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BRIEFING

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Switzerland's status as a domicile for companies and investment funds remains intact, though challenged by the current economic climate and the trend for increased regulation. In this week's briefings experts provide commentary on key developments including legislation affecting executive pay, the alignment of the Swiss regime with the EU on alternative investment funds, a new takeover regime and how Swiss law deals with bankruptcies

ADVERTISEMENT SUPPLEMENT

A say on bosses' pay

A binding say on pay is gaining steam in Switzerland but, unlike Europe, no remuneration caps are envisaged yet

Benjamin Dori (top) is a senior associate and Dunja Koch is a partner at Froriep Renggli

On 3 March 2013, Swiss voters highly approved the constitutional 'Fat Cats Initiative', which artfully wrapped the original intention of curbing excessive executive pay into measures strengthening shareholders' rights and boosting corporate governance. Who, in democratically minded Switzerland, could not back it?

Need for action

As per that date, the principles of the initiative have become part of the Swiss Federal Constitution but have yet to be transposed into law. Pending this new law being written, considered and adopted, the Federal Council announced to implement relevant regulations in a decree per 1 January 2014 already. Draft regulations are expected to be published in due course. Accordingly, although there is no need for immediate action, articles of associations, employment agreements, etc, will likely have to be amended by the end of the year.

Principles to be specified

The new law will only apply to Swiss companies listed on a Swiss or foreign stock exchange but not to foreign companies even if their stock is listed in Switzerland. How a dual-holding company structure involving a foreign-listed top holding company and a not-listed Swiss subsidiary holding company would be treated is unclear.

The initiative at a glance:

(i) It introduces a binding annual shareholders' vote on the aggregate compensation of directors, management and advisory board whose members, all individually, shall be elected yearly. Pension funds must vote their shares in the interest of the insured persons and shareholders must be given the opportunity to vote electronically.

(ii) 'Golden hellos', severance packages and rewards for buying/selling company divisions are no longer allowed. Directors and/or management may no longer have additional consulting/employment agreements within the group and the delegation of management to a legal entity shall not be permitted.

(iii) The articles of association must have rules regarding loans and pensions granted to directors/ management, participation plans, number of mandates held outside the group and regarding the terms of managers' employment agreements.

(iv) Finally but importantly, a breach of the aforementioned principles shall be a criminal offence punishable by a prison sentence of up to three years and a fine of up to six annual compensations.

Clear as mud then.

The initiative's new rules are open to various interpretations. To name but a few: will all provisions be mandatory or will some be optional; will the annual vote on compensation have to be taken in advance in the sense of a 'budget approval' or retrospectively and, if the latter, how shall a refusal be dealt with under a company's labour law obligations; and what ramifications, if any, will the ban of severance packages have on non-competition arrangements?

Nulla poena sine lege. This principle of legality explicitly codified in the Swiss Penal Code and further constitutional provisions defining serious violations of fundamental rights requires a formal legal basis passed by Parliament. The Federal Council's implementation of regulation does not satisfy the legality requirement and hence may not integrate the initiative's penal provisions at all. While one should expect the adoption of the first three rules (see above), one way or the other, likely as per 1 January 2014, it may only be in a few years' time that the statutory, including penal, provisions come in to force.

Is Switzerland (still) a place for high earners?

Certainly so. First, the law has yet to be enacted and it is unclear whether the new law will strictly follow the rules or take a more flexible approach. Second, some of the rules will strengthen corporate governance in Switzerland where, for instance, chairman and CEO are still often (although less) the same person. Third, there are valid reasons to believe that the initiative's new criminal offences will, due to required checks-and-balances procedures, be enacted only in a few years' time. Fourth, following the financial crisis where financial institutions led by highly paid key staff had to be bailed out, and in this era of low economic growth and falling average real wages, executive compensation is a hot topic elsewhere, too.

Similar measures are either being discussed (France, Germany, etc) or in place (Netherlands, Norway, etc) and the EU is planning to introduce legislation later this year to require all 27 EU countries to implement mandatory, binding say-on-pay votes. Furthermore, in contrast with the revised EU Capital Requirements Directive (expected as of 1 January 2014), the initiative does not introduce a remuneration cap.

