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Shareholder Loan, or Misappropriation of Corporate Funds? It Depends.

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A closely-held corporation is a form of business corporation where a small number of individuals own the majority of its shares and the stock is not traded on a public stock exchange. In addition to owning shares of the corporation, the shareholders often participate in the management and operation of the business as officers and/or employees. These shareholder-employees may receive disbursements from the company at various times and in various forms including the payment of salary, dividends, and also shareholder loans.

The salary and dividends paid to a shareholder are deemed income, and therefore subject to income tax. The disbursement of corporate funds as a "shareholder loan" presents various legal issues, including whether such disbursement is taxable income.

Numerous court decisions recognize that a corporation and its shareholders may enter into legitimate loan transactions. Importantly, however, the transaction must satisfy the requirements of a *bona fide* shareholder loan to avoid being construed as a taxable dividend or, worse, a misappropriation of corporate funds.

Factors Considered by the Courts

There is scant case law in Illinois addressing the requirements for a valid shareholder loan. However, the federal courts have addressed the issue in several judicial decisions. These federal decisions hold that the essential question when assessing whether a true shareholder loan exists is whether the parties intended to create a *bona fide*

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debtor/creditor relationship at the time of the distribution.

The following factors are considered when determining whether a *bona fide* shareholder loan exists: (1) whether the promise to repay is evidenced by a promissory note or other written debt instrument; (2) whether interest was charged and collected; (3) whether a fixed repayment schedule was established; (4) whether collateral was given to secure repayment; (5) whether repayments were made; (6) whether the borrower had a reasonable prospect of repaying the loan and whether the lender had sufficient funds to advance the loan; and (7) whether the parties conducted themselves as if the transaction was a loan by following other standard commercial requirements of a loan. This is a non-exclusive list of factors, and no single factor is dispositive in the analysis.

While courts have acknowledged that shareholders and their closely-held corporations often conduct business informally, these courts nonetheless reject any suggestion that different rules apply to closely-held corporations. Further, courts have made clear that the description or "legal label" attached to the transaction in the corporation's books and records is not determinative. Nor is the shareholder's subjective understanding or belief concerning the nature of the transaction a relevant consideration. Rather, the court must assess whether the objective evidence demonstrates an intent to create a *bona fide* debtor-creditor relationship.

Issue Arises in Various Setting

The issue of whether a *bona fide* shareholder loan exists may arise in various settings. One potential scenario is where the Internal Revenue Service (IRS) audits a shareholder's tax returns and concludes that the shareholder has underreported his or her income by misclassifying the receipt of corporate funds as a loan. Unless the shareholder successfully challenges this finding, the disbursements may be reclassified as dividends thereby exposing the shareholder to liability for unpaid taxes, interest and penalties.

The issue may also arise in the context of a dispute between shareholders of the corporation. For example, one shareholder (Smith) may discover that another shareholder (Jones) has received disbursements of corporate funds that were not disclosed to Smith – much less approved by Smith. In the ensuing litigation, Smith may contend that Jones misappropriated corporate funds and assert claims against Jones for breach of fiduciary duty and/or fraud. Both of these legal theories permit an award of punitive damages, in addition to compensatory damages, and therefore expose Jones to significant potential liability. Jones may defend these claims by asserting that his or her receipt of corporate funds was merely a "shareholder loan." In certain cases, the same underlying facts might also warrant a criminal investigation and/or prosecution of Jones for embezzlement, thus creating still additional legal risk for Jones.

Proving A Valid Loan is Only the First Step to Avoiding Liability

The shareholders in a closely-held corporation owe a fiduciary duty to each other similar to partners in a partnership. A corporate fiduciary bears the burden of establishing the fairness and propriety of his or her transactions with the corporation. Thus, as a corporate fiduciary seeking to establish a shareholder loan defense, Jones must demonstrate a *bona fide* loan as well as its overall fairness vis-à-vis the corporation by clear and convincing evidence.

Even assuming the court concludes that a *bona fide* shareholder loan exists, such finding does not necessarily absolve Jones from all liability arising from the loan transaction. Depending on the facts of the case, Smith may nonetheless assert that Jones breached his or her fiduciary duty to the corporation and the other shareholders by (1) failing to disclose the existence of the loan, (2) authorizing a loan of corporate funds without requiring any collateral to secure repayment; (3) authorizing a loan of corporate funds without any requirement for the payment of interest; (4) authorizing a loan of corporate funds without a maturity date or any fixed repayment schedule, and/or (5) causing injury to the corporation by failing to timely repay the loan.

Additional Legal Risks with Public Company Shareholder Loans

Corporate officers in publicly-traded corporations who engage in questionable shareholder loan transactions face additional legal risks. In one recent case, the United States Department of Justice (DOJ) brought various criminal charges against the Chief Executive Officer (CEO) of a publicly-traded corporation (FAT Brands Inc.) alleging that he disguised approximately $47 million in distributions as "shareholder loans" to avoid reporting these payments as income.

In characterizing the "loans" as mere sham transactions, the DOJ alleged that the CEO never posted any collateral to secure repayment of the "loans," never made interest payments on the "loans," and that the parties never observed "any of the other commercial requirements and realities of true loans." The DOJ further noted that the CEO never repaid the so-called "loans," and the loans were essentially "forgiven" by the corporation.

In addition to criminal prosecution for tax evasion and wire fraud, the CEO also faces a civil enforcement action brought by the Securities and Exchange Commission (SEC) alleging the company made false and misleading statements concerning the loan transactions and other matters in its SEC filings. The DOJ and SEC proceedings remain pending as of this publication.

Conclusion

A valid shareholder loan requires objective evidence demonstrating that the parties intended to enter into a *bona fide* debtor-creditor relationship at the time of the transaction. This is a fact-intensive inquiry requiring consideration of various factors. The legal validity of a shareholder loan transaction may be questioned in various settings. The failure to establish a *bona fide* shareholder loan exposes a shareholder to the risk of income tax liabilities, claims of breach of fiduciary duty and/or fraud, as well as potential criminal law violations. Shareholders and their closely-held corporations must structure and administer any shareholder loan transactions consistent with standard commercial loan requirements to mitigate these legal risks.

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