

# Structures and guidance

**Regulatory and jurisdictional arbitrage are the flavour of the month for politicians. Private equity funds need to know the options they have**

**D**ebate over the alternative investment fund managers draft directive is heating up in Europe, with political bodies becoming more involved every week. One important point of that debate is the idea that it will create regulatory arbitrage, with funds relocating to new jurisdictions within and outside Europe. At the same time, tax and transparency issues are also being discussed on the world stage and leading to debate over the relocation of funds. Against this background, it is important to understand the structures that are available for private equity funds based and investing in Switzerland.

Private equity firms investing in Switzerland do not necessarily need to use a Swiss structure but are generally free to choose the set-up they deem most appropriate for fundraising and investment. The main drivers for the appropriate legal structure are, in a nutshell: (i) the investment vehicle must be tax transparent – income, capital gains and any other proceeds from the portfolio

companies are subject to taxation at the investor level but not at the investment vehicle level (avoidance of double taxation), (ii) the investment vehicle must provide for limited liability, (iii) there must not be any laws or regulations restricting or limiting the investment activities of the private equity fund, and (iv) the investment vehicle can be established as a closed-end fund.

Although the Swiss Federal Act on Collective Investment Schemes (*Kollektivanlagengesetz/Loi sur les placements collectifs*) (CISA), which entered into force on January 1 2007 provides for legal forms that fulfill these requirements, the predominant legal form used by private equity firms in Switzerland is still the Anglo-Saxon limited partnership (LLP). The other main options are the Swiss limited partnership for collective investments (*Kommanditgesellschaft für kollektive Anlagen/la société en commandite de placements collectifs*) (Swiss LLP), the Swiss investment company (*Investmentgesellschaft/société*

*d'investissements*) (Investment Company) in the form of a Swiss stock corporation, and the Swiss stock corporation investing in venture capital and other risk capital (*Risikokapitalgesellschaft/société de capital-risque*) (Sicar).

## LLP

Typically, the foreign limited partnership provides investors with the tax transparency and limited liability they need. Further, it is usually free to make investments and is lightly regulated in its home jurisdiction. Due to tax reasons, LLPs are often incorporated in offshore jurisdictions like Bermuda, Jersey, Guernsey or the Cayman Islands. Swiss private equity firms most often chose Jersey or Guernsey given that in these jurisdictions the number of limited partners is not limited, there is no maximum term for the LLP and it is possible to establish accounts in different currencies.

The LLP is typically not a taxable entity in its chosen jurisdiction. If a limited partner is not resident there, any income derived from the LLP's international operations and any interest the limited partner receives is not regarded as arising or accruing from a source in the partnership's jurisdiction. In addition, no inheritance, capital gains, gifts, turnover or sales taxes are levied in the chosen jurisdiction in connection with the acquisition, holding or disposal of interests and no stamp duty or similar taxation is levied on the issue or redemption of partnership interests. However, interests in the partnership are generally not freely transferable and no secondary market exists.

## Single private equity investments

The majority of the single private equity investments in Switzerland are structured so that the fund incorporates a new Swiss company that then serves as special acquisition vehicle (SPV) to purchase the shares in the target portfolio company. While this SPV is typically formed with the minimum share capital of only SFr100,000 (\$97,000), the Fund Manager draws down the capital committed by the investors shortly prior to the transaction and funds the SPV with the required equity.

The majority of portfolio companies in Switzerland are structured as stock corporations (AG/SA); the legal form of the limited liability company (GmbH/Sàrl) is not (yet) used that often.

While the type and number of transaction documents varies from case to case, the main transaction documents produced

in a single private equity investment are typically:

- Documents in evaluation phase:
  - Confidentiality agreement and possibly exclusivity agreement.
  - Term sheet.
- Documents in acquisition phase:
  - Sale and purchase agreement regarding the purchase of shares in (or alternatively the assets of) the portfolio company; these sale and purchase agreements are typically drafted in accordance with international standards and include a comprehensive set of representations and warranties and often full indemnification clauses regarding certain tax risks, environmental risks, with some exceptions in the event of secondary buy-outs.
  - (Possibly) escrow agreement pursuant to which a part of the purchase price is deposited with an escrow agent during a certain period of time in order to secure purchaser's claims for breach of representations and warranties.
- Financing documents:
  - Senior (secured) credit facility agreement.
  - Junior (unsecured) credit facility agreement or mezzanine facility agreement (often combined with an equity kicker).
  - Shareholder loan agreements and possibly vendor loan agreements; the shareholder loans are typically subordinated.
- Security documents:
  - Pledge agreement over shares in

The LLP is usually organised as a closed-end limited partnership and has a general partner established in the same jurisdiction in the form of a company or limited partnership. The limited partners are typically the financial investors. The general partner is in charge of making the respective investments on behalf of the LLP and will be entitled to the carried interest, but it does usually delegate such investment activity to an external specialised management company (Fund Manager).

