Dear clients and business friends,

The granting of loans as well as the provision of securities within a group are widely spread in practice. When a Swiss company grants a loan or provides security for its parent company or an, several limitations and requirements of Swiss company law (as well as tax law) are to be considered. As there is no group law or specific legal provisions concerning such loans and securities, and there is no relevant case law thereto, Swiss companies are in practice forced to take a careful approach when granting upstream loans and providing upstream securities.

In the present issue of Legal News, in connection with upstream loans as well as securities, first, the terms will be defined, some examples of use will be mentioned, the applicable legal provisions will be stated, the arm’s length principle applicable in practice and the corresponding company law effects will be listed and, finally, the legal implications will be discussed.

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1. Terminology and examples of use

1.1 Terminology
The starting point of this issue of Legal News is upstream loans and securities. “Upstream” loan or security means that a Swiss company grants a loan or provides security for its direct or indirect foreign or Swiss parent company. The same provisions and principles, which apply to “upstream” loans and securities, apply to “cross-stream” loans and securities, where the Swiss company grants a loan or provides security for an affiliated company connected to its parent company.

Therefore, subsequently upstream loans also refer to upstream securities as well as cross-stream loans and securities.

1.2 Examples of use
Typical examples of use for upstream loans are:
- Assistance in the financial restructuring of a group;
- Transfer of liquid assets to an affiliated company (so-called cash management or cash pooling);
- Distribution of profits earned during the current year («interim dividend») by means of a loan to the parent company, which is offset the following year against the dividends.

Examples of use for upstream securities are the provision of securities for debts of an affiliated company in form of guarantees, pledges and assignments of assets (e.g. shares, intellectual property, bank accounts, etc.).

2. Applicable legal provisions
The legal provisions applicable to upstream loans and securities are of general nature. These are, in particular, art. 678 para. 1 SCO (return of benefits to shareholders, members of the board of directors as well as their close associates), art. 680 para. 2 SCO (prohibited repayment of capital contributions), art. 717 (duty of care and loyalty of the members of the board of directors and management) and art. 754 SCO (derivative corporate liability).

The implications of the application of the general legal provisions are further described below in number 4.

3. Arm’s length principle
The origin of the application of the arm’s length principle may be traced to the fact that Swiss company law does not provide for comprehensive group law. The board of directors of a Swiss group company must consider the financial situation of the Swiss companies under the assumption of a legally independent legal entity on an individual and independent basis. The board of directors may, therefore, based on the incumbent duty of care, not only have regard to the overriding interests of the group. This leads to the board of directors, in context of a group-internal loan or such a security, having to assure
that the loan or security meets the arm's length criteria, i.e. withstands a third party comparison. For a third party comparison concerning an upstream loan, especially the following criteria are observed:

- Credit worthiness of the borrower;
- Willingness and capability of the borrower to pay back the loan;
- Merchantability of the terms of the loan (duration, termination, amortization, etc.);
- Adequacy of the interest rate and regular payment of interest;
- Adequacy of the security of the loan (e.g. pledging and guarantee of a third party).

4. Company law implications

In spite of the lack of specific legal provisions, the above-mentioned general company law provisions as well as the arms length principle effect upstream loans and securities. The following requirements must generally, especially for upstream loans, be met:

a) The granting of upstream loans or the provision of upstream securities must be expressly provided for by the company's purpose.

b) The loans and securities must comply with the principle of adequate distribution of risk and avoid concentration risks.

c) They must comply with the principle of careful cash management, whereby especially the duration is considered.

d) The upstream loan may not exceed the freely disposable equity capital, which corresponds to the share capital minus the statutory and special reserves.

e) The upstream loan may not be a hidden distribution of profits. A loan, which does not meet the arm's length criteria, could be qualified as such a hidden distribution of profits.

f) In the context of the duty of care of the board of directors as well as management it is a constant duty of the members of the board of directors and management to review the creditworthiness of the borrower.

g) From a tax law point of view the interest rate of the upstream loan must be acceptable for the tax authorities.

h) The upstream loan may not be used to undermine the company by withdrawing its capital; this would amount to a de facto liquidation.

As specific legal provisions are missing and, therefore, above all the arms length principle and the requirements developed in practice must be applied, the analysis whether and to what extent the requirements in the concrete case actually apply and must be observed, is as a general rule difficult.

5. Legal consequences

Non-compliance with the above mentioned principles may render the upstream loan or security void or, especially in the case of bankruptcy, lead to personal liability of the members of the board of directors or management. Moreover, unfavourable withholding and profit tax implications (as e.g. withholding tax implications based on the loan being qualified as a hidden distribution of profits) may be caused. As the case may be, in extremis even a conduct relevant under criminal law (as e.g. creditor preference or disloyal management) or a contestable action under bankruptcy law may be found. In any case it is, therefore, important to approach upstream loans and securities with the necessary caution.