Dear clients and business partners,

If a public limited company is overindebted, the board of directors faces the difficult decision of whether to notify the court immediately – which can often prove detrimental from a business perspective – or whether to defer filing notification of overindebtedness. If the board opts for the latter course of action, it exposes itself to accusations of failure to file for bankruptcy in due time. A complicating factor which causes some uncertainty is that Swiss Federal Court practice is not consistent regarding the permissible maximum period a company may wait before lodging notification of overindebtedness. Consequently, a board that puts off filing for overindebtedness runs the latent risk of being made liable under company law.

A recent ruling last year by the Commercial Court of Canton Zurich addressed this matter. In the current issue of Legal News, we take this court decision as an opportunity to look at the underlying issues.

Daniel Bachmann
Attorney-at-law, Partner, Legal Services
daniel.bachmann@ch.ey.com

1. Introduction

If there are justified grounds for concern that a public limited company is overindebted, the board of directors is required to draw up an interim balance sheet and have it audited by a statutory auditing company or a registered auditor. If the interim balance sheet shows that the claims of the company’s creditors are not covered by assets either at going concern or liquidation values, the board of directors must notify the court (notification of overindebtedness) unless creditors are willing to subordinate their claims to the extent necessary to offset the shortfall (Art. 725 para. 2 Swiss Code of Obligations [CO]). If the board of directors does not comply with this duty either by taking no action or delaying notification of the court in an inadmissible manner, it will be deemed in breach of its duty and could potentially face a liability suit (Art. 754 CO) for failure to file for bankruptcy in due time.

However, under specific conditions, Federal Court practice has consistently been to waive the requirement of immediate court notification and to allow a certain tolerance period. In a recent decision by the Commercial Court of Canton Zurich on 7 March 2013, a tolerance period of approximately eight months was ruled to be permissible in a particular case.

Referring to established Federal Court practice, we will outline in more detail below the conditions under which it is permissible to delay filing for bankruptcy and how long a board may wait before lodging notification of overindebtedness.

2. When can a company defer notification of overindebtedness?

According to prevailing practice and doctrine, if the audited interim balance sheet shows that the company is overindebted, the board of directors must notify the court immediately. Nevertheless, the Federal Court consistently recognises that, under particular circumstances, the board of directors may wait for a certain period before notifying the court despite the company being overindebted. Under Federal Court practice, concrete prospects of recapitalisation justify waiver of the requirement of immediate court notification provided the claims of the company’s creditors are not jeopardised by a renewed worsening of the financial situation. The board is therefore not deemed to be at fault if, instead of contacting the court, it immediately sets about recapitalising and does what can be reasonably expected of any entrepreneur in a difficult situation.

If the board is to be exempted from immediately having to file notification of overindebtedness without being in breach of duty, the following conditions must be satisfied cumulatively:

The crux of the tolerance period for filing notification of overindebtedness

Anna Steiner, MLaw, attorney-at-law, Legal Services, anna.steiner@ch.ey.com
3. Federal Court practice on tolerance periods

Federal Court practice is inconsistent when it comes to how long a board may wait before notifying the court if the conditions listed in section 2 above are met. The Federal Court appears to allow itself a certain degree of scope when it comes to setting the tolerance period for depositing a balance sheet. This ranges from “a few weeks” or “60 days” to an “unlimited period”.

In the ruling of the Commercial Court of Canton Zurich cited earlier, a period of some eight months was seen as permissible. In justifying its ruling, the court stated that it was established that the board of directors had taken appropriate and timely measures to recapitalise the company and that the likelihood of success was still intact, to the extent that a continuation of business operations was fundamentally justified from an entrepreneurial standpoint since the prospects of recapitalisation significantly outweighed the risks. The court also argued that in the case of larger-scale, more complex recapitalisation plans a longer tolerance period was justified despite continuing overindebtedness provided the recapitalisation efforts were undertaken in earnest and showed promise of success.

In its decision of 11 November 2013 (4A_251/2013) based on the said ruling, the Federal Court neither explicitly nor implicitly stated whether a tolerance period of several months is permissible. It did not address the question at all since it established at the very outset that there was no risk of continuing damage and therefore no entitlement to compensation.

A brief examination of court practice to date shows that the question of what constitutes a permissible tolerance period has not been conclusively settled. The introduction of a mandatory fixed maximum period to be imposed regardless of the facts of the individual case makes little sense in our view. Depending on the circumstances, it may well be expedient to allow a longer or shorter tolerance period. Based in particular on the size of the company, the complexity of the recapitalisation measures and the concrete prospects of success, it might appear perfectly reasonable to grant the board more time for recapitalisation.

On the other hand, if the board were invariably obligated to file notification with the court after, say, 60 days despite entirely realistic prospects of sustainable recapitalisation, this could have undesirable consequences. Jobs or orders from suppliers and the like might conceivably be lost that could have been avoided by allowing a longer tolerance period.

It should also be briefly mentioned here that auditors have a subsidiary obligation to notify the court if the company is manifestly overindebted and the board of directors has failed to report this. The question of how the board’s duty to file notification meshes with that of the auditors, and indeed the question of how long the latter should wait before informing the court of the company’s overindebtedness cannot, of course, be answered with any degree of certainty. Further discussion of this issue is thus warranted.

4. Conclusion

There is no generally applicable maximum tolerance period. As so often, it depends rather on the concrete facts of each individual case. In the event of overindebtedness, the board is therefore advised in any case to make a thorough and objective analysis of the concrete situation with regard to the viability and risks of recapitalisation in light of the conditions listed in section 2 above. If the likelihood of successfully recapitalising clearly outweighs the risks and there is a realistic prospect of a sustainable recapitalisation, it may be permissible to defer filing notification of overindebtedness with the court for some considerable time.