Cash Pooling and Insolvency

A Practical Global Handbook

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Switzerland

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1. Introduction

1.1 Admissibility of cash pooling agreements

As a general rule, cash pooling agreements are permitted under Swiss law. Corporations may participate in cash pooling agreements and holding companies may set up cash pooling agreements with their group members, both notional and physical. As far as rules regarding the Swiss companies involved are concerned, the analysis does not change where foreign companies also participate in the cash pooling agreement (be it as the master account holder or as a group company).

1.2 Types of cash pooling agreement

Given that there are no specific legal restrictions and that many multinational companies either are headquartered in Switzerland or have a local subsidiary in Switzerland, all types of cash pooling agreement are used in Switzerland.

1.3 Legal requirements from various perspectives

Under Swiss law, there are no specific statutory rules governing cash pooling agreements.

However, while there is no specific statutory law governing cash pooling agreements, a number of general rules must be considered in connection with cash pooling agreements. Generally, purely notional cash pooling does not create legal issues, as it does not create material legal obligations. The typical issues arise in the case of physical cash pooling, which involves loans between group companies and the master account holder, or if securities are granted in connection with either physical or notional cash pooling.

Most of the following principles have been tested generally in the Swiss courts, though there is little case law specifically relating to cash pooling agreements. For the purposes of this chapter, we discuss what we perceive as the majority view in the legal doctrine and those theories most widely accepted that are reasonably likely to prevail in court. However, in most instances, the legal doctrine includes views that support both more restrictive and less restrictive positions.

(a) Company law

Most restrictions regarding cash pooling agreements under Swiss law are related to provisions of company law.

Directors' duties include their inalienable responsibility for the company's financial strategy, including its planning, implementation, management and monitoring. Financial transactions must be at arm's length, although terms of downstream loan to a subsidiary that are more beneficial to the subsidiary than the parent are generally not problematic. Therefore, before entering into a cash pooling agreement, the board (be it of a group company or the master account holder) has the duty to evaluate carefully whether participation in the cash pooling agreement is in the company's best interests and (in relation to up- or cross-stream counterparties) at arm's length. Generally, in the case of physical cash pooling target balancing will be easier to justify than zero balancing. After entering into the cash pooling agreement, the board has a permanent duty to monitor the cash pooling agreement, in particular, the creditworthiness of the master account holder and the other group companies and, if necessary, to take appropriate measures to reduce their company's exposure.

There is no strict definition of whether a transaction is at arm's length. A transaction is considered to be not at arm's length if there is a gross discrepancy between the parties' obligations. Not only the primary obligations such as the amount of the loan or interest rate, but all terms of the relationship need to be considered, including the term of the loan, termination provisions, securities, creditworthiness of the other party and so on. One test is whether the same terms could be obtained from a third party. As a general rule, the granting of security to parent or sister companies is considered to be almost impossible to be structured on arm's length terms in an intra-group set-up. To reduce the risk of liability, in particular, in case of security being granted to parent or sister companies, companies should typically amend their articles with a specific provision allowing the grant of such loans or security free of charge, as discussed below.

The directors of a company have a duty of loyalty. The directors must always act in the best interests of the company and not those of third parties, including those of a parent company or other group companies. While most of the time the interests of different group companies will be aligned, there is an increased risk of conflicts of interest in situations of financial distress. A cash pooling agreement is prone to such conflicts of interest if the same directors serve on the board of a group company and that of the master account holder. Generally, conflicts of interest cannot be excused. A company's share capital plus the statutory reserves (together, the protected equity) may not be distributed to the shareholders (be it as a dividend or otherwise, for instance, as a disguised or hidden distribution). Therefore, when dealing with a parent or a sister company, to the extent that the cash pooling agreement could affect the company's protected equity, a cash pooling agreement may only be entered into on arm's length conditions. It is standard practice for Swiss companies to include limitation language in the documentation regarding credit and, in particular, the documentation regarding security to prevent the company from having an obligation to violate its protected equity. If a cash pooling agreement is not at arm's length and the company's balance sheet is not strong enough to support a daily cash sweep, the parties should provide for appropriate safeguards. For instance, target balancing at an appropriate amount might limit the risk of undue distribution of protected equity.

