

When in distress

Alexander Vogel, Wolfgang Muller and Debora Kern of Meyerlustenberger Lachenal explore the restructuring options available to Swiss companies in times of difficulty

Swiss corporate law provides that the board of directors of a severely financially troubled company has to take specific formal measures to address its difficulties. These duties are inalienable and non-transferable, whether for stand-alone companies or within corporate groups. The type of measures depends on the level of losses incurred compared to the affected company's equity capital. Swiss law differentiates in particular between the status of (i) capital loss (partial loss of registered equity capital) and (ii) overindebtedness (complete loss of equity or negative equity).

If the last annual accounts show that half of the share capital and the legal reserves are no longer covered by assets (when there has been partial loss of the registered equity capital) Swiss corporate law obliges the board of directors to call a general meeting of shareholders without delay in order to propose a financial reorganisation of the company (article 725 paragraph 1 of the Swiss Code of Obligation (CO)).

In the case of a substantiated concern of overindebtedness, (that is, there is a serious concern that the company might have negative shareholder equity and, thus, the aggregate liabilities of the company exceed its aggregate assets) the board of directors is obliged to have an interim balance sheet prepared and audited by an accredited auditor (article 725 paragraph 2 CO). If the interim balance sheet confirms the negative equity both on a going concern basis and on a liquidation scenario basis, the board of directors is obliged to notify the competent bankruptcy court, unless creditors of the company agree to subordinate sufficient amounts of their claims to those of all other company creditors in order to fully compensate such negative equity (plus any losses to reasonably be expected in the foreseeable future).

It is therefore important for the board of directors of a Swiss company in distress to have precise information at hand at all times. The equity situation of the company must be monitored carefully and in the case of negative developments, the board of directors must ensure early enough that interim reports (including interim balance sheets) are established to be able to initiate adequate measures and discharge statutory duties. In a group of companies, the board of the parent company has on the one hand to ensure that it receives adequate information to be able to monitor the financial situation of the holding company and the group on a consolidated basis, since the board of the parent is responsible according to court precedent for the financial monitoring and planning of the group as a whole. On the other hand, the board of the parents has to consider very carefully whether a capital injection into a financially troubled subsidiary is advisable or not, since according to a recent decision by the Swiss Federal Supreme Court, the transfer of liquidity to a subsidiary may be considered to be negligent if at the same time serious steps of restructuring are not initiated at the subsidiary level, which ensure a realistic chance of a successful turn-around and eventually a repayment of the amounts transferred to the ailing subsidiary. If the members of the board of directors of a company incorporated in Switzerland do not

“A board of directors has at its disposal a wide variety of restructuring possibilities”

comply with these statutory duties, they are personally liable for any additional losses that the company suffers from when the board should have ceased its commercial activities and notified the bankruptcy court up to the time when the bankruptcy court was actually notified.

Below, the different restructuring measures available to the board of directors of a Swiss company in distress will be discussed. The focus will, in particular, be on restructuring measures with regards to the capital of the company.

Restructuring measures

The term restructuring has not been defined by Swiss corporate law. However, the Swiss Federal Supreme Court has defined it as the financial recovery of a company (ATF121 III 420), that is, measures which aim to secure the financial survival of the company and prevent it from being (involuntarily) liquidated.

There are a variety of restructuring measures, including financial, management and organisational options. Before implementing any radical restructuring measures, the board and the management of a financially troubled company should carefully review all possible alternatives to restruc-

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ture the company or to recapitalise its balance sheet, with regard to both debt and equity. It is further advised to start to evaluate possible fall back scenarios as soon as possible and to get an adequate number of specialists – either in-house or consultants – involved, since time is always a very critical factor in a restructuring process, particularly in the case of a group of companies with numerous (complex) intra-group transactions and trading relationships.

Liabilities

Possible measures on the liability side of the balance sheet include the restructuring of existing debt by extending its maturity, changing the financial and other covenants allowing for more flexibility for the management to plan and implement a turnaround plan, amending the collateral package, a subordination of existing debt or the taking up of new subordinated loans, and debt/equity swaps (conversion of existing debt into equity). A debt/equity swap – as well as the raising of new share capital from new shareholders – is likely to require the prior restructuring of the equity structure of the company, either by decreasing the existing share capital or by introducing preferred shares



About the author

Dr Alexander Vogel was admitted to the bar in Switzerland in 1992 and the New York Bar in 1994. He holds a degree from the University of St Gallen Law School and a master's from Northwestern University School of Law.

