Practical implications for directors of a financially impaired company under Swiss law

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This article tries to provide a brief overview of the problems which directors of a financially impaired company are facing under Swiss law. After discussing the directors' duties, it summarises the statutory provisions aimed at protecting the existence of the company on the one hand and the interests of creditors on the other. Finally, it concentrates on the rules to be observed in connection with attempts at arranging for a private financial restructuring in a situation where the liabilities of the company already exceed its assets.

Preliminary remarks

The purpose of this article is to provide a brief, practical overview of some principal legal considerations to be borne in mind by directors of a Swiss company in circumstances where the company is facing financial distress.

There are two main areas of relevance to the issue of personal liability of directors: first, the fiduciary duties which a director owes to their company as a director, and secondly the potential for personal liability of the directors in insolvency situations. Such liability applies not only to directors appointed as such, but also to 'de facto' directors and what are known as 'shadow directors' (ie, persons who are deemed to control and direct the actions of the company even though they are not formally elected directors).

Fiduciary duties and responsibilities of a director

Duties of loyalty and care

Under Swiss law, a director is required to act in way that he or she considers to be in the best interests of the company, applying appropriate skill and care expected of a director (duty of care). The director must place the company's interests before their own personal interests and those of others that they may represent including, with respect to a nominee director, any shareholders (duty of loyalty).

In circumstances where there are common directors to various group companies, it will be important for such directors to consider the position of each company as a separate legal entity and not in the context of (or the interests of) the group as a whole. This is because as a matter of strict law, a director of a company should exercise their powers and fulfil their duties in the best interests of that company alone. For example, confidential information obtained as a director of one company should not be disclosed in the course of a directorship of another company. When facing a financially distressed situation, independent and separate legal advice for each company should then be obtained to ensure that the directors of each company are complying with their duties.

In addition, there will often be a conflict of interest between creditors of a company that is facing insolvency. For example, a restructuring involving senior and mezzanine lenders is likely to impact negatively (and possibly leave behind) the mezzanine and second lien lenders. Although quite legitimate practical considerations may lead the directors to do a deal with a particular group of creditors, it will clearly be important for the directors to be aware of potential conflicts of interest between individual creditors and to protect their own position by obtaining proper independent legal advice and carefully considering any restructuring proposal.

The directors may find themselves in a situation where:

- the company needs to be restructured, with time often being of the essence, and such restructuring usually requires a mix of fresh capital and/or the reduction of the existing liabilities;
- the creditors want to be paid fully and are not willing to sacrifice (often significant) parts of their claims; and
- the shareholders hope that the problem can be solved without the investment of further risk capital or the dilution of their interest in the company.

Faced with such a difficult situation, directors may be tempted to resign, for example because they represent a shareholder who does not want to get involved in the envisaged restructuring, or they disagree with the majority of the board, or perhaps because they feel overburdened by the task at hand. It is important to note that resignation will not insulate the director from potential personal liability. In fact, resigning in a situation of distress might cause personal liability as the director has failed to act when the company was most in need and when the director should have contributed to the right decisions being taken.

Swiss law imposes a catalogue of non-transferable and inalienable duties on the board of directors. The most important in the context at issue here are: (i) the ultimate management of the company; (ii) the establishment of an appropriate structure and organisation; (iii) ensuring that the financing requirements are correctly identified and planned for; and (iv) that a proper financial controlling is set up. While the board of directors may delegate the preparation, the execution or the supervision of these duties to certain members or senior management, it remains responsible and personally liable for acting with due care in the selection, instruction and supervision of the individuals to whom responsibility was delegated.

Disposability

In order to carry out the above mentioned duties, the directors must ensure that they are available to consider and discuss relevant issues and make decisions. The law provides that a director must be able to attend board meetings as often as business requires. As long as everything is going well, this may be fairly easy, often requiring only monthly or even quarterly meetings. But this changes drastically as soon as the company is facing potential insolvency; now the directors must ensure permanent disposability.

Personal responsibility

In case of a breach of their duties, a director may become personally liable towards the company, its shareholders or – in the case of bankruptcy – its creditors, if the following four prerequisites are fulfilled:

- damages have been incurred;
- the director intentionally or negligently failed to perform the duties assigned to him or her by law or by the articles of incorporation of the company;
- the damages were proximately caused by the director's failure; and
- there is a lack of grounds for exclusion.

Further, as will be explained below, directors may also become personally liable where they fail to notify the court in due time of the existence of an excess of liabilities over assets in the financial statements of the company.

