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Insight

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Proposed Revision of the Swiss Debt Enforcement and Bankruptcy Act in a Nutshell

After several years of preparatory work conducted by various expert bodies and the competent Swiss authorities, on 8 September 2010 the Federal Council submitted the draft of a revision ("Draft") to the Swiss Debt Enforcement and Bankruptcy Act ("DEBA") together with the dispatch (*Botschaft/message,* "Dispatch") to the Swiss parliament. The Draft is subject to approval by parliament before it can enter into force. The revision has been influenced to a considerable extent by the debate following the insolvency proceedings in relation to the SAirGroup after its grounding in October 2002. According to the Dispatch, the revision aims at improving selected areas of current Swiss insolvency law with a focus on restructuring, without revising it in its entirety. Whilst the amendment deals mainly with composition proceedings *(Nachlassverfahren/concordat),* there are a number of changes contemplated by the Draft that relate to Swiss insolvency and commercial law in general. This article briefly summarises some of the most important changes put forward in the Draft. Text: Tanja Luginbühl, Partner Zurich / Cécile Badertscher, Associate Zurich

Changes to composition proceedings in general

The first step in composition proceedings is the grant of a provisional moratorium *(provisorische Nachlassstundung/sursis provisoire)* by the composition court *(Nachlassgericht/juge du concordat),* which is followed by a definitive moratorium *(definitive Nachlassstundung/sursis concordataire).* While such moratoriums have so far been used as a first step towards the conclusion of a composition agreement, according to the Draft, moratoriums will henceforth also be available for mere restructuring purposes.

Composition proceedings are generally initiated either on the request of the debtor, a creditor or the bankruptcy

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court *ex officio.* In accordance with the newly proposed option of using a moratorium for restructuring purposes, a debtor seeking composition proceedings (and, hence, a moratorium) will no longer have to submit a draft debt-rescheduling or dividend agreement. Instead, it will be requested to submit a so-called provisional restructuring plan *(provisorischer Sanierungsplan/plan d'assanissement provisoire),* outlining in particular whether it aims at a composition agreement or a restructuring. According to the Dispatch, the provisional moratorium will generally be granted unless it is obvious that neither a restructuring nor a composition agreement will be achieved. If the provisional moratorium is granted by the court, it will – differing from the current law *as a rule* – appoint a provisional administrator *(provisorischer Sachwalter/commissaire provisoire).*

The provisional moratorium may be granted for a period of up to four months (two months in the current law). It is followed by the definitive moratorium if the court finds that a composition agreement is likely to be concluded or that restructuring is likely. If restructuring is achieved during the moratorium, the moratorium will be withdrawn by the insolvency court *ex officio.* Where (i) it is obvious that no restructuring or composition agreement can be reached, (ii) it is necessary in order to safeguard the debtor's assets or (iii) the debtor goes beyond its rights to dispose of its assets or acts against the orders of the administrator, bankruptcy is opened by the competent court *ex officio.*

Once a composition agreement has been set up and has been approved by a qualified majority of the creditors (head count and claim amount), it needs to be confirmed by the composition court. According to the Draft, such confirmation will no longer require the securing of the unsecured privileged claims as provided for in the current law. Furthermore, in the event of a composition agreement with assignment of assets *(Nachlassvertrag mit Vermögensabtretung/concordat par abandon d'actifs),* approval by the court will no longer require that the estimated liquidation dividend for third class creditors under such agreement is expected to be higher compared to a bankruptcy scenario. In turn, the Draft contains a new provision according to which in case of an ordinary composition agreement (debt-rescheduling or dividend agreement), confirmation by the court will require that shareholders contribute "adequately" to the restructuring. According to the Dispatch, such contribution may, for example, be effected by a decrease in the company's capital immediately followed by an increase in capital.

Non-publication of provisional moratorium

Under Swiss corporation law, the board of directors of an over-indebted stock corporation must file for bankruptcy by notifying the judge. The current Article 725a of the Swiss Code of Obligations ("CO") provides for the option of an insolvency postponement *(Konkursaufschub/ajournement de la faillite)* in this context, which must be requested by the corporation or a creditor, and which is granted if the competent court finds that restructuring is likely to occur. Publication of the insolvency postponement only occurs if it is necessary to protect third parties' interests. According to the Draft, this remedy will be deleted from the CO, since the intention is to have all insolvency remedies incorporated in the DEBA. In order to uphold the remedy currently contemplated by Article 725a CO, and, in particular, the possibility of non-publication of a moratorium, the Draft offers the option of abstaining from publishing the provisional moratorium. As a consequence of the transfer of this remedy into the DEBA, not only the stock corporation and the limited liability company, but also other types of legal entities, will be able to benefit from such a remedy. However, in a deviation from the current Article 725a CO, the appointment of a provisional administrator is mandatory if non-publication is granted by the court.