(b)

(c)

Under the doctrine of *ultra vires*, any transaction outside the scope of the company's purpose (as defined in its articles of association) is void. Therefore, as regards payments to a parent or a sister company under a cash pooling agreement that are not on arm's-length conditions, there is a risk that they will be void unless approved as a formal dividend by the shareholders' meeting. To avoid such *ultra vires* issues, it is generally recommended that the articles of association of Swiss group companies participating in a cash pooling agreement include a specific provision allowing the grant of loans or security free of charge to parent or sister companies. A downstream loan to a subsidiary could, in particular circumstances, be treated as subordinated debt if such debt serves equity-like purposes, in particular where a subsidiary is undercapitalised. In an insolvency, such debt would be subordinated to other debt of the company.

If a group company is not 100% owned by the group that has set up the cash pooling agreement, but has outside shareholders, all terms of the cash pooling agreement must be at arm's length (or more favourable to the group company) to avoid a violation of the outside shareholders' right to equal treatment.

Not only the directors formally appointed and registered in the registry of commerce are subject to the duties of loyalty and care, but also any person (be it an individual or a corporation) that has an influence on the board's decisions as if such person were a board member. *De facto* directors are subject to the same liability as formal directors.

Swiss law recognises the concept of piercing the corporate veil in cases of abuse of law. Commingling of funds or a systematic undercapitalisation could be an indication of such abuse. The courts are usually reluctant to pierce the corporate veil in the absence of blatant abuse. If the corporate veil is pierced, the parent company becomes directly liable for the subsidiary's debt alongside the subsidiary.

(b) Bankruptcy law

Swiss bankruptcy law provides for claw-back under certain circumstances. In an insolvency the following transactions can be challenged:

- any transactions made in the year prior to insolvency that were not at arm's length, to the detriment of the insolvent company;
- any transactions made in the year prior to insolvency while the company's debt plus equity exceeded its assets where the transaction involved the grant of supplemental security or the repayment of a debt not due; and
- any transactions made in the five years prior to insolvency that were made intentionally in violation of the principle of equal treatment of all creditors. The threshold for assuming such intention is very low. Accordingly, any repayments of debt, even if due, or the grant of security, other than upon grant of a loan, could become subject to scrutiny.

(c) Criminal law

Prejudicing creditors prior to an insolvency is a criminal offence, where it is done intentionally or through gross negligence; as is violating directors' duties in certain circumstances.

2. Specific questions

2.1 Perspective A: corporate group

(a) ***Liability of group company and/or master account holder directors in the event of insolvency of a group company***

The members of the board of directors of a Swiss company are liable for any damage caused by a breach (whether negligent or wilful) of their duties. Claims for damages can be made by the company and, in particular in an insolvency, by the shareholders and the company's creditors. The board of a Swiss company is a one-tier board. Therefore, the rules regarding directors' liability apply to all directors, be they executive (with management function) or non-executive (with supervisory function), independently of how the company has actually organised such functions. In addition, members of the senior management and any other person acting as a *de facto* director can become subject to directors' liability as discussed below. Liability of the directors of a group company will mostly be an issue if a group company becomes insolvent and there is a balance in the cash pooling agreement in favour of the group company that cannot be recovered (in the case of zero or target balancing), or if securities granted by the company have been executed to satisfy debt other than the company's debt. In this case, the directors of the insolvent company could become liable, as outlined below, depending on how the cash pooling agreement is structured and on the actual circumstances.

If a group company becomes insolvent and there is a balance in the cash pooling agreement in favour of the master account holder, typically there will be no liabilities on group company directors that are specific to the cash pooling agreement.

Liability of group company directors: Where the master account holder is downstream from the insolvent group company, as a general rule, any terms of the cash pooling agreement that are not at arm's length, but are in favour of the subsidiary, would not be considered to be an issue, as they can be understood as capital injections that are also for the benefit of the parent and therefore there is no liability on the part of the directors of the parent company specifically related to the cash pooling agreement. Therefore, the following assumes that the master account holder is a parent or sister company of the insolvent group company:

- Duty to safeguard the protected equity – if payments under the cash pooling agreement or the execution of securities have the effect of being made out of the group company's protected equity, then the directors are in breach of their duty to protect the company's protected equity and will be liable for any damages caused thereby. While such depletion of the protected equity will not be an issue if made as part of a transaction at arm's length, in practice it is likely that it will not be possible to show this in the intra-group context of a cash pooling agreement, in particular to the extent that security is concerned. So, unless the group company's balance sheet is strong enough to support the loss of the respective assets, participation in a cash pooling agreement carries the risk for the directors of violating their duty to safeguard the protected equity.

