

PURPOSE IN BUSINESS: STEWARD OWNERSHIP AND ENTERPRISE

UNIMORE
Department of law
22-24/05/2025

Corporate finance: capital lock and its relevance for the debt financing of the company

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First of all, it is noteworthy to analyse the impact of capital lock on the financial structure of the LLC with bound capital. How does the asset lock affects the way to finance steward-owned businesses?

1) UNDERCAPITALIZATION

- In the start-up phase, it is likely that the company will face a situation of undercapitalization: the company has not been provided with sufficient equity or debt financing to meet the reasonably foreseeable needs of its business

- In such a case, the company lacks sufficient financial resources or capital to sustain its operations, meet its financial obligations, or fund its growth and expansion. Essentially, the company does not have enough equity or debt financing to cover its operating expenses, invest in necessary assets, or manage unexpected costs. This financial shortfall can lead to a range of problems, including cash flow issues, an inability to seize market opportunities, and a higher risk of insolvency

What's the impact of the rules of the draft on the undercapitalization?

It is likely that the LLC with bound capital is an undercapitalized company in the start-up phase.

Reasons for undercapitalization:

- A) The legal form of LLC with bound capital. The LLC with bound capital, in the German draft law, is a subtype of the GmbH, which is a closely held company with limited financing channels. U. is a phenomenon that is particularly frequent for limited liability companies rather than broadly held public corporations (Bainbridge).

- B) Not everyone can become a member of the LLC with bound capital. Only natural persons, other GmbH-gebVs, and other legal persons with a comparable capital lock may hold shares in a GmbH-gebV (§ 9 draft). Such limitations hinder equity raising.

- C) The capital lock could be a factor that increases the risk of u.
- The draft forbids profits from being distributed to shareholders (§ 16.1 GmbH-gebV Draft).
- The features of the LLC with bound capital result in the fact that the position of a shareholder is not the right fit for everyone, as it requires individuals who are intrinsically motivated and believe in the mission of the specific company and the concept of steward ownership.
- Why? Simply because the capital lock eliminates the fundamental incentive/purpose of shareholders: shareholder value.
- The operation of the firm is not intended to create private wealth for its members. The company is barred from distributing its net earnings, if any, to members both at the end of the fiscal year and in the case of liquidation.

➤ For all such reasons (A+B+C) LLC with bound capital will probably find it harder to obtain equity → undercapitalization

2) Capital Lock: Hindrance or Advantage in Financing?

- If, on the one hand, the capital lock can hinder equity financing (increasing the risk of undercapitalization in the start-up phase), on the other hand, it can also improve the financial structure and the debt financing of the company.
- The capital lock means that the company is barred from distributing its net earnings, if any, to members. The net earnings of the company must remain within the company estate.

2) Capital Lock: Hindrance or Advantage in Financing?

- For this reason, we can say that the draft provides a form of mandatory self-financing (**ex lege**) of the company by the shareholders through profits that must remain in the firm. The “**nondistribution constraint**,” which prohibits the distribution of operating profits to owners, keeps net assets (wealth) within the LLC with bound capital as a financial source. (This follows the same idea proposed by Hansmann for nonprofit organizations.)

The capital lock strengthens the company's financial structure

- In the LLC with bound capital the rationale of legal capital is enhanced
- The main purpose of legal capital rules is to regulate the conflict between shareholders and creditors and to resolve such a conflict. These rules play a **creditor-protection** role. The operation of a solvent company can create risks for creditors. For this reason, it is widely accepted that creditors need protection.
- In European legal systems, this protection takes the form of rules prescribing:
 - a **minimum level of capital** to be invested in the company by shareholders;
 - **restrictions on transfers** to shareholders under certain circumstances.
- In other words, legal capital rules serve as compensation for the benefits of **limited liability**.

- In the LLC with bound capital, this creditor-protection function is implemented **not only** through the **minimum capital** required by law for a normal LLC, **but also** through the “nondistribution constraint” of **earned revenues**, which must remain within the company as a consequence of the prohibition on paying dividends to members.
- In an ordinary LLC, the minimum capital may be used to pay company’s creditors but may not be distributed to shareholders.
- In the LLC with bound capital, creditors can be paid **not only** with the minimum capital (subject to the German GmbH-law rules on "capital maintenance"—**Regeln der Kapitalerhaltung**), but also **with the net earnings** of the company, which are preserved within the company estate due to the capital lock rule.