Extraordinary termination of continuing obligations
Under the current DEBA there have been some legal controversies as to how continuing obligations of the debtor should be dealt with in insolvency proceedings, especially in cases where neither the law nor the specific contract provided for a dissolution mechanism for such scenarios. The Draft addresses such legal uncertainties by introducing a possibility for the debtor to extraordinarily terminate such continuing obligations. However, such possibility is limited to debtors aiming at a restructuring (by way of a mere moratorium or by way of a debt-rescheduling or dividend agreement) and – in order to prevent abuse of such remedy – requires the consent of the administrator. Furthermore, it requires full indemnification of the counterparty, although this indemnification is subject to a potential subsequent composition agreement (where applicable).

Insolvency and transfer of employees
In the past, the consequences of a transfer of business in the context of insolvency proceedings have given rise to some legal controversies. One main open question was whether the current Article 333 CO applied to insolvency proceedings. This provision states that upon transfer of all or part of the business to a third party, all employment contracts related to the transferred business are automatically transferred to the transferee, unless the employee refuses such transfer. The Draft now contains an explicit provision, according to which upon transfer of all or part of a business in the context of (i) a moratorium, (ii) a bankruptcy or (iii) a composition agreement with assignment of assets, all or just part of the respective employment contracts are transferred to the transferee only where this has been agreed with the transferee.

In turn, the Draft provides for a new employer obligation for companies with at least 250 employees. In these cases the employer has to negotiate a social plan *(Sozialplan/plan social)* with the employees if it intends to dismiss at least 30 employees within 30 days and where such dismissals are not linked to the employees' personalities. This social plan must outline measures as to how to mitigate the risks and consequences of unemployment. The obligation, however, is not applicable to dismissals that take place in the context of insolvency proceedings.

Abandonment of insolvency privilege for value added tax claims
The Draft abandons a provision that only entered into force in 2010, and which has been criticised ever since. It provides for a privilege for the Swiss Federation's claims for non-paid value added tax in insolvency proceedings. The Federal Council now proposes the deletion of this privilege since, according to the Dispatch, it has come to the conclusion that the estimated amount of such claims, if being allocated to a privileged class of creditors, might hinder effective restructuring, which is one of the main goals of the revision. Moreover, it is suspected that in bankruptcy proceedings, the application of this privilege would result in unsecured, non-privileged creditors being deprived of any proceeds at all in a majority of cases.

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International Bankruptcy: Procedural Issues regarding the Local Standing of a Foreign Trustee

Although the global economic crisis appears to be behind us, its consequences can still be felt. As a result of financial distress, many firms throughout the world have been forced to initiate bankruptcy or composition proceedings. This article focuses on procedural issues which a foreign trustee must consider when initiating legal proceedings in Switzerland against a debtor.

Text: Guy Vermeil, Partner Geneva / Anil Nair, Associate Geneva

Introduction

The global economic crisis forced numerous companies throughout the world to initiate bankruptcy or composition proceedings. An example, among many others, is Lehman Brothers' filing for protection under Chapter 11 of the United States Bankruptcy Code in 2008, which generated a chain reaction, causing entities of the Lehman Brothers Group throughout the world to initiate similar proceedings.

The massive number of bankruptcies and liquidations worldwide – in particular in the light of their impact on the global economy – raises interesting questions on cross-border insolvency proceedings. From a Swiss law perspective, procedural requirements must be carefully considered by foreign trustees or bankruptcy estates before initiating any legal proceedings against a debtor domiciled in Switzerland.

Requirements for the recognition of a foreign bankruptcy

If a foreign authority decides to open insolvency proceeding, its decision will have no effect in Switzerland unless it is recognised by the Swiss courts.

Chapter 11 of the Swiss International Private Law Statute of 18 December 1987 (the "PIL Statute"), sets forth the conditions which must be satisfied for a foreign bankruptcy order to be recognised in Switzerland. The first step for a foreign trustee or a foreign creditor to obtain recognition of a foreign bankruptcy order is to file a petition for recognition with the competent Swiss court. According to Article 166 of the PIL Statute, the petition for recognition will only be approved if i) the foreign bankruptcy order is enforceable in the state in which it was entered; ii) there is no ground for non-recognition under Article 27 of the PIL Statute, such as unequal treatment of creditors, and iii) reciprocity is granted by the state in which the order was entered.

