

BANKING & FINANCE BRIEFING

GROUP CASH POOLING AND INTRA-GROUP LOANS – DECISION OF THE ZÜRICH COMMERCIAL COURT

by Dr. Ansgar Schott, LL.M., and Dr. Mark Montanari

In one of its recent decisions, the Zurich Commercial Court held in the context of a group cash pool agreement that loans granted by a company to its (indirect) parent or the subsidiaries of that parent (“up- or cross-stream loans”) block the freely disposable funds of the company (i.e. the free reserves and retained profits) on the liability side of that company’s balance sheet (Zurich Commercial Court, Decision HG080315, of March 9, 2012). As a consequence, a company that has granted up- or cross-stream loans may only pay out dividends to the extent the relevant freely disposable funds have not been used up by such types of loans. It remains to be seen whether this decision will be upheld by the Swiss Federal Court.

Up- and Cross-Stream Loans

Under Swiss law, it is generally acknowledged that a Swiss corporation or a limited liability company may grant a loan (in the sense of a debt instrument) to its shareholder. Pursuant to case law and legal writing, up- and cross-stream loans are permitted, in particular, if they are granted by the company at arm’s length terms and if, at the time of granting the loan, it can be expected that the loan will be repaid when due, also taking into account the creditworthiness of the borrower (i.e. the shareholder) (see with regard to the criteria under which a loan to a shareholder constitutes a deemed dividend distribution for tax purposes, Swiss Federal Court, BGE 138 II 57; 138 II 545).

Should these prerequisites not be fulfilled, the loan may be reclaimable or even be null and void: (i) a company and its shareholders have a claim for return of the loan to the extent that the loan is obviously disproportionate to the consideration and to the economic situation of the company (article 678 Swiss Code of Obligations (“CO”)); (ii) the loan is null and void if the company, on the liability side of its

balance sheet, has not sufficient freely disposable funds available (article 680 para. 2 CO); and (iii) some legal scholars argue that an up- or cross-stream loan that has not been granted at arm’s length terms is outside of the powers of the company and therefore void, unless the company’s statutory purpose expressly allows the company to also grant such loans without (adequate) consideration.

Further, the duty of care (article 717 para. 1 CO) requires the members of the board of directors and the management of a company to observe the principle of risk diversification, in particular, when the loan is granted by the company to one of its major shareholders (see Swiss Federal Court, BGE 113 II 52). The members of the board of directors or the management who violate the duty of care may become liable towards the company as well as the company’s shareholders and creditors for damage caused to such person (article 754 CO).

Zurich Commercial Court

In the context of a group cash pool agreement, a Swiss corporation (“Company”) granted a loan to its indirect parent as well as to the subsidiary of such indirect parent (the latter acting as cash pool leader). After the loans were granted, the Company paid a dividend to its shareholder. For that purpose, the Company’s auditors confirmed that the proposed dividend payment was in line with applicable laws and the Company’s articles of incorporation (see article 728a CO). After the dividend payment had been approved by the Company’s shareholder, the relevant amount was credited to the cash pool account of that shareholder who was also a party to the cash pool agreement. The cash pool leader subsequently went bankrupt. Since the loans remained outstanding, the Company suffered a loss.

The Company sued its auditors for the suffered loss (article 755 CO), claiming that the auditors wrongfully confirmed that the proposed dividend distribution was in accordance with the applicable laws and the Company's articles of incorporation. It argued that on the liability side of its balance sheet the freely disposable funds were already partially used up by the relevant amount of the up- and cross-stream loans; since dividends may only be paid out of the freely disposable funds of a company (article 675 para. 2 CO), only the excess amount (i.e. after deduction of the amount of the up- and cross-stream loans) would have been available for the proposed dividend distribution.

While the Zurich Commercial Court dismissed the claim of the Company against the Company's auditors due to lack of causality between the auditors' behavior and the alleged damage, it followed the arguments of the Company (claimant) insofar as it held that (i) both, up- and cross-stream loans have to be treated as loans to the shareholder; (ii) up- and cross-stream loans granted on the basis of a group cash pool agreement may be outside of the ordinary course of business of a company; and (iii) on the liability side of the balance sheet of a company, such loans block the freely disposable funds for the amount of the loans, provided that the loans may not be set off by the company against a claim of the relevant counterparty against the company. Further, it seems that (deviating from the prevailing doctrine; see above) the Zurich Commercial Court did not take into account, whether or not the loans had been granted at arm's length terms.

