THE LAWYER BRIEFING SWITZERLAND

UP- AND CROSS-STREAM GUARANTEES

Making guarantees

Guarantees are used widely in finance deals, but you need to consider the wording of the Swiss limitation language

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In the aftermath of the grounding of the Swiss national airline, the Swiss Federal Supreme Court passed another leading case on 16 October 2014. The focus of the decision was cash pooling, but the findings may also have an impact on intercompany lending and on up- and cross-stream guarantees.

The company at the core of the case, Swisscargo AG, participated in the Swissair group's zero-balancing cash pool. At that time, Swisscargo had cash pool claims against its sister company, which acted as cash pool leader, and claims not related to the cash pool against its indirect parent based on an intercompany loan. Swisscargo paid a substantial dividend to its sole shareholder, but only after its statutory auditors confirmed that the company had sufficient profits on its balance sheet. The dividend was paid via the cash pool. After the collapse of the group in 2001, the auditors were sued for wrongfully confirming the legality of the dividend payment.

Keeping at arm's length

One of the Swiss Federal Supreme Court's key findings was that Swiss capital maintenance provisions require that up- and cross-stream loans which are not at arm's length must be backed by corresponding freely disposable reserves. These 'freely distributable' reserves are blocked and the Swiss company's board of directors must ensure that they are not paid to the shareholders. In addition, the Swiss Federal Supreme Court confirmed that paid-in surplus capital (Agio) may be distributed as a dividend.

Guarantees are a standard security in largescale finance transactions. There is no need to address down-stream guarantees and payments by Swiss guarantors in the finance documents as specific instruments. Up- and cross-stream guarantee payments, however, must be limited to the freely distributable capital, because they may be considered as (hidden) dividend payments.

Therefore, it is widely accepted for finance documents to reflect that guarantee payments should be as high as possible, while also complying with Swiss corporate and tax law. This matter is usually addressed in a specific Swiss limitation language. In light of the Swiss Federal Supreme Court's decision, it may be worthwhile to reconsider parts of the wording of the Swiss limitation language that is frequently used in finance transactions with Swiss obligors. In particular, the issues covered in the decision relating to the requalification of the intra-group loans and the treatment of the Agio could have an impact on the wording of the Swiss limitation language.

It is currently being discussed whether or not explicit wording should be included in case equity is basically available but has to be blocked and becomes consequently unavailable for a distribution because of existing intercompany loans which are not granted at arm's length. In such a context, the blocked amount is treated like a non-disposable part of the (statutory) reserves, which is not explicitly provided for by Swiss corporate law but created by the Swiss courts. If such wording were included in the Swiss limitation language this could reduce the value of up-stream and cross-stream securities provided by Swiss guarantors.

On the one hand, further reducing the potential proceeds from the guarantee is not in the interest of the lenders. On the other, it may be more detrimental for the lenders if the board of a Swiss guarantor is afraid to honour its obligations under a guarantee, because they could incur personal liability. In this case, the board could block all guarantee payments.

A possible solution would be to avoid a detailed definition of the freely disposable amount in the Swiss limitation language and to solely refer to the Swiss guarantor's freely disposable equity in accordance with Swiss law and accounting principles. This would ensure that the board could act in compliance with Swiss law when the guarantee payment is requested, and that the proceeds from the guarantee are as high as possible.

A minority of Swiss legal authors have criticised the practice, but Agio has been distributed already. Therefore, the confirmation of the Swiss Federal Supreme Court that unpaid capital surplus may be distributed as dividends is helpful, but it does not actually increase the proceeds from up- and cross-stream guarantees and its impact on Swiss limitation language may not be as strong as expected.

How to avoid personal liability

In summary, some of the Swiss Federal Supreme Court's findings in its decision of 16 October 2014 are potentially onerous on Swiss guarantors and substantial personal liability risks remain for the board, if the new guidelines are not properly covered in Swiss limitation language.

It is not yet clear whether this decision is to be seen only in the context of the demise of the Swissair group, or whether this is the basis for general change in the way intercompany lending and up- and cross-stream guarantees in Switzerland have to be treated. For the time being, borrowers should ensure that up- and cross-stream guarantees are granted at arm's length and the definition of 'freely available amount' in Swiss limitation languages should be rather general.

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