Those LLPs that intend to gain Swiss investors as limited partners need to verify whether they qualify as foreign collective investment schemes, and, if so, whether they are subject to a licensing requirement under the CISA due to a connection to Switzerland (*Inlandbezug*). Foreign collective investment schemes that are the subject of public advertising in or from Switzerland are (irrespective of their legal form) governed by the CISA provisions. Public advertising under the CISA means any advertising which is not exclusively directed to qualified investors; moreover the type of advertising to such qualified investors should be common in the private equity market (such as one-on-one interviews, management presentations, business plans or private placement memoranda) in order for the advertising not to be considered public. If these requirements are met, no licensing requirement exists under CISA.

### Swiss LLP

The legal form of the Swiss LLP is, in principle, based on the Anglo-Saxon LLP

and generally provides for the same features. It is streamlined to the needs of private equity funds; hence private equity firms no longer have to rely on offshore LLP structures (as described above). The Swiss LLP is based on a general partner/limited partner structure with a general partner being fully liable for all the partnership's liabilities and limited partners being liable to the extent of their respective interests in the partnership. The general partner must be a Swiss corporation and the Swiss LLP must have a minimum of five limited partners that are all qualified investors. The Swiss LLP is subject to approval and licensing requirements under the CISA and subject to the supervision by the Swiss Financial Supervisory Market Authority (FINMA).

The CISA did not in itself lead to any major amendment to tax acts. Given that the qualification of certain concepts specific to collective investment schemes is uncertain under the applicable tax acts, the industry still awaits a clarifying circular from the Swiss Federal Tax Administration (SFTA). This circular will most importantly for the Swiss LLP deal with the treatment of the carried interest of the Swiss resident private equity fund managers (a key feature is expected to be the recognition that managers may realise co-investments qualifying as private assets benefiting from tax-free capital gains upon disposal). For the time being it can already be said that, save for cases where the Swiss LLP directly owns real estate properties (in which case specific rules apply), the Swiss LLP is considered to be a transparent entity and is not subject to income tax. No

issuance duty is due on the addition of new limited partners in the Swiss LLP and no turnover stamp duty is due upon redemption of a limited partner's investment. Investors dealing with units of Swiss LLPs may, however, be subject to turnover stamp duty if a Swiss securities dealer is involved.

Taxation is directly at the investors' level. The (corporate and individual) investors are therefore subject to ordinary income taxation upon receipt of profits. An exemption applies to the distribution of capital gains to Swiss resident individual investors that may benefit from an exoneration if, and to the extent that, those gains are clearly identified as such and are derived from investments held as private assets (subject to the so-called indirect partial liquidation).

Further, an exception may apply to domestic corporate investors that may benefit from tax exemptions on dividends in case they qualify as holding companies. In addition, the distribution of capital gains realised by the Swiss LLP and the repayment of the invested capital is exempt from Swiss withholding tax provided that certain reporting requirements are met. Distributions that do not stem from capital gains are subject to Swiss withholding tax at a rate of 35%, which may only be refunded to foreign investors if relevant double taxation treaties apply.

### Investment company

Swiss stock corporations can be used for private equity. Ordinarily, a Swiss holding company (Holdco) is set up as a two-layer structure with a wholly-owned offshore subsidiary. Holdco then collects funds by issuing shares to the public and the investments in the targeted private equity investments are then made through the captive offshore intermediary holding company. Such an investment company organised as a stock corporation is subject to the regulatory supervision of FINMA, unless it is listed on a Swiss stock exchange or all of its shareholders are qualified investors and some formal requirements are met. Pursuant to the new Listing Rules of the SIX Swiss Exchange, investment companies "are companies under the Swiss Code of Obligations, the sole purpose of which is to pursue collective investment schemes to generate income and/or capital gains, without engaging in any actual entrepreneurial activity as such".

The advantages of investment companies are: (i) the company is governed by established provisions of the Swiss Code of Obligations (CO) and is therefore in a well-

SPV, in portfolio company and in material subsidiaries.

- Silent security assignment of trade receivables.
- Pledge agreement over IP rights or other assets.
- Pledge agreement over bank accounts.
- Security assignment of shareholder loans.
- Mortgage over real property.
- Assignment of SPV's rights under the sale and purchase agreement.
- Documents governing the operation:
  - Shareholders' agreement governing certain important matters of the operation of the portfolio company as well as the shareholding of the investors and the management; the shareholders' agreements typically

contain provisions concerning (i) the composition of the board of directors (*Verwaltungsrat/conseil d'administration*) and special quorum requirements and veto rights for certain decisions, (ii) transfer restrictions, (iii) the protection of shareholders such as anti-dilution clauses or explicit subscription rights in case of share capital increases, (iv) different exit scenarios (tag along/drag along rights in a trade sale or put/call options), (v) good/bad leaver events, and (vi) the liquidation of the portfolio company. Certain (but not all) of these provisions are reflected in the articles of association of the portfolio company.

