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Subordination of Shareholder Loans in Estonian Law[*1]

1. Introduction

One basis of a Continental European company are the capital rules whose purpose is the protection of creditors of companies and which prohibit the repayment of contributions to shareholders during the lifetime of a company. The concept of capital rests on the assumption that a company's assets are constituted by means of share capital, on account of which the creditors can satisfy claims submitted by them against the company.[*2] Whether this objective can be achieved by means of capital rules is a different matter. It is clear that all business activities require a certain amount of capital. At the same time, the corresponding limits have not been established in Continental European law; the amount of obligatory investment has instead been determined by minimum capital requirements. In legislation, these requirements are established as universal for all companies and the company's actual capital needs are not taken into account.[*3] If shareholders invest in a company in such a way that the share capital is constituted in a minimum amount prescribed by legislation and the rest of the capital needed for the company's activity is lent to the company, they have fulfilled their obligation to form share capital of a certain amount, but it is clear that the equity capital investment they made is not sufficient. In this way they do, however, create the possibility to take the investment from the company without having to undergo complicated procedures. It must also be taken into account that several Continental European countries either have already removed the minimum capital requirement from their legislation or plan to do this in the near future, which means that any formal equity capital investment requirement will cease to exist in these companies. In these conditions, the likelihood will further increase that all capital necessary will be given to the company as a loan.

It may also be inevitable that shareholders give loans to companies, because if a company is facing financial problems and needs additional capital to continue its activity, it is often in a situation in which acquiring additional capital from third parties (including banks) is impossible as all securable assets are already encumbered or third parties do not want to take excessive risks. In addition, capital from shareholders may be less expensive. In this case, there are also two possibilities: to make an equity capital investment (particularly by means of increasing share capital) and to give the company a loan.

The main difference between the forms of financing derives from bankruptcy rules. Although in both cases the investment is made by the same persons, their legal status is diametrically different — in order for a loan to be repaid, an ordinary claim can be submitted in bankruptcy proceedings, while returning equity capital can only be considered after the satisfaction of all claims submitted by creditors.

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1 This article was published with support from ESF Grant No. 6747.

2 A. McGee. Share Capital. London 1999, p. 2.

3 By derogation, higher requirements apply in the financial services area, but these requirements depend on the type of activity and not on the extension.

A question arises as to whether such discretion can be complete. As giving a loan and making equity capital investment are financially equal investments from the point of view of the company and its creditors, merely providing this with a certain legal form should not be of determinative importance. While a shareholder is subject to the limited liability principle, the legal practice of each country also knows exemptions from this principle. Thus, there is no doubt that a claim for compensation of damages can be submitted against a shareholder who has been dishonest in his activities.

The issue regarding the legal status of loans given to a company by a shareholder primarily concerns whether such loans can be treated as regular loans or not. Here, problems may stem from different circumstances. At the same time, situations may arise wherein there are no negative objectives in giving a loan to the company in the form of an investment and the shareholders themselves agree that their claims are to be satisfied after the claims of all other creditors are satisfied. This choice, for instance, is justified in a situation in which a company needs a large investment for starting its activities, one that will no longer be needed after this. If the entire investment is made in equity capital in such a situation, it can only be returned by means of decreasing share capital, but this is an extremely long-term procedure accompanied by expenses. Considering that the duration of the procedure for decreasing capital exceeds six months according to the law, if the respective decision is made on the date of possibility of payment, the shareholders have to wait a very long time for their money, which is clearly economically ineffective because during this time the capital remains in the hands of the company, which no longer needs it.

The other problem regarding loans from shareholders is this: if we acknowledge the special status of shareholder loans, how is it possible to inform third parties thereof? As the corresponding publication is effected by means of the annual report, the central issue here is how these loans could and should be recorded in the balance sheet. It must be taken into account that false preparation of an annual report can be regarded as submission of incorrect information concerning the company's financial situation[*4] under the Penal Code.[*5]

