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Amendments to Subordination Agreements may become necessary after the Swiss Federal Supreme Court confirmed its practice on subordinated claims in insolvency proceedings.

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Amendments to Subordination Agreements

As a matter of statutory law, the subordination of claims is a valid and oft-used remedy that enables over-indebted companies to continue doing business. However, the Swiss Federal Supreme Court has recently held that the subordinated amount must be accounted for when determining the liability of officers and directors. In light of this court practice, it may be advisable for companies to review any subordination agreements they might have in order to reduce the personal exposure of directors and officers in the event of an involuntary liquidation.



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Over-indebtedness and Art. 725 Para. 2 Swiss Code of Obligations

The basis for the remedy of subordination is set forth in art. 725 para. 2 of the Swiss Code of Obligations («CO»). If concerns of over-indebtedness are substantiated, an interim balance sheet must be established. If the interim balance sheet shows – via an appraisal of the assets at going concern or liquidation values – that the claims of the company's creditors are no longer covered, the board of directors must notify the bankruptcy court, unless creditors' claims are subordinated to the extent of the capital deficit.

As art. 725 para. 2 CO makes clear, a subordination agreement becomes relevant when the company's interim balance reveals over-indebtedness, i.e. that the company's liabilities are no longer covered by its assets. Often there is just one option available to escape – at least temporarily – insolvency proceedings: Certain creditors subordinate their claims to the extent that liabilities exceed assets. This is not, properly speaking, a reorganisation measure since it does not change the company's financial situation (debts are not reduced and equity does not increase). However, subordination agreements can be seen as a first step in an endeavour to turn a company's financial situation around. At the same time, subordination agreements have characteristics of

a «last resort» in that an already over-indebted company has no other options than either receiving subordination in the amount of the shortfall or to go before the insolvency judge. Therefore, creditors, particularly those who are close to the company, are often willing to subordinate claims with the expectation that the operation of the business can continue.

Officers' and Directors' Liability in Insolvency Proceedings

According to art. 745 para. 1 CO, the members of the board of directors, and all persons engaged in the business management or liquidation of the company, are liable to both the company and the individual shareholders and creditors for any losses or damages arising from any intentional or negligent breach of their duties. The behaviour triggering liability must constitute a breach of the officers' duties. Further, such breach of duty has to result in a loss or damage, i.e. materialise in a financial loss. Adequate causation between the breach of duty and the damage caused is also required. In terms of persons that may claim damages, the law names three types of potential claimants: the company, its shareholders, and its creditors.

Corporate responsibility claims are, in principle, pursued by the administrator acting for the insolvent estate. However, if the administrator decides that litigation is not in the estate's interest, he has the discretion to assign the right

to litigate to individual creditors. Thus, one or more creditors may have the right to pursue such claims transferred to them. Any money recovered thereby is first used to satisfy the creditors who brought the litigation, while any excess amount will accrue to the insolvent estate for the benefit of the remaining creditors.

Creditors' Rankings

In insolvency proceedings, all claims are ranked and the proceeds from liquidation are distributed to claimants according to their ranking. Since the claims of the highest-ranked claimants will be satisfied first, it is possible that there may be insufficient funds to satisfy the remaining classes of claimants. Thus, the farther back a creditor is in the rankings, the higher the risk of loss in insolvency proceedings will be. However, while the legal right of the creditor might simply no longer be satisfied, it does not cease to exist. A creditor submitting his claim to subordination agrees to have his claim satisfied only after all other claims are satisfied notwithstanding any securities or privileges.

At this point, a potential source of confusion caused by terminology should be addressed: A distinction must be made between subordination agreements under art. 725 para. 2 CO and contractual subordination clauses as they are typically seen in inter-creditor agreements. The parties to a subordination agreement are a creditor and the company debtor whereas inter-creditor agreements are entered into by different creditors inter se. Inter-creditor agreements are used to define a specific contractual ranking scheme between the respective creditors and are not for the benefit of all creditors. Hence they usually do not qualify as a remedy under art. 725 para. 2 CO.

Practice of the Swiss Federal Supreme Court

In the latest of a series of similar decisions, the Swiss Federal Supreme Court examined an officer's liability claim. The officer was accused of having failed to make the accruals necessary to meet several significant litigation risks. As a result of the officer's negligence, the company distributed more of its profits than it would have been allowed. In consequence, the loss of assets could not be compensated before a declaration of bankruptcy. Upon the board of directors noticing the company's over-indebtedness the parent company, a creditor of its subsidiary, entered into a subordination agreement with the company. This subordination led to a deferral, rather than the avoidance, of bankruptcy. The court held that in the case at hand the subordination did not diminish the damage caused to the company. Rather the damage of the company was tantamount to the total debts of the company and since subordination did not constitute a waiver but left the balance of the company unaffected, the amount subject to subordination had to be added to the total damage.

Review of Subordination Agreements

The aim of this article is not to criticise the Swiss Federal Supreme Court's decision or the rationale underlying that decision, but to flag the latent risks inherent in the wording of subordination agreements that have often been used in the past. As long as a claim is merely subordinated it does not affect the financial situation of a company, and, therefore, the subordination will, according to the current practice of the Swiss Federal Supreme Court, be disregarded when calculating a possible damage to the company caused by officers' negligence. In order to avoid the subordinated claims being included in damage calculation in the event of an involuntary liquidation, the subordinated claims must be waived.

A subordination agreement geared at the Swiss Federal Supreme Court's practice might therefore include a conditional waiver, the condition being involuntary liquidation, i.e. the event of bankruptcy or execution of composition agreement with assignment of assets. A company is well advised to assess the interests involved and, if deemed necessary, review its subordination agreements.

Conclusion

Of course, subordination is not tantamount to a waiver, and a creditor wishing to support restructuring measures hardly wants to be put in a position where he has to waive his claim, even if such waiver is conditional. However, in the event that a company wants to continue doing business by subordination, the board of directors should consider the potential adverse implications of this measure. If and for as long as the Swiss Federal Supreme Court will maintain its practice in the matter, all future and currently existing subordination agreements should reflect this practice so as to avoid subordinated claims being included in damage calculation. Attentive crafting will be required to avoid a novation, which could expose the conditional waiver to being challenged.

The Walder Wyss Newsletter provides comments on new developments and significant issues of Swiss law. These comments are not intended to provide legal advice. Before taking action or relying on the comments and the information given, addressees of this Newsletter should seek specific advice on the matters which concern them.

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