He practises in the areas of corporate law and M&A, leveraged transactions, corporate finance/banking, bankruptcy law, capital markets and real estate. He has recently been involved in various national and cross-border acquisitions and acquisition financing structures for Swiss and international clients. He has advised clients and creditors in work-out negotiations and cross-border insolvency procedure, and advised on

defence strategies for companies and groups in financial distress.

Vogel is a member of the board of directors of several Swiss companies, and is involved in several research projects with the Swiss National Research Fund in the area of national and international corporate law. He speaks German, English and French.

Contact information

Alexander Vogel
Meyerlustenberger
Lachenal

Forchstrasse 452
Postfach 1432
8032 Zürich, Switzerland
T +41 44 396 91 91
F +41 44 396 91 92
W: www.mll-legal.com



About the author

Dr Wolfgang Muller is a partner in Meyerlustenberger Lachenal's capital markets/corporate group. He specialises in capital markets, in particular equity capital markets and M&A.

Muller graduated from the University of Zurich and obtained his MBA from the Australian School of Business, the University of New South Wales, Sydney, and the University of Michigan Business School and Ann Arbor, USA. He is a member of the Swiss Bar and the International Bar Association.

Contact information

Wolfgang Muller
Meyerlustenberger
Lachenal

Forchstrasse 452
Postfach 1432
8032 Zürich, Switzerland
T +41 44 396 91 91
F +41 44 396 91 92
W: www.mll-legal.com

or hybrid instruments for the converting debt holders, or a mixture of both. The reduction in capital followed immediately by an increase in capital (a capital cut or accordion recapitalisation) will be discussed in detail below.

Assets

On the asset side, possible measures include an aggressive management of the company's working capital (for example, decrease of inventory, strict payment terms, and strict management of accounts receivables), sale and lease back transactions and divestiture of non-operative assets or non-strategic or non-vital parts of the business (such as divisions, subsidiaries, and real estate). While liquidation or partial liquidation is always an option of last resort for an ailing company, it is usually the sale of all or parts of the business as a going concern that is likely to maximise the value for all stakeholders, in particular where discontinuing and liquidating the business or part of it is likely to lead to significant liquidation costs (such as severance payments, pension obligations, and rental agreements) or contingent liabilities (such as vacating of production sites, and damage claims under broken agreements).

Reduction and increase of capital

Reducing the capital and allocating it to the reserves, followed by an increase in capital immediately after, can be a means of restructuring. Article 732 paragraph 5 CO states that the share capital may be reduced to below SFr100,000 (\$110,000) as long as it is immediately replaced by fully paid in capital in the amount of at least SFr100,000. When the capital has been reduced to zero, it is considered as a capital cut (accordion recapitalisation).

When the capital is increased following a capital reduction, the rules with regards to amending the articles of association as well as an auditors report according to the Code of Obligation of an ordinary capital reduction, in principle, do not apply. However, for the increase in capital, the normal legal grounds have to be taken into consideration and abided by. Thus, the shareholders' meeting initially decides on a capital decrease followed by a capital increase. Immediately after, the board of directors executes the capital increase.

Capital cuts

A capital cut according to article 732a CO exists when the capital of a company is reduced to zero and immediately increased again for the purpose of restructuring a company. Thus, the capital is replaced by new capital. The membership rights of the current shareholders lapse at the time of the reduction and the issued shares must be cancelled. The current shareholders, however, have a subscription right that may not be withdrawn from them.

A capital cut to zero is only possible when it serves restructuring purposes and may only be decided upon by the shareholders' meeting when the company capital is objectively completely lost. Thus, a need to restructure as in the case of overindebtedness according to article 725 CO must lie at hand. However, the necessity to restructure the company on its own is insufficient to underpin a capital cut to zero as a measure with a restructuring purpose according to article 732a CO. When a company is overindebted, the short-term purpose of a restructuring measure is to place the company in such a position as to avoid having to inform the judge (according to article 725 paragraph 2 CO) irrespective of whether claims are subordinated. This is the

minimum target that should be achieved by the accordion recapitalisation. Should the increase in capital be insufficient to remove the overindebtedness, a restructuring purpose (as required by article 732a CO) may nonetheless lie at hand when further restructuring measures are planned to remove the overindebtedness.

