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Distributions to shareholders under the new Dutch private company law

With effect from 1 October 2012 Dutch private company law will be substantially overhauled. One set of changes likely to be troublesome in practice are the new rules concerning distributions to shareholders. These rules will affect a wide array of transactions from ordinary course matters such as final or interim profit distributions through to event driven transactions such as share buy-backs, share capital reductions, debt push downs, intra-group re-organisations, debt restructurings and similar financing arrangements.

On the one hand the new law creates a significantly simpler and more flexible regime and removes some of the formal share capital maintenance rules which were aimed at protecting creditors but proved relatively ineffective in practice, such as the prohibition of financial assistance.

At the same time it also shifts greater emphasis to director liability as the appropriate mechanism to protect creditors of the company.
This note summarises the most important 'need to know' changes to the rules in respect of distributions to shareholders and includes some high level recommendations as to how directors of Dutch private companies might consider mitigating the risk of incurring personal liability towards the BV or a bankruptcy trustee as a result of a distribution to shareholders. Please refer to our quick reference guide for the other key aspects of the new Dutch private company law.

Scope

The new rules only apply to Dutch private companies, often referred to as BVs. They do not apply to other commonly used entities such as Dutch public companies (often referred to as NVs) or Dutch cooperatives (often referred to as co-ops or UAs).
The rules explicitly apply to "distributions", share buy-backs and capital reductions (other than those for nil consideration). As regards "distributions", in this context the law does not distinguish between distributing current earnings, retained earnings or other distributable reserves such as share premium reserves. While not explicitly covered, upstream loans by a BV to its shareholder(s) in circumstances where the only recourse is to the BV itself (ie the relevant shareholders have no assets other than their shares in the BV) are quite likely to be subject to a very similar analysis, if not based directly on the new rules then based on existing doctrines of corporate benefit and director fiduciary duties.

Key points

- Most of the formal capital maintenance rules are abolished in favour of placing emphasis on director liability as the appropriate mechanism to safeguard the interests of creditors.
- Members of the Management Board must refuse to approve a distribution if they know or should reasonably expect that following the distribution the company will no longer be able to continue to pay its debts as and when they fall due.
- This will apply to both executive and non-executive members of the Management Board.
- The new rules do not formally apply to supervisory directors but in practice the analysis around their fiduciary activities will be very similar.

Criteria for distributions under the new law

Each of the following must be satisfied:

- Usually the general meeting of the company is empowered to resolve, by ordinary majority, any distributions by the company but only to the extent that the company's equity is greater than the reserves that must be maintained by law or by the terms of the company's articles of association. The company's articles of association may delegate this authority to another corporate body such as the management board (*bestuur*) of the company (the "Management Board"), or supervisory board.
- Any such resolution to distribute profits or make any other distribution (such as repayment of share premium) requires the approval of the Management Board of the company which approval may be granted on a conditional basis.

- The Management Board shall only withhold such approval if it knows or should reasonably expect that, following the distribution, the company will no longer be able to continue to pay its debts as and when they fall due. We will refer to this as the solvency test.

Share buy-backs

While there are some technical differences in the rules relating to distributions and share buy-back transactions, the essential point is that the solvency test described above applies equally to share buy-backs.

Key points

- Formalisation of the test based on the commercial solvency of the company.
- The new rules are likely to be applied equally to transactions that have the same economic effect as a distribution, such as certain upstream loans.

Corporate benefit, fiduciary duties and supervisory directors

It is worth noting that the new rules are not a radical departure from existing jurisprudence developed by the Dutch courts under the broader doctrines of corporate benefit and directors fiduciary duties which essentially already expect directors to consider the commercial solvency of their company and the position of creditors before approving or giving effect to certain transactions. These doctrines continue to apply to both managing and supervisory directors, recognising that supervisory directors generally have a supervisory role only. However, by formalising the solvency and related director liability tests, the legislator has both placed greater emphasis on this aspect and made the rules more precise, particularly as regards the forecast period discussed below.

Formal solvency test to protect creditors

The purpose of formalising the solvency test is to protect creditors by clearly linking the timing and amount of any distribution to the economic reality facing the company. In practice this means that each Management Board will need to assess the financial health of their company and in particular whether they have a reasonable basis to believe that their company will continue to be in a position to pay its debts as and when they fall due after the distribution.

It is important to note that the solvency test is broad enough to capture not only debts that are incurred but not yet payable at the time the distribution is approved or paid but also those that are likely to be incurred in the foreseeable future in the course of giving effect to the relevant company's business plan, as well as other indebtedness, such as long term debt financing and debts arising on the basis of applicable tax laws, tort or any other cause of action.

There is unfortunately no precise checklist of the steps a Management Board needs to take to arrive at a decision. Based on our experience however, we would expect:

