

# Risks for Transactions and Directors in Financially Distressed Businesses (Switzerland)

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A Practice Note addressing the legal and practical considerations in Switzerland for a company director where that company is in financial distress and may subsequently enter insolvency proceedings. This Note also explores certain types of claims that may be brought against directors as well as claims to challenge transactions approved by these directors.

## Directors' Duties

### How Directors' Duties Change in the Pre-Insolvency Period

- Duty to Monitor Solvency
- Duty to Rectify a Capital Loss
- Duty to Notify the Court in Case of Over-Indebtedness
- Duty to Treat Creditors Equally

### Examination of Directors' Pre-Insolvency Actions During Insolvency Proceedings

- Examination in Bankruptcy Proceedings
- Examination in Composition Proceedings

### Potential Claims Against Former Directors

When a company is in financial distress and enters into insolvency proceedings, there are a variety of legal and practical issues to consider. Before the distressed company goes into insolvency proceedings, the directors may need advice on what they need to do to fulfil their duties to the company, its creditors, and its shareholders, and will need to consider the status of any ongoing transactions the company may be engaged in. Once the company has gone into insolvency proceedings, the pre-insolvency actions of the directors will be scrutinised by insolvency officials attempting to achieve the greatest return for the company's creditors.

This Note considers the legal and practical issues involved in the law of Switzerland, including an overview of the duties of the members of the board of a Swiss stock corporation that is in financial distress and may subsequently enter insolvency proceedings. It addresses:

## Special Legal Claims

### Criminal Claims

### Company Transactions That Can Be Challenged and Unwound if the Corporation Becomes Insolvent

- Gifts and Gratuitous Transactions
- Transactions Made During Over-Indebtedness
- Transactions With the Intent To Cause Damage

### Duties of Insolvency Officials and Office Holders to Investigate Pre-Insolvency Transactions and Director Conduct

### Powers of Insolvency Officials to Require the Production of Information, Documents, or Assets When Investigating

- The duties that directors owe to their company, its shareholders, and its creditors, and how these may change according to the company's financial situation.
- The investigation of the directors' pre-insolvency actions by insolvency officials.
- The powers of the insolvency officials to challenge transactions, and general powers of recovery, in their aim to achieve the greatest possible return for the company's creditors.
- The potential for any claims against the company's directors, and whether the directors can be personally pursued because of certain conduct even if ordinarily they would not be liable for the insolvent company's debts.

While this Note refers to the duties of the directors of a Swiss stock corporation and the consequences of

their violation, the duties of the managing officers of a Swiss limited liability company, which is the other type of corporate form normally used in Switzerland, and the consequences of a violation of these duties, are generally the same. Furthermore, some additional duties may apply in case of Swiss stock corporations, which are listed on a stock exchange, which are not further discussed in this Note.

### Directors' Duties

The duties of a Swiss corporation's directors are set out in the corporate law section of the [Swiss Code of Obligations](#) (CO), which has been recently revised (article 620 et seqq. CO, the directors' duties being mainly set out in articles 716 – 717a CO and articles 725 – 725b CO). According to the CO, the main task of the board, and therefore also its main duty, is to manage the corporation's business. However, the board may delegate the day-to-day management duties to a separate executive management. It cannot delegate certain non-transferable and inalienable duties of the board, which are:

- The overall management of the corporation and the issuance of the required directives.
- Determining the corporation's organisation.
- Organising the accounting, financial control, and financial planning systems as required for management of the corporation (which should also include a system to monitor liquidity).
- Appointing and dismissing persons entrusted with managing and representing the corporation.
- Overall supervision of the persons entrusted with managing the corporation, specifically regarding compliance with the law, articles of association, operational regulations, and directives.
- Compiling the annual report, preparing for the shareholders' meeting, and implementing its resolutions.
- Filing an application for composition moratorium and notifying the court if the corporation is over-indebted.