2. The nature of a subordinated loan

A subordinated loan is usually defined as a loan that is subject to repayment upon termination of the debtor after the claims of all other creditors.[*6] A subordinated loan is therefore a conditional claim of the lender against a company and the condition of repayment of debt is the prior satisfaction of claims of all other creditors of the company. On a regulatory basis, a loan can be subordinated by the law but in this case the legislation must include standards that prescribe the qualification of certain loans as subordinated loan. A loan may also be rendered subordinated by agreement, in which case one of the parties must be the provider of the loan. The other party to such an agreement is generally the recipient of the loan (the company), but it cannot be ruled out that a subordination agreement is concluded between the creditors and the company as a recipient of the loan does not enter this agreement.[*7]

In the Continental European judicial area, the issue of subordinated loans is primarily treated under capital rules, which are based on two primary postulates: capital must be paid in and capital cannot be repaid.[*8]

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4 J. Sootak, P. Pikamäe. Karistusseadustik: Kommenteeritud väljaanne (Penal Code. Commented edition). 2nd supplemented and revised edition. Tallinn 2004. § 381 comment 3 (in Estonian).

5 Karistusseadustik. Adopted on 6.06.2001. – RT I 2001, 364, 2008; 13, 87 (in Estonian).

6 T. E. Stocks. Corporate Finance: Law and Practice. London 1995, p. 13.

7 For instance, the case law in the United Kingdom has acknowledged an agreement between the creditors in which the company did not participate as a subordination agreement. See E. Ferran. Company Law and Corporate Finance. London 1999, pp. 546–548.

8 J. Rickford. Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance. – European Business Law Review 2004 (15), p. 279.

3. The legal approach to shareholder loans in EU and other countries

3.1. The European Union

The Second Company Law Directive[*9], which regulates capital, includes provisions concerning distributions made to shareholders (in Article 15), but these rules concern only payment of interest to shareholders related to dividends and shares; they do not address other payments. In addition, the directive is only applicable to public limited liability companies and, although many Member States have also established similar requirements for private limited liability companies, it is not obligatory for these.[*10] In view of the extreme strictness of the directive in protecting capital, such an unfinished solution is further confirmation of the claim that, despite its strict requirements, the directive is in fact ineffective and does not regulate certain economically relevant issues that have repeatedly been pointed out by several authors.[*11]

The rules of European law regarding subordinated loans are included in banking directives, where they are handled in connection with prudential norms.[*12] However, as the emphasis of these rules is different, there are also no rules regarding the possibility of subordinating loans. In addition, most companies fall outside the scope of application of these directives.[*13]

3.2. Germany

In Germany, matters related to shareholder loans have been resolved differently at different times. First, the issue was dealt with in case law concerning limited liability companies. In these cases, by applying sections 30 and 31 of the *Gesetz betreffend die Gesellschaften mit Beschränkter Haftung* (GmbHG)[*14], the courts have considered loans to be subordinated loans when the loan was given to a company already experiencing solvency problems.[*15] The GmbHG in its § 30 lays down the prohibition of making payments to shareholders from assets that are necessary for preserving share capital, and § 31 sets forth the repayment obligation for payments made in violation of this prohibition. In 1984, the German Federal Supreme Court (BGH) extended these principles to public limited companies, though as a limitation stating that the shares of the shareholder providing the loan must account for more than 25% of the share capital.[*16] The courts relied on § 57 (on the contribution payment obligation of shareholders) and § 62 (on liability of shareholders in the case of illegitimate payments) of the *Aktiengesetz*[*17] (AktG).

In 1990, the matter of subordinated loans was regulated in Germany by means of legislation: § 32a and § 32b of the GmbHG, with the corresponding amendments made in 1994 to sections 39 and 135 of the *Insolvenzordnung*[*18] (InsO) and § 6 of the *Anfechtungsgesetz*[*19] (AnfG).

[9] Second Council Directive of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (77/91/EEC). – OJ L 26, 31.01.1977, pp. 1–13.

[10] In a report published in 1992, a proposal was made to extend the requirements of the directive to private limited-liability companies and a discussion was also held with regard to this proposal but no decision was made. See V. Edwards. EC Company Law. Oxford 1999, pp. 54–55.

