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- recapitalisation issues (capital increase, debt-equity swaps, rescue companies, ring-fencing)
- acquisition of business entities or assets from companies with high risk of insolvency
- legal aspects of dealings with counterparties in financial distress (set off, netting, termination rights, right to request security, etc.)
- advice on all aspects of debt collection, debt enforcement, bankruptcy and insolvency law

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Statutory framework for companies in distress

Alexander Vogel, Wolfgang Müller and Daniel Schoch of meyerlustenberger outline the Swiss insolvency regime

Swiss corporate law provides that the board of directors of a financially troubled company incorporated in Switzerland has to take specific formal measures to address these problems. The type of measures depends on the level of losses incurred compared to the company's equity capital. Swiss law differentiates in particular between the status of: (i) capital loss (partial loss of registered equity capital) and; (ii) over-indebtedness (complete loss of equity or negative equity).

In the case of a partial loss of the registered equity capital (if, according to the last annual accounts, half of the equity capital and the legal reserves are no longer covered by assets), Swiss corporate law obliges the board of directors to call a general meeting of shareholders in order to propose a financial reorganisation of the company.

If there is a serious concern that the company might have a negative shareholders' equity (that 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. 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 bankruptcy court. This is unless sufficient creditors of the company are willing to subordinate their claims to those of all other creditors of the company to cover the amount of such negative equity (plus the amount of foreseeable losses in the short term).

It is important to note that the test described above is a balance sheet test and does not (directly) take into account whether the company is insolvent or not. Even when the company is solvent but has a negative equity, the obligation to notify the bankruptcy court is triggered. Conversely, if the company is insolvent, it is obliged to establish its interim balance sheet based on liquidation values only and is not allowed to use going concern values anymore, which leads in most cases to a negative equity.

Therefore, the board of directors of a Swiss company in distress has to carefully monitor the equity situation of the company and, in the event of negative developments (cash flow and profit margins from operations are decreasing, material devaluation of its assets due to market changes and the like) early enough ensure that interim reports are established to be able to timely discharge its statutory duties. The members of a board of directors of a company incorporated in Switzerland that do not comply with these statutory duties are personally liable for any additional losses which occur due to the failure to comply with the statutory duties.

Therefore, the board of an ailing company is well advised to address a possible restructuring and to get the necessary specialists involved well before the equity status of the company reaches a critical level. This is a very important variable in order to allow the board of directors and the management to consider and review all potentially viable alternatives to restructure the company and/or to recapitalise its balance sheet.

At an early stage, potential measures may still include:

- a recapitalisation with a lender who is willing to provide subordinated loans;
- a corporate finance or M&A process that leads to new equity capital through a capital increase with or without a change of control;
- the divestiture of parts of the business; or
- a sale of non-operative assets which will generate both gains and liquidity or ultimately the sale of the company as a whole.

Out-of-court solutions are almost always preferred and, if still possible, in general are by far the most efficient way to restructure a company in distress.

In-court restructuring

The consequence of a notification to the bankruptcy court is that bankruptcy procedures will be initiated. However, on request of the board of directors or a creditor of the company, the court can postpone the initiation of bankruptcy procedures if the court is presented with an (out-of court) restructuring pro-

“Even when the company is solvent but has a negative equity, the obligation to notify the bankruptcy court is triggered”

“With the opening of bankruptcy proceedings, the company’s business activities are immediately and irreversibly stopped”

positional, which it considers to be viable and to have sufficient chances to succeed. In this case, the judge has to take appropriate measures to preserve the value of the company’s assets. He can also appoint a commissioner or administrator and either limit the powers of the board of directors, in particular with regard to a disposal of assets, or make its decisions subject to the approval of the commissioner. The powers and duties of the commissioner have to be fixed by the court. The granting of a deferment to initiate a bankruptcy procedure is only published to the extent necessary to protect third parties.

With the opening of bankruptcy proceedings, the company’s business activities are immediately and irreversibly stopped and the company loses its right and ability to dispose over its assets. In most cases a state official is appointed as bankruptcy trustee. In complex cases a private bankruptcy trustee (a law firm or accounting firm) can also be elected by the creditors if at the first creditors’ meeting a sufficient number of creditors are represented. The bankruptcy trustee has to establish an inventory of the assets of the debtor company and to start the realisation of such assets. Since the realisation of the company’s

assets is subject to very stringent rules, more often than not the debtor company’s assets are realised in a suboptimal manner.

