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Group cash-pooling limitations – new Federal Supreme Court guidance

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Authors

Markus Dörig

Jeannette Wibmer

Introduction

On October 16 2014 the Federal Supreme Court decided an appeal (4A_138/2014) against a Zurich Commercial Court decision and clarified important issues under mandatory Swiss company law.

In the bankruptcy of the Swissair Group (the former Swiss national carrier), the Federal Court upheld PricewaterhouseCoopers' (PwC) personal liability for auditing and approving a dividend payment by Swisscargo (a Swissair indirect subsidiary) to its direct holding company (another Swissair group member) – both of which are now bankrupt. PwC's personal liability resulted from the fact that the profits and losses booked into Swisscargo's accounts failed to reflect that two loans advanced by Swisscargo to two other Swissair Group companies (one, the internal group cash-pooling entity) did not pass the arm's-length test because they were not properly secured and the credit standing of the receiving group companies had not been verified by Swisscargo.

For these reasons, the Federal Court recharacterised the loans as (forbidden) hidden capital repayments under Article 680 II of the Code of Obligations and held that the respective amounts could not be advanced as dividend payments by Swisscargo (ie, Swisscargo would have been entitled to advance only a much lower dividend).

Swiss and foreign companies participating in cash-pooling systems or intra-group loans involving Swiss companies as lenders, and the respective Swiss lenders' boards, management members and auditors, must follow meticulously the strict new limitations on cash pooling and other intra-group loans in order to avoid personal liability under mandatory Swiss company law resulting from the approval of unlawful dividend payments or the advancing of intra-group loans that do not meet the arm's-length test.

Case history

The Zurich Commercial Court decided that PwC was liable for violating Swiss law as a result of its approval of dividend payments to Swisscargo's direct parent company, irrespective of the fact that Swisscargo also used funds for these dividend payments out of a loan which the parent had paid back to Swisscargo through the group's cash-pooling system earlier in the business year (for further details please see "New limitations on cash pooling?").

As the parent company went bankrupt a few months later, the creditors of now-insolvent Swisscargo lost a bankruptcy dividend of Sfr4 million from the Swissair Group cash-pooling entity, to which they would have been entitled in the absence of the earlier dividend payment to Swisscargo's parent. According to the Zurich Commercial Court, the auditors should have blocked this dividend payment, as the loan in the Swissair Group should have been recharacterised as an equity repayment and been unavailable for later dividend payments as a result.

Federal Court decision

The Federal Court mostly upheld the Zurich Commercial Court decision and clarified company law issues in relation to intra-group loans and cash-pooling systems:

- From a procedural perspective, it is unnecessary to first claim back the forbidden dividend payment from the parent company or – should they have sufficiently deep pockets – from other possible defendants, such as board or management members under Article 754 (ie, the personal liability claim against the auditors under Article 755 of the Code of Obligations can be made directly).
- If upstream and cross-stream loans within the group are paid out of the free capital and do not breach equity protection rules, they will nevertheless always block the otherwise available free

reserves for dividend payments in the related amount if the loans would not have been granted to a third party on the same terms and conditions (the arm's-length test).

- In applying the arm's-length test, the Federal Court uses different criteria from the Zurich Commercial Court. An intra-group loan will fail the arm's-length test if:
  - its repayment is not properly secured;
  - the company advancing an intra-group loan has not verified the credit standing of the receiving company before such an advance; or
  - the respective loan agreement was not properly documented.
- Although not mentioned in the decision, the existing Federal Tax Administration circular letter on acceptable interest rates for shareholder loans provides useful guidance on arm's-length interest rates for intra-group loans.
- The Federal Court even questioned in passing whether the participation in a zero cash-pooling system might, as such, fail the arm's-length test, without ultimately deciding the issue. The intra-group loans in the Swisscargo case clearly failed the arm's-length test for other reasons.
- It is advisable to provide in the company's articles of association that a Swiss group company may also be used to finance other companies of the same group, as otherwise it is unclear that such group financing and participation in a cash-pooling system are covered by the Swiss group company's statutory purpose.
- It is also advisable to document accurately all terms and conditions of the intra-group loan in an arm's-length loan agreement standard.
- The Federal Court overturned the Zurich Commercial Court decision in one respect. Unlike the lower-instance court, the Federal Court held that share capital subscription payments above par (known as '*agio'* (paid-in surplus) payments on top of the nominal share price) may become available for dividend payments if the general legal reserves to which they belong are higher in total than half of the nominal share capital.

For these reasons, the Federal Court held PwC personally liable under Article 755 for allowing the dividend payment by Swisscargo to its parent company, despite the amounts which should have been blocked as a result of the intra-group loans not advanced at arm's-length terms and conditions. The Federal Court remanded the decision to the Zurich Commercial Court for a recalculation of damages due by PwC to Swisscargo, taking into account that dividend payments out of the *agio* were outside the above limitations.

Comment

Although this decision concerned the personal liability of the auditing company (Article 755), it is also applicable to board and management members of the respective Swiss lenders' group companies, which must follow the Federal Supreme Court's strict limitations on cash pooling and other intra-group loans meticulously in order to avoid personal liability under mandatory company law (Article 754) resulting from the approval of unlawful dividend payments or the advancing of intra-group loans that do not meet the arm's-length test.

While the new decision does not prohibit cash-pooling systems in general, it does limit the amount of free reserves which can be paid out as dividends for as long as loan advancements to other group companies exist which are not at arm's length within the Swiss company. In this respect, the new decision specified only why the arm's-length requirement was not met; it did not provide a complete list of all respective requirements. Thus, it is paramount to:

- adhere to strict standards for applicable interest rates (which reflect market conditions) for such intra-group loans;
- secure related repayment obligations;
- verify the credit standing of the receiving company;
- properly document intra-group loans; and
- ascertain that funds for the dividend payment are available in the company before the end of the respective business year (ie, not only at a later date when the dividend is paid).

For further information on this topic please contact Markus Dörig or Jeannette Wibmer at BADERTSCHER Rechtsanwälte AG by telephone (+41 44 266 20 66), fax (+41 44 266 20 70) or email (doerig@b-legal.ch and wibmer@b-legal.ch). The BADERTSCHER Rechtsanwälte AG website can be accessed at www.b-legal.ch.

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