[11] See, e.g., J. Armour. Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law. – Modern Law Review 2000 (63) 3, p. 355 *ff.*; L. Enriques, J. R. Macey. Creditors versus Capital Formation: The Case Against the European Legal Capital Rules. – Cornell Law Review 2001 (86) 6, pp. 1165 *ff*; F. Kübler. The Rules On Capital Under The Pressure Of The Securities Markets. – K. J. Hopt, E. Wymeersch (eds.). Capital Markets and Company Law. Oxford 2003, p. 95 *ff.*

[12] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions. – OJ L 177, 1-200; Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions. – OJ L 177, 201–255.

[13] E. Werlauff has expressed the opinion that the provisions in these directives can be a source of inspiration for other public limited liability companies. The positive meaning of such inspiration remains unclear because as we are talking about prudential norms, voluntary application thereof may probably be considered, which any company would hardly undertake. See E. Werlauff. EC Company Law. The common denominator for business undertakings in 12 states. Copenhagen 1993, p. 145.

[14] Gesetz betreffend die Gesellschaften mit beschränkter Haftung vom 20. April 1892. – RGBl. I p. 477.

[15] A. Cahn. Equitable Subordination of Shareholder Loans? – European Business Organization Law Review 2006 (7), p. 289.

[16] U. Huber, M. Habersack. Special Rules for Shareholder Loans: Which Consequences Would Arise for Shareholder Loans if the System of Legal Capital Should be Abolished? – Legal Capital in Europe. M. Lutter (ed.). Berlin 2006, p. 309.

[17] Aktiengesetz vom 6. September 1965. – BGBl. I p. 1089.

[18] Insolvenzordnung vom 5. Oktober 1994. – BGBl. I p. 2866.

[19] Gesetz über die Anfechtung von Rechtshandlungen eines Schuldners außerhalb des Insolvenzverfahrens vom 5. Oktober 1994. – BGBl. I p. 2911.

In § 32a of the GmbHG, it is specified that if a shareholder has provided a company with a loan in a situation in which he could have increased the share capital as a diligent entrepreneur, he may claim the repayment of this loan in bankruptcy proceedings as a subordinated creditor. In addition, it has been laid down that if a loan has been obtained from third parties for the same reasons and a shareholder has secured the loan, the third party may submit a claim in the bankruptcy proceedings as a regular claim only to the extent that cannot be satisfied on account of securities. The conditions stated are also applied to other, economically equivalent transactions, and therefore the form in which the loan is provided is not important.[*20]

In 1998, the legislation was once again amended in Germany and two exemptions were included in § 32a of the GmbHG. According to the first of these, the requirement to subordinate claims is not applied to shareholders not managing a company where the shareholder's holding is less than 10%. Under the second exception, those loans were cleared from subordination claims that had been given to the company by persons who had acquired a holding in the company during a crisis with the purpose of helping the company overcome solvency problems; this applies to all loans given by said persons.

Earlier case law and current legislation are at variance in certain ways in Germany. In § 30 of the GmbHG, which was applied to shareholder loans until the amendments in 1990 took effect, payments made to shareholders are limited in the extent corresponding to the deficit in equity capital, and § 32a prohibits repayment of a loan also if equity capital is not lost and as long as the company has not overcome the crisis. The other difference between § 30, which formed the basis for earlier judicial decisions, and § 32a, which currently regulates the matter, is that the latter is only applicable if the company is insolvent, while previous judicial decisions also considered it unlawful to repay the shareholder loans outside the context of bankruptcy proceedings.[*21]

There is a plan to amend the legislation that is currently valid in Germany; the corresponding draft (MoMiG[*22]) was published in 2006. According to the latter, the plan is to delete sections 32a and 32b of the GmbHG and supplement § 30 (1). The purpose of the proposed amendments is to simplify the rules and exclude payments made to shareholders in the interests of the company on the basis of an agreement from the restriction on making payments. In addition, some of the rules currently included under § 32a will be transferred to § 30 (1) (including the prohibition of repayment of a loan in the case where a shareholder has provided a loan where he could have made a contribution to the share capital as a decent operator). The amendments should primarily ensure that it is impossible to make payments to shareholders in a situation wherein equity capital has been lost, while carrying on regular economically justified transactions is not impeded (primarily cash pooling).

