Financiering en vermogensonttrekking door aandeelhouders: een studie naar de grenzen aan de financieringsvrijheid van aandeelhouders in besloten verhoudingen naar Amerikaans, Duits en Nederlands recht

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CHAPTER 22
SUMMARY & CONCLUSIONS

22.1 Reason for the study

22.1.1 Takeovers in the newspaper industry

"Currently, the *PCM* Group is being cleaned out by the British shareholder, *Apax*, which rapidly converted equity into debts and is now taking off with the spoils."[1] This statement by Van Dam, a member of the Dutch Lower House, illustrates the tumultuous public debate in 2006 that followed the brief participation of private equity investor *Apax* in *PCM Uitgevers*, the Dutch newspaper and magazine publisher. When *Apax* acquired a majority interest in *PCM* in 2004, the publisher's equity was 268 million euros; when *Apax* exited just two years later, *PCM*'s equity was negative, with the publishers' balance sheet burdened by debts totalling more than 600 million euros.[2] *PCM*'s takeover has been discussed in numerous newspaper articles, and has been the subject of several documentaries; the sequence of events has been reconstructed in two books.[3] The media commentary primarily criticized *PCM*'s shareholders and directors for allegedly thriving at the expense of the company's interest. This opinion also came through in the Enterprise Chamber's decision, which issued a ruling at the request of two trade unions which alleged that mismanagement had been involved.[4] However, opinions on the *PCM* case vary amongst legal experts. Although some experts argue that the conduct of private equity investors qualifies as "legalized robbery",[5] others believe that the funding of *PCM's* takeover should be qualified as conservative, and that any criticism is especially inspired by a lack of understanding of the financial structure applied.[6]

In the United States, the acquisition of a newspaper group also gave rise to legal proceedings and a heated public debate regarding the conduct of the investors involved. In December 2007, the *Tribune Company*, publisher of, *inter alia*, the *Chicago Tribune* and the *L.A. Times*, was taken over by the investment company of

1 *Kamerstukken II* 2006/07, 30 800 VIII, no. 76, p. 4.
2 Data derived from the 2006 annual report.
3 Romaer 2009 and Schaepman & Spinhof 2008.
4 OK 27 May 2010, *JOR* 2010/189, *Ondernemingsrecht* 2010/91 (*PCM II*).
5 Schoordijk 2009, p. 362.
6 Honée 2008, pp. 127-132 and Mol 2012, p. 111.

real estate tycoon Zell.[7] In the scope of the takeover, *Tribune* incurred new debts totalling nine billion dollars. Soon after the transaction, *Tribune* ran into financial problems, leading to massive layoffs at the company. Within one year after the takeover, *Tribune* was forced to apply for *Chapter 11* bankruptcy protection under the U.S. *Bankruptcy Code.* An independent examiner appointed by the judge hearing the case concluded that as a result of the takeover, the shareholders of *Tribune* had withdrawn a substantial amount of money from the company, and that it was highly likely that *Tribune* had been left without adequate capital after the transaction.[8] For that reason, in 2010, the unsecured creditors in the *Tribune* bankruptcy initiated legal action against both the shareholders and the banks involved in the takeover, because they felt that the transaction had exposed the company and its creditors to unreasonable risks.[9]

22.1.2 Developments in the financing practice: increase of debt financing and complex financing structures

The *PCM* and *Tribune* cases are certainly not isolated cases, but they are prime examples of how many companies were funded in the years before the financial crisis. The ample availability of credit meant that enterprises increasingly funded their activities using loan capital.[10] Particularly in takeovers by private equity investors, equity on the target's balance sheet was replaced by secured debt. Due to the leverage created, shareholders realized high returns in a prosperous economy; on the other hand, the financial resilience of some companies proved to be too limited when the economic tide turned. Not only did listed, financial institutions have inadequate capital in 2008, but unlisted, non-financial businesses also heavily suffered from the capital structure they had chosen.

The *PCM* and *Tribune* cases also illustrate that in the past few decades, financing structures have become increasingly complex. In each case, the takeover was structured as a *leveraged buyout* (LBO), an acquisition structure whose popularity reached a record level in the run-up to the credit crisis. An LBO is a takeover that is mostly funded by loan capital, with financing for the takeover coming at the target company's expense. As a rule, an LBO is comprised of a large number of closely related (legal) transactions involving the takeover target, the old and the new shareholders, as well as the financing banks. The manner in which the law should stipulate limits for LBOs is the subject of discussion in many jurisdictions. The

7 See Ginsberg e.a. 2011, pp. 72-74.

8 *In re Tribune Co*, Case No. 08-13141 (KJC) (Bankr. D. Del.), Report of Kenneth N. Klee as Examiner, Volume One, p. 18.

9 *Complaint, Wilmington Trust Co. v. JPMorgan Chase Bank*, N.A., No. 10-50732 (Bankr. D. Del. Mar. 4, 2010). The *Chapter 11* procedure of *Tribune* ended in December 2012 by – very briefly – approval of a plan of reorganization providing settlement for (part of) the claim of the unsecured creditors.

10 See Chapter 2.

special, composite nature of the transaction structure gives rise to questions regarding the application of the existing system of legal standards. What stands out is that wide- ranging approaches are chosen in the various jurisdictions. For example, until recently, in many European Member States, LBOs primarily gave rise to difficult questions regarding the application of the formal capital rules; on the other hand, since the 1980s the prevailing opinion in the United States has been that in principle, LBOs comprise legitimate transactions, that nonetheless may give rise to liability on the part of the parties involved if the target company's creditors have been exposed to unreasonable risks.

22.1.3 Review of the legal framework: flexible capital rules and open standards

In the past decade, the statutory system of standards regarding the financing of a limited company has been subject to change as well. This has occurred in part as a result of the increased competition between the different national private corporate forms, as in the past few years, a variety of Member States have tried to make their national company laws more attractive to investors. In this scope, many Member States abolished or relaxed formal rules regarding the capital of a private limited company. For this reason, in many jurisdictions it is currently possible to incorporate a capital company with limited liability without contributing any equity. For example, as a result of the implementation of the *MoMiG* act in 2008, the capital rules for the *GmbH* have been extensively revised in Germany; in addition, a new '*capital light*' legal form with limited liability was introduced. In the Netherlands, the coming into force of the *Flex-BV* Act on 1 October 2012 almost completely abolished the capital protection for the BV.[11] In both countries, the regulation of shareholder funding is currently primarily found in the rules regarding distributions to shareholders, which – very briefly – prescribe that shareholders may not withdraw capital from the company if it is reasonably foreseeable that as a result, the company will encounter continuity problems.