Last but not least, Switzerland (still) ranks top five out of the 34 OECD countries in income tax and social security burdens, according to the OECD Taxing Wages 2011-2012 report of 2013, and thus provides an attractive fiscal environment for executive compensation (even with income tax rates of 19 to 40 per cent in the Greater Zurich Area or up to 46 per cent in Geneva).

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Peering over the hedge

New regulation abandons the light supervision of asset managers of foreign funds and the lean private placement regime

Anita Schläpfer is a partner at Schellenberg Wittmer

After a highly debated legislative process, important revisions to the Swiss Federal Act on Collective Investment Schemes (CISA) and the implementing regulations entered force on 1 March 2013.

The revisions aligned Swiss regulation with the European Alternative Investment Fund Managers Directive (AIFMD) to ensure continued access to Europe's financial markets. Whether this goal has been achieved is arguable but the new rules considerably affect managers and distributors of offshore hedge funds.

The old liberal times when Swiss managers of foreign hedge funds could operate without a licence from the regulator, the Financial Market Supervisory Authority (FINMA), have passed. Under the new CISA, these managers require a FINMA licence and are subject to ongoing supervision unless they can rely on a de minimis exemption, i.e, have relatively small fund assets under management.

To obtain (and keep) the FINMA licence, the hedge fund manager must, among others, meet stringent minimum capital requirements, implement detailed internal regulations and an appropriate (staff-intensive) business organisation and, upon request of the FINMA, comply with the regulator's recognised rules of conduct. Furthermore, the asset manager has to ensure both the portfolio and the risk management for the relevant funds. Delegation of tasks is possible but subject to conditions. Remarkably, the AIFMD's restrictive regime on manager remuneration has not been translated into Swiss law.

From public advertisement to distribution

Previously, only 'public advertisement' was regulated, and customary placement efforts towards a broadly defined group of 'qualified investors' were not deemed public advertisement. Now, all activities qualifying as 'distribution' in the sense of the revised CISA are 'in scope'. However, a different level of regulation applies for distribution to (non-supervised) qualified investors and non-qualified investors.

'Distribution' is defined as any offer or advertisement for collective investment schemes not exclusively directed towards supervised institutional investors, i.e., financial intermediaries and insurance establishments. The term does not include, among others, the provision of information and purchase of funds (i) at the investor's own initiative (reverse solicitation) and (ii) within the framework of certain asset management mandates.

Effective from 1 June 2013, the provisions on 'qualified investors' also changed. While typical institutional investors both supervised and unsupervised continue to be qualified investors, two important changes hamper the distribution to individuals. Wealthy individuals must declare in writing that they want to be qualified investors (opting in) and must either (i) have liquid assets of at least CHF500,000 and experience in the financial sector or (ii) own qualifying assets (including, to a limited extent, real estate) of at least CHF5m. Conversely, asset management clients may declare in writing that they do not want to be qualified investors (opting out).

As a result, wealthy individuals who do not eventually opt in and opted-out asset management clients have to be treated like any other retail investor. This closes the door to an important distribution channel for foreign hedge funds. The funds have to be authorised for distribution by the FINMA, which would be impossible because, due to stringent prerequisites, virtually only UCITS can achieve such authorisation in Switzerland.

Newly regulated distribution

The good news first: marketing activities targeting supervised institutional investors continue to be unregulated.

Also, neither a FINMA distributor licence nor a FINMA product authorisation is mandatory for distributing foreign hedge funds to non-supervised qualified investors, including opted-in wealthy individuals. However, the revisions introduced some burdensome requirements. In particular: a FINMA-licensed Swiss representative and a Swiss paying agent must be appointed; and a foreign distributor must be a financial intermediary with distributor authorisation in its home jurisdiction and sign a distribution agreement with the Swiss representative

Need for action

New market players are immediately subject to the revised CISA. For asset managers and distributors of foreign hedge funds that were active on 1 March 2013, the applicable transitional rules grant a short respite. They will have to adapt soon, however, or move their operations elsewhere. Most importantly, Swiss hedge fund managers must submit a licence application to the FINMA not later than 1 March 2015. Foreign distributors and hedge funds distributed in Switzerland to non-supervised qualified investors must comply with the new regulatory requirements by the same date.