As has been noted, in Germany the provisions regarding subordinated loans are also in the bankruptcy law. The InsO's § 39, regulating the order of satisfaction of claims, ranks all loans provided by shareholders behind other creditors' claims; § 135 of the InsO prescribes the basis for recovery of repayment of shareholder loans; and § 6 of the AnfG lays down the same possibility in relation to reorganisation proceedings. These rules are in essence the same as those provided in the GmbHG.[*23] If the special rules regarding subordinated loans otherwise apply to only the GmbH company form, the rules for bankruptcy proceedings apply to all companies.[*24]

3.3. The United States of America

There are no provisions pertaining to shareholder loans in the United States of America, but there is a case law on subordination of loans. The US courts have made decisions related to the subordination of loans that are based on consideration of the fact that the managing shareholder has acted in a way that is unfair to the company. Such subordination may lack any connection with the loan itself or its repayment; instead, the basis for subordination (and the resulting ranking of the shareholder loan after the claims of the rest of the creditors) is merely the shareholder's dishonest behaviour. In application of this approach, the condition of the company at the time of receiving the loan from the shareholder is of no significance. It is also noteworthy that subordination of claims in the United States of America only occurs in bankruptcy proceedings.[*25]

[20] A. Baumbach, A. Hueck. Gmbh-Gesetz. 18., erweiterte und völlig überarbeitete Auflage. Leinen 2006, § 32a.

[21] A. Cahn (Note 15), pp. 290–291.

[22] Gesetzentwurf der Bundesregierung. Entwurf eines Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG). Stand 23. Mai 2007. Available at http://www.bmj.bund.de/files/-/2109/RegE%20MoMiG.pdf (19.11.2008).

[23] Münchener Kommentar zur Insolvenzordnung: InsO. 2. Aufl. Leinen 2008, § 135, margin number 8.

[24] U. Huber, M. Habersack (Note 16), p. 310.

[25] A. Cahn (Note 15), p. 292.

4. The legal approach to shareholder loans in Estonia

4.1. Subordination of loans by legislation

The first thing that must be said about the Estonian approach is that we lack company law provisions regarding subordination of shareholder loans. The first draft of the Commercial Code*[26] included a provision corresponding to § 32a of the GmbHG with regard to private limited companies, but it was deleted from the draft. The Bankruptcy Act*[27] does not discuss the matter of subordinated loans. Estonia also lacks case law in the corresponding field. It is therefore impossible to describe the existing situation, but a question must be raised as to whether current legislation allows subordination of shareholder loans.

The term 'subordinated loan' is not unknown to Estonian legislation; it has been used in acts regulating providers of financial services (credit institutions*[28], insurance undertakings*[29], electronic money institutions*[30], investment firms*[31], and fund management companies*[32]). However, these acts do not address subordinated loans from the company law standpoint; instead, subordinated loans have been regulated as a part of equity capital and an order has been established by the respective legal provisions, according to which loans taken out by companies in the financial services sector that correspond to certain conditions can be treated as equity capital. There is also the difference here that subordinated loans are not equal to shareholder loans; they can also be provided by third parties. Provisions relevant to company law are included in the Credit Institutions Act only because it states that a subordinated claim is subject to repayment after satisfaction of the claims of the rest of the creditors (§ 131 (2)). Although all of the acts mentioned overlap, regulating essentially the same matter, others lack corresponding provisions for other sectors, and cases in these areas are thus subject to general rules (or lack of rules, to be more exact).

In connection with the absence of direct provisions in current Estonian legislation, our situation is in many respects similar to that seen in Germany before 1990. Payments to shareholders of a private limited company are regulated by § 157 (1) of Commercial Code, which specifies that dividends to shareholders may be taken from net profit or retained earnings from previous financial years, from which the non-covered loss of previous years has been deducted. Paragraph 3 of the same section prohibits payments to shareholders if the company's net assets recorded in the annual report approved by the company at the end of the previous financial year are less or would be less than the total amount of share capital and reserves specified as the upper limit for payment to shareholders in relevant legislation or the articles of association. Payments to shareholders of public limited companies are regulated by § 275 (1) of the Commercial Code, which prohibits the repayment of a contribution to a shareholder (this is essentially the same provision as § 57 (1) of the AktG); § 276 (1), which links the permissibility of making payments with the end of the financial year; and sentence 3 of § 278, which defines the maximum amount of dividends that may be paid to shareholders (based on Article 15 of the Second Company Law Directive). It is noteworthy that, although the norms regarding a private limited company and a public limited company have mostly been harmonised and the capital rules also should be the same for these two cases, the text of the act is slightly different with respect to these as a result of the use of different sources.