22.2 Objective of the study

22.2.1 Starting point: the shareholder's discretion to decide on the financing of the company

The two developments outlined above – the changes in the financing practice and the relaxation of the statutory system of standards for the private company – are the reasons for this study. The study aims to answer the central question to what extent,

11 *Stb.* 2012, 299; *Kamerstukken* 31 058 (act adopting the Flex-BV Act) and *Stb.* 2012, 300; *Kamerstukken* 32 426 (act implementing the Flex-BV Act).

and how, the shareholder's discretion to decide on the financing of the private company (*de financieringsvrijheid van aandeelhouders*) should be limited on behalf of the interests of the other parties involved in the company, in particular when the shareholder intervenes in the company's capital structure.

> Even though the term '*financieringsvrijheid*' is almost never used in the Dutch private-law doctrine,[12] I believe that the starting point is that in principle, shareholders have a discretion to determine the way in which they finance the company.[13] This notion is more explicitly recognized in the German dogmatics. For example, Beck considers: "*Die unternehmerische Finanzierungsfreiheit ist Grundelement der Finanzverfassung der GmbH. Dem Unternehmer steht es frei, Art und Umfang der Finanzierung der Gesellschaft zu gestalten.*"[14]

In my opinion, the shareholder's discretion to decide on the financing of the company applies to three financial options for the shareholder. Firstly, the shareholder can freely determine the extent to which he will finance the company; in other words, the total capital that he will make available to the company. Secondly, the shareholder can determine the legal form of the financing he furnishes in accordance with his own views: does he provide capital and in this way contribute to the company's equity, or does he grant a loan to the company, possibly in exchange for security, resulting in an increase of the company's debts? Finally, the shareholder is free to withdraw equity from the company by means of formal distributions, such as payments of dividends, the repurchasing of shares or payment in the scope of a reduction of capital. In addition, the shareholder can enter into other transactions with the company that result in a reduction of the company's equity in favour of the shareholder.

22.2.2 Main question: the limits to the shareholder's discretion to decide on the financing of the company?

The shareholder's discretion to decide on the financing of the company is not unlimited; it is limited by the interests of third parties. Firstly, reference is made to the creditors of the company. Given that they can only seek redress against the assets of the legal entity, creditors have an interest in a debtor/company whose financial structure is such that their payable claims can be paid on time. This means that, to some extent, the shareholder must take the legitimate interests of the company's creditors into account in actions regarding the company's funding.

12 The term sometimes occurs in a fiscal context, see, for example, Habermam 1993, pp. 25 ff.
13 Cf. *Asser/Van Solinge & Nieuwe-Weme 2-IIA* 2013, no. 95.
14 Beck 2006, p. 38.

Other parties can also have an interest in maintaining the company capital, especially if the company runs a larger business with a more institutional character. For example, generally, the interests of employees, suppliers and buyers of a company are not limited to their 'creditor's interest' in the payment of their payable claims; they also primarily have an interest in continuing their relationship with the company. In addition, public interests can be involved in the company's continuity. The question of whether, under specific circumstances, the shareholder should also take these interests into account in his financing decisions, remains.

22.2.3 Sub-questions

To answer the main question of the subject study, a number of sub-questions arise. These sub-questions are addressed in the last section of this summary, offering a picture of the shareholder's discretion to decide on the financing of the private company under Dutch law. The sub-questions are as follows:

vi. What role does the term 'undercapitalization' play in the regulation of the shareholder's discretion to decide on the financing of the company?
vii. What limits are there on the shareholder's discretion to decide on the financing of the company in terms of withdrawing capital from a company or entering into other types of transactions with a company that reduce the assets of the company?
viii. What limits are there on the shareholder's discretion to decide on the financing of the company in terms of financing a company upon incorporation and at the start or change of business activities?
ix. What limits are there on the shareholder's discretion to decide on the financing of the company in terms of financing a company using loan capital issued by shareholders themselves?
x. How should complex capital withdrawals by shareholders comprised of closely related (legal) transactions be regulated?

22.3 Demarcation and justification of the study

22.3.1 The private (unlisted) company

For a number of reasons, this study is aimed at the privately held company, rather than the listed company.[15] Firstly, the problems studied are especially prone to occuring in private companies. Due to the interest they hold or due to their involvement in the company on any other account, the shareholders in such companies can usually exercise considerable influence on the company's monetary

15 The subject study starts from the statutory provisions that apply to the closed corporation, *GmbH* and BV. Since 1 October 2012, a BV can also have an 'open character', just as an NV can have a 'closed character'.

policies. Because the interests of shareholders and company creditors do not always run in parallel, great shareholder influence can imply a larger risk that the company and its creditors will be exposed to unreasonable risks. Given that the policy of the listed company with widespread shareholdings is primarily determined by the board, this conflict of interests plays a less pertinent role here.[16]

The previously mentioned relaxation of the *BV*-rules also justifies the study's focus on the private company. The abolishment of capital protection and the introduction of open formulated (liability) standards give rise to the question regarding the responsibility that the shareholder bears for adequate funding. In part based on the experience with foreign flexible private company law, this study tries to work out the details of these standards.