Therefore, for the shareholders' meeting to decide on an accordion recapitalisation for the purpose of restructuring a company, the overindebtedness must either be removed or further restructuring measures must be decided upon. These, together with the capital increase must provide reasonable prospects for a sustainable restructuring of the company. The board of directors must establish a restructuring plan which relieves it of the duty to inform a judge irrespective of whether claims are subordinated. Additionally, it must inform the shareholders' meeting of further restructuring measures which are planned in order to achieve the restructuring purpose. Without this information, the shareholders cannot evaluate whether the reduction in capital followed by an immediate increase in capital contains a restructuring purpose. Furthermore, shareholders cannot evaluate whether they want to make use of their preemptive right and carry on participating in the company.

The prerequisites for the application of article 732a CO as discussed above have been laid down clearly in the decision issued by the Swiss Federal Supreme Court on February 13 2012.

Decision by the Swiss Federal Supreme Court (ATF 138 III 204)

Initially, X Holding AG (the Company) had a share capital in the amount of SFr500,000 divided into 500 shares with a nominal value



About the author

Debora Kern was admitted to the bar in Switzerland in 2011 and holds an MLaw from the University of Fribourg. Her practice covers corporate law and M&A, notarial services, and capital markets.

She recently worked on: the restructuring of existing financing transactions for banks as well as borrowers; loan and securitisation contracts plus all related documents; and various national and cross-border acquisitions for Swiss and international clients. She speaks German, English and Afrikaans.

Contact information

Debora Kern

Meyerylustenberger
Lachenal

Forchstrasse 452
Postfach 1432
8032 Zürich, Switzerland
T +41 44 396 91 91
F +41 44 396 91 92
W: www.mll-legal.com

of SFr1,000 each. Three shareholders each held 10% and the majority shareholder held 70% of the shares in the Company. These four shareholders were the members on the board of directors since the Company's incorporation. One of the minority shareholders was also the controller of the Company and so had to supervise and implement the business plans.

At the end of 2006 the board of directors would have had to notify the court (based on article 725 paragraph 2 CO) due to an impending overindebtedness. The majority shareholder subordinated his claims out of a loan to the extent of the capital deficit and thus, the court did not have to be notified.

An extraordinary shareholders' meeting was called for February 18 2008 so that the shareholders could decide on a capital reduction followed by an immediate increase in capital. At the shareholders' meeting no information of further restructuring measures was provided, although one of the minority shareholders had requested such information in writing. The shareholders' meeting then resolved to reduce the capital to zero and immediately increase the capital by SFr500,000. Immediately after, the board of directors executed the increase in capital and passed a resolution regarding the ascertainment of the ordinary capital increase.

One of the minority shareholders demanded from the district court that the resolutions passed at the extraordinary shareholders' meeting should be declared void or annulled based on article 706 CO. The district court and, then the cantonal court rejected the appeal by the claimant. The claimant then filed an appeal to the Swiss Federal Supreme Court.

In the case the Company was in a situation of overindebtedness. Therefore, the shareholders' meeting could rightfully decide on a capital cut according to article 732a CO.

However, the reduction in capital followed by an immediate increase in capital did not lead to a removal of the overindebtedness of SFr4 million – it only alleviated the overindebtedness to some degree. The board of directors was obliged to inform the shareholders' meeting of further restructuring measures, which it did not do. Therefore, the shareholders' meeting could not evaluate whether the accordion recapitalisation contained a restructuring purpose as required by article 732a CO. Additionally, the shareholders could not take a decision regarding the use of their pre-emptive rights and further participation in the company as they were insufficiently informed. The prerequisites according to article 732a CO were

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not fulfilled, resulting in the resolution being unlawful.

Since the resolutions passed violated the law, they could be appealed within two months. One of the minority shareholders launched an appeal within the given timeframe. The Federal Supreme Court then retrospectively annulled the resolutions passed by the shareholders' meeting. This was effective for and against all shareholders. The ascertainment by the board of directors in the form of a public deed, which followed the resolutions passed by the shareholders' meeting, no longer had any ground and thus were invalid (according to article 714 CO).

A duty of care

A board of directors has at its disposal a wide variety of restructuring possibilities, which it should implement in a timely fashion. If a situation of overindebtedness exists, the reduction in capital followed by an immediate increase in capital, according to article 732a CO, may be considered. However, the board of directors must inform the shareholders comprehensively of this mode of restructuring if the capital cut does not remove the overindebtedness directly. This is necessary so that the shareholders can decide whether the restructuring measures are sustainable and whether they want to make use of their pre-emptive rights. The Federal Supreme Court lay down very clearly in its ruling how far the duties of the board of directors go in such a case.