The first issue related to the given norms is whether the same situation has been handled differently for a private limited company and a public limited company. The text of the act itself is practically the same, and it therefore seems groundless to seek two different situations. When considering the decisions of shareholders, the Supreme Court has found that there is no justification for treating the same situation differently in a private limited company and a public limited company.*[33] Although we must agree with this view of the Supreme Court on the basis of the case considered and the same viewpoint should be justified currently as well, it must be noted that the Supreme Court filled a gap in the legislation while in the case of the legislation currently in effect, there are legal provisions and the matter can be interpreted pursuant to these. At the same time, there is no basis for interpreting the provisions differently.

[26] Äriseadustik. Adopted on 15.02.1995. – RT I 1995, 26/28, 355; 2008, 16, 116 (in Estonian).

[27] Pankrotiseadus. Adopted on 22.01.2003. – RT I 2003, 95; 2007, 67, 413 (in Estonian).

[28] Krediidiasutuste seadus (Credit Institutions Act), § 741. Adopted on 9.02.1999. – RT I 1999, 23, 349; 2008, 3, 21 (in Estonian).

[29] Kindlustustegevuse seadus (Insurance Activities Act), § 68. Adopted on 8.12.2004. – RT I 2004, 90, 616; 2007, 68, 421 (in Estonian).

[30] E-raha asutuste seadus (Electronic Money Institutions Act), § 37. Adopted on 19.10.2005. – RT I 2005, 61, 473; 2007, 65, 405 (in Estonian).

[31] Väärtpaberituru seadus (Securities Market Act), § 97. Adopted on 17.10.2001. – RT I 2001, 89, 532; 2008, 13, 89 (in Estonian).

[32] Investeerimisfondide seadus (Investment Funds Act), § 86. Adopted on 14.04.2004. – RT I 2004, 36, 251; 2008, 13, 89 (in Estonian).

[33] CCSCd 3-2-1-6-03, 29 January 2003. – RT III 2003, 4, 41 (in Estonian).

It must also be emphasised that the provisions regarding making of payments were initially different in their text but, with the inclusion of a provision in § 278 of the Commercial Code corresponding to Article 15 of the Second Company Law Directive[*34] and the simultaneous amendment of § 157 of the Commercial Code, the differences were eliminated. Therefore, it can be said that the most direct source of the norm related to a private limited company as well as a public limited company is the directive and that, in view of the purpose of the directive alone, this is simply a provision regulating dividend rates.

The next issue is the content and purpose of the provisions. Here, it must first be noted that the section headings are confusing. The heading of § 278 of the Commercial Code, regarding a public limited company, is 'Amount of dividend', which should confirm that this provision is to be applied to dividend payments only. A similar provision concerning private limited companies is § 157 (3) of the Commercial Code, the heading of which is 'Making of distributions'. At the same time, however, the heading of a section has no meaning as such. It does not include a legal provision, and one cannot proceed from the heading in determining the content of the provision; therefore, the failed headings should not have an impact on the interpretation and application of the provision. The confusion with the headings probably stems from the fact that § 157 of the Commercial Code initially also included a subordination rule corresponding to § 32a of the GmbHG, which is the reason the scope of application of the provision was wider, and after its removal from the draft the section heading remained the same and thereby became inaccurate.

The above arguments support the viewpoint that the corresponding provisions of the Commercial Code do not allow the treatment of shareholder loans as subordinated loans. However, such a conclusion cannot be justified. It must first be noted that the provisions discussed do not speak of dividends but, instead, prohibit the shareholders from making payments in certain situations, which provides the possibility to regard other payments in addition to dividends as such payments. Another issue is the purpose of the provision, which is to prohibit making payments to shareholders in excess of share capital — in essence, making payments on account of external finances. Such an objective cannot be limited by a formal dividend payment alone but must extend to all cases because otherwise the principle that shareholders receive from the company what they have provided only if the claims of the creditors are satisfied is infringed. The opposite interpretation would be contrary to the principle of good faith. In addition, the fact cannot be overlooked that Estonian case law often proceeds from principles that have been accepted in Germany, and, considering the legal practice of the latter, our courts can also proceed from the same goals even if the standards are different. From a legal political perspective, such an approach in the given case may even be justified, because otherwise a situation could arise with respect to the free movement of capital in which investors discover Estonia as a country where one can create a better situation for oneself when compared to other countries, whereby the purpose of such an advantage would not be *bona fide*.