Alternatively, the board of directors (or one of the company’s creditors) has the option to apply for a moratorium to be followed by a court-approved restructuring scheme. The moratorium suspends or prevents most debt enforcement proceedings against the company.

Such a grace period allows the company to work out under the supervision of a court appointed commissioner or administrator a proposal to either:

- Restructure its debt by entering into a debt restructuring agreement providing for a partial waiver of its debt with the result that the company regains the right and legal capacity to continue its business; or
- Wind down its business in a considerate way under a debt restructuring agreement providing that the company’s assets are sold off by a liquidator elected by the creditors and supervised by a creditors’ committee under far more flexible rules than in ordinary bankruptcy proceedings.

Further, as opposed to bankruptcy proceedings, the moratorium allows for a (limited) continuation of the company’s business activities, which avoids the immediate loss of value caused by the interruption of the company’s business operations inevitable in bankruptcy procedures. In order to protect the interest of creditors, most business decisions of the debtor company are subject to approval by a court-appointed administrator. Further, as opposed to a deferment of the bankruptcy procedures described above, the granting of the moratorium is published by the court.

In Switzerland, the first alternative (a restructuring agreement providing for a partial waiver of debt) is rather the exception than the rule. Under the second alternative, a creditor supervised liquidation of the company, which is by far the more often chosen type of restructuring, it is possible to rescue viable parts of the company’s business that are usually span

off into a new legal entity and subsequently sold.

The rules applicable in debt restructuring procedures also facilitate the sale of assets located abroad. However, in order to apply for a moratorium, the company must show that certain conditions are met. In particular, the company must have sufficient unencumbered assets to cover all privileged claims (in particular the claims of employees as well as social security contributions due) and any new debt to be created by the company from the time the moratorium is granted by the court.

The petition for the granting of a moratorium has to be accompanied by various supporting documents. This includes the draft of the debt restructuring agreement, certain corporate documents, detailed accounts and bank statements for the last business years, up-to-date trial balance and status of assets, up-to-date lists of creditors and debtors, list of employees and salaries, and, to the extent required, copies of material agreements. Therefore, if the board of a distressed company intends to submit a petition, it needs to allow enough time for the preparation of the petition, in particular in view of the fact that the petition requires careful planning for the period of the moratorium.

The bankruptcy court may grant a provisional moratorium after the filing of a petition for a moratorium (by either the debtor or a creditor) for of up to two months. The court can set the duration of the (final) moratorium for a period of four to six months. Further, the moratorium may be extended in complex cases up to twenty-four months.

Within this timeframe, a final debt restructuring agreement needs to be worked out and submitted to the creditors for approval. Such approval requires either a majority of the creditors holding at least two thirds of the aggregate claims or a quarter of the creditors holding at least three quarters of the aggregate claims. In addition, the agreement must be ratified by the court. Once approved by the creditors and ratified by the court, it takes effect with respect to all



About the author

Qualified

Admitted to the bar in Switzerland in 1992 and admitted to the New York Bar in 1994.

Degrees

University of St. Gallen, Law School (degree) and Northwestern University School of Law (masters).

Areas of practice

Corporate law and M&A, leveraged transactions, corporate finance/banking, capital markets, real estate and bankruptcy law.

Recent transactions

Acquisition finance to core shareholders of a listed company in an amount exceeding CHF1 billion; acquisition finance to core shareholders of an investment company in an

amount exceeding CHF0.8 billion; various national and crossborder acquisitions for Swiss and international clients; several tender offers on Swiss listed companies; and advice on defence strategies for listed companies in Switzerland.

Professional associations/memberships

Member of the board of directors of several Swiss companies, including companies active in the areas of financial services, consulting, and real estate. Vogel is also a member of the Swiss Notaries Association, a public notary in the Canton of Zug and is involved in several research projects with the Swiss National Research Fund in the area of national and international corporate law.

Languages

German, English and French.

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unsecured creditors and puts an end to all ongoing debt enforcement proceedings. If the restructuring agreement is not approved and ratified or if the moratorium expires, any creditor may request an immediate initiation of bankruptcy proceedings.

Clawback provisions

As in most jurisdictions, the trustee in bankruptcy (or under certain conditions the creditors) may bring a restitution claim against third parties who have benefited from unfair preferences or fraudulent transfers by a debtor prior to a seizure of assets. The same can be done for if this happens prior to the opening of a bankruptcy or in-court debt restructuring procedure. In the latter case, this can occur to the extent that the debt restructuring procedure fails or results in the liquidation of the debtor company.