This decision of the Zurich Commercial Court may, in particular, have the following consequences for up- and cross-stream loans if it will not be overturned by the Swiss Federal Court (at least where the jurisdiction lies with the courts of the Canton of Zurich or as far as other Swiss courts may follow the decision of the Zurich Commercial Court):

- An up- or cross-stream loan may only be granted by a company to the extent that, on the liability side of its balance sheet, the company has sufficient freely disposable funds available in the relevant amount.
- A company that has granted up- or cross-stream loans may only pay out dividends to the extent that it has sufficient freely disposable funds available, deducting the relevant up- or cross-stream loan amounts.
- Further, when a company provides a security interest to its (indirect) parent or to a subsidiary of such parent, for the benefit of a third party, the available amount in the case of an enforcement of such security interest shall be reduced by any outstanding up- or cross-stream loans of the company, at each time the amount of the security interest is limited to the freely disposable funds of the company (as it is commonly agreed in financing and security agreements).
- It may be essential that the company's statutory purpose in its articles of incorporation expressly mentions that the company may grant up- and cross-stream loans and enter into a cash pool agreement with other group members, even where the company has entered into the relevant transaction or agreement at arm's length terms.

No Final Decision by the Swiss Federal Court

Following the Company's appeal against the decision of the Zurich Commercial Court, the Swiss Federal Court sent the case back to the Zurich Commercial Court for further examination of the facts (Swiss Federal Court, Decision 4A_248/2012, of January 7, 2013). Until the Swiss Federal Court shall have finally decided on the matter, it remains unclear as to what extent a company may grant up- and cross-stream loans to its affiliates and how this may affect its ability to pay out dividends.

Dr. Ansgar Schott, LL.M.

aschott@froriep.ch
Tel. +44 44 386 60 00

**Dr. Mark Montanari**

mmontanari@froriep.ch
Tel. +41 44 386 60 00



YOUR SPECIALISTS IN FINANCING TRANSACTIONS

Dr. Ansgar Schott, LL.M., Zurich

aschott@froriep.ch
Tel. +41 44 386 60 00

Dr. Catrina Luchsinger Gähwiler, Zurich

cluchsinger@froriep.ch
Tel. +41 44 386 60 00

Dr. Beat Barthold, Zurich

aschott@froriep.ch
Tel. +41 44 386 60 00

Patrick W. Vogel LL.M., Geneva

pvogel@froriep.ch
Tel. +41 22 839 63 00

Jérôme de Montmollin, Geneva

jdemontmollin@froriep.ch
Tel. +44 20 7236 6000

Dunja Koch, London

dkoch@froriep.ch
Tel. +44 20 7236 6000

Dr. Mark Montanari, Zurich

mmontanari@froriep.ch
Tel. +41 44 386 60 00

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GENEVA

4 Rue Charles-Bonnet
CH-1211 Geneva 12
Tel. +41 22 839 63 00
Fax +41 22 347 71 59
geneva@froriep.ch

ZURICH

Bellerivestrasse 201
CH-8034 Zurich
Tel. +41 44 386 60 00
Fax +41 44 383 60 50
zurich@froriep.ch

ZUG

Grafenastrasse 5
CH-6304 Zug
Tel. +41 41 710 60 00
Fax +41 41 710 60 01
zug@froriep.ch

LAUSANNE

9a Place de la Gare
CH-1003 Lausanne
Tel. +41 21 863 63 00
Fax +41 21 863 63 01
lausanne@froriep.ch

LONDON

17 Godliman Street
GB-London EC4V 5BD
Tel. +44 20 7236 6000
Fax +44 20 7248 0209
london@froriep.ch

MADRID

Antonio Maura 10
ES-28014 Madrid
Tel. +34 91 523 77 90
Fax +34 91 531 36 62
madrid@froriep.ch