22.3.2 The role of the shareholder

The role of the shareholder in funding the company is the main issue in this dissertation. The responsibility and the possible liability of directors only become an issue if the legislature allocates a specific task regarding the funding of the company to the board of directors. For further analyses of the board's role, please refer to the extensive literature on D&O liability that has been published in the past few years.[17]

The study focuses on the shareholder for a number of reasons. If a company encounters financial problems or is declared bankrupt, the aggrieved parties often look to the directors. That is understandable and often appropriate, given that the board is primarily responsible for the company's financial policies. However, this responsibility does not detract from the responsibility and possible liability of shareholders on account of their own involvement in the company's funding. For example, shareholders rather than the directors primarily decide on the amount of equity that is used to fund the company. In addition, it is the shareholders (as recipients of the withdrawn means) rather than the directors who are enriched by any capital withdrawals prior to the bankruptcy. Even if the company's bankruptcy was caused by the unreasonable funding of a company by loan capital, casting a critical glance at the shareholders involved is justified. After all, the shareholder is the primary beneficiary of this high-risk financing structure. Thus, in companies in a private limited context, it is frequently the shareholder who insists on a high-risk capital structure at the time the company is incorporated, in the event of a financial

16 Kraakman e.a. 2009, p. 117.

17 See, for example, Assink 2007 and Strik 2010. In particular on the role of the board in capital withdrawals by shareholders, see, *inter alia*, Lennarts 2012, Stokkermans 2012, Viëtor & Scheentjes 2012, Mol 2012, Barneveld 2012b, Raaijmakers 2011, Barneveld 2011c, Brink-van der Meer, Huizink & Ledeboer 2011, Barneveld 2009c, Huizink 2009b, Verkerk 2008, Bier & Van der Zanden 2007, Lennarts 2007, Bier 2006a, De Kluiver 2006.

restructuring or in the scope of a takeover. Placing liability consequences exclusively on directors because of inadequate funding not only ignores the formal and actual influence of many shareholders on the establishment of the financial structure, it also ignores the fact that high-risk funding primarily serves shareholder interest.

22.4 Regulation of shareholder funding from a (legal) economic perspective

The main rule that shareholders are entitled to the company's unlimited profit potential, but only share in potential losses up to their contribution, means that shareholders can externalize costs to creditors and other company stakeholders. Thus, the risks resulting from a high-risk financing structure are not only borne by the shareholder, but also – and sometimes primarily – by these parties.[18] Many professional creditors, such as banks and credit companies, are perfectly able to protect themselves against these risks. For example, they usually stipulate compensation for these risks in the form of a risk premium on the interest rate that the company has to pay on the credit. In addition, the professional creditors can stipulate personal guarantees from shareholders and, in this way, contract around the limited liability shield; they may also demand security on the company's assets. Moreover, loan agreements usually impose contractual limitations on shareholders' ability to change the company's risk profile *ex post* – that is, after the credit has been furnished – for example by making distributions, raising additional loan capital or changing the risk profile of the business activities. However, there is no such thing as a totally infallible credit agreement, so that the shareholder sometimes can prejudice professional creditors by changing the company's risk profile beyond the expectations of the parties.

Not all of the company's creditors are capable of protecting themselves against a transfer of risks by shareholders. Trade creditors, employees, consumers and, in particular, involuntary creditors are frequently not in a position where they can influence the terms and conditions of their relationship with the company. This means that, to a certain degree, shareholders can externalize the costs of the business to specific creditors of the company, especially if they undercapitalize the company, withdraw capital from the company or have the company raise extra loan capital.

In the run-up to the credit crisis, it was demonstrated that shareholders sometimes prefer a (too) high-risk financing structure on rational grounds;[19] this gives rise to the question regarding how the law must impose limits on the shareholder's discretion to decide on the financing of the company. In my opinion, limited liability serves to protect shareholders from run-of-the-mill company risks and special, unforeseen risks. However, it does not aim to enable shareholders to pass on reasonably foreseeable costs to third parties. For that reason, I believe that under

18 See Chapter 3 for more details.
19 See Chapter 2 for more details.

specific circumstances, shareholders may have the responsibility to adequately fund the company at the time it is incorporated or when its activities have changed, such that the funding is in reasonable proportion to the nature and scope of the business activities and the risks resulting from this. Nor may shareholders expose creditors to risks that they reasonably did not have to allow for by capital withdrawals and leveraging. In short, the regulation of shareholder funding serves to prevent shareholders from externalizing reasonably foreseeable costs to the creditors and other stakeholders of the company.

22.5 Four doctrines that regulate the shareholder's discretion to decide on the financing of the company

22.5.1 Company law regulation of capital and distributions

In many countries, the emphasis on the regulation of shareholder funding has shifted from absolute capital protection rules to generally formulated liability standards. For example, in all three jurisdictions studied, the focus is currently on the regulation of capital withdrawals by shareholders, even though few requirements are outlined for the contribution by the shareholders. In all countries studied, distributions to shareholders must initially satisfy a balance sheet test and (de facto) an economic test.[20] Germany has the most stringent balance sheet test, given that distributions are only permitted to the extent that equity exceeds the *Stammkapital.* Most U.S. states have the more flexible rule that allows the *entire* equity to be distributed to the shareholders. Since the review of 1 October 2012, the Dutch rules as outlined in Section 2:216 DCC are the most flexible in this respect, because no balance sheet test is prescribed (in the absence of reserves that must be maintained by law or pursuant to the articles of association). This means that distributions in the event of or resulting in a negative equity are possible, even if there is no profit in the current financial year.

In all countries studied, the second economic test – in brief – holds that it must be reasonably foreseeable that the company's continuity will not be at issue after the distribution. This test is not grafted on the company's financial statements, but requires a reasonable opinion of the company's ability to continue to fulfil its due and payable obligations in the future. This assessment should not be limited to the company's (forecast) liquidity position; the anticipated solvency, profit margins and sales must also be included in the analysis. It is *communis opinio* that this distribution test is more imprecise and therefore leads to more uncertainty regarding the permissibility of a distribution, but also that creditors derive the most protection from this test.

20 For America, see Chapter 5; for Germany, see Chapter 11, for the Netherlands, see Chapter 17.

In all jurisdictions studied, the board fulfils a prominent role in distributions to shareholders; shareholders cannot withdraw capital from the company without the board's intervention. All countries studied provide for liability rules for directors that cooperate in or approve a distribution, even though they knew or should have foreseen that the distribution would lead to continuity problems.

The company law of the various jurisdictions also recognizes a restitution obligation for shareholders that have received an unauthorized distribution, although there are some differences between these rules. For example, the U.S. model act – the RMBCA – only offers directors who are held liable the possibility to seek redress from the shareholders who received the distribution. In most American states, under company law, a claim for repayment can only be brought against shareholders if they were aware of the unauthorized nature of the distribution. However, based on the common law rules, a claim for repayment can also be brought against shareholders who received a dividend *in good faith*, provided that the company was insolvent at the time the distribution was made.

In Germany, based on § 31 GmbHG, a claim for repayment can be brought against shareholders if the distribution was made in breach of the capital protection rules. This repayment obligation also applies to the shareholder who receives dividends in good faith. The *GmbH-Gesetz* also provides for an alternative liability of shareholders for distributions to their fellow shareholders if it proves impossible to seek redress against those fellow shareholders.

