“Cirque du Monde”

Juggling Money and Liability in an International Insolvency Case

Responsibilities of Directors and Officers in Insolvency and Pre-Insolvency Situations Worldwide.

Some reflections under Swiss Law

1. **Group Support under Swiss Law; General Aspects**

   Swiss statutory law does not provide for a full formal legal frame work for groups of companies. The law applicable is mostly the same as the one applying to independent entities. The law provides for some specific regulations only, in particular regarding statutory accounting in a group context. Basically, the law assumes that each legal entity works and acts on its own and, therefore, puts each company under the obligation to protect and pursue its own interests independently from the interest of other related parties. A Swiss company, even if controlled 100% by another company, has to act within its own statutory limits.

   Board members of a Swiss subsidiary are under the obligation to protect the interests of the subsidiary and can be forced by law to act against the interests of the parent company or the group, if a transaction is disadvantageous to the subsidiary.

   A transaction, therefore, has to be analyzed under various aspects to determine if i) a Swiss subsidiary supports the group and ii) if such support is legally binding and valid.

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1 The legal issues outlined in this memorandum are currently subject to intensive discussions. No specific decisions of the Swiss Federal Tribunal (highest court in Switzerland) on the discussed issues have been published. The comments, therefore, are based on the doctrine which is not yet settled, is subject to further discussions and is not approved by the Swiss Federal Tribunal.
Persons in power to represent the company may, in the name of the company perform all legal acts that may arise within the company’s purposes (article 718a Swiss Code of Obligations (“CO”). The purpose of the company is defined by two elements, namely by the company’s purpose and the company’s interests. If a transaction is not covered by the company’s purpose and its interest the related agreements may be qualified as null and void. To reduce the risk of dealing outside the company’s purpose it should be ascertained that the purpose clause of the articles of association of the Swiss subsidiary expressly includes the support to group companies.

Furthermore, the final purpose of a Swiss company is to make profit to be distributed at some point of time to the shareholders. Thus, non-profit arrangements could be in contradiction to this final purpose.

On the other hand it is not exactly defined what the legal nature of a company’s interest is. This will have to be analyzed on a case-by-case basis. It can be in the company’s interest to enter into a non-profitable transaction to secure its future on the other hand, some business might be profitable in the short run but can be disadvantageous in the long run. It is argued, therefore, that if the transaction is not necessarily in line with the final purpose it has to be supported by the company’s interest at least. As a consequence the company has to receive an equivalent consideration in the transaction or in other words the parties will have to deal on the basis of an arm’s length transaction.

2. Principles regarding financial assistance

2.1 Repayment of capital

Article 680 para. 2 CO prohibits the return of capital contributions to the shareholders or indirectly via third parties outside of a formal capital reduction or liquidation procedure\(^2\). This, in particular, includes the repayment of the nominal share capital, of statutory reserves and of any agio (surplus) paid when the shares were issued. Whether surplus payments are included and whether the restriction also applies to undisclosed (“silent”) reserves is a matter of dispute. It is generally recognized, however, that despite the existing uncertainties loans, guarantees and security granted for upstream and/or cross-stream obligations by a Swiss subsidiary have to

\(^2\) Capital reduction and liquidation proceedings include specific creditor protection rules.
be limited to the freely distributable equity (accrued and distributable profits) of such subsidiary. The reason behind this restriction is that the grant of such financial assistance is similar to the payment of a dividend and therefore needs to be made subject to the statutory limitations in regard to the payment of dividends. As a further consequence results that the payment of dividends can only be decided by way of a formal resolution of the general shareholders meeting. Also, profits may only be paid out of the profit reflected in the (audited) financial statement or out of reserves created for this purpose (article 675 para. 2 CO).

2.2 Unjustified Benefits; Distribution of Profits

A further issue to be considered is that according to article 678 CO shareholders as well as members of the board of directors and persons associated with them may have to repay distributions of profits or interim interests that they cause to be paid to themselves without justification and in bad faith. They also must repay other payments that they have received to the extent such benefits are obviously disproportional. Generally, a person is considered close, if the service granted to that person would not have been granted to another person under the same terms. According to the doctrine group companies are considered to be close persons in the sense of article 678 CO. If a transaction, therefore, is in breach of article 678 CO related agreements are void and the persons having received such benefits have to repay them. Again, a distribution of profits is subject to shareholders' resolution to be formally adopted by a general shareholders' meeting.