If the claim succeeds, the third party must return the assets formerly belonging to the debtor company to the bankruptcy trustee or the liquidator under the restructuring scheme. In severe cases, the responsible officers and directors of the debtor may also be subject to criminal prosecution for fraudulent bankruptcy. The third party obliged to restate in turn has a claim against the bankruptcy estate which ranks equal with the claims of unsecured creditors.

Swiss law provides three possible grounds for a restitution claim: (i) transactions at an undervalue; (ii) amortisation or securing of preexisting debts without any contractual obligation to do so, and; (iii) transactions intended to privilege certain creditors to the disadvantage of others.

Undervalue transactions

Transactions by the debtor company in which the debtor company did not receive an arm's length consideration and, thus, can be considered to be an effectively gratuitous or at least partially gratuitous transfer of assets by the debtor company to a third party may be challenged. But only if they were implemented within a year prior to the moratorium or the bankruptcy. In order to protect against such a challenge, a credible valuation report relating to the assets to be transferred by an independent third party is required which confirms the price agreed between the parties to be at arm's length.

Amortisation

Further, certain specific transactions by the debtor company may be challenged. These include particular debt/asset swaps, the payment of debts that are not due or the collateralisation of previously unsecured debts. This can be done to the extent that:

- they occurred within a year prior to the moratorium or the bankruptcy;
- the debtor company at the time of the transaction at issue already operated with a negative equity; and
- the counterparty cannot prove that it was, and could not have been, aware of the negative equity situation at the time of the transaction.

However, a challenge is excluded, if a security interest has been granted by the debtor company on shares or other financial instruments, which are traded at an exchange or similar representative market and the debtor company was under a contractual obligation to honour a margin call. This can also happen if the assets that are subject to the security interest are replaced by other assets according to the contractual arrangements in place between the parties.

Unfair preferences

Any other acts by the debtor company can be attacked if they took place within five years prior to the moratorium or the bankruptcy and the debtor company intended to disadvantage its creditors or to treat certain creditors more favorably than others. In principle, such intent of the debtor company to disadvantage or privilege certain of its creditors must be apparent to the counterparty.

However, according to recent court decisions, the constructive intent of the debtor company is sufficient. In other words, the fact that the debtor company accepted the fact that by entering into the transaction all or some of its other creditors will most likely be disadvantaged. On the other hand, a counterparty that knew about the financial distress situation of the debtor company is assumed to be able to recognise that it will most probably be unfairly privileged, or the other creditors unfairly disadvantaged, by a specific transaction.

Thus, to the extent that the counterparty has actual knowledge of, or could not ignore under the circumstances, the financial difficulties of the debtor

company, such a requirement is most likely to be regarded as fulfilled by the courts. By lowering the thresholds for both intent of the debtor company and actual knowledge of the counterparty, the courts have significantly increased the risks of counterparties for dealing with a debtor company in distress.

The calculation of the one year or five year period, as applicable, is subject to additional time periods being added. These are the duration of preceding composition proceedings, the duration of a stay of opening a bankruptcy and the duration of the preceding enforcement proceedings.

Out-of-court restructuring

Out-of-court solutions are the preferred approach in most cases and, in view of the limitations of the in-court restructuring procedures, they usually are the most efficient way to restructure a company in financial difficulties. As long as the equity situation of the company has not reached a critical level and thus permits the board of directors to refrain from a notification of the bankruptcy court (or if the company has successfully obtained a deferment of the bankruptcy proceedings), the board of directors is free to plan, decide and implement a restructuring of the company.

According to case law, the powers of the board of directors of a distressed company should be interpreted broadly. Therefore, under certain circumstances the board is allowed to sell certain assets or the vast majority of the assets of the company even without prior shareholder approval if the urgency of the situation justifies such measure. Conversely, certain restructuring measures, for example, a reduction of share capital and to a certain extent a capital increase, always require shareholders approval in order to be valid.

Out-of-court restructuring does not need to be made public by the debtor company. (With the exception of listed companies which have to publish an out-of-court restructuring under the applicable listing rules based on the ad hoc publicity requirements.)

However, before implementing any radical restructuring measures, the board and the management of a financially troubled company should carefully review all possible alternatives to restructure the



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Admitted to the bar in Switzerland in 2003.

Degrees

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Areas of practice

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Recent transactions

Various national and crossborder acquisitions for Swiss and international clients; loan and securitization contracts as well as all related documents and restructuring of existing financing transactions for banks as well as borrowers.