By virtue of the Dutch distribution rules in Section 2:216 (3) DCC, shareholders who received a distribution even though they knew or should have foreseen that after the distribution, the company would be unable to continue to pay its due and payable obligations, can be sued by the company to make up for the deficit that occurred as a result of the distribution, up to no more than the amount or the value of the distribution received by the shareholder, plus the statutory interest as of the day of the distribution. Even though based on the rules initially proposed in the preliminary draft of the *Flex-BV* Act, a claim for repayment could also be brought against the shareholder who acted in good faith, Section 2:216 DCC thus does not provide for liability of the shareholder who acted in good faith.

22.5.2 Bankruptcy law limits on capital withdrawals

The shareholder's discretion to decide on the financing of the company is not only regulated by company law rules; bankruptcy law also imposes limits on this discretion. By invoking bankruptcy law provisions, a trustee can sometimes challenge a capital withdrawal by a shareholder. For this reason, the bankruptcy law doctrines that serve to avoid prejudicial transactions are a functional equivalent of the distribution rules. For example, in the U.S., fraudulent transfer law plays an important role in the regulation of transactions between the company and its shareholders.[21] American trustees who seek to avoid a distribution rely more frequently on the bankruptcy law doctrine of fraudulent transfers than on the company law rules. In the U.S., a trustee – and sometimes an individual creditor, as well – can nullify a transfer by the company to a shareholder if the company did not receive a reasonably equivalent value in exchange and, after the transaction, became insolvent or was left with an unreasonably small capital. This does not require that the shareholder be aware of the unauthorized nature of the transaction. Even though there is no German case law in which the *Insolvenzanfechtung* is applied to distributions to shareholders, a growing number of legal authors in Germany does argue that distributions can be nullified based on this bankruptcy law doctrine.[22] However, opinions differ regarding the way in which reclaiming distributions should be incorporated in the highly complex system of the *Insolvenzanfechtung.* In the Netherlands, it is common opinion that distribution resolutions can be nullified by means of an *actio pauliana.*[23] In recent years, trustees appear to be using this possibility more and more often.

22.5.3 Piercing the corporate veil

In all jurisdictions studied, the involvement by the shareholder in the financing of the company can also lead to a direct or indirect piercing of the corporate veil. The term ‘piercing the corporate veil’ expresses the fact that despite the privilege of limited liability, the shareholder is nevertheless liable to the company’s creditors or to the company itself, because the corporate veil is being pierced or because the shareholder’s acts or omissions qualify as a wrongful act. Even though the dogmatic basis and details of the ‘piercing the corporate veil’ doctrine differ for each country, there are nevertheless a number of similarities between the countries. First of all, what stands out is that in all jurisdictions the ‘piercing the corporate veil’ doctrine as developed in case law has a strongly contextual and case-based character. American judges frequently use metaphors and long lists of relevant circumstances for piercing the corporate veil, which frequently conceal the underlying considerations.[24] Even though the German *Bundesgerichtshof* substantiates its rulings with clear findings and extensive references to legislation, case law and literature, on a number of occasions it has significantly amended the ‘piercing the corporate veil’ doctrine.[25] In the Netherlands, the ‘piercing the corporate veil’ case law is also very much case based.[26] The Supreme Court’s findings frequently focus on the specific circumstances of the case at issue, without formulating any general rules.

21 See Chapter 6.
22 See Chapter 12.
23 See Chapter 18.
24 See Chapter 7.
25 See Chapter 13.
26 See Chapter 19.

Despite this contextual and case-based character of the 'piercing the corporate veil' case law, the contours of the doctrine can be outlined in general terms; a number of similarities between the various countries stand out in this regard. For example, in all jurisdictions studied, piercing the corporate veil has exclusively been assumed in private companies with a limited number of shareholders. In addition, capital withdrawals at a time when the shareholder could foresee that after the withdrawal, the company would encounter continuity problems, can constitute a reason for piercing the corporate veil in all countries studied.

However, the consequences of 'piercing the corporate veil' are not the same in all countries. For example, in the American veil piercing proceedings, unauthorized withdrawals usually lead to direct liability of the shareholder to a specific creditor. In Germany, *existenzvernichtenden Eingriffs* no longer lead to any direct piercing of the corporate veil, but qualify as an *unerlaubte Handlung* vis-à-vis the company, so that the claim for compensation must be lodged by the company – usually the trustee in bankruptcy. In the Netherlands, unauthorized capital withdrawals may constitute a wrongful act vis-à-vis the collective creditors. This means that both an individual creditor and the bankruptcy trustee acting on behalf of the collective creditors can commence legal action against the shareholder.

22.5.4 Special rules for shareholder loans

Under American and German law, special rules apply to loans that the shareholder makes to the company. For example, since *MoMiG*'s implementation in Germany in 2008, in a bankruptcy, all loans furnished by shareholders are subordinated to the claims of the other creditors.[27] Security that the company established for shareholder loans has no effect in bankruptcy; the trustee can nullify all repayments that the company made towards a shareholder loan in the period of one year prior to the bankruptcy. Thus, the German legislature opts for a very absolute regulation of shareholder credit and of the "*fragwürdige*" repayments made towards such credit. The American *Bankruptcy Code* also offers the possibility of subordinating shareholder claims and transferring the security on such claims to the bankrupt estate; however, these rules are based on a different notion.[28] Where the subordination rules in Germany seem to be based on a vague notion of the general financing responsibility of shareholders, the bankrupty trustee in the US, in order to successfully invoke subordination, has to demonstrate that the shareholder can be blamed for inequitable conduct towards the company's creditors. The American *Bankruptcy Code* also offers the possibility of nullifying payments to certain

27 Loans furnished by shareholders who hold less than 10% of the shares in a company and who are not directors of the company fall outside the subordination rules.

28 See Chapter 8.

shareholders; however, this requires – in brief – that the company be insolvent at the time of payment and where payment was not made "*in the ordinary course of business or financial affairs*". Thus, on this point as well, the American rules reflect a different approach as compared to the absolute German standard. The Netherlands does not have any special standards for shareholder loans.[29] For this reason, some authors advocate for the introduction of rules where shareholder loans can be subordinated in the event of bankruptcy, and where payments made on those loans can be nullified. On the other hand, others argue that the current system offers sufficient tools to challenge any prejudice caused by shareholder loans.