If all of these conditions are satisfied, recognition will be granted. In other words, an ancillary insolvency proceeding – so-called "mini bankruptcy" – will be opened in Switzerland under the authority of a Swiss bankruptcy estate which will, in conformity with Swiss insolvency rules, realise the debtor's Swiss assets. In the distribution of the proceeds of these assets, priority will be given to the secured creditors – i.e. creditors whose claim is secured by pledged assets located in Switzerland – and unsecured, but privileged, creditors domiciled in Switzerland. Any balance will then be remitted to the foreign trustee or bankruptcy estate provided that certain requirements, in particular fair and equal treatment of Swiss unsecured creditors in foreign insolvency proceedings, are met.

Recent case law relating to the recognition of foreign bankruptcy

In a decision issued in 2008, the Swiss Supreme Court answered two related questions in connection with the recognition of a foreign bankruptcy:

1. Within the framework of a pending civil legal proceeding initiated by a foreign trustee against a Swiss debtor, can the recognition of a foreign bankruptcy order be requested by the former as a preliminary question?

2. In the same context, can a civil legal proceeding be initiated by a foreign trustee against a Swiss debtor without obtaining prior recognition of the foreign bankruptcy order?

On the first issue, the Swiss Supreme Court followed the view of the main legal scholars. In a pending civil legal proceeding initiated by a foreign trustee against a Swiss debtor, the recognition of a foreign bankruptcy order cannot be requested by the former as a preliminary question. Instead, the foreign trustee must file a separate petition for recognition and obtain such recognition before initiating any legal proceeding. Indeed, in the opinion of the Swiss Supreme Court, if a foreign trustee was able to obtain the recognition of a foreign bankruptcy order within the framework of a pending civil legal proceeding, the ancillary insolvency – which aims to protect the interests of the creditors who have a claim secured by pledged assets located in Switzerland and the unsecured, but privileged, creditors domiciled in Switzerland – could be bypassed.

On the second issue, the Swiss Supreme Court ruled that a foreign trustee does not have the right to initiate legal proceedings against a Swiss debtor and act on behalf of the bankruptcy estate without having obtained prior recognition of the foreign bankruptcy order. In other words, the recognition of the foreign bankruptcy decision grants a foreign trustee the authority to initiate a legal proceeding in Switzerland against a debtor. The Swiss Supreme Court believes that this is the only way to guarantee foreseeability and consistency in the application of Swiss international private law.

Conclusion

Switzerland does not follow the principle of automatic recognition of foreign bankruptcy orders. Indeed, with regard to insolvency procedures, Switzerland relies on the principle of territoriality. Moreover, according to case law and legal scholars, prior recognition of a foreign bankruptcy decision by the competent Swiss court is necessary for a foreign trustee to be able to initiate legal proceedings in Switzerland on behalf of the foreign bankruptcy estate. Such request must be made by filing a separate petition for recognition and cannot be the object of a preliminary question in a legal proceeding against a Swiss debtor.

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The Draft for a Revision of Restructuring Proceedings in Switzerland: a Path towards DIP Financing?

In its recently published dispatch (the "Dispatch") accompanying the draft (the "Draft") for a revision of the provisions regarding restructuring proceedings in the Swiss Debt Enforcement and Bankruptcy Act ("DEBA"), the Swiss Federal Council rejected a request from certain political parties and associations such as economiesuisse, SwissBanking and the association of Swiss cantonal banks to include the privileged treatment of pre-petition financings under applicable avoidance provisions if such pre-petition financing had been granted to the debtor with a view to enabling a financial restructuring. According to the Swiss Federal Council, this goal can be achieved with much greater certainty for the relevant creditors providing the required liquidity once a provisional moratorium has been granted. In essence, the Federal Council appears to be preparing the ground for DIP financing in Switzerland.

Text: Roland Fischer, Associate Zurich

The background

The intricacies and pitfalls of providing financing to companies in financial distress has been on the agenda of banks and their advisors for a long time, but it was not until the landmark decisions of the Federal Supreme Court in connection with repayments of loans by members of the former SAirGroup that the issue hit the radar of a much greater audience and became an issue for political debate. In such rulings, the Federal Supreme Court tended to adopt a strict interpretation of the avoidance provisions, which resulted in a number of financial institutions having to repay to the insolvency estates amounts received from former SAirGroup entities shortly before a moratorium was granted. However, the Federal Supreme Court also indicated that the repayment of certain loans might be viewed differently under the Swiss avoidance regime if such loans had been granted in the context and with the aim of allowing the financial restitution of a debtor. However, the exact requirements for preferential treatment remained in the dark, and the Federal Supreme Court's considerations on this matter never became pertinent in a case. In reaction to court rulings of this type, one school of legal thought attempts to flesh out the requirements for a rescue loan for which preferential treatment would be available, while another school rejects the concept for lack of precision and justiciability.

