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FLR Switzerland Guide 2015, S. 18 – 20

# Intragroup arrangements - Swiss subsidiaries to face stricter limitations

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# Swiss subsidiaries to face stricter limitations

**Stéphane Konkoly** and **Rolf Wüthrich** of **burckhardt** discuss the future of intragroup financing arrangements in light of the recent Swiss Supreme Court ruling on the collapse of the Swissair group

In October 2014, the Swiss Supreme Court issued a ruling on upstream financing arrangements in a cash-pooling setting, which led to some uneasiness and uncertainty in the Swiss financing landscape.

### The situation before the ruling

Like other subsidiaries all over the world, Swiss subsidiaries quite often provide financial assistance to other group (parent or sister) companies, by way of intragroup arrangements such as (upstream or cross-stream) loans or guarantees, or participation in a cash-pooling structure.

When setting up such financing arrangements, the management of a Swiss subsidiary has to bear in mind that Swiss law does not provide for rules relating to groups of companies in general and, in particular, does not recognise the specific needs for financial assistance within a group. Thus, a Swiss subsidiary has to treat other companies of its group as a third party in the broadest sense and upstream or cross-stream financing arrangements must be provided at arm's length. Most important in this context is the prohibition for Swiss companies to repay capital contributions to its shareholders (article 680 paragraph 2 of the Swiss Code of Obligations). Non-compliance with such rules triggers strict consequences: (at least partial) nullity or revocability of the arrangements, liability of directors, and payment of withholding taxes.

**Upstream and cross-stream financings can be problematic under Swiss law**

However, Swiss law is silent on the conditions for dealing at arm's length and, in the absence of court rulings on this matter, legal authors and professionals therefore developed their own criteria. Given the uncertainty, clients were usually advised or requested to apply specific precautionary measures: the upstream or cross-steam arrangement had to be approved by the shareholders' meeting and the board of directors, the corporate purpose in the articles of association had to allow specifically such kind of arrangement and the payment obligations under the arrangement had to be limited to the freely disposable equity of the subsidiary.

### The Swiss Supreme Court ruling

The facts of the case date back to 2000 and are linked to the painful collapse of the Swissair group. In a nutshell: a Swiss subsidiary of the Swissair group was party to a zero-balancing cash pool within the group. The pool leader was a Dutch company belonging to the (indirect) parent company of the Swiss subsidiary; it held the master bank account at the managing bank through which all reciprocal claims and obligations of the participants were balanced on a day-to-day basis, so that the account of each participant showed zero at the end of each day. On 31 December 2000, the Swiss subsidiary's claims against group companies amounted to some SFr23.7 million or $25.5 million (SFr16.5 million as claim against the pool leader under the cash-pooling arrangement and SFr7.2 million against its indirect parent company out of short term deposits). Its free equity distributable as dividends amounted to SFr29.2 million and was confirmed in the auditor's report. In 2001, the Swiss subsidiary distributed a SFr28.5 million dividend which was paid in June through the cash pool by crediting the parent company of a corresponding amount against the master account of the pool leader. Between the balance sheet date and the dividend distribution, the claim of the Swiss subsidiary against the pool leader under the cash-pooling arrangement had been repaid. In the following months, the Swissair group experienced financial difficulties. The managing bank terminated the cash-pooling arrangement in September 2001; in December 2001, the Swiss subsidiary entered into composition proceedings and in March 2002 the pool leader went bankrupt. The trustee of the Swiss subsidiary announced its claim under the cash-pooling arrangement in the bankruptcy of the pool leader and obtained certain dividends. However, he was of the opinion that the earlier dividend payment to the parent company violated Swiss law since the then existing financing arrangement under the cash pooling was not entered into at arm's length and therefore reduced the amount of the free equity which could be distributed as dividends. Consequently, the claims of the Swiss subsidiary against the pool leader and the related dividends out of the bankruptcy estate would have been higher. The trustee claimed the difference of SFr4.5 million from the auditor for breach of its legal duties.

In a first ruling, the Swiss Supreme Court ruled that there was not sufficient evidence that the payment of the dividends through the cash pool did accordingly reduce the claim of the Swiss subsidiary against the pool leader (against the opinion of the first court which had rejected the trustee's claim). The matter went back to the first instance court, which then approved the claim by deciding that the intragroup financings within the cash-pool arrangement had not been granted at arm's length. The Swiss Supreme Court upheld the ruling.

### Dealing at arm's length test

This is the first time that the civil chamber of the Swiss Supreme Court had to decide on the criteria for the dealing at arm's length test. In an earlier tax matter, the public law chamber of the Supreme Court had ruled that an upstream loan should be considered a payment in kind to a shareholder when, on the basis of formal indications, it appears that a loan is a simulated transaction because the parties did not intend to repay such loan at all.