22.6 The limits on the shareholder's discretion to decide on the financing of the company under Dutch law

Based on the analysis in the previous chapters of the four doctrines discussed above, the sub-questions formulated in the introduction of this chapter can be answered. Based on those answers, the limits on the shareholder's discretion to decide on the financing of the company are presented below.

22.6.1 What role does the term 'undercapitalization' play in the regulation of the shareholder's discretion to decide on the financing of the company?

22.6.1.1 A vague term

The exact contents of the term 'undercapitalization' and its standard meaning are not clear. The term hardly plays any role in the Dutch regulation of shareholder funding. Even though a considerable number of legal academics believe that in the Netherlands, an unwritten rule applies to the effect that the funding of the company must be in reasonable proportion to the activities the company develops; the term is rarely used in case law. In part, this may be because different authors attach different meanings to the term.

The term *undercapitalization* is frequently used in American case law and literature; however, in the US, as well, not everyone seems to understand this term in the same way. Even though there is case law from which it may be inferred that undercapitalization may constitute grounds for the liability of shareholders, and a considerable number of American authors have advocated in favour of such a rule, based on a majority of American rulings it may be concluded that without additional circumstances, in and of itself, undercapitalization is insufficient to assume the liability of shareholders or subordination of shareholder loans. It is clear that capital withdrawals by shareholders that result in an *unreasonably small capital* can be reclaimed in bankruptcy.

29 See Chapter 20.

In Germany, there is a very great deal of legal literature on *Unterkapitalisierung*, and apparently a more uniform understanding of this term. Until the review of 2008, the term 'nominal undercapitalization' was used if the shareholders failed to fund the company with adequate capital, but did furnish loans to satisfy the company's financial needs. In that case, the shareholder loans had to be subordinated. Given that since 2008, shareholder loans are *automatically* subordinated, 'nominal undercapitalization' is no longer a legally relevant term. In Germany, the term 'substantive undercapitalization' refers to situations where the shareholders have failed to fund the company with adequate equity in light of the scope and nature of the activities developed. A large number of legal academics support the introduction of the standard that shareholders can be liable vis-à-vis the company's creditors based on substantive undercapitalization. The BGH has never accepted such a rule, but did explicitly leave open the possibility that substantive undercapitalization can qualify as a *unerlaubte Handlung* of the shareholder in the sense of § 826 BGB.

22.6.1.2 The normative role of undercapitalization

In my opinion, undercapitalization has occurred if, in view of the solvency, liquidity position, forecast profitability and the insurance that the company has taken out, the company has insufficient means to safeguard its continuity. Thus, the nominal capital is not a calibration point in determining undercapitalization, given that the company can meet its capital needs by both equity and loan capital. In this definition, 'undercapitalization' is an objective, factual term that indicates a funding shortfall, without the cause of this shortfall playing any role. Thus, a bankrupt company that was at some point in a state of undercapitalization does not justify any liability consequences for shareholders. This does not alter the fact that the determination of undercapitalization can most certainly play a role in assessing the conduct of shareholders regarding the funding of the company.

Firstly, a situation of undercapitalization – irrespective of its cause – may mean that shareholders are limited in their discretion to decide on the financing of the company because they are no longer permitted to withdraw capital from the company or keep the company going without reservation by issuing credit. Secondly, the shareholder may be responsible for *the occurrence* of the undercapitalization, for example by capital withdrawals or by creating an inadequate financial structure. For the sake of clarity, the term 'culpable undercapitalization' is used for these cases in the subject study to express that the shareholder can be blamed for (the occurrence of) the undercapitalization.

22.6.2 *What are the limits on the shareholder's discretion to decide on the financing of the company in terms of withdrawing capital from the company or entering into other types of transactions with the company?*

22.6.2.1 Limits on formal distributions

All doctrines discussed above maintain the standard that the shareholder's discretion to withdraw capital from the company ends if the shareholder knows or reasonably should realize that after the distribution, the company will encounter continuity problems. For example, by virtue of Section 2:216 (3) DCC, the shareholder must refrain from making any distribution if he knows or should foresee that as a result, the company will encounter payment problems. The shareholder who does not receive a distribution in good faith can be sued by the company for the deficit caused by the distribution. In this context, it is irrelevant whether the shareholder contributed to the establishment of the distribution by exercising his voting right. The assessment is made at the time at which the shareholder *receives* the dividend rather than the time of the decision-making process. In the event that continuity problems are not foreseeable at the time the GM adopts the distribution resolution, but can be (and should be) foreseen at the envisaged time of making the dividend payable, the shareholder should thus refrain from the (actual) withdrawal. In that case, the interests of the company's creditors in maintaining the company's capital prevail over the interests of the shareholders in the anticipated distribution.

Established case law demonstrates that under certain circumstances, by virtue of Section 6:162 DCC, shareholders can also be required to repay any unauthorized distribution. For this to apply, the shareholder must have exercised his voting rights and thus contributed to the establishment of the distribution resolution, even though at that time, he *seriously should have allowed* for a deficit. In the event of liability due to withdrawals, the Supreme Court uses a less stringent requirement of knowledge – which will thus be satisfied more readily – than in the event of liability based on a wrongful continuation of loss-making activities. For that reason, it may be possible for the company to be undercapitalized to such an extent that the shareholders are *not* (yet) acting wrongfully by having the company continue its activities, but *are* acting wrongfully if they withdraw capital from the company at that time. I believe that this distinction is correct, given that continuation of the business will usually also be in the interest of creditors and other stakeholders, as long as there is a reasonable chance of survival. On the other hand, capital withdrawals by shareholders result in prejudice to creditors without reservation if bankruptcy follows. Moreover, capital withdrawals do not serve any of the company's short-term economic or strategic objectives, and they adversely affect the company's financial resilience. Thus, in difficult financial times, withdrawals from the company's capital should not be made. In addition, in principle a wrongful capital withdrawal does not lead to an actual piercing of the corporate veil in the sense that the shareholder can be required to pay creditors' claims against the company, but only a repayment obligation: the shareholder must repay the company the amount withdrawn – by way of compensation – and as a result, is placed in the same position he was in before the unauthorized withdrawal. In American and German case law, capital withdrawals more frequently and more quickly lead to the liability of shareholders than the continuation of a loss-making business.