- Duty to treat shareholders equally – if the group company is not a 100% subsidiary of the group that set up the cash pooling agreement, and if its terms are not at arm's length in all respects, then the directors will be liable for damage to minority shareholders for having violated their duty to treat all shareholders equally.
- Duty to manage finances properly – the directors are liable for mismanagement if they entered into the cash pooling agreement other than at arm's-length conditions. Even if the terms of the cash pooling agreement were originally at arm's length, the directors could be liable for mismanagement if they did not properly monitor the cash pooling agreement – for instance, if they did not reduce the exposure under the cash pooling agreement or ask for security as the creditworthiness of the master account holder deteriorated. In addition, the directors could be liable for unlawful hidden profit distributions (unless there was a specific and formal authorisation by the shareholders' meeting of the respective payments).
- Duty of loyalty – directors appointed by the parent company could be in breach of their duty of loyalty if participation in the cash pooling agreement was not in the best interests of the group company, but was forced on the group company by instruction from the parent company.
- Duty not to act *ultra vires* – if a transaction under the cash pooling agreement was not made at arm's length, the directors may have acted *ultra vires* and might be in breach of their duty to act within the company's purpose. As a general rule, the purpose of a Swiss corporation includes making profits. This could be avoided if the group company's articles of association waived the profit-making purpose by specifically permitting the grant of loans and security to parent and sister companies. Such a provision in the articles of association may also alleviate the directors' liability for breaches of their duties of care (other than the duty to protect the protected equity, which is absolute) or duty of loyalty discussed above.
- Criminal liability – the directors may be subject to criminal liability if they intentionally, or through gross negligence, prejudice the company's general pool of creditors in connection with transactions contemplated under the cash pooling agreement.

Liability of master account holder directors: The directors of the master account holder may become personally liable in an insolvency of a group company if they acted as *de facto* directors of the group company other than as appointees on the board (in which case they would be directly liable as formal directors). The criteria that could lead to a person being treated as a *de facto* director are relatively narrow. Only if a person had a direct influence similar to a formal director and, for instance, coerced the group company into becoming a member of the cash pooling agreement, or had significant influence in determining the group company's financial policies, would that person be considered to be a *de facto* director. If such a person did not act on his own, but as a representative acting on instructions from his employer, it will depend on the circumstances of the case whether he can excuse himself or will be

liable together with the company from which he received instructions or by which he was employed. If a person is considered to be a *de facto* director, then he is treated like a director of the company and personally liable like a proper director of the group company as discussed above (and unlike the master account holder's liability, discussed at section 2.1(c) below).

Listed companies: As a basic rule, the standards of directors' liability are the same for the directors of private and listed companies. However, a listed company is subject not only to general corporate law, but also to the regulations of the stock exchange where it is listed. Such regulations may have been violated by the cash pooling agreement (eg, capital maintenance requirements or obligations regarding publicity).

Cross-border issues: Swiss company law applies to all companies registered in Switzerland. Therefore, for the liability of the directors of a Swiss master account holder or a Swiss group company, it does not matter whether other parties such as the bank or other group companies are registered in other jurisdictions. Liability as a *de facto* director is determined by the law applicable to the company of which such a person is acting as a *de facto* director. Therefore, a foreign person could become liable as a *de facto* director of a Swiss group company under the rules outlined above, while it will depend on the rules of the relevant foreign law whether a director of the Swiss master account holder acting as a *de facto* director of a foreign group company will be liable.

(b) Liability of group company and/or master account holder directors in the event of insolvency of the master account holder

Liability of group company directors: If the master account holder becomes insolvent, the directors of a group company may become liable if the group company had a net claim against the master account holder that cannot be recovered. The directors' liability will be to the group company and, in particular in the event of the group company's insolvency, towards the group company's creditors and shareholders. In such case, the liability of the directors is as discussed in section 2.1(a) above. If the director of any group company acted as a *de facto* director of the master account holder, such a director will become liable as described in section 2.1(a) above as if it were a formal director of the master account holder.

