Dear customers and business friends,

In connection with loans made to shareholders under a cash pool arrangement, a recent Swiss Federal Supreme Court decision (4A_138/2014, 16 October 2014) held for the first time that a paid-in surplus (Agio) is to be treated as part of the statutory general reserve and may therefore be distributed, provided the general reserve remains higher than one half of the share capital. The Federal Supreme Court also held that intra-group upstream and cross-stream loans not made at arm’s length will result in the freely disposable equity capital used for (dividend) distributions being blocked in an amount equal to such loans. In respect of Switzerland’s capital protection requirements, upstream and cross-stream loans granted at arm’s length remain permissible.

In the current issue of Legal News, we summarise the main conclusions to be drawn from the Federal Supreme Court decision and discuss (potential) legal problems in the context of intra-group financing.

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1. Background
Swisscargo Ltd. (A.) participated in the Swissair Group’s zero balancing cash pool. As at 31 December 2000, A. had total claims of CHF 23.65 million outstanding, comprising a claim of more than CHF 7.15 million against the parent company Swissair Swiss Air Transport Company Ltd. resulting from fixed-term deposits, and a claim of CHF 16.5 million against the Dutch cash pool leader (G.). A.’s equity consisted of the following positions (CHF millions):

- Share capital: 2.50
- Paid-in surplus: 2.43
- General reserve: 1.25
- Retained earnings: 29.17
- Total: 35.35

The general meeting of A.’s shareholders approved the proposal of the board of directors to appropriate the retained earnings to pay a dividend of CHF 28.5 million to the sole shareholder for the 2000 financial year. The statutory auditors confirmed, without qualification, the proposed appropriation of retained earnings. The dividend was subsequently paid out through the cash pool. In the aftermath of the collapse of the Swissair Group in autumn 2001, the cash pool leader went bankrupt. In response to this, the estate of A. sued the auditors for damages of CHF 4 million, arguing that A.’s CHF 23.65 million in claims against Group companies represented loans to the shareholder and that the disposable equity drawn on for the distribution should have been blocked in an amount corresponding to these loans. The argument continued that, as a result, the payout ought to have amounted to only CHF 5.52 million (retained earnings minus intragroup loans) and that the auditors had therefore acted unlawfully. If the difference had remained in the cash pool, the estate of A. would have received a CHF 4 million higher bankruptcy dividend.

2. Problem
Group companies are permitted to conduct transactions with one another. In principle, this includes granting loans. However, in a downstream direction (from parents to subsidiaries), this kind of financing is typically in the form of a capital contribution. Upstream (from subsidiaries to parents), it tends to be as a dividend payment. This can give rise to difficult questions as to where to draw the line. To protect companies against unjustified withdrawals of equity capital by shareholders, (dividend) distributions are only allowed under strict formal and material conditions. As well as a ban on the refund of capital contributions, these conditions also include provisions to protect reserves, and formal requirements for resolutions on dividend payouts and capital reductions. A breach of these conditions renders the payout void and reclaimable.

In this connection, it should be noted that sidestream (or cross-stream) loans (among companies with the same parent) are treated like upstream transactions because shareholders also derive a pecuniary advantage from group companies controlled by them.
3. Blocking disposable equity by granting intra-company loans that qualify as distributions

In respect of upstream or cross-stream intra-group loans (to be assessed in light of the ban on the refund of capital contributions), the Federal Supreme Court and prevailing doctrine apply the arm’s length principle (see also the November 2012 issue of Legal News). Shareholder loans not paid out of freely disposable equity capital must be granted at the same conditions that apply in the case of independent third parties. If this is not the case – at any rate in the (somewhat contentious) interpretation of the Federal Supreme Court – the loan is deemed to be fictitious, i.e. a concealed distribution which results, de facto, in the freely disposable equity used for (dividend) distributions being blocked in an amount equal to said loan. In the distribution under discussion here, the Federal Supreme Court did not, in fact, establish a violation of the ban on the refund of capital contributions since the amount of the loans did not exceed the freely disposable equity. That being said, in the Federal Supreme Court’s opinion, the loans failed to satisfy the arm’s length test and should therefore have been factored in when determining the amount of the dividend payment since they caused a de facto blocking of freely disposable equity.

We would also point out that the Federal Supreme Court’s assessment of whether sufficient freely disposable equity is available for the dividend distribution is based solely on the most recent balance sheet date and not on the date of the dividend payout. This appears rather significant, inasmuch as the loans in question were repaid prior to the contested dividend resolution and, certainly in the case of the loan to G., even before the audit report was drawn up.

4. Paid-in surplus (Agio) may be used for dividend distributions

The question of whether, in what amount and as of when a paid-in surplus constitutes freely disposable equity capital had previously remained unanswered by the Federal Supreme Court. In its decision of 16 October 2014, the Federal Supreme Court follows the prevailing doctrine that a paid-in surplus must be treated like a normal general reserve, which does not require any special protection and can therefore be used for dividend distributions. The paid-in surplus is allocated ex lege directly to the general reserve without the need for an additional resolution by the general meeting. This is in line with the practice adopted by the tax authorities, who have been treating paid-in surpluses as a generally disposable reserve ever since the capital contribution principle was introduced. Consequently, in the case under examination, the Federal Supreme Court held that, besides the amount of CHF 5.52 million referred to above, effectively another CHF 7.95 million was also available for the dividend payout.

5. Federal Supreme Court assessment of cash pool operations and the arm’s length test

The Federal Supreme Court noted that it was “inherently questionable” whether participation in a cash pool would ever pass the arm’s length test in cases where the participant freely disposes of liquidity. The Federal Supreme Court did not, however, examine this question more closely since the loans were indisputably unsecured, nor had the auditors claimed to have verified the creditworthiness of the debtors. In the opinion of the Federal Supreme Court, for this reason alone the loans could not be classified as market-compliant. Furthermore, there was merely a framework agreement in place for the cash pool, but no written arrangements regarding repayment, interest commitments or collateral. Unfortunately, this did not constitute an appropriate basis for the Federal Supreme Court to define clear arm’s length guidelines.

6. Recommendations for intra-group financing

It seems safe to assume that discussions on intra-group financing will increase. Cash pools and upstream/cross-stream loans should be carefully evaluated. In particular if these loans exceed the lender’s freely disposable equity capital, additional collateral should be provided and it is advisable to adequately monitor the financial situation of the parties involved. Depending on the circumstances, it is worth considering reducing any loan amounts which are in excess of the freely available equity.

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