Hedge fund promoters are advised to review their offshore fund structures involving offshore asset managers and/or Swiss advisory companies. The FINMA will no longer accept these structures and will require the Swiss 'adviser' to be licensed, unless there is sufficient substance offshore. Accordingly, existing tax rulings may no longer be valid.

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REVISED TAKEOVER REGIME

Regime change

The rules in the revised Swiss takeover regime have made stakebuilding more complex and are more restrictive on the bidder

Mariel Hoch is a partner at Bar & Karrer

The revised Swiss takeover regime came in to force on 1 May 2013. The most significant changes are the abolition of the control premium and the obligation to offer an all-cash alternative in some new situations.

With regard to the structuring of public tender offers, bidders need to consider the implications of the revised regime and explore novel approaches.

Pre-tender offer stakebuilding

Stakebuilding prior to the launch of a public tender offer enables the bidder to increase their chances of success because a significant stake at launch reduces the likelihood of a competing bid. If a competing bid is launched, the initial bidder is likely to make an attractive return on investment on the stake it tenders into the competing bid.

Under the revised takeover regime, pre-offer stakebuilding has become more complex. According to the minimum-price rule, the offer price in the public tender offer must be at least equal to the highest price that the bidder has paid for target shares in the 12 months preceding publication of the public tender offer and to the 60 trading-day volume-weighted average price (or based on a valuation if the target shares are deemed illiquid).

The minimum-price rule applies to mandatory and change-of-control offers, i.e. offers which extend to shares whose acquisition would entail a mandatory offer obligation. It does not apply to purely voluntary offers, including partial tender offers and offers for any portion of shares of a target which has a valid opting-out provision in its articles of association.

The abolition of the control premium means that in down markets or when a specific target's share price plummets due to a target-specific negative event, a bidder's purchases of target shares in the 12 months preceding the launch of the offer and, in particular, those prior to the fall of the target's share price will set the floor for the subsequent tender offer price.

Under the revised minimum-price rule, a bidder will have to carefully weigh the advantages of pre-launch stakebuilding against the risk of setting the minimum-offer price at a level that may prove unnecessarily high.

Another new restriction on pre-launch stakebuilding applies to exchange offers. An all-cash alternative must be offered to all recipients of a change-of-control offer if the bidder (or persons acting in concert with the bidder) has purchased 10 per cent or more of the target shares for cash during the 12 months preceding the announcement of the exchange offer.

Opting out to ensure flexibility?

The only way to avoid the application of the revised minimum-price rule (and the obligation to offer a cash alternative in exchange offers where the bidder buys 10 per cent or more of the target shares for cash prior to the offer) is to introduce a valid opting-out provision in the articles of association of the potential target company.

According to the revised practice of the Takeover Board, the shareholders' resolution on the introduction of an opt-out is assumed to be in the interest of the target company or its shareholders if a majority is reached by counting the votes of all shareholders represented and the votes of only those shareholders who have no interest in introducing the opting-out provision.

Even if these requirements are fulfilled, the Takeover Board may, in exceptional circumstances, hold that the assumption proves wrong. If the shareholders' resolution does not fulfil the requirements of the double counting of votes, the Takeover Board assumes that the opting-out provision is to the disadvantage of the minority shareholders and therefore not validly introduced.

All-cash alternative during exchange offers

The rules on cash alternatives in exchange offers have been tightened not only for pre-offer stake-building. The Takeover Board has acknowledged that, during the period following the settlement of the offer, there should no longer be any restrictions on the bidder with respect to purchases of target shares for cash.

A bidder in an exchange offer may therefore acquire target shares for cash following the settlement of the offer for as long as the best-price rule is respected (i.e. for six months after the end of the additional acceptance period, the price paid may not be higher than the value of the shares offered in exchange).

Another accentuation of the revised regime on exchange offers relates to the period from the publication of the offer until the settlement. It extends to all types of offer, including partial offers and those where the target company disposes of a valid opting-out provision in its articles of association. In the event that during this period the bidder (or any person acting in concert) purchases any amount of equity securities of the target for cash, the bidder must extend an all-cash alternative to all recipients of the exchange offer.

In all situations where a cash alternative must be offered, the cash alternative and the shares offered in exchange may differ in their respective values. However, according to the Takeover Board, both must comply with the minimum-price rule.