The new approach

In the Dispatch, the Federal Council tends towards the view of the latter group of scholars in emphasising that it is a *"huge problem … to set out the requirements for a privileged loan… . A generic definition of the requirements for the privilege will not be helpful for all practical purposes".* In the view of the Federal Council, however, legal certainty and the availability of privileged treatment may be obtained when the debtor enters a moratorium and the court appointed administrator approves the loan to be granted to the debtor. If so, preferential treatment of the relevant creditor under a DIP financing arrangement follows from Article 310 para. 2 DEBA, which states that obligations of the debtor which have been created during the moratorium with the consent of the administrators will be treated as obligations of the insolvency estate in a subsequent bankruptcy or composition agreement with assignment of assets (i.e. if the financial restructuring fails) and, thus, will be paid before any other creditors of the debtor. While avoidance is, in theory, still applicable as long as the financing has not been approved by the court or a creditors' committee (Article 285 para. 3 DEBA *e contrario),* this option is ruled out for all practical purposes by the requirement that an action which is subject to avoidance has caused damages to the creditors which, barring exceptional circumstances, appears to be rather unlikely in case of obligations of the insolvency estate which will be paid with priority. Taking further into account that a moratorium is available somewhat sooner in the process than under the current law and that a provisional moratorium will not necessarily have to be made public (for further details see the article by Tanja Luginbühl and Cécile Badertscher in this edition, on page 1) the Federal Council is positive that the financing of debtors which are in a moratorium will be a viable alternative for lenders and corporate debtors without negatively affecting the reputation of the debtor.

A likely success story?

Obviously, the new approach suggested by the Federal Council depends on whether corporate debtors will indeed choose the option of a non-public provisional moratorium over an out-of-court contractual debt restructuring process involving the most important creditors. Whether or not this will be the case remains to be seen, but a few question marks remain. In particular, lenders will certainly consider that the powers of an administrator in a (provisional) moratorium in Switzerland are not as far-reaching as those of administrators in other jurisdictions. In particular, *ipso facto* clauses (i.e. automatic or voluntary termination provisions in the case that insolvency events occur) are still valid and enforceable in Switzerland, which may prevent a corporate debtor from entering into a (provisional) moratorium in the first place if the continuing existence of essential contracts is at risk.

Moreover, the Draft does not tighten the filing requirements for Swiss board members (e.g. inclusion of a filing obligation in the event of insolvency rather than in a situation of over-indebtedness only), which is why board members may still prefer out-of-court restructuring over a provisional moratorium. Finally, while the entering into of a provisional moratorium may not have to be made public under the DEBA, publication may have to occur under the listing rules setting forth the ad hoc disclosure obligations of listed companies. If so, out-of-court restructuring may still be the preferred route to take, even if, as most recent examples have shown, it is difficult to keep such discussions confidential.

Conclusion

While only time will tell whether the DIP financing outlined by the Federal Council in the Dispatch will indeed become a viable alternative to out-of-court debt restructuring arrangements between corporate debtors and its lenders, certain obstacles such as the termination rights of important third parties will have to be overcome. Consequently, a prudent debtor will have to scrutinise its existing arrangements with important third parties, and will probably have to enter into discussions with such third parties prior to filing a request for the grant of a provisional moratorium. As is already the case under the existing regime, the corporate debtor may also have to approach a potential administrator early in the process and discuss the restructuring process and proposed DIP financing arrangements with the administrator so that, once court approval of the provisional moratorium has been granted, the most important aspects of the financial restructuring can be implemented without delay.

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Pledges on Movable Goods under Swiss Law: Practical Aspects in Light of a Recent Decision by the Swiss Federal Supreme Court

Pledges on movable goods are a traditional form of security that is well suited for a debtor having no access to other forms of security, such as a guaranty provided by a third party (e.g. bank guaranty) or the mortgage of real estate. However, the pledge under Swiss law raises practical difficulties that are discussed in this article in the light of a recent decision by the Federal Supreme Court. Text: Daniel Tunik, Partner Geneva / Ilir Cenko, Associate Geneva

Introduction

In rem secured rights under Swiss law are governed by the *numerus clausus* principle pursuant to which no other form of property right than those established by the law (mainly the relevant titles of the Swiss Civil Code) may be agreed upon by the parties. Insofar as movable goods are concerned, the main form of collateral is the pledge *(Pfand/ nantissement)* pursuant to Articles 884 ff of the Swiss Civil Code ("CC"). The most salient feature of the Swiss law pledge, which distinguishes such collateral under Swiss law from similar institutions in other jurisdictions, is the principle contained in Article 884 para. 3 CC pursuant to which no pledge is validly constituted as long as the pledgor retains possession over the pledged assets. A condition for the perfection of the pledge is thus the transfer of the possession of the assets to the pledgee or to an agent of the pledgee. The rationale for this provision, enacted in 1907, lies in the protection of third parties, who should not be misled by the erroneous appearance that the debtor fully owns the assets that he possesses.

