Feature

KEY POINTS

- A judgment of the Swiss Federal Supreme Court has left the Swiss market with uncertainty surrounding central questions of intra-group lending.
- Care must be taken when structuring upstream and cross-stream loans to ensure compliance with Swiss corporate law.
- Any violation of the statutory capital protection provisions must be regarded as a material breach of Swiss corporate law and may lead to direct personal liability for damages, and even criminal prosecution, of individuals involved in such transactions.

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Intra-group lending in Switzerland – risky business?

This article discusses key legal issues arising in intra-group lending in Switzerland.

INTRODUCTION

It has been just over 2.5 years since a judgment of the Swiss Federal Supreme Court on zero balancing cash pooling (BGE 140 III 533 of 16 October 2014, the "Judgment") sent a shockwave through the Swiss banking and finance community. Although the dust has settled since then, there is still a high level of uncertainty surrounding central questions of upstream and cross-stream intra-group lending arrangements, resulting in legal risk for entities and individuals involved in such transactions.

CLASSIFICATION OF INTRA-GROUP LOANS UNDER SWISS CORPORATE LAW

In the Judgment, the court held that:

- an upstream or cross-stream loan which is not made at arm's length terms (a "Loan with Distribution Characteristics") constitutes a hidden distribution of profit;
- if the amount of a Loan with Distribution Characteristics exceeds the amount of the lending company's distributable equity (ie the amount available for dividend distributions), such loan constitutes a violation of the statutory capital protection provisions; and
- if the amount of a Loan with Distribution Characteristics does not exceed the lending company's distributable equity, such loan does not violate the statutory capital protection provisions, but blocks the lending company's distributable equity in an amount equal to the amounts outstanding under the loan.

Against the background of the Judgment, intra-group loan arrangements can be divided into three categories from the perspective of Swiss corporate law:

(1) **fictitious loans** – ie transactions for which the parties choose the form of a loan but which, in substance, are distributions, particularly because the borrower has no intention, or is obviously unable, to repay the loan;

(2) **Loans with Distribution Characteristics**; and

(3) **genuine loans** – ie transactions which are loans in form and substance which are made at arm's length terms.

IMPORTANCE OF PARTIES' INTENT

The distinction between fictitious loans on the one hand and Loans with Distribution Characteristics and genuine loans on the other hand is mainly a matter of construction of the parties' intent. If it is clear to the parties from the outset of a transaction that the borrower has no intention, or is obviously unable, to repay the funds received, such transaction does not qualify as a loan. Rather, it constitutes a hidden distribution of profit or – if in excess of the lending company's distributable equity – a repayment of capital in violation of the statutory capital protection provisions. As such, it must fulfil all formal and substantive requirements of a dividend distribution. By contrast, the mere fact that an intra-group loan is not made at arm's length terms does not, in and of itself, turn that loan into a fictitious loan.

UNCERTAINTY AS TO ASSESSMENT CRITERIA FOR ARM'S LENGTH ANALYSIS

The decisive factor as to whether an intra-group loan qualifies as a Loan with Distribution Characteristics or as a genuine loan is whether the intra-group loan is made at arm's length terms.

Against the background of the Judgment, a technical committee of EXPERTsuisse (formerly the Swiss Chamber of Auditors and Certified Tax Experts) released a Q&A document (the "Q&A Document") which contains, inter alia, recommendations to auditors on how to treat intra-group receivables in the course of an audit. Although auditors are not obliged to follow recommendations issued by EXPERTsuisse, such recommendations are considered best practice by most Swiss auditors.

Unfortunately, neither the Judgment nor the Q&A Document clearly specify as to what constitutes arm's length terms. However, the Q&A Document contains a list of assessment criteria that should be taken into consideration for the purposes of an arm's length analysis. These assessment criteria include:

- formalities (are the loan and the arm's length analysis documented?);
- content of the contract (have matters such as the applicable rate of interest, the term of the loan, termination modalities, repayment and security been specified?);
- counterparty (what is the borrower's creditworthiness, ability and willingness to repay, and is interest paid or merely capitalised?); and
- risk (eg what is the ratio of the lender's aggregate amount of intra-group receivables and its total assets?).

BOUNDARIES SET BY STATUTORY CAPITAL PROTECTION PROVISIONS

Fictitious loans

Fictitious loans must comply with all formal and substantive requirements of dividend distributions. The formal requirements are that:

- there be audited financial statements; and
- the shareholders approve the distribution of profit.

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In terms of substantive requirements, the distributing company must have distributable equity in an amount equal to or higher than the amount of the proposed loan. Non-compliance with this requirement constitutes a violation of the capital protection provisions contained in the Swiss Code of Obligations.