In summary, the revised Swiss takeover regime is more restrictive on the bidder and will increase his financing costs.

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SHAREHOLDER LOANS IN INSOLVENCIES

A problem shared

The Swiss Federal Supreme Court may have to take a stance on the subordination of intercompany loans

Daniel Hayek (top) is a partner and Alexander Flink is an associate at Prager Dreifuss

Shareholders of a Swiss corporation can fund their company either by way of capital contributions or by providing loans. Particularly in the context of a group, debt capital in the form of intercompany loans is often preferred to equity as a source of corporate finance.

One of the reasons for this preference is that the granting of intercompany loans benefits the parent company in the case of an insolvency of the subsidiary because intercompany claims rank pari passu with the claims of third-party creditors.

This ranking may result in an unwanted shift of the business risk from the company's owners to independent creditors. If the borrower is in distress, shareholders will be more tempted to provide the required funding in the form of intercompany loans than as additional equity to ensure they receive a distribution if the company goes bankrupt.

German doctrine

In view of this, several jurisdictions provide for statutory subordination or recharacterisation of certain shareholder loans into equity ('kapitalersetzendes Darlehen') in case of insolvency.

In the absence of an express statutory basis, it is controversial among Swiss legal writers whether such a concept should be applied in Swiss bankruptcies.

The author who first introduced the concept to Swiss legal literature, Christoph von Greyerz, was inspired by the German doctrine. In order to find out whether a loan should be requalified as equity, he suggests two standards or 'tests':

(i) Third party: The loan would not have been available from a third-party creditor

(ii) Recapitalisation: The loan was granted when the only appropriate solution to the borrower's financial problems would have been a capital contribution.

Other authors deem the consequences of requalifying loans as equity to be too far-reaching. They suggest considering such loans as subordinated by implication to the claims of independent creditors. In either case, the lender would only receive proceeds from the liquidation of the borrower in the unlikely event of all other creditors being paid in full. In addition, legal doctrine suggests that loans granted to a company before it becomes overindebted should be subordinated, provided that the lender implicitly refused to reclaim the nominal value of the loan by all legal means necessary when he was legally allowed to do so.

Precedents

There exist the following precedents:

- In 1993, the High Court of the Canton of Zurich (Obergericht) decided that certain intercompany loans should not be admitted to a borrower's schedule of claims because they were granted when the borrower was already in distress
- In 2004, the District Court Zurich (Bezirksgericht) decided to subordinate an intercompany loan. It found that the third-party creditors could trust that the loan which covered the negative equity in the balance sheet of the borrower would not rank pari passu with their own claims, particularly because the intercompany loan of CHF36.5m was disproportionately high compared with the borrower's equity of CHF20,000.
- In 2006, the Swiss Federal Supreme Court had to decide whether a shareholder's loan that was granted immediately before a moratorium was to be qualified as an equity-replacing loan and consequently had to be considered as equity, or at least as subordinated.

The court stated that the German legal concept of recharacterising loans was not familiar in Swiss law and acknowledged that some authors suggest that certain intercompany loans should not be requalified as equity capital but rank behind the unsubordinated claims of the other creditors. It remained unclear, however, whether this theory would be in line with Swiss law because when the loan in question was granted, the borrower was neither overindebted nor did the company's balance sheet show negative equity.

Swiss courts have undoubtedly been influenced by the discussion regarding the recharacterisation of shareholder loans into equity.

The cited judgments show a clear tendency to adjust the ranking of claims in insolvencies in favour of independent creditors.

Although the precedents take as starting points the 'third-party test' and the 'recapitalisation test', there is no established practice to the prerequisites. At its heart, the underlying question is whether or not the bankrupt company was sufficiently capitalised. As Swiss law provides only for minimal equity (except for certain types of company, such as banks, which are subject to stricter regulatory capital requirements), Swiss courts will probably also take into account the relation between debt capital and equity capital.

It seems as if the Swiss Federal Supreme Court does not approve of the requalification of debt capital into equity but it has not yet rendered a final verdict on the subordination of intercompany loans in insolvency cases.

Against the background of the current major Swiss bankruptcy cases, the Supreme Court may soon have the opportunity to take a stance on the issue.

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