Some Swiss authors followed a similar approach and developed a set of various formal criteria to determine whether an upstream or cross-stream financing is granted at arm's length. The criteria were: the existence of a written agreement; adequate interests; granting of securities; ongoing verification of the borrower's creditworthiness; duration of the loan and conditions for termination; regular payment of interests; and absence of a cluster risk. These formal criteria would also help to determine whether the parties intended to repay the loan. For some, the intention of the parties, coupled with the borrower's financial capacity to repay the loan, is one of the strongest indications that the loan is a real financing and not a hidden distribution of dividends.

In the case at hand, the Swiss Supreme Court retained neither the borrower's financial capacity nor the very fact that the claim of the Swiss subsidiary as lender under the cash-pooling arrangement had been repaid before the shareholder's meeting approved the distribution of the dividends. For the court of first instance, the financing was not granted at arm's length since no written agreement existed regarding the individual loans under the cash-pooling arrangement (the written framework agreement setting up the overall cash-pool structure was apparently not sufficient), the Swiss subsidiary did not verify the creditworthiness of the pool leader and did not bring evidence that the pool leader regularly repaid the loans. The Swiss Supreme Court upheld the ruling, albeit retaining another criterion next to the absence of verification of the pool leader's creditworthiness: the fact that no security was granted for the loan was most relevant. The Supreme Court also wrote in a side comment that it was even questionable whether a cash-pool arrangement, where a group company can dispose of the liquidities of another group company, can fulfill at all the requirements of a transaction at arm's length. As a consequence, the Swiss Supreme Court, following a minority opinion among the Swiss authors, decided that the portion of the financings which was not granted at arm's length should be considered a locked or frozen reserve, therefore reducing the amount of free equity distributable as dividends. The auditor therefore violated its legal duties when authorising the payment of the dividends and had to pay damages to the Swiss subsidiary. Like the court of first instance, the Swiss Supreme Court stressed the importance of the Swiss legal principle prohibiting the repayment of capital contributions.

In the same ruling, the Swiss Supreme Court also decided that a company can distribute a share premium (*agio*) as dividend to its shareholders, thus ending a long-lasting dispute among Swiss authors.

The ruling has a strong impact on intragroup financings in general and on the potential liability of directors and auditors of Swiss subsidiaries in particular. It has already caused unrest in the legal community.

**After the ruling**

It was already admitted before the ruling that upstream and cross-stream financings can be problematic under Swiss law and must therefore be granted within strict limits in order not to violate the prohibition of capital contribution repayment. In this sense, the ruling of the Swiss Supreme Court is not a surprise. It is even comforting, since it admits that financings which are not granted at arm's length do not violate such prohibition if they do not exceed the amount of the freely distributable equity and since an existing share premium is now considered a part of the distributable equity, therefore increasing the financial assistance a Swiss subsidiary can offer. In addition, the criteria applied by the Swiss Supreme Court to assess whether a financing is granted at arm's length are not new.

However, the test's requirements have become much more stringent because of the importance the Swiss Supreme Court grants to specific criteria (here, the fact that no security was offered for the loan) and because it seems to indicate that a financing would fail the test if any one criterion is not fulfilled. Even more surprisingly, the subsequent repayment of the loan by the pool leader does not constitute sufficient evidence for the court, which only relies on the situation on the balance sheet date. The consequences of failing the test (the creation of a new type of locked reserve not provided for in the law and not recognised by accounting principles) already led to criticisms and queries. In particular, it is not clear whether a locked reserve allows for the distribution in kind of the same upstream loan from which said reserve originates or whether the creation of this reserve in the book of the Swiss subsidiary would cure the non-compliance with the test requirements.

**Validity of intragroup arrangements**

Due to new uncertainties created by the ruling, intragroup financing arrangements should not, to be safe, exceed the amount of free distributable equity. This equally applies to upstream and cross-stream loans, guarantees or securities. Therefore, the measures regularly advised by Swiss financing practitioners in such a context will continue to be justified. The financing agreements should contain so-called Swiss limitation language, which provides that the payment obligations of any Swiss subsidiary towards group companies (other than its own subsidiaries) under the agreements are limited to the amount of its free equity.

It does not mean that financing arrangements which exceed the amount of the free equity are not valid, but the criteria of the dealing at arm's length test should then be observed to the strictest possible extent. For instance, the terms of the financing, including the conditions for an early termination, must be set out in a written agreement which must provide for sufficient remuneration (interests or fees) for the financing. Such remuneration must be effectively paid on a regular basis and not only accounted for. The provider of the financing must continuingly monitor the creditworthiness of the beneficiary and take the necessary measures if a financial risk materialises. If the financing is provided without a security or absorbs a large part of the provider's financial capacity, the reasons for this should be explained and evidenced in writing. The financing should also be approved by the board of directors of the Swiss company.

**"The intention of the parties, coupled with the borrower's financial capacity to repay the loan, is one of the strongest indications that the loan is a real financing**

Issues regarding due authorisation of intragroup financings (such as the need for shareholders' approval) and their compatibility with the company's corporate purpose are separate topics, which are not answered in the ruling of the Swiss Supreme Court.