Company in distress – statutory protection regulations under Swiss law

General remarks

Swiss law imposes specific duties on the board of directors in order to prevent a company from wrongful trading (ie, to continue trading without equity). Interestingly, the current statutory regime does not explicitly mention failing liquidity in this context, but there is no doubt that the board must keep an eye on this vital aspect, because a lack of liquidity might expose the company to immediate bankruptcy upon request of the creditors.[1]

Loss of capital – calling a general meeting of the shareholders

If half of the share capital and the legal reserves of the company is no longer covered by assets, the directors have to immediately call a general meeting of the shareholders and propose a financial restructuring. As already mentioned, the restructuring measures almost always involve some form of cash injection, be it a formal capital increase and/or informal contributions to the equity of the company. Prima facie less painful, but often only postponing harsher remedies, is the subordination of debt. Depending on the complexity of the envisaged measures, the board will need time to put the restructuring package together. In these circumstances, it may be sensible to have a first shareholders' meeting which informs the shareholders about the current situation and the envisaged measures, followed by a second meeting which actually resolves on the proposed measures. The shareholders may only take

resolutions with respect to issues that are in their competence. Restructuring measures regarding business operations remain basically in the sole competence of the board of directors.

Unfortunately, experience shows that this first warning often does not have the desired effect, because a restructuring involves painful decisions, almost always fresh cash and, after all, there is always the hope that things may get better. And hope dies last.

Liabilities exceeding the assets – notification of the bankruptcy court

Unfortunately, matters often get worse. If there are concerns that the company's liabilities might exceed its assets, the board of directors must prepare an interim balance sheet and submit it to a qualified auditor. If the interim balance sheet shows that the liabilities of the company do indeed exceed its assets – on a going concern basis and based on liquidation values – the board of directors is obliged to notify the bankruptcy court. Upon notification by the board, the court promptly opens bankruptcy proceedings unless the board or a creditor files a motion requesting the court to postpone the opening of bankruptcy proceedings. Such motion will be granted only if there are concrete prospects of a financial restructuring.

If the motion for postponement is granted, the court may publish the postponement of bankruptcy proceedings if it concludes that publication is necessary to protect third party interests. Furthermore, the court may appoint an administrator who has to approve the resolutions of the board, or the court may order the administrator to assume full control over the financial restructuring, thereby totally disempowering the directors.

In situations where the board believes that there is still hope for a restructuring, the prompt notification of the court together with a motion seeking a court order postponing bankruptcy looks attractive. But it has weaknesses: creditors cannot be forced to accept a restructuring plan and the company is not protected from creditors seeking to enforce their claims. In addition, the board might lose control over the company. In practice, the board is therefore much more likely to seek either a private financial restructuring or to apply for composition proceedings under the Swiss Federal Act on Debt Enforcement and Bankruptcy ('DEBA').

Private financial restructuring

General remarks

We will concentrate here on the private financial restructuring. In a situation where the liabilities exceed the company's assets, the board of directors may wait before notifying the bankruptcy court only if:

- creditors of the company subordinate claims to those of all other creditors of the company to such an amount as to eliminate the excess of liabilities over assets; or
- there are concrete prospects for a prompt financial restructuring of the company.

Before we discuss the aspects of private restructuring in more detail, we need to make two brief comments on subordination and liability.

Subordination of claims

The subordination of claims is technically not a restructuring measure. It affects the balance sheet but does not reconstitute the finances of the company. However, subordination of claims buys the board more time to establish a proper financial restructuring. Subordinating claims is therefore often a first step towards a successful restructuring.

Subordination and yet wrongful trading?

As just mentioned, subordination does not restructure the finances. The directors must thus not relax and abandon their efforts to achieve a sound financial restructuring. Should the company continue to incur losses exceeding the amount of the subordinated claims, the ensuing bankruptcy might expose the directors to claims that they failed to act in a timely fashion and that such failure resulted in losses to the creditors for which the directors are held liable.

Rules of conduct for a private financial restructuring

The following rules of conduct should be observed during a process seeking financial restructuring:

Concrete prospects for a successful restructuring

Answering in the affirmative to the question as to whether concrete prospects for a financial restructuring indeed exist, requires that the board justifiably concludes that the chances of success are higher than 50 per cent.

It follows that the directors are allowed to fail: even if a restructuring should ultimately prove to be impossible, the directors will not be exposed to liability if their attempt to restructure the finances was, at the

time it was taken, the economically correct decision. Pursuant to the Swiss Federal Supreme Court, this is the case if 'the risk that compulsorily goes with any attempt of a financial restructuring is compensated by the economical value of the chance for a successful financial restructuring'.[2]

Time-frame

The law does not provide for a specific time-frame within which a financial restructuring must be successfully completed. While the prevailing doctrine is of the opinion that the restructuring must be completed within four to six weeks,[3] some authors suggest the time-frame could be up to 60 days.[4] However, in our experience, restructurings tend to take considerably longer, particularly where negotiations involve several significant creditors and bank syndicates of senior and mezzanine lenders. In such situations, the directors will have to assess the progress and the chances to complete a successful restructuring at regular intervals. The issue of wrongful trading at Swiss law tends to be strongly fact specific and the approach of the law places a great deal of emphasis upon the record, namely whether directors considered the point on a regular basis and recorded their decision making by reference to up to date financial information and professional advice.

