REPRINT FINANCIER WORLDWIDE

JUNE 2015

FINANCIER WORLDWIDE corporatefinanceintelligence

MERGERS & ACQUISITIONS

Cash pooling in Switzerland – impact on financings and M&A transactions

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Cash pooling, which allows companies to combine their credit and debit positions from various accounts into one account, has become common for multinational groups in the business world of today. In Switzerland, company groups often rely on cash pooling solutions to optimise their financial management. Such cash pooling solutions include a flow of funds in the group. From a legal perspective, particularly interesting are the cash flows from a subsidiary to its parent company, also referred to as 'upstream', or from one subsidiary to another subsidiary, also referred to as 'cross-stream'.

According to Swiss law, these types of cash flows can, in principle, either be qualified as a loan, a dividend distribution or the repayment of equity to the parent company. While such cash flows are basically unproblematic if qualified as loans, the classification as a dividend distribution, as well as the qualification as repayment of equity, lead to legal formalities which have to be observed and brought in line with the respective legal requirements.

An important criterion for the qualification of an intra-group cash pool payment as a genuine loan arrangement is that such a loan is granted under the

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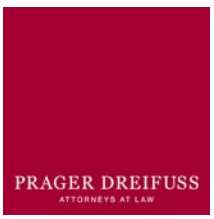

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same conditions as it would have been granted to a third party, i.e., on an arm's length basis – this is also referred to as an 'arm's-length test'. In Switzerland, a recent decision of the Swiss Federal Supreme Court puts limits to the use of cash pooling by setting very high, but somewhat undetermined, standards to pass the arm's-length test.

In this regard, it seems noteworthy that with the conditions set by the Supreme Court, many existing cash pools involving Swiss group companies could violate Swiss law. Therefore, the decision by the Supreme Court will have a significant impact for company groups in Switzerland. It has already become a hotly debated subject in the Swiss legal community.

In the first part of our article we summarise, briefly, some of the main points of the decision of the Supreme Court. In the second part we try to outline the extent to which the aforementioned decision might have an influence on financings and M&A transactions involving Swiss group companies. In the final section we try to bring the key points of the first two sections together and indicate which points have been criticised or welcomed by the Swiss legal doctrine.

Cash pooling – decision of the Supreme Court of 16 October 2014

The factual background of the case at hand can be summarised – without going into too much detail – as follows: Company B was a Swiss subsidiary of Group C and participated in the group's zero balancing cash pool, together with several other group companies. Company B had short-term receivables due from the group's parent company and a claim against the cash pool leader in a total amount of CHF 23.7m as of 31 December 2000. At the time the balance sheet of Company B showed *inter alia* accumulated profits of more than CHF 29m. The statutory auditors confirmed that a dividend distribution proposed by the board of directors in the amount of CHF 28.5m was in compliance with both Swiss law and the articles of association of Company B. After having received this confirmation, the aforementioned dividends were distributed to the sole parent company of Company B. After the collapse of Group C in September 2001 the auditors were sued for wrongfully confirming the legality of this dividend distribution – according to Swiss law, auditors are liable both to the company and to the individual shareholders and creditors for the losses arising from any intentional or negligent breach of their duties.

On 20 January 2014, the Zurich Commercial Court had decided that the auditors were liable for violating Swiss law because of its confirmation regarding the dividend distribution in the amount of CHF 28.5m. The Zurich Commercial Court had ruled that the auditors had to pay an amount of around CHF 4.3m, plus interest, to Company B. According to the Zurich Commercial Court, the auditors should have rejected the dividend payment at least in the amount of Company B's intra-group claims because these did not pass the arm's-length test. Therefore, they were interpreted by the Zurich Commercial Court as a hidden equity repayment. Consequently, so the reasoning of the court went, these intra-group claims would have been unavailable for a later dividend payment.

The decision of the Zurich Commercial Court was mostly upheld by the Supreme Court in its decision of 16 October 2014. In particular, the following points of the Supreme Court decision are noteworthy. First, while the Zurich Commercial Court had come to the conclusion that the intra-group loans do not pass the arm's-length test using different criteria – in particular it had argued, amongst others, that no specific written loan agreements

had been concluded (the general cash-pooling agreement of the group was not considered by the Zurich Commercial Court), no security had been granted, no regular amortisations had been stipulated and that the supervision of the debtor's credit-worthiness had been insufficient – the Supreme Court argued that in the case at hand not all the criteria brought forward by the parties (and analysed by the Zurich Commercial Court) are necessary to determine if the intra-group loan passes the arm's-length test or not. The decisive criterion for the Supreme Court was that the intra-group loans were granted completely unsecured and that Company B had allegedly not examined the debtor's credit-worthiness when entering into the loans. The Supreme Court held that granting of intra-group loans in a total amount of CHF 23.7m on a completely unsecured basis does not pass the arm's-length test.

The Supreme Court held that intra-group loans that are not granted on an arm's-length basis do not by themselves qualify as a violation of the prohibition of repayment of capital contributions according to Article 680 para. 2 of the Swiss Code of Obligations (CO); however, they have an influence on the freely disposable equity of a company for dividend distribution, as such freely disposable equity has to be reduced by an amount equivalent to the intra-group loans not granted at arm's-length, i.e., a double use of funds is not permitted in the same business year. In other words, such funds are blocked and not available for a dividend distribution. However, a violation of the prohibition of repayment of capital contributions occurs if such loans exceed the freely disposable equity.