Loans with Distribution Characteristics

According to the Judgment, the aggregate amount of Loans with Distribution Characteristics must not exceed the lending company's distributable equity. Non-compliance with this requirement constitutes a violation of the above-mentioned statutory capital protection provisions.

Genuine loans

The making of a genuine loan does not raise any issues with respect to the statutory capital protection provisions.

Violation of statutory capital protection provisions

There is consensus among the Swiss Federal Supreme Court and eminent Swiss legal scholars that the principle of capital protection is one of the most fundamental principles of Swiss corporate law. Therefore, any violation of the statutory capital protection provisions must be regarded as a material breach of Swiss corporate law and may lead to direct personal liability for damages on the part of the lending company's formal, material and/or de facto managing bodies if such violation results in a loss of the lending company, its shareholders or creditors. Such loss may, in particular, occur if upstream or cross-stream loans are not repaid (eg due to the borrower's insolvency). Formal managing bodies are the company's directors. Material managing bodies are persons to whom the company's directors have formally delegated management duties (ie officers). De facto managing bodies are persons who take decisions which are meant to be taken by formal managing bodies (eg direct or indirect shareholders taking such decisions).

In extreme cases, provided that the violation of capital protection provisions results in a loss on the part of the lending company, such violation may even lead to criminal prosecution of the lending company's formal, material and/or de facto managing bodies on charges of unfaithful business management. If the violation of the statutory capital protection provisions leads to the lending company's insolvency, further criminal offences could be relevant.

A violation of the statutory capital protection provisions renders the underlying transactions (eg the loan agreement) null and void. To the extent that a loan was made against the lending company's protected reserves, the borrowing company's repayment obligation is requalified into an obligation based on unjust enrichment. To the extent that a loan was made against the lending company's share capital, the shareholder's obligation to pay the share capital is reinstated.

Finally, if a company has made Loans with Distribution Characteristics in an aggregate amount exceeding its distributable equity, the Q&A Document recommends that auditors include a respective note in that company's audit report. The direct consequences of such a note must be assessed on a case by case basis. It may, in particular, trigger an event of default under certain material contracts (eg financing agreements) and may lead to negative publicity.

IMPACT ON LENDING COMPANY'S ABILITY TO DISTRIBUTE DIVIDENDS

According to the Judgment, Loans with Distribution Characteristics block the lending company's distributable equity in an amount equal to the amounts outstanding under the loan. As a result, a lending company may only distribute dividends to the extent that its distributable equity has not been blocked by such loans. If the aggregate amount of Loans with Distribution Characteristics is equal to or even exceeds the lending company's distributable equity, no dividends may be distributed.

A dividend distribution in an amount exceeding the company's distributable equity violates the statutory capital protection provisions and renders the shareholders' resolution adopting such distribution and, therefore, the distribution itself, null and void. The shareholders who have received dividends based on a void dividend resolution and in bad faith may be obliged to repay the dividend. To the extent that a dividend is distributed against the company's share capital, the shareholders' obligation to pay the share capital is reinstated.

A dividend distribution in violation of the statutory capital protection provisions may lead to direct personal civil and/or criminal liability of the distributing company's formal, material and/or de facto managing bodies as described above.

If a company has made Loans with Distribution Characteristics in an aggregate amount exceeding the company's distributable equity, the Q&A Document recommends that the audit report include a note stating that the proposed appropriation of available earnings is not compliant with Swiss law. The direct consequences of such a note must be assessed on a case by case basis.

INTRA-GROUP LOANS AND CONCENTRATION OF RISK

According to eminent Swiss legal scholars, a company's managing bodies may be acting in breach of their duty of care if they cause (or allow) the company to make a loan that leads to an excessive concentration of risk. Such breach of duty may result in direct personal liability for damages on the part of the company's formal, material and/or de facto managing bodies if such violation results in a loss of the company, its shareholders or creditors. Such loss may occur if upstream or cross-stream loans are not repaid (eg due to the borrower's insolvency).

LIMITATION ON LOAN AMOUNTS

In light of the potentially harsh consequences of a violation of the statutory capital protection provisions and the duty of care, individuals involved in upstream and cross-stream intra-group lending transactions are well advised to exercise caution when structuring such transactions to ensure compliance with Swiss corporate law. Given, in particular, the uncertainty surrounding the arm's length analysis, a potential precautionary measure is to ensure that the aggregate amount outstanding under all upstream and cross-stream loans is, at all times, limited to the amount of the lending company's distributable equity.

CONCLUSION

Intra-group lending allows liquidity to be allocated to its most productive use within a group of companies and constitutes an important source of financing. However, in the Swiss context, care must be taken when structuring upstream and cross-stream loans to ensure compliance with corporate law. ■