4.2. Loan subordination agreements

Subordination of a loan by agreement occurs when a creditor of a company agrees that his loan will be returned after the claims of all other creditors are satisfied.[*35] As such agreements are not directly regulated by legislation, a corresponding agreement is subject to the general legal rules, including the principle of freedom to determine the content of a contract. The latter gives rise to the question of whether such agreements are allowed. As there are no common and clear rules regarding the given cases in Estonia, there are also no clear prohibitions. However, it cannot be said that there are no restrictions, as these may arise from the nature of some provisions. We can only agree that such assessments are also generally the most complicated in nature[*36], and the given case is further complicated by the fact that the existence of limitations may arise not from the standards of private law but from those of procedural law.

As the subordination of a loan determines the ranking of its repayment in relation to others, the issue regarding freedom of contract is also primarily related to the general order of satisfaction of claims. This matter is regulated by § 153 of the Bankruptcy Act, which determines the order of satisfaction of claims. This also gives rise to the question of whether the Bankruptcy Act represents imperative rules or it is also possible to agree differently from what it sets forth. A position should definitely be taken that the order of satisfaction of claims cannot be amended such that creditors agree among themselves on some seemingly random order. One of the purposes of a bankruptcy proceeding is clarity of the proceedings, and in this case this principle would be infringed. At the same time, a subordinated loan may be considered to be one exemption, the nature of which gives rise to the need to apply special rules — i.e., placing the claim in a ranking that is not prescribed by the Bankruptcy Act.

34 In essence, the text of the directive was transposed word for word and a different solution would have probably been impossible considering the normative nature of the directive. See C. Villiers. European Company Law — Towards Democracy? Aldershot 1998, pp. 28–29.

35 See E. Ferran (Note 7), p. 549.

36 Võlaõigusseadus I. Üldosa (§§ 1–207): Kommenteeritud väljaanne (Law of Obligations Act I. General Part (§§ 1–207): commented edition). P. Varul, I. Kull, V. Kõve, M. Käerdi (eds.). Tallinn 2006, § 5 comment 4.4.4 (in Estonian).

A solution to this problem may be sought in case law; however, this is extremely poor. We know of only one case in which the issue of subordinated claims has been disputed.*[37] In that case, a bank had received a loan by means of two different agreements, for a loan conditionally subject to repayment and a subordinated loan. In making its decision, the Supreme Court treated these loans as subordinated loans and agreed with the lower courts, which had decided that the claims made were to be subject to satisfaction after claims that were not submitted in due time but are qualified. Here, the Supreme Court applied § 37 (2) 4) of the Credit Institutions Act*[38] valid until 30 June 1999, which laid down the definition of a subordinated loan. It is noteworthy that in the legislation applied here, there were no standards regarding the way in which claims arising from subordinated loans should be satisfied in a bankruptcy proceeding and the court regarded the loan as subordinated on grounds that the claim arising from the subordinated loan was included under the credit institution's own funds according to § 37 (2) 4) of the Credit Institutions Act. Therefore, according to the court's conclusions, ranking of these loans was a result of an agreement between the parties. The court has not based its decision on any other arguments, nor has it provided any broader treatment of subordinated loans.