In addition to these specific duties of the board, Swiss law provides for certain general duties that the directors must observe. These general duties include:

- A duty of care and loyalty, which requires that the directors perform their duties as directors with due diligence and safeguard the interests of the corporation in good faith.
- A duty to treat the shareholders equally in like circumstances.

### How Directors' Duties Change in the Pre-Insolvency Period

As set out above, the directors have a general duty to safeguard the corporation's interests, and to act in its best interest. Because of this general duty, the board's main duty in a situation of distress is to ensure the corporation's continuity as a going concern. Therefore, to ensure the corporation's continuing existence, the board should implement any necessary restructuring measures, if this is reasonably possible.

In addition to this general duty, Swiss corporate law provides for certain specific duties, which apply in a situation of distress (these are set out in articles 725 – 725b CO). Most are triggered by the (declining) balance sheet situation of the corporation. They include the duty to:

- Monitor the solvency of the corporation (see Duty to Monitor Solvency).
- Rectify a capital loss (see Duty to Rectify a Capital Loss).
- Notify the court in case of over-indebtedness (see Duty to Notify the Court in Case of Over-Indebtedness).

The duties to rectify a capital loss and to notify the court in case of over-indebtedness are tied to the balance sheet situation of the corporation and not its liquidity situation (to which the duty to monitor solvency is tied). However, the corporation's liquidity usually also plays a decisive role in whether these duties are triggered. According to Swiss accounting rules, a corporation's financial accounting must switch from going concern to liquidation values, if continuing the corporation's business activities during the next 12 months is likely impossible (which means that the corporation is no longer a going concern). This is the case if the corporation does not have sufficient liquidity (or access to liquidity) for this period. The switch from going concern to liquidation values typically leads to over-indebtedness, and therefore triggers the duty to notify the court.

Therefore, a key focus of the board in a distress situation must be the liquidity situation of the corporation. The directors must constantly monitor (but also conserve and obtain access to) liquidity. They must implement a monitoring system, if not in place, which allows visibility of the liquidity situation (actual and over 12 months on a rolling basis).

### Duty to Monitor Solvency

Most importantly, according to article 725 CO, the board must monitor the solvency of the corporation. This

duty, which also exists outside of a situation of distress, becomes particularly important if the corporation enters a phase of distress. If the corporation is threatened with insolvency, the board must:

- Implement measures to ensure its solvency.
- Where necessary, implement further measures to restructure the corporation. If these measures fall within the competence of the shareholders' meeting (such as, for example, a capital increase), the board must propose them and request the shareholders' meeting's approval for them.

Furthermore, the law provides that the board must "file for composition proceedings, if required" (that is, to apply for Swiss in-court restructuring proceedings). It also specifies that the board must act with the required urgency if there is a threat of insolvency. However, this provision does not, in our view, obligate the board to file for composition proceedings if there are impending liquidity problems.

### Duty to Rectify a Capital Loss

A capital loss occurs where the corporation's assets minus its liabilities cover less than half of the value of the protected equity. Protected equity is the sum of:

- The share capital.
- The statutory capital reserve not to be repaid to the shareholders.
- The statutory retained earnings reserves.

According to article 725a CO, if the annual financial statements of the corporation indicate that there is a capital loss, then the board must:

- Implement measures to rectify this capital loss.
- If necessary, implement further measures to restructure the corporation. If these measures fall within the competence of the shareholders' meeting, the board must propose and request the approval of the shareholders' meeting.

If the corporation does not have an external auditor, the annual financial statements (which show the capital loss) must also undergo a limited audit by a licensed auditor before the shareholders' meeting approves them. The board of directors must appoint the licensed auditor, unless it directly applies for a composition moratorium (that is, for Swiss in-court restructuring proceedings). The law also specifies that the board of directors (and the external auditor or the licensed auditor) must act with the required urgency if there is a capital loss.