To assume liability based on an unauthorized capital withdrawal, the shareholder is not required to have extensively interfered in the company's policy; the withdrawal in combination with the knowledge mentioned above is sufficient for this purpose. In the event that there is a causal link between the distribution and the company's bankruptcy, by virtue of Section 6:162 DCC the shareholder can also be sued for any damages in excess of the amount of the distribution. In that case, the shareholder is not blamed for withdrawing capital at a time when the company was already undercapitalized, but for *causing* the undercapitalization. In that case, a repayment obligation is no longer involved, but rather liability for the damages that the creditors suffered as a result of the undercapitalization.

Sections 2:216 (3) and 6:162 DCC only point to liability if the shareholder was aware or should have been aware of the unauthorized nature of the distribution. In addition, under certain circumstances, the application to set aside a fraudulent transfer offers the trustee the possibility of reclaiming a distribution that the shareholder received *in good faith.* In my opinion, the GM's distribution resolution and the approval resolution of the board qualify as voluntary legal transactions for no consideration, so that they qualify for nullification in the event that *the company* had knowledge of prejudice in the sense of Section 42 *Fw* (Dutch Bankruptcy Act) at the time of the decision-making process. If the trustee targets the approval resolution of the board, he will have to contend and prove that at the time of (approval for) the distribution, the board knew or should have realized that this would prejudice the creditors. If the bankruptcy trustee succeeds, the nullification of the resolution eliminates the legal basis for the dividend distribution, so that the distributed capital can be reclaimed from the shareholder as unduly paid. If the company is declared bankrupt within one year after the distribution, by virtue of Section 45 *Fw*, the company is presumed to have had the previously mentioned knowledge of prejudice.

The trustee who observes directors and shareholders who knew or should have realized at the time of the distribution that the company would result in continuity problems can choose which party to sue by virtue of Section 2:216 (3) DCC. If the trustee elects to initiate legal action against the directors, they can add the shareholders as third parties to the proceedings or they can seek recourse from the shareholders. After all, the ultimate obligation to contribute is borne by the shareholders, because they were enriched by the distribution. Even if *only* the board was aware of the continuity problems and the shareholders thus received the distribution in good faith, the trustee has two options. Based on Section 2:216 (3) DCC, he can initiate legal action against the members of the board, or he can nullify the approval resolution by invoking fraudulent transfer and subsequently reclaim the distribution from the shareholders. If the trustee manages to reclaim the dividend from the shareholders, initially the directors are in the clear: after all, the repayment has eliminated the deficit that was caused by the distribution. I believe that it is reasonable that in this situation, the adverse consequences of a distribution are placed more with the beneficiaries of the transaction, and the board's obligation to contribute is *in fact* reduced to the part of the distribution that the company cannot reclaim from its shareholders. In America, as well, the shareholder who receives the distribution in good faith can be required to repay the capital withdrawal which left the company with an *unreasonably small capital.* In Germany, shareholders receiving a distribution which results in an *Unterbilanz* in good faith are also required to repay the dividend.

Finally, it is possible that due to his role in a capital withdrawal, the shareholder qualifies as a factual policymaker. In that case, based on Section 2:216 (4) in conjunction with (3) DCC, the shareholder can be sued for the full amount of the distribution, including the part that was distributed to his fellow shareholders. If a causal link between the distribution and the bankruptcy can be demonstrated, by virtue of Section 2:248 (7) DCC, the shareholder can be sued for the entire deficit in bankruptcy. The shareholder qualifies as a factual policymaker if he directly interfered in the management of the company, coupled with brushing aside the formal board. This brushing aside can be found, for example, in the actual influence that the shareholder exercises on the board. The shareholder who extensively interferes in a refinancing of the company and in so doing, in fact, imposes his will on the formal board, qualifies as a factual policymaker under certain circumstances. The fact that interference with the company board occurred only once is no limitation.

22.6.2.2 Limits on 'de facto' distributions and reducing exposure

In addition to distributions, other types of transactions between a company and its shareholders frequently occur. Section 2:216 DCC does not directly apply to such transactions, but these transactions can nevertheless also be prejudicial to creditors and thus give rise to shareholder liability. In this context, I feel that it is useful to distinguish between 'de facto' distributions and payments that only reduce the exposure of the shareholder. In my definition, a 'de facto' distribution is involved if a transaction between the company and a shareholder or a third party, in fact, results in a decrease of the risk-bearing capital of the company in favour of a shareholder. I believe that the same standard applying to formal distributions applies to these transactions, as well: if at the time of the 'de facto' distribution, the shareholder seriously had to allow for a deficit, he acts wrongfully vis-à-vis the collective creditors by accepting the distribution. As a result, from the time when the shareholder must seriously allow for a deficit, intragroup transactions must be conducted at an arm's length basis. If the company makes interest payments on a shareholder loan during this period that do not conform to market terms, the amount paid in excess can be reclaimed from the shareholder in the event of bankruptcy by virtue of Section 6:162 DCC. If in this period, the company repays a shareholder loan that should be deemed to be part of the company's *risk-bearing* capital due to the imbalance between equity and loan capital, the shareholder can be required to repay the means received. Finally, the shareholder also acts wrongfully if at the time when he must seriously allow for a deficit, he receives security for a loan that he previously furnished to the company.

In my opinion, a payment reducing the shareholder's *exposure* is involved if a payment by the company to (or in favour of) a shareholder does not lead to a reduction of the *risk-bearing* capital, but results in the shareholder's *exposure* in bankruptcy being reduced. This can occur, for example, in the repayment of a regular credit furnished by a shareholder, or in the payment of regular debts to third parties that the shareholder or other group companies have warranted. In my view, restraint should be exercised in assessing these payments. If these payments are made *voluntarily* at a time when it was foreseeable that the payments would be prejudicial to the creditors, they are subject to nullification based on Section 42 Fw, in which the trustee is considerably assisted by the probable evidence of Section 43 Fw. If the company was *required* to make the payments, the fraudulent transfer in bankruptcy law generally cannot be invoked; in principle, the payments are not wrongful, either. If the company has run into difficulties and its shareholders must seriously allow for insolvency, they should refrain from making any formal or 'de facto' distributions, but compulsory payments to shareholders that are made in the ordinary course of business are permitted. Wrongful conduct by the shareholder can only be involved if the payments obviously serve to reduce the shareholder's exposure, do not serve any reasonable objective of the company or if the company's bankruptcy is inevitable.