Liability of master account holder directors: If the master account holder was not the parent of the group and granted its loans to a parent or sister companies and had outstanding net balances against group companies in its favour that cannot be recovered (in the case of zero or target balancing) or if security granted by the company has been executed to satisfy debt other than the company's debt, then the directors of the master account holder may become liable on the basis described in section 2.1(a) above in relation to directors of the group company. If the master account holder is the parent of the group, then typically this is not an issue, as described in section 2.1(a) above.

Listed companies and cross-border issues: It will not make a difference whether the group company is a listed corporation or a privately held corporation as discussed in section 2.1(a) above. There is also no difference in the event that the bank or its counterparty is registered in a foreign jurisdiction, as also discussed in section 2.1(a).

(c) ***Liability of group companies in the event of insolvency of the master account holder***

As a general rule, the creditors of an insolvent company have a claim only against the estate, but no direct claims against third parties such as debtors of the insolvent company. Therefore, in the event of insolvency of the master account holder, its creditors have no claims against group companies. However, in the course of the insolvency proceedings, the administration may assign claims against debtors of the insolvent company to the extent that the administration does not enforce them itself. In connection with cash pooling agreements, such claims of the master account holder against group companies could include claims arising from *de facto* directorships, claw-back and unlawful distributions. In addition, the creditors of an insolvent company may have a direct claim against the parent company if there is a reason to pierce the corporate veil. Finally, equity-like debt may become subordinated.

***De facto* director:** Any group company that acted as a *de facto* director of the master account holder could become liable for breaches of care and loyalty, as discussed above in section 2.1(a). Typically, this would be the parent company if the master account holder was a special finance entity. The concept of *de facto* directorship applies not only to individuals, as discussed in section 2.1(a) above, but also to corporations. The corporation would become liable if it had an influence on the master account holder like that of a director, for instance by forcing the master account holder to enter into the cash pooling agreement and giving instructions on how to act. The group company could become liable exclusively or together with an individual that represented the group company when acting as a *de facto* director. If acting as a *de facto* director, the group company could become liable for breaches of its duties of care and loyalty, as discussed in section 2.1(a).

Claw-back: The estate or a creditor to which a claim has been assigned can challenge any transactions made up to five years prior to an insolvency in violation of the statutory claw-back provisions. Particularly susceptible to claw-back in connection with cash pooling agreements are the following situations:

- any repayments of outstanding loans, unless all creditors were treated equally;
- the provision of additional or new security under an existing arrangement; and
- any transactions that were not made at arm's length (for instance low interest rates).

If a company starts to discriminate among creditors by delaying payment for some creditors, automatic daily sweeps under the cash pooling agreement (qualifying

as repayments of outstanding debts) may become subject to claw-back after the company has gone into insolvency.

Repayment of unlawful distributions: If the cash pooling agreements terms were not made at arm's length to the disadvantage of the master account holder, and the master account holder made payments to a parent or sister group company in violation of its protected equity, then the recipient group company would be liable to pay back any such distributions to the master account holder.

Piercing the corporate veil: The master account holder's parent company could become directly liable for the debt of the master account holder if there is a basis for piercing the corporate veil. This could be the case if the use of a separate corporate form for the master account holder was abusive – for instance, if there was a commingling of funds and functions.

Subordination of debt: While not a strict liability, a risk of loss arises where payments were made by a group company to the master account holder (assuming that the latter is a parent or sister company) if such payments could be considered to have been given in place of equity. Such debt could be treated like equity and would be subordinated to all other debt of the insolvent master account holder.

Cross-border issues: All of the above claims are linked to the location of the master account holder. If the master account holder is located in Switzerland, it is subject to Swiss corporate and bankruptcy law and, thus, the above claims are governed by Swiss law independently of where the claiming creditor or the group company is located.

(d) ***Liability of the master account holder in the event of insolvency of a group company***

In terms of liability, there is no difference between that of the master account holder and that of any group company. So the liability applying to group companies in the event of the master account holder's insolvency, as discussed in section 2.1(c) above, would apply in the same way to the master account holder in the case of a group company's insolvency.

2.2 Perspective B: bank

(a) ***Banking requirements***

Under Swiss law, no specific banking regulation applies to cash pooling agreements. Independently of whether the members of a group of companies have entered into a cash pooling agreement, the bank must treat such customers as a group for the determination of any concentration risks. The respective rules will not change with the gradual implementation of Basel III, which is starting in 2013.