### Duty to Notify the Court in Case of Over-Indebtedness

According to article 725b CO, if there is substantiated concern that the corporation's liabilities are no longer

covered by its assets (which means that the corporation is over-indebted), the board must immediately prepare interim financial statements using both:

- Going concern values.
- Liquidation values. However, interim financial statements at liquidation values are not required if the going concern assumption still applies, and the interim financial statements at going concern values do not indicate over-indebtedness. If the going concern assumption no longer applies, interim financial statements at liquidation values are sufficient.

The interim accounts must be audited (either by the external auditor or, if the corporation has no external auditor, by a licensed auditor which is appointed by the board), whereby the board and the auditor must act with the required urgency. If the interim financial statements show that the corporation is over-indebted, then the board must either file for bankruptcy or for composition proceedings (that is, for Swiss in-court restructuring proceedings). However, the board may refrain from notifying the court if either:

- Creditors of the corporation subordinate their claims to those of all other creditors of the corporation in the amount necessary to cover the over-indebtedness.
- There is a reasonable prospect that the over-indebtedness can be remedied within a reasonable period (but no later than 90 days after the audited interim financial statements are available), if this delay does not additionally jeopardise the creditors' claims.

### Duty to Treat Creditors Equally

In addition to the board's aforementioned duties, a distress situation also triggers arguably an indirect duty of the board to treat the corporation's creditors equally. Swiss corporate law does not explicitly provide for this duty, and the duty to safeguard the interests of the distressed corporation may actually warrant unequal treatment to protect the value of the corporation's assets. However, article 167 of the [Swiss Criminal Code](#) provides that if a debtor favors certain creditors over others, this act can, depending on the specific circumstances, constitute a criminal offence. Therefore, the board must carefully assess how it treats the corporation's creditors in a case of financial distress.

### Examination of Directors' Pre-Insolvency Actions During Insolvency Proceedings

The examination of directors' pre-insolvency actions during subsequent insolvency proceedings depends on the type of insolvency proceedings. Swiss law provides

for two general types of insolvency proceedings, which are both set out in the [Swiss Debt Enforcement and Bankruptcy Act \(DEBA\)](#):

- Bankruptcy proceedings, which lead to the dissolution of the corporation with the objective of liquidating the corporation's estate and proportionately satisfying the corporation's creditors by classes through the distribution of the proceeds (see Examination in Bankruptcy Proceedings).
- Composition proceedings, which are Swiss in-court restructuring proceedings that protect the distressed corporation from its creditors to enable the corporation to either attempt to reach a court-approved debt-restructuring agreement (a composition agreement) with its creditors or to restructure outside a court-approved debt-restructuring agreement (see Examination in Composition Proceedings). The composition agreement can take the form of either:
  - an “ordinary composition agreement,” in which the corporation and its creditors agree either on a specific payment plan, a haircut, or a combination of these (and therefore the survival of the corporation); or
  - a “composition agreement with assignment of assets,” which provides for the assignment of the corporation's assets to its creditors, for realisation by a liquidator elected by the creditors, in satisfaction of the creditors' claims, leading to the dissolution of the corporation.

### Examination in Bankruptcy Proceedings

If bankruptcy proceedings open, the bankruptcy administration (which usually is the bankruptcy office (and therefore, state officials) at the seat of the bankrupt debtor, but which can also be an elected private practitioner depending on the type of bankruptcy proceedings), has to do everything needed to preserve and realise the bankruptcy estate. This is because its guiding principle is to maximize the bankruptcy estate and the result of its realization (and therefore to maximize the value for the creditors). As liability claims against directors for a breach of their duties (to the extent they have caused damage to the corporation) are part of the bankruptcy estate, the bankruptcy administration must investigate the pre-insolvency actions of the directors in view of a potential breach by these directors of their duties.

If directors have breached their duties and are liable for causing damage to the corporation, the bankruptcy estate, acting through the bankruptcy administration, has the right to file the corresponding claim against the directors in court. If the bankruptcy estate, by way of a majority decision of the creditors in bankruptcy, waives

its right to make this claim, then each creditor of the bankrupt corporation (whose claim has been admitted in the bankruptcy proceedings) can bring this claim in court. However, in most bankruptcy proceedings, except for bigger bankruptcy proceedings, potential liability claims against directors are simply listed in the inventory of the bankruptcy estate and not further investigated by the bankruptcy administration or pursued in court, unless creditors actively investigate and pursue these claims.