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company and/or to recapitalise its balance sheet, with regard to both debt and equity. It is further well advised to timely start to evaluate possible fall back scenarios 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. This is particularly true in the case of a group of companies with numerous intra-group transactions and trading relationships.

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 turn around plan. In addition, amending the collateral package, a subordination of existing debt or the taking up of new subordinated loans and debt/equity swaps are popular measures. 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 or hybrid instruments for the converting debt holders or a mixture of both.

On the asset side, possible measures include an aggressive management of the company's working capital, sale and lease back transactions and divestiture of non-operative assets or non-strategic or non-vital parts of the business. While the 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. This is particularly true where discontinuing and liquidating the business (or part thereof) is likely to lead to significant liquidation costs or contingent liabilities.

However, the divestitures of parts of the business or the business as a whole require careful planning, a good management of the M&A process and an early evaluation of alternatives and fall back positions. The paramount objective – and at the same time usually difficult task – for any M&A transaction of a dis-

tressed company is to maximise the proceeds of the assets or business units to be sold.

In order not to get caught in a situation with its back to the wall and almost no bargaining power, the company and advisers should carefully assess the circumstances. Is the business to be sold cash positive or negative? Is it a "broken balance sheet" or a "cash burn" situation? How long can the company survive as a going concern without the transaction being closed?

If the company has almost used up its equity and/or defaulted under its bank debt, but is cash positive, the task is usually easier. This is because the company generates positive cash flow but is over-leveraged. So a sale can be accomplished in a more or less orderly and straightforward, however, accelerated manner. It is usually less difficult to find a number of potential acquirers who are interested in a transaction, because the underlying business is healthy even though the company itself is undercapitalised and over-leveraged. Although there might be time pressure from the creditors who want to recover their defaulted loans, there is in general more time available to sign and close a transaction than is available when a company is cash negative and thus approaching illiquidity.

If the latter is the case, in order to maintain the business as a going concern and to create the breathing space necessary to enter into a transaction with an acquirer, in addition to the transaction related activities, management has to focus on stopping the cash outflow by implementing short term measures. It must also stabilise operations and communicate with customers, suppliers, employees, senior and junior lenders, trade creditors, and other stakeholders in order to preserve the business as a going concern. This will therefore preserve value too.

Successful sale processes

In order to gain time and to be able to negotiate and advance a potential transaction with several potential acquirers in parallel, the company is well advised to

prepare the due diligence by compiling the relevant documents early. It should create a comprehensive due diligence package to be made available in an electronic data room. While it is important to have more than one potential acquirer on the shortlist in order to have fall back positions and thus negotiation leverage, a company in distress should limit the number of interested acquirers who will get access to the data room in order not to consume too much of management's valuable time.

Further, access to the data room should be a properly managed process to avoid damaging the value of the business. Allowing unrestricted access to sensitive company information to strategic competitors too early in the process or without definitive agreements in place can make a company vulnerable to poaching or even unattractive for other potential acquirers.

Further, another important aspect of preparation is a thorough analysis of the insolvency and reorganisation laws of the jurisdiction(s) in which the company is operating itself or through its subsidiaries in order to fully understand for each jurisdiction the relevant rules. For example, the applicable timelines and the potential leverage and remedies of creditors trying to influence the sales process for their own benefit. Without such knowledge, the board of directors and management risk to lose control over the process which may lead to a significant loss of value.

The going concern value may be significantly negatively affected if important parts of a corporate group can not be sold anymore to an interested acquirer because creditors have already taken action and forced vital subsidiaries into an in-court restructuring or even bankruptcy procedures under the applicable local law.

Finally, the debtor company can create additional value by having legal and tax advisors in place early on to help potential acquirers to quickly develop and implement tax advantageous deal structures, which are likely to prompt potential acquirers to increase their bids.



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Admitted to the bar in Switzerland in 1993.

Degrees

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Areas of practice

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Recent transactions

Transaction counsel in the rights offering of a Swiss listed company, advising a Swiss company in its intended acquisition of a real estate business exceeding CHF1 billion,

representing a Swiss listed company in the sale of a business division to a US listed company (transaction value around €60 million) and the restructuring of the remaining company. Müller has also completed various national and crossborder acquisitions for Swiss and international clients, several tender offers on Swiss listed companies and is advising a Swiss listed company on defence strategies.

Professional associations/memberships

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