The legal requirement that possession be abandoned is, however, difficult to reconcile with the practical needs of the debtor. In a commercial context, a company that wished to use its assets (stock and inventory) as security to obtain a loan would be compelled, in order for the pledge to be perfected, to abandon control over said assets. The practical difficulties that can arise render the Swiss pledge much less attractive than similar institutions under foreign law (e.g. a floating pledge). The decision by the Swiss Federal Supreme Court[1] on which we comment below illustrates these difficulties, although the outcome for the beneficiary of the pledge was eventually satisfactory.

1 Decision by the Federal Supreme Court dated 13 August 2009, 5A_315/2009. Lenz & Staehelin acted for the beneficiary of the pledge.

The dispute

A foreign investor, through a company owned by him (the "Parent Company"), acquired the entire share capital of a well-known Swiss manufacturer of high precision machines in Geneva (the "Company" or the "Debtor") that had a long history of prestige as well as of repeated financial crises and bankruptcies. In order to provide the Company with the required working capital, the Parent Company extended repeated loans at a time when the situation was already quite critical. The question that arose was what sort of collateral could be provided by the Debtor as security for the significant loans that were being granted by the Parent Company. The only assets that could be identified for this purpose were some machines that had been manufactured by the Debtor and that were either finished or completed to a large extent. The practical difficulty that the lender and the Debtor had to address was how to comply with the legal requirements for a valid pledge under Swiss law, namely the dispossession of the debtor. The machines that were to be the object of the pledge were heavy and fragile objects that are difficult to move and that need to be stored under specific conditions. Removing the machines from the premises of the Debtor and storing them in a different location was therefore not a viable option. It was thus decided that the machines would remain in the Debtor's warehouse without being displaced from their location, but that fences would be erected around the machines and would be closed by locks. In addition, large notices were placed on the fences indicating that the machines were pledged in favour of the Parent Company. It must also be mentioned that the foreign investor, the sole shareholder of the Parent Company and the ultimate economic beneficiary of the Company, was also the chairman of the Company's board of directors.

Despite this financial support granted by the Parent Company, the Company found itself in a situation of over-indebtedness which led the competent Geneva judge to pronounce its bankruptcy.

The Parent Company, as creditor of the Company, claimed the amounts of the loans in the bankruptcy proceedings and invoked the right to be treated as a secured creditor with respect to the pledged machines. The bankruptcy office denied the claims of the Parent Company and refused to consider that the latter was a secured creditor.

The Parent Company filed an action before the Geneva courts to challenge the schedule of claims that refused to consider it as a secured creditor, and the matter was ultimately brought before the Federal Supreme Court.

The decision by the Swiss Federal Supreme Court

The first substantial issue reviewed by the Federal Court was whether the requirement of the abandonment of the possession by the debtor was fulfilled in the present instance. The bankruptcy office had held that this requirement was not fulfilled in the present instance since the Debtor could have broken the locks and/or removed the fences – there were some cranes alongside the machines that might have been used – and thus gain access to the pledged machines. In other words, the measures taken by the parties were not sufficient to constitute an abandonment of possession by the Debtor.

The Federal Supreme Court rejected this argument. It noted, from a factual point of view, that the measures of protection put in place could not be considered as being purely symbolic. More significantly, the Federal Supreme Court found that removing the locks and fences would only have been possible by causing damage to the property (breaking the locks and fences) or through clandestine operation of the crane to remove the fences, either of which would have amounted to a breach of a provision of the criminal code. In other words, to the extent that the Debtor could have regained possession of the pledged machines only by committing a criminal offence, the judges of the Federal Supreme Court reached the conclusion that the pledgor had indeed abandoned possession.

The second ground invoked by the bankruptcy office for refusing the validity of the pledge related to the dual functions of the ultimate shareholder, who was both the Parent Company's beneficiary and the chairman of the board of directors of the Debtor, the pledgor. Therefore, according to the bankruptcy office, the Debtor had maintained access to the pledged machines to the extent that the keys for the locks were kept by an individual who, among others, was a director of the Debtor.

The Federal Supreme Court reiterated in this context that a valid pledge presupposes a transfer of possession. What is required under Swiss law is not that the pledgee acquire exclusive possession, but that the pledgor lose exclusive possession. Referring to the existing case law and the opinions of scholars, the Federal Supreme Court indicates that the purpose of this rule is not only to ensure the publicity of a right of pledge vis-à-vis third parties, but also to avoid a situation where the debtor is in a position to constitute a new pledge on the same assets in a manner that would be detrimental to the first pledgee.