22.6.2.3 The role of the company interest in withdrawals

A distribution that will not result in continuity problems in the foreseeable future may nevertheless be contrary to the company's interest. This situation will not quickly occur in the one-man private company, but can certainly occur if the company runs a more institutionalized business in which more interests are involved than those of the shareholders and of the creditors with a due and payable claim. In that case, the stakeholders of the company will not only have an interest in payment of their due and payable claims, but also in a continuation of their relationship with the company. These interests are expressed in the company's interest. The formulation of the approval authority in Section 2:216 (2) DCC and the explanation to this section suggest that directors and shareholders do not have to take the company interest into account in distributions, as long as it is not foreseeable that the company will encounter payment problems in the near future. However, I believe that in withdrawing capital, a shareholder may not always ignore the company's independent interest. In the event of a large, institutionalized enterprise, it follows from Section 2:8 DCC that the shareholder will have to refrain from any capital withdrawals that are seriously in breach of the company's strategy. In my opinion, this also follows from the OK's final decision in the *PCM* proceedings.

22.6.3 What are the limits on the shareholder's discretion to decide on the financing of the company in terms of financing the company upon incorporation and the start or change of the business activities?

22.6.3.1 Culpable undercapitalization

Shareholders can not only expose creditors to unreasonable risks by withdrawing capital from the company, but they can already do so by creating an inadequate financial structure upon the company's incorporation or at the time the activities are commenced or changed. In my opinion, the fact that the law does not require (or no longer requires) a minimum equity upon incorporation of a BV does not detract from the unwritten rule that shareholders must make an effort to properly fund the company. Shareholders are not required to provide the *best possible* funding of the company. However, I believe that the shareholder who knows or should realize that the funding is *inadequate* and who can prevent or cancel the establishment of the financial structure is acting wrongfully by nevertheless rendering his assistance in the establishment or maintenance of the financial structure. Due to the risks and uncertainties that typically surround the start of a new enterprise, it should not be rashly assumed that the shareholder could have foreseen the continuity problems. If it is nevertheless established that the shareholder should have foreseen the continuity problems at the time of incorporation, culpable undercapitalization is involved in the definition that I gave. There may be a variety of causes for culpable undercapitalization. For example, the company may have been equipped with insufficient equity to absorb reasonably foreseeable setbacks. In addition, undercapitalization can result from the fact that the company's profitability is negative, because it only bears the costs of the business that is run by the group. The undercapitalization may also be caused by the fact that the company insufficiently covered foreseeable risks for third parties through insurance.

Liability by virtue of Section 6:162 DCC due to the creation of an inadequate financial structure first of all requires the shareholder to be directly involved in the setting up of the financial structure; in addition, the shareholder knew or must have realized that this structure was inadequate and that it would therefore lead to creditor prejudice. In my opinion, the shareholder who satisfies both requirements acts wrongfully vis-à-vis the collective creditors of the company, so that the trustee can also lodge a *Peeters/Gatzen* claim against the shareholder.

22.6.3.2 Undercapitalization and risk acceptance by creditors

Previously in this study, the heterogeneity of a company's creditors was highlighted; it was concluded that an inadequate financial structure is not necessarily prejudicial to *all* creditors. In my opinion, this means that the extent to which a creditor can be deemed to have accepted the risk associated with the financial structure is relevant for liability of shareholders due to culpable undercapitalization. The bank that was or could have been fully aware of the company's financial position and nevertheless proceeded to issue financing cannot bring legal action against the shareholder based on Section 6:162 DCC if the risks materialize and the company is declared bankrupt. On the other hand, trade creditors, employees and consumers will not readily be assumed to have accepted the intrinsic risks of undercapitalization.

This distinction results in difficult questions; if the trustee brings legal action against the shareholder on behalf of the collective creditors, for example, by means of a *Peeters/Gatzen* claim, or based on Section 2:248 (7) DCC. Even though as a result of the culpable undercapitalization, the shareholder acted wrongfully vis-à-vis the *collective* creditors, perceived as a unit, it would be unreasonable if owing to the trustee's intervention, creditors who could never have initiated legal action against the shareholder independently can now pass on the accepted risk to the shareholder, because they participate in the proceeds of the claim via the bankrupt estate. This problem falls outside the scope of the subject study, but Dutch law does not appear to provide a ready-made solution.

22.6.4 What are the limits on the shareholder's discretion to decide on the financing of the company in terms of financing the company using loan capital issued by the shareholder himself?

Given that there are no special rules for shareholder loans in the Netherlands, these loans will have to be assessed in light of the general civil system of standards previously outlined. I believe that there are no convincing arguments to simply subordinate the claims of shareholders, as is done in Germany.[30] Unconditional

30 See Chapter 20.

subordination of shareholder loans is not in line with flexible company law that is trying to distance itself from *ex ante* regulation formulated in absolute terms due to the objections described in Chapter 3. The special risks that are intrinsic to funding using shareholder loans do not justify expanding the current statutory framework. For example, advocates of subordination rules point to the possibility of shareholders calling in their loans the moment the company runs into difficulties. However, as indicated in par. 21.4.2.2, the wrongful act and the fraudulent transfer in bankruptcy law offer sufficient protection in this regard.

Others have submitted that shareholder loans should be subordinated, because otherwise there might be an incentive for rational shareholders to finance inefficient rescue operations, and in this way keep doomed enterprises afloat. However, because a subordination rule only has a limited effect on the evaluation of risks of the shareholder of the company in financial distress, such a rule does not prevent all rescue operations with a negative value (seen objectively); sometimes, this rule does stand in the way of rescue operations with a positive value (seen objectively). Moreover, for creditors, the wrongful act in itself offers considerable protection from the risk that an enterprise that is certain to fail is continued. The shareholder who enables a company to enter into new obligations by furnishing financing, even though he knows or should realize that the company does not have any reasonable chance of survival, acts wrongfully vis-à-vis these 'new' creditors if he fails to ensure that their claims are paid. In addition, under those circumstances, any security established in favour of the shareholder is exposed to the risk of being nullified by invoking the fraudulent transfer. Rather than an unconditional subordination of all shareholder loans that were furnished in a crisis or a general prohibition of shareholder security, inefficient rescue operations should be prevented by the threat of the wrongful act and the fraudulent transfer (in bankruptcy law). These two doctrines are supported by open standards that enable the judge to assess in retrospect whether a rescue operation had a fair chance of success.