The Supreme Court even raised in one sentence of its decision the question of whether the participation in a cash pooling solution, whereby the participating Swiss company disposes over its liquidity (a so-called zero cash-pooling system), may ever pass the arm's-length test, but did not decide on this issue. Further, the Supreme Court ruled that the paid-in surplus, also called 'agio', may be distributed as dividends, under the same conditions as the other general reserves (Allgemeine Reserve). Thereby, the Supreme Court made clear that the agio is not subject to the strict rules protecting the paid-in nominal share capital. In this respect, the Supreme Court overturned the decision of the Zurich Commercial Court.

As mentioned above, the Supreme Court mostly upheld the verdict of the Zurich Commercial Court and concluded that the auditors are liable according to Article 755 CO. The case was sent back to the Zurich Commercial Court for the recalculation of damages due by the auditors to Company B.

Possible impact on financings and M&A transactions?

In financings of multinational groups, quite regularly the situation is as follows: the actual borrower is not a Swiss entity but the existing Swiss entities of the group, usually subsidiaries, act as guarantors under the respective facility agreement.

In such a scenario, the security interest granted by a Swiss security provider has to be limited according to mandatory Swiss corporate law to the security provider's total equity (including retained earnings and current net profits) minus firstly the total share capital and secondly the statutory reserves (including reserves for its own shares and revaluations as well as agio, but excluding the unrestricted, i.e., freely disposable, portion of the general and statutory reserves). The wording included in a facility agreement in such a case is usually referred to as Swiss limitation language. Obviously the exact wording

of the Swiss limitation language varies somewhat from case to case. However, in essence (and according to mandatory Swiss law) it comes down to the above described formula.

In the meantime, and because of the decision of the Supreme Court described above, discussions have started within the legal doctrine in Switzerland whether or not the Swiss limitation language has to be adapted. In particular, the issues covered in the decision relating to the re-qualification 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 covering the case that equity (in the case at hand mainly in the form of profits) is basically available, but has to be blocked and becomes consequently unavailable for a distribution because of existing intra-group 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 newly-created by the Swiss courts (the Supreme Court mentioned a blocked reserve (gesperrte Reserve)). If such wording were included in the Swiss limitation language this could substantially reduce the value of upstream and cross-stream securities provided by Swiss guarantors. As financings and M&A transactions often go hand in hand, it seems quite clear that if upstream and cross-stream securities provided for by Swiss guarantors were indeed to lose value because of the decision of the Supreme Court, and if this were to lead to less financing available for M&A transactions, also the latter would (indirectly) suffer from the above described decision. The decision of the Supreme Court only clarifies that the agio (as part of the general reserves) can be distributed as dividends, as soon as the legal requirements are met and consequently forms part of the freely disposable portion of the general and statutory reserves mentioned above. Therefore, this should not have an influence on the Swiss limitation language.

If the Supreme Court were to conclude, in a future decision, that intra-group loans granted within zero cash-pooling systems do generally not pass the arm's-length test and are therefore qualified as equity payments (and hence limiting dividend distributions as well as the value of upstream and cross-stream guarantees given by Swiss companies) this could adversely influence the environment in Switzerland for financings and business transactions as a whole for multinational groups. However, for the time being it is too early to look at such a scenario in further detail.

Comment regarding impact of decision for Swiss companies

To summarise, we may note that the clarification of the Supreme Court regarding the qualification of the agio goes along with (probably) the majority view in Swiss doctrine and ends a long lasting controversy. Apart from this welcomed clarification, the decision of the Supreme Court has been criticised in several publications. In particular, it has been argued that the decision does not reflect the criteria established by the legal doctrine regarding the arm's-length test and that it (together with the mostly upheld decision of the Zurich Commercial Court) sets overly onerous standards for the characterisation of an intra-group payment in the cash pool as a legally permitted intra-group loan. Further, as the Supreme Court – by relying in the case at hand (mainly) on the argument that the intra-group loans were granted completely unsecured – refrained from giving clear criteria how intra-group

loans can pass the arm's-length test it has to be noted that this decision leads in this regard to more ambiguity because of its *obiter dictum* regarding the participation for Swiss companies in a zero balancing cash pool being questionable in itself. Consequently, a decision by the Supreme Court clarifying its position in further detail would be welcomed.

Clearly, after the decision of the Supreme Court that substantial personal liability risks remain – as the case at hand showed – for auditing companies, as well as board and management members, it will thus be important to observe the guidelines presented by the recent Swiss court decisions.

For the time being it remains to be seen whether, and to what extent, the decision of the Supreme Court will have an impact on financings and M&A transactions involving Swiss group companies. In particular, it will be interesting to observe whether the Swiss limitation language section will be changed in future transactions. Such a change could lead to a reduced value of upstream and cross-stream guarantees given by Swiss companies and hence influence financings and indirectly also M&A transactions. ■