As a matter of principle, the Federal Supreme Court considers that a representative of the pledgee cannot at the same time be a representative of the pledgor, since this would confer upon the pledgor a right of control over the pledged asset which is not permissible under Swiss law. There is, however, an exception to this principle whenever the representative of the pledgee has the possession of the pledged asset and, as the case may be, can prevent an act of disposition by the pledgor.

In the present case, as regards the dual function of the ultimate shareholder, both a representative of the creditor and a director of the Debtor, the Federal Supreme Court held that there was no risk that he would have wished to exercise his functions – and thus his control over the pledged asset – for the benefit of the Debtor. Indeed, to the extent that he knew the vulnerable financial situation of the Debtor, the ultimate shareholder, in his capacity as director of the Debtor, he would have had no incentive whatsoever to dispose of the security in favour of anyone else. In other words, although the ultimate shareholder could indeed act on behalf of both parties, the judges of the Federal Supreme Court found that the interests at stake, i.e. maintaining a security for the loans extended, were sufficient to ensure that the ultimate shareholder would exercise his right of control over the pledged asset as a representative of the pledgee, and not of the pledgor. Consequently, the pledgor is deemed to have abandoned exclusive possession of the asset so that a valid pledge under Swiss law was created.

Conclusion and assessment

In this particular case, the Federal Supreme Court ruled that a valid pledge under Swiss law was constituted even though the machines remained on the premises of the Debtor. The outcome of this case should, however, not affect the general view that the Swiss law pledge is not well suited to the stocks and inventory of an enterprise. In addition to the practical difficulties relating to the abandonment of possession by the pledgor, this decision illustrates the difficulties that arise in situations – which are not uncommon whenever the creditor and the debtor are related entities – where the same person acts for both the pledgor and the pledgee.

From a practical standpoint, this decision by the Federal Supreme Court calls for the following recommendations:

1. To the extent possible, the pledged assets – if they are not remitted to the pledgee – ought to be clearly segregated from the other goods of the pledgor to avoid an uncertain discussion as to whether or not the pledgor validly abandoned possession of said goods;

2. Access to the pledged assets should be conferred upon a person who is contractually bound to the pledgee exclusively, and not to the pledgor.

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Piercing the Corporate Veil in the Context of Shareholder Loans to Distressed Companies

In a recent decision, the Swiss Federal Supreme Court has pierced the corporate veil to re-qualify a shareholder loan as equity. The case accentuates the need to act with great diligence when providing funds to a distressed company in the form of a shareholder loan, and emphasises the importance of clearly separating the interests of the controlling shareholder (e.g. parent company) or the group from those of the company in situations of financial distress. This article summarises the key facts of the case and highlights certain implications for companies controlled by a majority shareholder.

Text: Maja Baumann, Associate Zurich / Dominik Kaczmarczyk, Associate Zurich

Factual background

In the case at hand the majority shareholder of a company, who also acted as the chairman of its board of directors, had rented several commercial premises to the company. In 2000 and 2001, the company carried out substantial maintenance and reconstruction work on these premises, on the understanding that the work would be reimbursed by the shareholder. Also in 2000 and 2001, the majority shareholder granted several loans to the company. The loans had fixed terms, but the shareholder never demanded repayment of any of them on maturity. The company was already in financial difficulty in 2000 and continued to suffer substantial losses in 2001 and the first half of 2002. The shareholder was aware of the distressed financial condition of the company. At the end of July 2002, the company was declared bankrupt.

The Swiss Federal Supreme Court's decision focused on two actions that both occurred less than 30 days before the declaration of bankruptcy, i.e. at a time when the financial difficulties of the company were evident. Firstly, the company and the shareholder entered into new lease agreements for the same premises, which significantly increased the rent for the leased premises, although the fixed term of the existing lease agreements had not yet expired. Secondly, the company issued to the shareholder an invoice for the work it had performed in 2000 and 2001. The payment terms of the invoice issued by the company stated that the amount payable would be offset against and deducted from the shareholder loan granted to the company. Both actions were the subject of a challenge by the bankruptcy administration, which was sustained by the competent cantonal court and, therefore, appealed to the Swiss Federal Supreme Court by the shareholder. In particular, the Swiss Federal Supreme Court had to decide whether the set-off declared by the company was valid.

