ARTICLE

The Use of the Netherlands Cooperatives in Tax-Driven Restructurings

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1. Introduction

Default rates of leveraged companies are at an all-time low. At the same time, debt levels are at an all-time high. The market expectation is that the first insolvency wave may hit as early as the end of 2007 or early 2008.

Lenders looking to restructure their loans to a company in financial distress via a 'debt-for-equity' restructuring should consider the Netherlands cooperative as the restructuring vehicle of choice, with its favourable tax treatment and flexible legal characteristics. In this scenario, (1) a cooperative is placed on top of the distressed company and will hold its shares; and, (2) the loan receivables of the lenders on the distressed company are contributed to the cooperative in exchange for a predetermined amount of 'equity' (i.e. membership interests) in the cooperative.

The main benefits of using a Netherlands cooperative are discussed herein. Obviously, the strategic location of the Netherlands in Europe continent and the strong professional infrastructure of the Netherlands are also important factors.

2. What is a cooperative?

The cooperative is a special type of association. Historically, cooperatives were primarily used in the agricultural sector, but that is not to say that cooperatives are small enterprises by nature. Rabobank and Campina, for example, are actually both very large cooperatives. The cooperative is also increasingly used as a holding company, mainly in private equity structures, but also in group structures.

In comparison with a BV or a NV (the Netherlands limited liability companies), the requirements for establishing a cooperative are minimal. For instance, a Declaration of 'No Objection' from the Ministry of Justice is not required, as is for other types of entities. A cooperative is established by notarial deed, and can be established in a matter of days. The cooperative must be registered in the Trade Register run by the Chamber of Commerce. A cooperative must be established by at least two members.

All cooperatives must abide by the following objective: to provide for 'certain material needs of its members by concluding agreements with them (which may not be insurance agreements) in the business it conducts or causes to be conducted to that end for the benefit of its members'. The object clause contained in the articles of association of the cooperative may list specific activities in which the cooperative is involved.

A cooperative is a legal entity and as such can own assets, can incur liabilities and is capable of suing and being sued in its own name. The articles of association may exclude or limit, up to a certain maximum amount, any liability of the members or former members of the cooperative. If the articles of association provide a limitation or exclusion of liability, the name of the cooperative must contain the letters 'BA' (if liability is limited) or 'UA' (if liability is excluded). If the liability is not excluded or limited, the name of the cooperative must contain the letters 'WA'. Cooperatives are required to publish an annual account and an annual report.

3. How is a cooperative governed?

The main governing bodies of a cooperative are the Managing Board and the General Meeting of Members. The cooperative may also have a Supervisory Board and/or other bodies.

The Managing Board manages the cooperative. Directors on the Managing Board can be either natural persons or legal entities. The Managing Board decides on the admission of members to the cooperative, the suspension of membership rights and the termination of membership. The articles of association can, however, contain other arrangements. In order to be able to benefit from the favourable tax features of a cooperative (see below), the admission of new members and the transfer of membership interests by members are subject to certain limitations.

The General Meeting of Members has all powers not conferred on other bodies of the cooperative by law or under the articles of association. The most important power of the General Meeting of Members is the power to appoint, suspend and dismiss directors serving on the Managing Board. The articles of association may, however, provide that one or more (but less than one half) of the directors serving on the Managing Board be

appointed, suspended and dismissed by other persons (including outsiders). This is a feature that the BV and NV do not have.

Should one be appointed, a Supervisory Board will supervise the policy of the Managing Board and the general course of affairs of the cooperative. The Supervisory Board also acts as an advisor to the Managing Board. Only natural persons (and not legal entities) are allowed to be members of the Supervisory Board, and the provisions regarding the appointment, suspension and dismissal of the directors serving on the Managing Board apply equally to the directors serving on the Supervisory Board.

The Netherlands Civil Code contains few provisions regarding the rights and obligations of members, which – compared with a BV or an NV – allows great flexibility to structure cooperatives for specific purposes, for instance:

- Special arrangements regarding voting rights – i.e., giving voting rights to outsiders – may be included in the articles of association, provided that each member has at least one vote.
- Instruments resembling shares, such as participations, may be created.
- 'Tag-along' and 'drag-along' provisions, as well as other provisions often used in private equity deals, can be included.

4. Tax considerations

A cooperative is not a taxable distributing entity for the purpose of the Netherlands Dividend Tax Act, provided certain limitations are complied with upon the transfer of ownership interests by members. Profits distributed by the cooperative to its members are therefore not subject to any withholding tax in the Netherlands.

Members with an interest of 5% or more in a cooperative may be subject to Netherlands corporate income tax with respect to their interests in the cooperative. However, a structure may often be set up to avoid that the member will not become subject to Netherlands corporate income tax with respect to its interest in the cooperative.

