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Important Decision of Swiss Federal Supreme Court on Intra-group Financing Arrangements

The Swiss Federal Supreme Court ruled in a recent decision that up-stream and cross-stream loans must be entered into at arm's length terms. If not at arm's length, the decision seems to suggest that such loans constitute *de facto* distributions and may only be granted for an amount that does not exceed the lender's freely distributable reserves. The court also imposed stringent requirements on satisfying the arm's length test. In addition, the court held that an up-stream or cross-stream loan that is not entered into at market terms reduces the lender's ability for future dividend distributions by the amount corresponding to the loan.

Further, the Swiss Federal Supreme Court raised the question whether Swiss companies are allowed to participate in zero balancing cash pools at all.

On a more positive note, the Swiss Federal Supreme Court used the decision to give the long awaited confirmation that paid-in surplus capital (*Agio*), including capital contribution reserves, need not be treated in the same way as nominal share capital but, instead, may be distributed to shareholders in accordance with the general rules applicable to the distribution of dividends.

Background

The case before the Supreme Court related to a Swiss subsidiary of the former Swissair group, which participated in a zero balance cash pooling arrangement. The subsidiary had a positive outstanding balance against the cash pool leader (a sister company) and a loan against its grandparent company when it resolved on a distribution of a dividend. The dividend was paid via the cash pool and the subsidiary's auditors confirmed that the payment of the dividend complied with the law and the company's articles of association. In the aftermath of the Swissair grounding in 2001, the administrator of the subsidiary sued the auditors for giving such confirmation on the basis that the two loans should have been deducted from the subsidiary's freely distributable reserves as at the relevant balance sheet date

What the Swiss Federal Supreme Court Decided

High Standards for Up-stream and Cross-stream Loans to Pass the at Arm's Length Test

In its decision, the Swiss Federal Supreme Court held that, in light of mandatory Swiss capital maintenance provisions, the ability to grant loans between companies belonging to the same group

is limited. In particular, in the case at hand it ruled that an intra-group loan granted by a subsidiary to its shareholder or a sister company may constitute a *de facto* distribution rather than a loan, and it seems to suggest that such loan may only be granted for an amount not exceeding the subsidiary's freely distributable reserves. Until now, the majority of legal doctrine has only imposed this requirement on fictitious loans and similar financing arrangements under which repayment is unlikely or not even intended; while it was generally recognized that non-market term interests could under certain circumstances constitute a hidden distribution, the absence of market terms did not necessarily result in a requalification of the entire loan.

In addition, the Swiss Federal Supreme Court's decision suggests that surprisingly high standards will be imposed for up-stream loans to pass the arm's length test. While the Swiss Federal Supreme Court did not specify what constituted arm's length terms in the context of the case at hand, it held that none of the loans entered into were at arm's length because the loans were unsecured and the creditor allegedly did not analyze the debtors' credit-worthiness at the time it entered into the loan. The court made its finding without taking into consideration the particular circumstances of the case or the indirect benefits of the intra-group financing arrangement (or indeed the fact that the relevant loans had already been repaid).

Intra-group Loans that are not at Arm's Length Restrict the Ability to Pay Future Dividends

Further, the Swiss Federal Supreme Court introduced a new requirement for up-stream and cross-stream loans that are not at arm's length terms according to which the creditor has to set aside a corresponding amount of freely distributable reserves and ensure that it is not distributed to shareholders. In combination with the exacerbated standards for such loans, this may constitute a challenging new requirement for Swiss companies as it suggests to require them to closely monitor freely distributable reserves in light of their intra-group financing arrangements and to assess whether these may have been entered into at market terms.

Permissibility of (Zero Balancing) Cash Pool Arrangements Left Open

The Swiss Federal Supreme Court also raised the question of whether the participation by a Swiss company in a cash pooling arrangement according to which the participant disposes over its liquidity is at all capable of constituting an arm's length transaction. However, the court held that the question could remain unanswered in this particular case because the loans that had been granted as part of the cash pooling arrangement were not on market terms in any event for the reasons indicated above.

Paid-in Surplus Capital (Agio) May Be Distributed to Shareholders

On a more positive note, the Swiss Federal Supreme Court further decided conclusively that paid-in surplus capital (*Agio*) may be distributed as dividends. While companies have distributed billions of Swiss Francs out of capital contribution reserves that were accumulated from surplus capital in recent years this practice was criticized by a minority of legal scholars. Therefore, a clear ruling on this by the Swiss Federal Supreme Court has been much anticipated. The court decided that paid-in surplus capital is not subject to the strict rules protecting the paid-in nominal share capital but that it is governed by the rules applicable to general reserves (*Allgemeine Reserve*). It follows that Agio may be distributed if and to the extent that such general reserves exceed half of the nominal share capital (or 20% in the case of holding companies).

What the Decision Means for Swiss Companies

In light of this recent decision we recommend that Swiss companies review their intra-group financing arrangements, in particular, up-stream and cross-stream loans, cash pooling arrangements and also any up-stream and cross-stream security. The review should focus on, *inter alia*, the following key topics:

- Up-stream and cross-stream loans should only be granted at arm's length terms;
- if there is any doubt as to whether the loan constitutes an arm's length transaction, cautionary measures should be taken; and
- cash pooling arrangements involving Swiss companies should generally be assessed in light of the recent decision.

The decision raises a number of legal questions and certain of its parts appear to deviate from past precedents and established legal doctrine without discussing this in depth. In our view this may suggest that, although the court does not explicitly mention it, some of the rulings of the court may rather have to be seen in the context of the particular case and less in more general terms. In any event, the practical impact of the decision on Swiss companies remains to be seen. This will in part depend on how auditors implement the Swiss Federal Supreme Court's decision because it is the auditors who will have to give confirmation that dividends comply with the law and with the companies' articles of association. Given the complexity of the legal and financial issues involved with intra-group financing and in view of the paramount importance of efficient liquidity management for Swiss companies, further clarification in case law would be welcome. We can only hope that courts will take into account the crucial need for efficient financing and liquidity management within groups of companies.

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