To the extent that directors have breached their duties, and have caused damage only to creditors or shareholders (but not to the corporation), only these parties can bring this claim in court.

### Examination of Special Legal Violations

The competent administration (for example, the tax administration), rather than the bankruptcy administration, investigates and enforces the potential liabilities of directors which are based on special laws (for example, liability for unpaid social security contributions, as well as certain other unpaid taxes of the corporation; see Special Legal Claims). The most important potential liability is for unpaid social security contributions, which is enforced directly by the cantonal compensation offices (that is, the cantonal administration which administers and enforces the social security laws).

### Examination of Criminal Conduct

The competent law enforcement authorities investigate the potential criminal liability of directors based on their pre-insolvency conduct (for example, the preferential treatment of creditors or an undue delay in filing bankruptcy proceedings) (see Criminal Claims). In nearly all cantons of Switzerland, the cantonal laws provide for a duty of the bankruptcy officers to report to the competent law enforcement authorities any criminally relevant pre-insolvency conduct by a director that they discover. However, in practice, the pre-insolvency conduct of directors is rarely analyzed from a criminal law perspective in Switzerland.

### Examination in Composition Proceedings

If composition proceedings are opened, the administration must prepare an inventory of the assets of the distressed corporation and therefore must verify whether there are potential liability claims against the directors which they should include in the inventory. However, whether and how these potential liability claims are later pursued depends on the outcome of the composition proceedings. If composition proceedings end with:

- An out-of-court restructuring of the corporation or with a court-approved restructuring (that is, with an ordinary composition agreement), then no claims will be made against the directors in the context of these proceedings. Shareholders and creditors can later pursue the directors for any violation of their duties, in accordance with the normal rules which apply outside of insolvency.
- A composition agreement with assignment of assets (that is, a composition agreement which provides for the assignment of the corporation's assets to its creditors for realisation by a liquidator elected by the creditors in satisfaction of the creditors' claims), then the situation is comparable to the situation in bankruptcy and similar rules apply regarding the enforcement of claims against directors for their pre-insolvency conduct (see Examination in Bankruptcy Proceedings).

### Potential Claims Against Former Directors

According to article 754 CO, each director is personally liable to the corporation, its shareholders, and the corporations' creditors, for any damage caused to them by that director intentionally or negligently breaching their duties (see Directors' Duties and How Directors' Duties Change in the Pre-Insolvency Period). Therefore, each director has a potential personal civil liability towards the corporation, its shareholders, and its creditors, if that director intentionally or negligently violates his or her duties, and thereby causes monetary damage.

In the insolvency of a corporation, the typical civil liability claims made against directors for their pre-insolvency conduct are based on:

- The board unduly delaying the filing for insolvency proceedings.
- The board failing to implement restructuring measures early enough.
- The board violating the "at arm's length" principle in dealings between the corporation and related parties.
- The board preferring certain creditors over others before the opening of insolvency proceedings, specifically regarding payments made to creditors shortly before the opening of insolvency proceedings, without this unequal treatment being in the interest of the distressed corporation (or for other types of preferential or fraudulent transactions).

### Special Legal Claims

Apart from the potential claims against the directors for a violation of their duties, the directors may face liability

claims due to their personal liabilities based on social security and tax laws, specifically regarding unpaid:

- Social security contributions of the corporation (article 52 of the Federal Act on Old-Age and Survivors' Insurance).
- Withholding taxes of the corporation (article 15 of the Federal Act on Withholding Tax).

The most typical claim made against directors is for unpaid social security contributions of the corporation (a similar liability exists under Swiss law for unpaid pension fund contributions). Although the law provides that directors are only liable for intentional or grossly negligent breach of these laws, in practice they are strictly liable as the courts basically consider any delay in payment of these contributions a grossly negligent act of all directors.