This results in two important effects:

- a) The rule prohibiting dividend payments to members **helps mitigate undercapitalization**, i.e., the inadequacy of the company financial resources for conducting its business, because such a rule leads to an increase of the estate of LLC with bound capital.
- b) Since profits must remain in the firm, creditors have a higher likelihood of having their rights paid compared to a classic company. This enhances the **creditworthiness (Kreditwürdigkeit)** of the LLC with bound capital and **increases its borrowing capacity**, allowing it to access loans on **more favourable terms**, as capital lock regulations reduce the risk associated with lending operations for creditors.

3) Debt financing regulation

- **Financing instruments** — such as mezzanine financing — can be used. Investors may receive **limited profit participation rights** as remuneration for their invested capital (§ 18.2 draft).
- Equity-like investments, which grant profit participation rights instead of fixed and regular interest payments, are necessary because they allow steward-owned companies to access capital without being burdened by unsustainable interest payment obligations in the event of missing profits.
- This is particularly crucial for **start-ups**, as these companies **typically do not generate profits in their early stages** but still require investments. However, even **established businesses** depend on the ability to receive capital investments **without incurring interest payment obligations** during economically difficult periods.

3) Debt financing regulation

- The tools that the **GmbH-gebV** can use for debt financing.
- It can use **all types of bond-based financing instruments**, whether secured or unsecured. These include:
 - **Profit participation rights** (*Genussrechte*) or **profit participation certificates** (*Genussscheine*),
 - **Silent partnerships**,
 - **Bonds or debt securities**,
 - **Participatory loans, subordinated loans, and traditional loans.**

4) § 18 draft: Corporate Finance

- § 18 provides for the legal framework for corporate financing of the GmbH-gebV.
- § 18, Abs. 2, S. 1 allows the distribution of profits to third-party funders.
- The purpose of this provision is to ensure the financing of this legal form while preventing the circumvention of the capital lock. A key guiding principle is that control rights and profit participation rights must be separated. Consequently, the management of the company must remain in the hands of the shareholders and directors, while profits may only be distributed to third parties.

4) § 18 draft: Corporate Finance

- Third-party profit participation **must not be unlimited or permanent**. Granting investors unlimited or indefinite profit participation rights —without the possibility of unilateral revocation by the **GmbH-gebV**— would not be consistent with the principles of **steward ownership** and the **capital lock**. There is a risk of **potential circumvention of the capital lock through profit participation rights**
- The risk of **circumventing the capital lock** by granting third-party investors the right to participate in profits is addressed in § 18(2) of the draft, which **requires financing agreements to comply with market conditions**. This serves as a general clause to prevent undue restrictions on entrepreneurial freedom.

4) § 18 draft: Corporate Finance

- Additionally, § 18(2), sentences 1 and 2, introduce the **adequacy principle**, which regulates **the limits and the conditions** of third-party profit participation. Profit participation **cannot be considered adequate** if it:
 - **is unlimited in amount,**
 - **has no time restrictions, or**
 - **is not revocable at any time.**
- Moreover, according to § 18(2) of the draft, investors cannot assume an equivalent position to that of shareholders. However, this does not exclude the possibility of agreeing on certain rights that allow investors to protect their interests without exercising direct influence over the management of the company.

5) Shareholders loans

- Shareholders may grant **loans to the company**, but the **compensation they receive** for providing such loans **must not be excessively high** (§ 16(2) draft).
- Risk of Capital Lock Violation
- There is a risk that **compensating shareholders for loans** may **breach the capital lock** and the fundamental separation in an **LLC with bound capital** between **control rights and profit participation rights**.
- To avoid such a risk, § 16(2), sentence 3, provides for the "adequacy ("angemessen")" of shareholder loans **compensation: the term** refers specifically to the **amount of compensation**, which **must not be a hidden profit distribution**.

Shareholders loans

The adequacy principle is a general clause (:undefined content) that is difficult to apply, so court decisions will be important in determining the meaning of this general clause