The payment of a direct or constructive dividend is – save for respective double taxation treaty relief – subject to a 35% withholding tax.

3. Directors' liability

Directors and officers of a Swiss corporation have a duty to manage the corporation with due care and to preserve the corporation’s interests. For companies registered in Switzerland such responsibility will be dealt with under the principles of Swiss law. Board members of a Swiss subsidiary are under the obligation to protect the interests of this specific subsidiary and can even be forced by law to act against the interests of the parent company or of the group if a transaction is disadvantageous to the subsidiary. Directors and managers can become liable towards the shareholders or the creditors for all damages caused by way of negligent or intentional violation of their duties. These responsibilities apply to formal, i.e. properly elected board members and correspond to their actual function and influence on the decision making process (BGE 117 III 442). Their responsibility is defined by the specific corporate
law provisions as well as in the internal business regulations adopted by the board. The responsibility of the business operations can be delegated by the board to the management, thereby limiting the duty of the directors to the strategic business decisions and supervision of the management. The board, however, remains responsible for the finances of the company for the proper organisation of the accounting system, the financial control and financial planning. Regarding financial planning it should be ascertained that the necessary financial means for the business operations are available and that the liquidity is there to meet due creditors’ claims.

When it comes to preservation of liquidity specific personal directors’ liabilities are established by statutory law to secure payment of withholding tax and social security contributions.

De facto managers/directors: In addition to the formally elected board members and managers the persons who actually participate in the decision making process of a corporation can become liable as well. The factual corporate body must have been in a position to avoid the damage. In this context legal entities can be considered de facto corporate bodies which also includes in particular the mother company and/or its delegates.

4. **Cash pooling**

The consolidation of a cash management system of a group of companies with an automatic “sweep” is generally discussed under the term “cash pooling”.

With a “notional” cash pooling the companies’ accounts remain physically separated but virtually they are used to determine the overall net position of a group to calculate the interest amount of the group’s financial position. No loans are thereby extended to other group companies and accordingly, no related (direct) risk is assumed when participating in a notional cash pooling system.

In contrast, in case of a physical cash pool (“zero-balancing cash pool”) pursuant to the terms of the account arrangement with the bank, the liquidity of each participating group company is automatically transferred (swept) to a target account kept by one of the group companies. Groupwise credit and debit positions will be generated and most likely on a daily basis be netted. The transactions within the physical cash pool between the target account and the specific group company’s account will be recorded by way of operation of a current account. The credit exposure of the lending company is determined by the financial situation of the target account holding company and its credit standing; its credit standing is usually heavily dependant on the loans which are automatically extended (for reason of liquidity needs) to the
other group companies. While the groupwide handling of liquidity, thus, allows the head quarter to monitor cash streams and to generate advantageous financial terms for the group financing the individual companies run significant risks:

- the participating company loses control over its liquidity;
- it will concentrate its lending to one borrower what results in a critical risk allocation;
- and it will not be able to control the use of its funds by the target account holding company (borrower).

While legal thinking is gradually penetrating the set-up and operation of zero cash pooling arrangements no court decision is available for direct guidance at present.

Nevertheless, in BGE 130 III 213 (a decision rendered by the Swiss Federal Tribunal on January 9, 2004) the Federal Tribunal clearly confirmed that the corporate body of a Swiss company has to act in the proper interest of that specific company which interest is overriding any conflicting interests of the group. Likewise, it is said that the duty of diligence and loyalty (and therefore the personal liability of the directors) shall be high when own interests, interests of third parties or of shareholders are preferred over the company’s proper interest.

- Zero cash pool arrangements will be viewed as granting of group loans with the consequence that restrictions imposed by group legal assistance principles (as discussed above) have to be observed.
- Diligent business management requires proper risk allocation. Zero balancing pool arrangements are predestined to create lump risks.
- The operation of a centralized (in particular automatic) cash management system becomes increasingly critical in case of a financial crisis.
- Even in a situation of excellent credit standing the lack of diversification of the investments of the company’s funds might lead to personal liabilities of the directors should the company suffer a damage.

The set-up and participation in the operation of a zero cash pool arrangement, thus, means a high risk exposure for the individual board members/managers of a Swiss company.

Zurich, April 29, 2005