In my opinion, a more difficult issue is involved in the situation in which the financing of the company is adequate, but virtually the *entire* company risk will be borne by the unsecured creditors *upon incorporation or at the start of the activities in the event that* the company goes bankrupt. With this financing method, the creditors are not exposed to any unreasonable bankruptcy risk, but the prejudice of the creditors lies in the fact that the shareholder limited his own exposure to the detriment of the creditors. I believe that it in a bankruptcy case, if there is an obvious imbalance between equity and loan capital, a judge will rule that part of the shareholder's contribution should have been contributed as risk-bearing capital, and that for this reason, the shareholder acted wrongfully by making this part available to the company as a loan.

22.6.5 How should complex capital withdrawals by shareholders comprising a complex of closely related legal transactions be regulated?

Finally, this leads to the question regarding the standardization of capital withdrawals by shareholders consisting of complex, closely related (legal) transactions, in particular *leveraged buyouts.* As indicated before, a *leveraged buyout* generally consists of an extensive capital withdrawal, without necessarily using the formal distribution possibilities. For example, the actual withdrawal may be in the fact that the target company furnishes an unsecured loan to a marginally capitalized acquisition vehicle, which immediately uses the means acquired in this way to pay the purchase price of the shares. In the event that the unsecured creditors of the company are exposed to unreasonable risks by the LBO, Section 2:216 (3) DCC does not offer any help. Even if the capital withdrawal did have the form of a formal dividend distribution or repurchase of shares, the target company's trustee in bankruptcy can do little with Section 2:216 (3) DCC or the fraudulent transfer in bankruptcy law. After all, the capital was formally withdrawn from the target by the acquisition company; as a rule, the latter company does not offer any recourse.

In the United States, LBOs and other complex transactions with shareholders are nevertheless principally regulated by the insolvency law doctrine of *fraudulent transfer law.* The fact that this doctrine, which is based on a two-party relationship, managed to capture an important role in the regulation of LBOs is primarily due to the willingness of American judges to 'consolidate' the LBO for the application of the doctrine: the judge assesses the LBO as if one transfer by the target company to the selling shareholders was involved. This is an attractive approach, because it takes into account the net effect of the entire transaction and puts the contents above the form. Nevertheless, this approach leads to difficult questions and new problems. How should the multistep transaction be qualified for the application of the *fraudulent transfer* rules? Exactly what are the consequences of impairing the entire transaction? Is it reasonable that only the shareholders who alienated their shares in the scope of the LBO are required to repay the funds they received or should the buyer of the shares, who effectuated an important part of the LBO, also be liable under certain circumstances? Finally, is it reasonable that the bank that was closely involved in setting up the new financial structure shares in the proceeds of the *fraudulent transfer claim*? Because the consequence of successfully invoking the *fraudulent transfer* rules is quite absolute (nullification), the application of this doctrine to complex transactions offers the judge insufficient discretion to take the specific circumstances of the case into account in the *ex post* assessment of the financing structure, in particular if more than two parties were involved in the transaction. I believe that this problem would equally occur in a 'consolidated' application of the Dutch fraudulent transfer in bankruptcy law to complex capital withdrawals by shareholders.

I feel that the doctrine of the wrongful act is more suitable for assessing the acts of shareholders in an LBO. The flexibility of the wrongful act standard offers more room to standardize complex capital withdrawals subject to all relevant factors and circumstances of the specific case and makes it possible to place the substantive contents of the transaction above its formal structure. In my view, the primary issue in this assessment is the question regarding whether the company's financial resilience after the LBO was sufficient to bear the reasonably foreseeable risks. Was the LBO based on reasonable, realistic forecasts that offered sufficient room for setbacks? In the event that the LBO took unreasonable risks, can the selling shareholders and the new (purchasing) shareholders be liable to pay compensation to the collective creditors?[31] I believe that liability of the selling shareholder is not precluded by the fact that formally, the withdrawals from the capital of the company only occurred *after* the shares were transferred to the purchasing shareholder. The selling shareholders act wrongfully if they were aware of the fact that the purchase price would be financed by withdrawals from the company's capital, and seriously had to allow for a deficit as a result. Generally, the purchasing shareholder is formally a marginally capitalized acquisition company, but is, in fact, the underlying investor. In practice, this investor is quite frequently the architect of the financing structure and often has a leading role in realizing the financing, such as in the negotiations with the financing bank. In my opinion, the fact that it is not the underlying investor itself, but an acquisition company that he incorporated for the LBO that acquires the shares in the target company should not preclude his liability without reservation. As a rule, the acquisition company can be designated as an undercapitalized company that is fully controlled by the investor, so that it is possible to 'pierce the corporate veil' to the underlying investor; the latter is acting wrongfully by creating an inadequate financial structure, while he should seriously allow for a shortfall.

22.7 Finally: the newspaper industry continues to be in some disarray

The motiviation for conducting this study was borne from the public discussion and the legal proceedings generated by the *leveraged buyout* of *PCM Uitgevers* in 2004. The recent developments around the *NRC Handelsblad*, which was still being published by *PCM* in 2004, demonstrate that financing and capital withdrawal by shareholders continues to be a current topic. The *NRC* is currently in the hands of investment company Egeria and 'media tycoon' Derk Sauer. At the time of this book's completion, a fierce discussion was raging between the *NRC*'s works council and its directors and shareholders regarding the distribution of a considerable super dividend of almost two-and-a-half times the annual profit, even though the paper's earning model is under pressure and there have been several cuts in the paper's

31 Moreover, in this case, as well, the question regarding whether it is reasonable that all creditors benefit via the bankrupt estate from the compensation paid by the shareholders (see par. 21.4.3.2 above) also plays a role. For example, with an LBO, the financing bank will usually have been perfectly aware of the transactions and the associated risk.

staffing levels. According to the Works Council, the distribution would erode the company's solvency and liquidity position, while the shareholders take the position that the capital withdrawal is in line with the agreements made when they became shareholders. This dispute illustrates all the more the interest of a clear normative framework in re the shareholder's discretion to decide on the financing of the company.