Reasoning and conclusion by the Swiss Federal Supreme Court

In its reasoning, the Swiss Federal Supreme Court examined whether the shareholder could rightfully offset his claim against the company's claim under the rules of the Swiss Debt Enforcement and Bankruptcy Act (DEBA). As a general rule, a set-off of claims is permitted in the event of bankruptcy, provided that certain requirements are met. However, giving particular consideration to the fact that the shareholder's claim arose from a loan to the company, the Swiss Federal Supreme Court analysed whether this loan should be considered as debt *(Fremdkapital / fonds étrangers)*, or rather as equity *(Eigenkapital / fonds propres)*.

The Swiss Federal Supreme Court held that, in consideration of the principle of the legal duality between the company and its shareholders, shareholder loans in general are to be qualified as debt. However, the principle of legal duality is not absolute. The Swiss Federal Supreme Court maintained that the applicability of this principle is no longer justified if all or substantially all of the funds of the company (directly or indirectly) belong to one and the same person, i.e. if the company is just an instrument of this person (who economically is identical with the company), and the duality between the company and its shareholders is abused. In such (rare) cases, the Swiss

Federal Supreme Court has already in previous instances pierced the corporate veil and treated the controlling (sole or majority) shareholder and the company as one subject.

Based on this reasoning, the Swiss Federal Supreme Court advanced the view that in the case at hand – despite formally being two separate legal persons – the shareholder and the company were in fact economically identical. Unfortunately, the Swiss Federal Supreme Court did not elucidate in detail the facts that had led to the conclusion that the legal duality between the shareholder and the company had been abused. However, two factors have apparently influenced the court's decision:

1. The company, already when issuing the invoice, declared that the invoiced amount would be offset with the shareholder loan; this, however, was not in the interest of the company and harmed the other creditors. Furthermore, the invoice was issued less than one month before the declaration of bankruptcy at the end of July 2002, while the work had been performed back in 2000 and 2001.

2. The new lease agreements, which contained significantly worse terms for the company, were concluded at a time when the company's bankruptcy was imminent and the existing agreements have not yet expired.

As a result of considering the company and the shareholder as one subject, the Swiss Federal Supreme Court concluded that the shareholder loan was to be considered equity of the company and that the shareholder therefore did not have any counterclaim which could be offset against his liability in relation to the work performed by the company. Consequently, the shareholder was held to pay to the bankruptcy administration the entire amount owed to the company for the maintenance and repair work.

Consequences for controlling shareholders of Swiss companies

The decision of the Swiss Federal Supreme Court lacks a detailed reasoning and remains rather nebulous as to which conditions exactly will lead to a piercing of the corporate veil and the re-qualification of a shareholder loan as equity of the company.

Despite the court's rather unclear reasoning and possible further factual elements that might have influenced the court's decision, this case shows that the actions taken by a controlling shareholder shortly before the declaration of bankruptcy will be scrutinised very closely by the bankruptcy administration and the competent courts. Also, it seems likely that this decision by the Swiss Federal Supreme Court will strengthen the tendency of bankruptcy administrations to requalify shareholder loans given to financially distressed companies as equity, especially in cases where certain facts indicate that the legal duality between the shareholder and the company has been abused and the interests of the company and the shareholder have been mixed.

As a result, a controlling shareholder should make sure that the shareholder's and the company's decision-making is clearly separated, and that all actions taken by the financially distressed company are in the best interests of this company (and not of the shareholder or the group). Furthermore, before providing additional funds to a distressed company in the form of a shareholder loan, the entirety of the relevant circumstances, in particular all relationships between the distressed company and its controlling shareholder and the likelihood of a bankruptcy in the near future, should be carefully assessed.

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Swiss Banking Secrecy and Disclosure of Information for Avoidance Actions: Reconciling Conflicting Interests?

Swiss banking secrecy has been facing serious attacks from the tax authorities of many foreign countries that consider that their interest in collecting money due from their taxpayers should prevail over the accountholders' right of privacy. The present article looks at how Swiss banking secrecy is weighed against a creditor's interest in obtaining information about its debtor for the purposes of an avoidance action. More particularly, this note examines whether a bank, in the context of the seizure of the assets of a debtor, can be compelled to produce information not only about the assets still held by the debtor at the time of the seizure, but also about transactions that occurred in prior years.

Text: Benoît Chappuis, Partner Geneva / Rocco Rondi, Associate Geneva

The conflicting interests at stake

Banking secrecy is designed to protect the privacy of citizens. Despite current challenges and adaptations required in relation to tax, it remains an essential principle under Swiss law. Banking secrecy is not – and has never been – absolute, and is limited by the operation of the law in different areas (criminal, administrative or civil).

In debt collection procedures it is commonly accepted that a bank, as a third party in the context of a dispute opposing a creditor and a debtor holding an account, is under a duty to provide information in the context of an order seizing the assets of the debtor. In such cases, the creditor's interest in having its claim satisfied takes precedence over the debtor's right to privacy. As a result, a bank is under a legal obligation to disclose to the debt collection authorities the amounts held with it by the debtor. Banking secrecy does not apply, and the bank must communicate the balance held by its client at the time of the seizure.