- Most Management Boards will conduct a financial modelling exercise which they consider to be sufficiently robust in the circumstances to satisfy themselves that the proposed distribution is prudent and on the basis of which they can reasonably conclude that the company and, where appropriate, the members of its group will have the required cash flow to be able to implement their proposed business plan and strategic objectives and meet their payment obligations as and when they fall due.
- This modelling will usually show the financial projections for the company and its group going forward for a period of at least 12 months. The parliamentary debate at the time of enacting the new law suggests 12 months as a general rule of thumb but explicitly leaves open the possibility that a Management Board could in certain circumstances reasonably be expected to consider a longer forecast period. This could include, for instance, the amortisation schedule on significant long term financing arrangements in place at the time of the distribution and the ability of the company to refinance that debt as and when it comes due, taking into account not only business specific factors such as current trading but also market factors – both those affecting the markets in which the business operates and the financing markets generally - especially given the extreme volatility seen in such markets over the last few years. That said, we would also expect a Dutch court to understand that the degree of precision of the cash flow forecast is inherently less in respect of periods further into the future.
- This modelling will be adequately stress-tested. Depending on the circumstances this might require it to be reasonably detailed and prepared with sufficient input from the material business units rather than being limited to a quick, high level exercise. However, depending on the circumstances, a Management Board may also consider it prudent to seek expert external assistance to assist it in stress-testing its

forecasts to ensure they are sufficiently robust and that the underlying assumptions are reasonably realistic and achievable.
- Given the inherent uncertainty in any forecasting exercise a Management Board may consider it prudent to build in some "headroom" for unforeseen contingencies.
- Management Boards to place some emphasis on the current trading results of the relevant businesses and the impact that that has, or is reasonably likely to have, on the solvency of their company going forward.
- The directors to be satisfied that adequate management continuity is ensured such that it can reasonably be expected that the business plan underlying the liquidity analysis is capable of being delivered upon.

As mentioned, there is unfortunately no complete checklist for the steps a Management Board can or should take. The steps outlined above are simply suggestions based on our experience and should not be read to imply a formal test which requires each one to be complied with. The key point is that each member of the Management Board must carefully reflect on the proposed distribution and ask itself pertinent questions as to whether and to what extent the company can afford to make such distribution.

Clearly where an ordinary course distribution of year end profits is concerned, the analysis described above will in any event be part of the forward financial planning of the company.

However, where a significant event driven distribution is contemplated, for instance in the context of a debt push down, debt restructuring or similar event, the executive directors will typically want to be seen to have been prudent and cautious in their decision making process and perhaps place additional emphasis on the underlying financial modelling and decision making process.

Key points

- In pratice the formal solvency test will place greater emphasis on financial modelling and director decision making process.
- A 12 month forecast period is the rule of thumb but it may be prudent in certain circumstances to have a longer outlook.
- A well documented decision making process will be one of the key ways to mitigate risk of repayment.

At the risk of stating the obvious, where the liquidity analysis either suggests the distribution is not justifiable or is marginal and does not provide a clear outcome to that effect then, depending on the circumstances it may well be feasible to structure the relevant transaction differently such that it allows the directors to reach the clear conclusion that their company will remain commercially solvent despite the distribution.

Records of the decision-making process

Were the validity of a distribution ever challenged, we would expect that it would be generally useful if:
- The record reflects both the substance and process of the decision-making on this topic, not just the eventual outcome. While clearly useful to have this in formal minutes we do not want to place undue emphasis on minutes of meetings (as opposed to the broader record as to how and on what basis the eventual decision was made). Ideally the record would include, for instance, some form of commentary from the Management Board as to where they see material risk factors during the forecast period which they consider to be either high risk or high impact and to include some sensitivity analysis for different outcomes and how that is taken into account in the model justifying the expected solvency of the company.
- All material decisions, discussions and approvals are recorded, where appropriate with references to the meetings and documents reflecting the various questions and answers, including any dissenting opinions and votes.
- The record reflects that the Management Board has been critical in its decision making process, ie it has reviewed the information provided to it by the relevant business units, asked follow up questions where the Management Board considered that necessary and received satisfactory answers.

Timing

The solvency test is to be applied at the time the distribution is actually paid. In practice the time between approval of the distribution and actual payment of the distribution is usually brief and the solvency test applied at the time of the approval will be sufficient for the assessment of the company's solvency state at the time of the actual payment.

However, if for some reason there is a longer period before actual payment and/or new facts or circumstances arise in the period between the approval and the payment which materially impact on the director's assessment of the company's solvency, a prudent Management Board may consider withdrawing their approval. Or put differently, a prudent Management Board might in certain cases make their approval conditional on there being no material adverse developments in the period between them giving their approval and the actual payment of the distribution.

Liability of the Management Board

If, after a distribution, a company is unable to pay its debts as and when they fall due, then the members of the Management Board who, at the time of the distribution, knew or reasonably ought to have foreseen that that would be the case are jointly and severally liable to the company (and any bankruptcy trustee) for the lower of (i) the amount distributed and (ii) the amount of the deficit caused by the distribution, plus interest at the applicable statutory rate. Any assessment of whether or not members of the Management Board actually incur personal liability is always going to be highly fact specific.

Individual directors can disculpate themselves by proving that they are not responsible for the distribution by the company and that they have taken adequate measures necessary to avert the consequences of the distribution. In practice this will apply for instance to those directors who were not satisfied by the solvency analysis and voted against approving a distribution or perhaps non-executive directors. It goes beyond the scope of the note to consider the other bases upon which directors may incur personal liability.

Key points

- While the formal solvency test is forward looking, the reality is that in a bankruptcy scenario it may be difficult to get a bankruptcy trustee or a Court to place themselves in the positions of the directors at the time the relevant distribution decision was taken without the benefit of hindsight.
- The new law expressly provides that under certain circumstances directors who approve a distribution, as well as shareholders receiving such distribution, may become liable to the company and any bankruptcy trustee of the company.

Shareholder liability

Shareholders who receive a distribution in circumstances where they know or should reasonably foresee that the company will not be able to continue paying its debts as and when they fall due, are obliged to repay an amount equal to the lower of (i) the amount distributed and (ii) the deficit resulting from the distribution, provided that they will not have to reimburse an amount exceeding the amount received by them.
Again it goes beyond the scope of the note to consider the other bases upon which shareholders may incur liability.

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