subordinate such a loan if the shareholder also exercised a certain measure of control over its subsidiary. In what way such control must be exercised remains unclear. In this case the District Court found that it was relevant that the shareholder had incorporated the company, had kept it going through current-account financing and had both actual and operational management control within the company. It appears that these facts are so specific that they cannot be considered the criteria for determining whether 'control' exists. Subsequent case law may clarify this issue.

It will be interesting to see whether the Carrier I decision and this decision will be followed in future case law. In another decision of the District Court of Amsterdam in 2008, it was decided that under Dutch law no rule exists based on which a shareholder loan should be treated as capital. This decision is not as surprising as it seems, because currently under Dutch law, there is no clear basis for deviating from the principle of equality of creditors.

Given the present uncertainty regarding the character of shareholder loans, it is advisable to carefully consider whether or not to provide funds to subsidiaries and to not rely on the mere fact that the agreement between parent and subsidiary states that it is a loan.

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