If the assets held are insufficient to satisfy the creditor's claims, for example because transfers occurred before the seizure, the debt collection agency will attribute whatever was obtained and deliver to the creditor a certificate of shortfall for the balance. The creditor may then wish to overcome his or her frustration by considering avoidance actions, i.e. by having assets held by the debtor before the seizure reintegrated into his or her assets for the benefit of the creditors.

The question that arises in this context is whether the bank, in the context of a seizure, can be compelled to both disclose the balance in the account and produce information about past transactions, making it possible to determine how the debtor used the account in previous years and whether third parties benefited from undue transfers.

This article will not look at the different types of avoidance actions envisaged under Swiss law (for this, see Articles 286 to 288 of the Swiss Debt Enforcement and Bankruptcy Act). Suffice to say that, among other things, transactions made in the five years prior to the seizure of assets or the opening of bankruptcy proceedings with the intention – apparent to the other party – of disadvantaging his creditors or favouring certain of them to the detriment of others are voidable (Article 288 DEBA).

The first prerequisite for considering such an avoidance action is to be able to invoke transactions in the period that preceded the seizure or the opening of bankruptcy proceedings that were detrimental to the creditors. Can the creditor have access to such information, and in particular to bank accounts revealing the transfers made by the debtor before the seizure of the account?

The debate among Swiss scholars

Swiss scholars have been divided, supporting two different positions.

The first camp holds that the duty of disclosure of a bank as a third party in the context of debt enforcement proceedings is limited to revealing the assets that can be seized, that is to say assets that are still held with the bank at the time of the seizure. Accordingly, debt collection authorities would have no right to ask the bank to send additional information, for example details of past transactions, which would constitute a breach of banking secrecy.

Some scholars, on the other hand, support a more liberal view and consider that in addition to covering assets still held by the bank, the duty of disclosure also encompasses information that may be required to enable a creditor to commence an avoidance action. Pursuant to this view, the debt collection agency should therefore be able to request that the bank provide a record of all transactions made through the account in question during the five years before seizure.

The position of the Swiss Federal Supreme Court

This delicate controversy has been addressed by the Federal Supreme Court in a number of decisions rendered several years ago, but which still represent the status of the law. And as shown below, there is still no absolute and conclusive rule that can be derived from them.

The Federal Supreme Court had initially expressed the view that it was not part of the powers of a debt collection agency to order a debtor to justify the use of assets that had been in his or her possession in the past but which were no longer there at the time of the seizure. In a decision rendered in 2001, the Federal Supreme Court held, however, that it was justifiable to depart from this view in the light of specific circumstances of the case at stake. Indeed, by contrast with the prior case, the matter in question dealt with a debtor who had previously deliberately failed to disclose part of his assets. Under such circumstances, the Federal Supreme Court ruled that it was legitimate for the debt collection agency to order this debtor to provide information about assets that he had possessed but no longer had.

The question of whether a bank could be compelled to provide information about past transactions was addressed in 2003. As a matter of Swiss law, the judges held that the bank, as a third party, was under a similar duty as the debtor to respond to requests for information. Here again, the highest Swiss court then took into consideration the fact that the debtor had not disclosed the existence of a certain asset, a bank account. Accordingly, the Swiss Federal Supreme Court found that the request for information about past transactions was legitimate, and did not exceed the powers of the debt collection agency to the extent that the behaviour of the debtor was of a nature to cast doubts about possible transfers during the period that preceded the seizure. In other words, indications had been uncovered justifying the consideration of an avoidance action.

Conclusion

A debtor's right to privacy in relation to his or her bank account conflicts naturally with the interest that a creditor may have in finding out information about past transactions that could serve to commence avoidance actions and enable the creditor to obtain the payment of the sums owed. The position taken by the Federal Supreme Court is a compromise between competing interests. Indeed, the creditor is given the possibility to request that a bank be ordered to disclose further information, but only to the extent that the creditor can refer to indications that would show that the debtor might be hiding assets or might have made voidable transactions. In the absence of such circumstances, a request for information by the debt collection agency could be considered as an abuse of its power of discretion, and banking secrecy would prevail.

The thin line that is drawn by the Federal Supreme Court raises practical difficulties for the creditor, which might explain why, in practice, such devices are rarely used. Indeed, precisely because of banking secrecy, the creditor is likely to have difficulties in adducing indications that the debtor disposed of bank assets in a manner that might justify an avoidance action. It is precisely for the purposes of finding evidence of such acts that a creditor may require a bank to be compelled to produce information.

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