We must agree with the position of the Supreme Court with regard to the agreement between the parties and the resulting subordination of the loan. It is noteworthy that the Supreme Court gave preference to an agreement between the parties over the legislation, which did not include special rules regarding subordinated loans. In general, this means that the Supreme Court is of the opinion that by agreement parties can establish a claims arrangement different from the one prescribed by the Bankruptcy Act for the ranking for satisfying claims, at least insofar as the creditor's claim is ranked lower by agreement than is prescribed by legislation (the court has not said anything with regard to the reverse situation, which it is unlikely could be allowed). That § 86 of the Bankruptcy Act*[39] as applied, which was valid until 1 January 2004 and is currently invalid, did not prescribe a ranking in which the court was to place the disputed claims implies that the list of rankings prescribed by legislation is not exhaustive and it should therefore also be allowed to supplement this by means of an agreement. Here a reservation must probably be made that such an amendment could concern a change in rankings backward but not forward.*[40] It may therefore be concluded from the views of the Supreme Court that the subordination of loans by agreement is possible and allowed.

Unfortunately, the decision of the Supreme Court referred to here includes relatively few arguments. It is also impossible to determine all of the circumstances of the case, which makes it problematic to rely on this solution. Among other things, there are no indications as to the viewpoints of the parties, which may be of determinative importance. It is thus impossible to determine whether the plaintiff in this case relied on the argument that it is impossible to change the order for the satisfaction of claims prescribed by legislation by agreement. If he did not rely on this argument, it cannot be said that the Supreme Court has assessed amendment of the order for the satisfaction of claims by agreement. As to the case of a contractual subordination of claims, it must also be pointed out that, in connection with the latter, it is not quite accurate to speak about shareholder loans, as any creditor may subordinate his claim in this manner. Problems of a different nature may arise here if the corresponding claim is secured by a pledge, as this inevitably gives rise to the question of whether to regard these claims as claims secured by a pledge or as subordinated claims.

5. Conclusions

It is probably impossible to provide uniform answers to the questions raised in the introduction to this paper. If we take only the above-mentioned German or US approach to the issue of subordinated loans as an example, fundamental differences can be seen, which point to the question of whether results achieved with different methods are fundamentally different. All in all, the objective of avoiding unfair situations in both countries is the same. Therefore, the issue of the methods implemented is not primary in some sense.

On the other hand, current legislation regarding subordinated loans in Estonia is more similar to the legislation in the United States of America — both lack standards regarding the problem considered here. It should be kept in mind here that judicial precedent in these legal orders has a different meaning and that the options of a court are also different and, thus, the lack of rules in Estonian legislation must be considered abnormal. Therefore, regardless of the solution, I dare to claim that the establishment of any rules is better than the current disorder.

The answer to the question of whether loans given to a company by shareholders should be treated differently from all other loans is affirmative. It is not justified to grant the investments that shareholders have made

[37] CCSCd 3-2-1-114-00, 17 January 2001. – RT III, 2001, 3, 30.

[38] Krediidiasutuste seadus. Adopted on 15.12.1994. – RT I 1995, 4, 36; 1999, 23, 349 (in Estonian).

[39] Pankrotiseadus. Adopted on 10.06.92. – RT I 1992, 31, 403, 2003; 17, 95 (in Estonian).

[40] For instance, the case law of United Kingdom allows the amendment of the *pari passu* principle precisely in this manner. See E. Ferran (Note 7), pp. 550–552.

in the company as a loan or as a contribution to equity capital a diametrically different legal status, as it is accompanied by potential abuses and may give unjustified advantages to shareholders in circumstances wherein they are in control of the company's management. It may also make it too easy to ensure low risk of the loss of the investment; given the limited responsibility of these persons for the company's liabilities, the risk is already relatively small. Therefore, the subordination of loans is justified and the inclusion of corresponding rules in our legislation merits serious consideration. At the same time, a stance should be taken that existing standards can also be relevantly applied.

The other issue examined in this paper was whether loan subordination agreements are allowed. At a fundamental level, there is nothing wrong with such agreements and current legislation also lacks rules prohibiting them. Therefore, loan subordination agreements must be regarded as valid. The status of such agreements is indeterminate in bankruptcy proceedings, but, if one proceeds from the point of view of the Supreme Court, claims resulting from these agreements must be given a ranking that in essence corresponds to the content of the claims (i.e., after the claims of all other creditors).

In conclusion, it must be noted that, by means of the Second Company Law Directive, the EU has tried to establish common standards among its member states with regard to capital rules. What is stated in the present article should provide grounds for the claim that no unity can actually be spoken of. We can conclude from this, in turn, that the regulatory framework established by the second directive must be replaced with rules proceeding from the goal.