Conduct during the restructuring

Independent of the question as to whether efforts for a restructuring should be continued beyond the time-frame discussed above, the board must constantly monitor the restructuring process. Whenever it should realise that there are no realistic prospects anymore, it must react immediately and notify the court, even if the time-frame is not yet exhausted.

In order to be able to do so, the directors are well advised to prepare the documentation required for the notification of the court in parallel to the ongoing restructuring efforts. If the directors fail to do so and consequently incur delays in notifying the court, the risk of wrongful trading increases daily. Letting the creditors and shareholders know that the bankruptcy filing is being prepared usually has the welcome side-effect of keeping all parties involved focused on completing the restructuring swiftly.

When considering a restructuring proposal, the directors must be aware that in certain circumstances a court may be able to set aside transactions entered into by the company which has subsequently gone into bankruptcy proceedings. Apart from a number of defined 'voidable acts', there exists a catch-all provision[5] stipulating that all transactions can be set aside which the company carried out during the five years prior to the bankruptcy or the granting of a moratorium with the intention, apparent to the other party, of disadvantaging its creditors or of favouring certain creditors to the disadvantage of others. In recent decisions,[6] the Swiss Federal Supreme Court was quick to set aside transactions arguing that creditors had not been treated equally, even in cases where the assets of the company had not been diminished by the transactions at issue.

As we have seen above, restructuring efforts might force the directors to treat creditors differently in order to satisfy their foremost duty: looking after the interests of 'their' company. However, if the risk is high that transactions approved by the board will be set aside, will this expose the directors to potential personal liability for breach of their duties to the company? Although this question is currently being debated in Switzerland, we believe that the setting aside of a transaction can not, in itself, have a prejudicial effect on potential responsibility claims. The directors owe their duties of care and loyalty primarily to the company, not to its creditors. Personal liability of the creditors requires a finding that the directors did not act in the interest of the company. As already mentioned, the interest of the company might actually require the directors to treat creditors differently. A liability for breach of the director's duties is thus conceivable only in cases where the directors were (or should have been) aware that bankruptcy was inevitable and that there was no reasonable prospect for a successful restructuring any more.

As the line between justifiable pursuit of further restructuring efforts and the conclusion that the restructuring has become unrealistic might be fine, it is crucial that the directors constantly monitor the restructuring process, discuss the prospects and take minutes about the contents of their discussions and the reasoning for continuing the restructuring. Taking minutes is important because the directors are entitled to a review of their acts and omissions from an ex-ante perspective. As any court conducting such a review will do so knowing that the restructuring has failed, there is the risk that this knowledge of the failure will result in the court considering the decision-making process more critically. In such circumstances, it is crucial that the directors can produce evidence showing on which basis they came to their conclusions at that time.

Conclusion

The directors must look after the interests of their company; the interests of the creditors are secondary. Conflicts of interest must not interfere with the decision-making process. The more critical the situation, the more important it is to have high disposability of the board members. The board must ensure that an efficient financial controlling mechanism is set up to receive reliable data promptly. If the company has lost more than half of its equity and statutory reserves, the board should call a general meeting of shareholders and use its best efforts to arrange for a sound restructuring at this stage. Should this fail and the company be confronted with an excess of liabilities over assets, the board will have little time to achieve what should have been achieved at an earlier stage. In any event, it must take decisions on an informed basis, carefully evaluating the proposed measures with the help of external professional advice and record its reasoning in written minutes. If the restructuring becomes unrealistic, it must react immediately and notify the bankruptcy court. To be able to do so requires that the board prepare the filing already in advance in parallel to the restructuring efforts.

Notes

1 Intended amendments to Swiss corporate law which are currently being discussed in parliament include a new provision whereby the board of directors will be obliged to take measures in case that: (i) the loss of equity of the company reaches certain levels, or (ii) the liquidity of the company is failing.

2 Swiss Federal Supreme Court Decision No 4C.366/2000, E 5b aa.

3 Based on older decisions of the Swiss Federal Supreme Court regarding the personal liability of directors.

4 Based on the most recent decisions of the Swiss Federal Supreme Court regarding the personal liability of the company's auditors.

5 Article 288 of the Swiss Federal Act on Debt Enforcement and Bankruptcy.

6 Swiss Federal Supreme Court Decisions Nos 134 III 273, 134 III 452, 134 III 615, 135 III 265.

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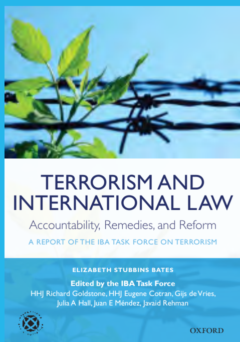

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