- Employment agreement with managers.

## Issues in acquisition financing and financial assistance

While there are different constraints depending on the actual circumstances, some of them are briefly described below:

**Deductibility of Interest:** Interest payments on debt can, in general, be deducted from taxable profits. With respect to shareholder loans it should be noted that deduction may be limited under the SFTA's arm's length rules for interest rates or under the thin-capitalisation rules (see below) if the debt-to-equity ratio exceeds certain thresholds. Further, it should be noted that anti-avoidance rules generally prevent interest from being tax-deductible if the respective financing is granted to the SPV and the acquired operating business is subsequently merged with the leveraged SPV. Switzerland's legislation does not cover tax consolidation (interest paid by one group company may not be deducted from another group company's profits).

**Thin-capitalisation rules:** Swiss corporate law does not contain specific rules on debt-to-equity ratios for a company. However, the capital structure of a Swiss company is strongly influenced by tax rules that do have such restrictions. Federal income tax law provides, for instance, that the debt-to-equity ratio in finance companies should not exceed six to one for federal corporate income tax. These rules are of relevance to private equity investment structures only insofar as leverage is concerned. In practice, however, the standard ratio of six to one allows for leverage of up to 85% debt and 15% equity, which should nowadays be largely sufficient for even highly leveraged acquisitions.

**Financial assistance:** Although under Swiss law there are no detailed rules specifically dealing with financial assistance (as they exist in EU countries), there are nevertheless general principles that produce similar results. Most importantly, the target company (and its subsidiaries) can provide or secure acquisition financing to the SPV only up to the amount of its freely disposable equity. Further, due to the general principle that a company is only bound by acts within its corporate purpose, upstream and cross-stream financial assistance must be mentioned in the company's corporate purpose and be approved by the respective shareholders and board of directors.

known legal environment, (ii) the company's shares can be listed, which may be helpful to increase liquidity to offset the rigidities deriving from Swiss corporate law, and (iii) the structure is not subject to supervision by FINMA or any other regulatory supervision (subject to fulfillment of the above criteria).

There are, however, certain disadvantages: (i) most importantly, share capital increases and reductions have to be made in accordance with the cumbersome procedures set out in the CO. This makes it difficult to replicate the favoured drawdown procedures; (ii) the Swiss stock corporation cannot be structured in a way that allows redemption of shares or that grants its shareholders redemption rights; and (iii) Swiss law provides for certain (minority) shareholder rights. This may be interesting for investors but it may conflict with the rights of limited partners in an Anglo-Saxon limited partnership. One of the goals of the two-layer structure is to secure as much freedom as possible for management in the investment process.

We do not elaborate on the applicable (tax) regime because recent developments have shown that several investment companies listed on the SIX Swiss Exchange have chosen to change their legal form from an investment company into an investment fund. The main reason for this is that most investment companies are traded at a (substantial) discount: the market share price is lower than the net asset value per share. The change aims to eliminate this discount. The conversion from a Swiss investment company listed on a Swiss stock exchange into an investment fund can be achieved relatively easily by way of a (friendly) public exchange offer to all shareholders of the respective investment company (see for example the public exchange offer by Vontobel Holding for all shares in MicroValue to convert MicroValue into MIV Global Medtech Fund or the public exchange offer by Vontobel Beteiligungen for all shares in BB Medtech in order to convert BB Medtech into Bellevue Funds (Lux) – BB MEDTECH). The conversion into an investment fund often represents the most attractive option for shareholders.

### Sicar

A Sicar is generally considered a corporation, the purpose of which is to invest its funds in venture capital. From a Swiss law perspective, a Sicar is an investment company in the form of a Swiss stock corporation that is upon written request acknowledged and approved as a Sicar by the

Swiss Federal Department of Economic Affairs. In order to qualify, the stock corporation must invest in venture capital and have invested at least 50% of its capital in private venture capital portfolio companies. The portfolio companies must, among others, (i) have their registered office or actual management and the main part of their activities in Switzerland, (ii) pursue innovative, international projects, (iii) not be listed companies (with certain limited exceptions), (iv) have started their business not more than five years prior to investment by the Sicar, and (v) make their investment through equity or subordinated debt or similar venture capital financing.

If all of these criteria (and a few more in the relevant act) are met, the stock corporation is exempt from stamp duties and federal taxes on profits generated from the holding of portfolio companies. While these tax incentives are attractive for private equity investors, it is difficult to meet the criteria; so the structure has not often been used.

*by Andreas Röheli and Stephan Erni of Lenz & Staehelin*