Directors may also typically face claims by the tax authorities for unpaid withholding taxes relating to hidden distributions made shortly before the opening of insolvency proceedings.

### Criminal Claims

Directors may also face a criminal liability for their acts, specifically for:

- An undue delay in filing for insolvency proceedings.
- Preferred treatment of creditors.
- Other types of preferential or fraudulent transactions.

### Company Transactions That Can Be Challenged and Unwound if the Corporation Becomes Insolvent

According to the DEBA, certain actions carried out by a debtor (and therefore also by a corporation) before the opening of insolvency proceedings and that disadvantage its creditors (or favour certain of its creditors to the disadvantage of others) may later be challenged under certain circumstances by the bankruptcy administration (or under certain circumstances also by creditors) in the bankruptcy proceedings by way of an avoidance action. In the context of composition proceedings, these actions can only be challenged on confirmation by the composition court of a composition agreement with assignment of assets, but not during the composition proceedings or on conclusion of an ordinary composition agreement.

The following actions can be challenged:

- Gifts and gratuitous transactions (see Gifts and Gratuitous Transactions).



- Certain transactions made during over-indebtedness (see Transactions Made During Over-Indebtedness).
- Certain transactions made with the intent to cause damage (see Transactions Made With The Intent To Cause Damage).

If the avoidance action is successful, the transaction remains valid (that is, the transaction is not null and void), but the counterparty to this transaction must return the relevant assets that it has received to the bankruptcy estate (and becomes a creditor of the bankruptcy estate for the consideration paid, if any).

### Gifts and Gratuitous Transactions

All gifts and gratuitous transactions, as well as all dispositions made by the debtor without receiving adequate consideration, during the year before the opening of bankruptcy proceedings (or, in the case of composition proceedings, during the year before the granting of the composition moratorium) can be challenged.

Therefore, fire sales face a considerable risk of being challenged if the seller is declared bankrupt shortly after the transaction. Challengers can argue that the seller has sold its assets at a too-low price due to the specific situation in which the sale has occurred (for example, seller liquidity problems paired with time pressure). The adequacy of the consideration must be verified based on, and in relation to, the market value of the assets sold. Regarding dispositions carried out by a debtor in favour of related parties (for example, group companies), the DEBA contains a legal presumption that the consideration received by the debtor from related parties has not been adequate (which leads to a reversal of the burden of proof such that the debtor must show that the consideration was adequate).

### Transactions Made During Over-Indebtedness

Certain legal acts are voidable, if carried out by the debtor during the year before the opening of bankruptcy proceedings (or, in the case of composition proceedings, during the year before the granting of the debt moratorium), and if the debtor at that time was already over-indebted. These legal acts are:

- The granting of collateral for existing obligations that the debtor was previously not bound to secure.
- The settlement of a (monetary) debt by unusual means of payment (such as the assignment of a claim instead of payment).
- The payment of an unmatured debt.

However, avoidance is precluded if the recipient proves that it was unaware and could not have been aware of the debtor's over-indebtedness.

### Transactions With the Intent To Cause Damage

Any acts that have been carried out by the debtor during the five years before the opening of bankruptcy proceedings (or, in the case of composition proceedings, during the five years before the granting of the debt moratorium) are voidable that have the purpose, apparent to the other party, of disadvantaging its creditors or preferring certain of its creditors to the detriment of others. For an act to be voidable according to this provision, the following four requirements must be met:

- The debtor's act must have caused damage, so that the creditor's rights to enforcement are affected.
- The debtor must have acted with the intent to cause damage. It is not necessary that the debtor has directly aimed at causing a damage, but it is sufficient if the debtor could, and must have, recognised that its act would cause a damage. Therefore, it is sufficient if the debtor merely accepts a preference or disadvantage as a possible consequence of its act.
- The counterparty knew, or should have known, of the debtor's intent to cause damage.
- The act must have been carried out in the five years before the opening of bankruptcy proceedings (or, in the case of composition proceedings, during the five years before the granting of the debt moratorium).