A cooperative is, in principle, subject to Netherlands corporate income tax at ordinary rates. However, all benefits – such as dividend income received by the cooperative and capital gains realised by the cooperative – derived from qualifying shareholdings are exempt from corporate income tax, provided that the conditions of the participation exemption are met. The conditions for the application of the participation exemption are the same as the conditions that apply to Netherlands BVs and NVs.

The Netherlands has an extensive treaty network and is, as a member of the European Union, party to the EC directives. Dividends, interest and royalties paid to the Netherlands often benefit from reduced withholding tax rates or a complete elimination of withholding tax under applicable tax treaties or EC directives.

No stamp duties or other documentary taxes are due with respect to the establishment of a cooperative.

The tax features of a cooperative i.e. no corporate income tax on dividends received on the shares issued by the distressed company and the absence of withholding tax on distributions of dividends by the cooperative to the members (former lenders) of the cooperative make it an interesting vehicle to consider in a 'debt-for-equity' restructuring. The limitation on the transfer of ownership interests by the members may, in practice, impose restrictions on feasibility of such restructurings if many lenders are involved.

5. Regulatory issues

Using a cooperative triggers only a few regulatory issues in the Netherlands.

The first issue to consider is that the Financial Supervision Act of the Netherlands (FSA), among other things, prohibits the offering of securities, such as membership interests in a cooperative, without a prospectus. However, certain exceptions exist. For instance, this prohibition does not apply where the securities are offered to professional market parties only or to 100 or fewer people. The prohibition also does not apply where the securities have a denomination of EUR 50,000 or more (or equivalent in another currency), or where they can only be acquired for a minimum consideration of EUR 50,000 (or equivalent) per investor.

The FSA also needs to be considered where, after the debt-for-equity swap, certain loans remain outstanding. The FSA, in short, prohibits persons to act as a 'bank' in the Netherlands (conducting the business of borrowing and/or the lending of money) or to borrow money from 'the public'. However, these prohibitions do not apply where funds are borrowed solely from 'a restricted circle' or from professional market parties. In addition to the categories which already existed under the Netherlands Credit System Supervision Act 1992 (which was replaced by the FSA), the Netherlands Central Bank will introduce a new category of professional market party. A person who acquires a loan (or a package of loans) with a nominal value of at least EUR 50,000 (or equivalent), or for a consideration of at least EUR 50,000 (or equivalent), is automatically considered a professional market party. The introduction of this new category has not yet been formalised, but the Netherlands Central Bank has confirmed that market parties may already rely on this new category. The 'old' categories still exist where the above does not apply. The duty to verify the capacity of the professional market parties which existed under the old legislation has been abolished. The borrower continues to have a duty of care to ensure that it only attracts repayable

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funds from professional market parties, which can be met, for example, by including suitable wording or a selling restriction in the relevant documentation.

6. The Netherlands insolvency regime and 'shareholders' liability'

The insolvency regime of the Netherlands is among the most creditor-friendly in Europe. This may be relevant where, after the debt-for-equity swap, certain loans remain outstanding.

In comparison with many other European jurisdictions, the Dutch requirements for a successful action on this basis are fairly strict and lenders – obviously – benefit from these strict requirements. At the same time, setoff rights are fairly broad and lenders, again, may benefit from these broad rights.

Members of a cooperative with excluded liability are not liable by law for the obligations of the cooperative (see above), nor has the Supreme Court held members of a cooperative liable for the cooperative's obligations. It could, however, be argued that the doctrine of shareholders' liability – which applies to shareholders of BVs and NVs – applies here by analogy. However, even if this were the case, members of the cooperative could only incur liability in extraordinary circumstances.

7. Areas of uncertainty

The legal doctrines applicable to cooperatives are not yet fully developed. The Netherlands Civil Code contains few rules regarding cooperatives, in comparison with BVs and NVs, and the available case law is limited. The key areas of the resulting uncertainty are as follows:

- the phrase 'to provide for certain material needs of its members', required in the objective of all cooperatives, is ambiguous. However, the general feeling is that 'financial needs' are material by nature;
- it is not clear whether the agreements required to be in place with cooperative members can be embodied in the articles of association, or whether separate agreements are necessary; and
- some scholars take the view that a cooperative acting as a holding company does not 'conduct a business' activity under the law.

It is also important to bear in mind that, at the request of the Managing Board or any interested party, the Public Prosecutor or the Netherlands courts may dissolve a cooperative if, for example, its articles of association do not comply with the statutory requirements. The courts may grant the cooperative a grace period in which to comply, and the cooperative will continue to exist after its dissolution in order to wind up its affairs. However, there is no track record for such dissolutions.

8. Conclusion

Given the favourable tax treatment of the cooperative and its relative flexibility and the impending trend towards insolvencies, it is likely that the range of applications to which this structure may be put will be further developed in the coming years. Lenders would be wise to consider using the cooperative to take advantage of its favourable status.

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