(b) ***Liability of the bank in the event of insolvency of the master account holder or a group company***

In the event of the insolvency of the master account holder or a group company, the bank could become liable as a *de facto* director and also be liable to claw-back claims as discussed in section 2.1(c). Therefore, potentially, liability for the bank could arise if the bank had a direct influence over the insolvent company, or if the bank had a direct banking relationship with the company. Any liability claims are linked to the location of the insolvent company; therefore, a foreign bank may also be subject to liability.

2.3 Insolvency

(a) ***Cash pooling agreements from the insolvency practitioner's perspective***

Claims relating to a non-Swiss insolvent entity can be enforced in Switzerland only by way of recognition of the foreign main proceedings by either the competent court or the Swiss Financial Market Authority. One condition for recognition is reciprocity. Therefore, if Swiss insolvency proceedings are not recognised in the jurisdiction of the insolvent entity, then no recognition will be granted in Switzerland. If recognition is granted, then a so-called mini-bankruptcy procedure is conducted in Switzerland. The questions related to claw-back and void transactions have been addressed above (see sections 1.4(b) and 2.1(c)).

In the event of the insolvency of the bank, the bank's administrator will enforce all claims on the part of the bank against the master account holder or the group company, regardless of whether such companies are registered in Switzerland. In the event of the insolvency of master account holder, that company's administrator will enforce all claims on the part of the master account holder against the bank or the group company, regardless of whether such companies are registered in Switzerland.

In the event of the insolvency of the group company, that company's administrator will enforce all claims on the part of the group company against the bank or the master account holder, regardless of whether such companies are registered in Switzerland.

(b) ***Special rules as regards creditors of other parties to the cash pooling agreement***

The administrator of the insolvent entity – be it the bank, the master account holder or a group company – has an obligation only to the creditors of the entity administered by him. There is no formal or substantive consolidation of insolvency proceedings of several insolvent entities in Switzerland. If more than one insolvent entity is a debtor of the same claim, then a creditor cannot receive payments from such entities exceeding the total claim notified and admitted in the insolvency proceedings (ie, a creditor can never receive more than 100% of its claim).

(c) ***Dissolution/termination of the cash pooling agreement in the event of liquidation of the master account holder, a group company or the bank***

Generally speaking, the parties to a cash pooling agreement may agree contractually, within certain limits, on the consequences of the liquidation of a party. Under the

the Swiss Code of Obligations rules governing loans, the lender may withhold performance (and may also terminate the loan agreement) if the other party has become insolvent (which may occur prior to the opening of formal proceedings) after conclusion of the agreement, or even before its conclusion if the insolvency was unknown to the lender. Termination cannot be prevented by the borrower by granting security. Under bankruptcy law, an administrator can honour contracts containing reciprocal obligations. However, the counterparty may demand that security be furnished (to what extent parties to a contract may rule out the applicability of this provision of bankruptcy law is disputed). As performance by the administrator of a contract converts the claims of the counterparty into administrative expenses, it is extremely unlikely that the administrator of an insolvent bank (if the activity is permitted in liquidation) or administrator of the insolvent master account holder would invoke the right of performance.

2.4 Perspective D: regulatory

There are no regulatory requirements specifically applicable to cash pooling agreements in Switzerland.

2.5 Perspective E: tax

From a Swiss tax point of view, the following aspects should be considered in connection with cash pooling agreements. As a general rule, issues arise only in connection with physical cash pooling:

- The terms and conditions agreed between the master account holder and the group companies must be at arm's length. Terms that are not made at arm's length may trigger withholding taxes (where excessive interest rates are paid by the Swiss entity to a parent or sister company) or stamp duty (where too low interest rates are paid by the Swiss entity to a parent company, or excessive interest rates are paid by the parent company of the Swiss entity). The Federal Tax Administration issues a circular letter every year setting out accepted maximum and minimum interest rates as safe haven rules.
- As a general rule, a participation by a Swiss master account holder or group company in a cash pooling agreement is no longer considered to be an issuing of bonds by the Swiss entity and, therefore, there are no withholding tax and stamp duty consequences. This new exception does not apply if the Swiss master account holder or a Swiss group company has granted a downstream guarantee for a foreign bond. In this case, if located in Switzerland, the master account holder and the group companies may become subject to withholding tax and stamp duty depending on the number and type of outstanding credit obligations (the so called '10/20 Swiss non-banking rule').