### Duties of Insolvency Officials and Office Holders to Investigate Pre-Insolvency Transactions and Director Conduct

If bankruptcy proceedings are opened, the bankruptcy administration must do everything needed to preserve and realize the bankruptcy estate, its guiding principle being to maximize the bankruptcy estate and the result of its realisation (and therefore maximize the value for the creditors). This includes investigating the pre-insolvency actions of the directors and the pre-insolvency transactions entered into by the corporation to verify whether the directors have breached their duties or whether any transaction has been implemented which can be challenged by way of an avoidance action, as potential liability claims against directors for a breach of their duties and avoidance actions are part of the bankruptcy estate. However, except in bigger bankruptcy cases, bankruptcy

administrations in practice seldom investigate in detail the pre-insolvency actions of directors in view of potential liability claims (see Examination in Bankruptcy Proceedings). The same applies, though to a somewhat lesser degree, to the investigation of pre-insolvency transactions of the corporation in view of potential avoidance actions. Instead, it is rather the creditors which actively investigate these actions and transactions.

In composition proceedings, the situation is similar. According to the DEBA, on the opening of composition proceedings, the administration must prepare an inventory of the assets of the distressed corporation and therefore must also investigate whether there are potential liability claims against the directors (see Examination in Composition Proceedings). The same applies regarding pre-insolvency transactions in view of potential avoidance actions even though these claims only emerge where the corporation is declared bankrupt or if a composition agreement with assignment of assets is concluded.

As for the pre-insolvency actions of the directors, which may be relevant from a criminal law point of view, the legislation of nearly all cantons of Switzerland provide that debt enforcement and bankruptcy officials must report these actions to the competent law enforcement authorities, if they become aware of any criminally relevant pre-insolvency conduct by a director (see Examination of Criminal Conduct).

### **Powers of Insolvency Officials to Require the Production of Information, Documents, or Assets When Investigating**

The DEBA sets out the main powers of the bankruptcy administration to require the production of information, documents, which are underpinned by criminal sanctions set out in the [Swiss Criminal Code](#) (PC).

The DEBA not only provides in general for the debtor's obligation to be at the disposal of the bankruptcy

administration during the bankruptcy proceedings (article 229 DEBA), this duty being subject to a criminal fine in case of its breach (article 323 PC), but specifically requires that:

- The debtor must declare and make available to the bankruptcy administration all assets (article 222 DEBA). In this context, the Swiss Criminal Code states that a debtor who fictitiously reduces its assets to the prejudice of its creditors (for example, conceals assets) is subject to a criminal fine or a custodial sentence (article 163 PC). Furthermore, the Swiss Criminal Code states that a debtor who fails to disclose or make available all its assets to the bankruptcy administration, is subject to a fine (article 323 PC). The debtor must also open the premises and boxes to the bankruptcy administration on request and, if necessary, the bankruptcy administration may use police powers (article 222 DEBA).
- Third parties who hold assets of the debtor in custody or with whom the debtor has credit balances must provide information and surrender the assets to the same extent as the debtor (article 222 DEBA). According to the Swiss Criminal Code, a third party who fails to comply with this duty would be subject to a criminal fine (or could even be subject to a custodial sentence if it conceals these assets) (articles 163 and 324 PC). Authorities must also provide information to the same extent as the debtor (article 222 PC).
- The bankruptcy office should make a creditors' call. This creditors' call not only includes the request to all creditors of the debtor to file their claims against the debtor with the bankruptcy office, but also a request to:
  - the debtors of the bankrupt corporation to report their debts to the bankruptcy office within one month; and
  - persons holding the debtor's property as pledgee or for other reasons to make this property available to the bankruptcy office within one month.

Both of these duties are subject to a criminal fine if they are breached (article 324 PC).

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