**Validity of cash-pool structures**

In an unfortunate side statement of its ruling, the Swiss Supreme Court seems to question the general validity of cash-pool arrangements. The reason for this apparent mistrust is not clear. Within a company group, these arrangements serve legitimate financial interests, which can equally benefit all subsidiaries. Of course, if a Swiss subsidiary decides or is forced by its parent company to commit its entire liquidities to the cash pooling, this would undoubtedly constitute a violation of the directors' duties. On the other hand, if the liquidities tied to the cash-pool structure do not affect the company's ability to face its foreseeable payment obligations, there is no reason why such a structure should be treated differently to other intragroup financing arrangements.

Cash-pool arrangements are blue-sky arrangements and do not attract much attention as long as the financial situation of the whole company group is healthy. However, they can very suddenly become a burden for a subsidiary and its directors when a parent company navigates in rough seas. Therefore, a Swiss subsidiary should insist on complying with the requirements of the dealing at arm's length test set out above and, in particular, should constantly monitor the financial situation of the group and of the cash-pool leader since participants' claims to a cash pool are rarely secured. If no rating is available, the cash-pool agreement should provide the Swiss participant with a right to request and obtain financial information from the parent company or the pool leader. Even better, the payment obligations of the Swiss participant should be limited to its free equity or a percentage of it. Such participant should also insist on contractual terms which allow for a termination or a suspension of the cash-pool arrangement in case of a financial deterioration of the group, or if the participant does not obtain sufficient information regarding the financial situation of the group or if its obligations under the cash-pool structure reach the amount of its free equity (or a specific percentage, since the amount of the free equity continuingly fluctuates).

### Other impacts

A Swiss subsidiary must now expect a much deeper investigation of its intragroup financing arrangements by its auditor. Given the new situation created by the ruling, auditors will probably be reluctant to sign off on the annual accounts and on the payment of dividends if the obligations of the Swiss subsidiary under said arrangements are not limited to its free equity.

**The ruling has a strong impact on intragroup financings and on the potential liability of directors and auditors of Swiss subsidiaries**

Under Swiss law, the directors of a company are responsible for the drafting of the annual accounts. Even though the ruling of the Swiss Supreme Court only dealt with the liability of the auditor, there is little doubt that the directors of the Swiss subsidiary could have been held liable for breach of their duties since the annual accounts were incorrect and since they proposed the payment of dividends without sufficient free equity. Intragroup financing arrangements are quite often suggested by parent companies. In such a case, the directors of a Swiss subsidiary must keep in mind that they have to apply strictly the requirements of the dealing at arm's length test or limit the exposure of the company to its free equity, even against the will of the parent company. On the other hand, the parent company (as a shareholder) and its officers cannot be held liable if the requirements for dealing at arm's length are not complied with, unless they direct the Swiss subsidiary to enter into the financing arrangements and could therefore be regarded as de facto directors. However, intragroup transactions which violate the legal principle prohibiting the repayment of capital contributions are at least partially void and the Swiss subsidiary is entitled to claim back any payment made under them. The related risks might be limited as long the Swiss subsidiary is fully-owned and in sound financial condition, but might suddenly become a hot topic in case of bankruptcy, as evidenced in the collapse of the Swissair group. In this context, the ruling of the Swiss Supreme Court implies that past good faith distributions of dividends might actually not be valid; damage caused to a Swiss subsidiary and repayment obligations of its parent company might have piled up over the years, therefore substantially increasing the potential risk.

Finally, from an economic point of view, the Swiss Supreme Court ruling will certainly reduce the capacity of Swiss companies to financially support their parent company or other group members and to distribute dividends in case of intragroup financing arrangements. This negative impact might be considerable, even if slightly moderated by the fact that share premiums are now part of the distributable equity.

### The present, the future

The ruling of the Swiss Supreme Court has wide implications. Even though it was rendered in the very specific context of the Swissair collapse, its legal principles apply to all and will not only affect cash-pooling structures but also upstream and cross-stream financings in general.

For now, company groups with a Swiss subsidiary would be well-advised to review their existing intragroup arrangements in the light of the dealing at arm's length requirements developed by the Swiss Supreme Court. They may have to adapt these arrangements to the new environment and to assess whether their distribution of dividends still complies with Swiss law.

In the future, directors of Swiss subsidiaries will have to keep in mind the stricter legal limitations and their consequences when entering into new upstream or cross-stream financings or when proposing the distribution of dividends to the company's shareholders.

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Stéphane Konkoly is partner at burckhardt Attorneys. His areas of expertise are contract and corporate law, with a specific focus on national and cross-border structured finance transactions and M&A transactions. Stéphane Konkoly regularly advises national or foreign companies, group companies and banks on corporate finance matters, secured and unsecured lending, project and acquisition finance (in particular the financing of movable equipment through leasing), often with respect to complex cross-border transactions covering several jurisdictions. He graduated from the University of Neuchâtel (1993) and from the New York University School of Law (LLM 1998). He was admitted to the bar in 1995.

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