November 2014

Newsletter No. 112

Cash Pooling and Intra-Group Financing:

Very recently, the Swiss Federal Supreme Court *(Bundesgericht)* has rendered a decision on financial assistance, intra-group financing arrangements and cash pooling. The case involved SAirGroup's cash pool and, more specifically, unsecured up- and cross-stream loans granted by a subsidiary to financially distressed borrowers within SAirGroup. The Supreme Court scrutinized the terms of such loan arrangements. It concluded that, in light of the specific facts and circumstances (in particular: lack of security, significant loan amounts and, to some extent, distressed financial conditions of the borrowers), the terms of the loans had not been at arm's length. Thus, in connection with a dividend distribution, the lender's freely distributable equity should have been reduced by the respective (up- and cross-stream) loan amount. This newsletter summarizes the key holdings of this Supreme Court decision and presents a brief overview on its potential consequences for Swiss companies participating in comparable intra-group financing arrangements.

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Supreme Court Decision on Cash Pooling and Intra-Group Financing

On 16 October 2014, the Swiss Federal Supreme Court (SFSC) rendered a decision on intra-group financing arrangements (4A_138/2014). Assessing SAirGroup's cash pool, the SFSC clarified that up- and cross-stream loans, if not granted at arm's length-terms, limit the ability of future dividend distributions. Unfortunately, the SFSC failed to seize the opportunity to establish a reliable standard of what exactly constitutes at arm's length-terms. At least, discussing a separate issue, it confirmed that paid-in surplus *(Agio)* may be distributed to shareholders.

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Factual Background

A subsidiary (the lender) within the failed SAirGroup brought a claim against its statutory auditors for unlawfully confirming the legality of a dividend distribution by the respective lender. The core issue revolved around up- and cross-stream loans granted by such lender under the group's cash pooling arrangement.
In essence, the lending entity argued that its dividend payment exceeded the freely distributable reserves (calculated as of the respective balance sheet date) as they should have been reduced by an amount corresponding to the up- and cross-stream loans actually granted.

Up- and Cross-Stream Loans and Subsequent Dividend Distributions

The court decision essentially confirms established practice and doctrine. Unfortunately, however, the SFSC omitted to seize the opportunity to establish a clear-cut test to assess at arm's length-terms, one of the most pressing questions in practice.

Loans at Arm's Length-Terms

With reference to established Swiss doctrine, the SFSC confirmed that up- and cross-stream loans granted at arm's length-terms are – from a capital protection perspective – always permissible.

Still Unclear What at Arm's Length-Terms Means

Without specifying what exactly constitutes at arm's length-terms and thus establishing a reliable standard, the SFSC denied that the (cross-stream) loan granted in the case at hand was at arm's length. With reference to the lower court, the SFSC noted that the loans were unsecured and – although the parties had entered into a framework agreement with respect to the cash pool – no written agreement on refunding, interests or collateral existed. It was further considered that the financial standing of both borrowers was doubtful. Under such conditions, so the lower court, one could not conclude that the borrowers under the cash pool had either the intention or the ability to repay (*Rückzahlungsabsicht oder Rückzahlungswille*) the loans. An argument often raised in practice, namely the fact that the lender (presumably) benefited from the pooling arrangement, was not taken into consideration.

Unfortunately, the decision remains unclear as to whether the SFSC would have affirmed at arm's length-terms had all the elements discussed been met. Therefore, it remains unsettled if further documentation, collateralization and/or sound financial standing of a borrower, each individually, manages to affirm at arm's length-terms. This will be a topic in future discussions with auditors.

In going beyond the reasoning of the lower court, the SFSC addressed whether, generally speaking, it was even possible for a company to participate in a zero balancing cash pool at arm's length-terms. It ultimately left the issue unresolved as it held that the loans, in amounts of several million Swiss Francs, were unsecured and granted without taking the financial situations of the borrowers into consideration. Against this backdrop, the SFSC concluded that the loans had not been at arm's length-terms.

Loans not at Arm's Length Limit Future Dividend Distributions

The SFSC held that one of the core principles in Swiss corporate law, the prohibition to refund capital contributions (*Verbot der Einlagenrückgewähr*), aiming at the protection of a company's share capital and relevant reserves, also limits the granting of up- and cross-stream loans not being at arm's length-terms.

The SFSC specified that the granting of any up- or cross-stream loans not at arm's length-terms did not qualify as a breach of the prohibition to refund capital contributions as long as the relevant loan amount was covered by freely disposable equity. However, as a result of such a loan, a prudent board would have to block a corresponding amount which would thus no longer be available for subsequent dividend distributions. Any up- or cross-stream loan not at arm's length-terms would conflict with the prohibition to refund capital contributions if and to the extent the loan amount exceeded the freely disposable equity. Also, when determining the freely distributable equity amount for purposes of dividend distributions, the amount corresponding to such loan may not be included in the freely distributable reserves.

Relevant Time

Furthermore, the SFSC also held that the relevant point in time to assess whether a company possesses enough freely disposable equity to distribute a dividend was the balance sheet date and not the date of the dividend distribution.

Paid-in Surplus is not Protected under the Prohibition to Refund Capital Contributions

Finally, the SFSC settled a long-disputed issue in Swiss doctrine. It held that capital surplus, including capital contribution reserves, was not protected under the prohibition to refund capital contributions but may be distributed by way of dividends (as long as all other general prerequisites to pay out dividends are met).

So far, a minority in Swiss legal doctrine argued that additional paid-in capital was not intended to be (re-)distributed to shareholders as it did not form part of the profit disposable to shareholders. In contrast, the majority opinion in Swiss doctrine (in support of most audit firms' practice) held that paid-in surplus was to be treated as a general reserve, governed solely by the pertinent provisions applicable thereto without any additional protection, particularly not by the prohibition to refund capital contributions.

Any uncertainty in this regard has now been eliminated and this issue has been finally settled. The SFSC held that additional paid-in capital is to be allocated – *ex lege* and without requiring further resolutions by the shareholders' meeting – to the general reserves. Such additional paid-in capital may thus be freely distributed if and to the extent that it exceeds, together with any other general reserves, one-half of the nominal share capital (or twenty percent thereof for holding companies). This holding also aligns Swiss corporate law with Swiss tax law which, ever since the introduction of the principle of capital contribution, treated additional paid-in capital as distributable.

Practical Implications

In essence, once the dust has settled, one realizes that the decision by and large confirms established doctrine. Unfortunately, the SFSC failed to seize the opportunity to establish a reliable test to assess at arm's length-terms and legal practice will need to continue to deal with this uncertainty going forward.

Considering this court decision, we have identified the following key takeaways:

– Same as prior to this court decision, up- and cross-stream loans granted at arm's length-terms are – from a capital protection perspective – permissible.

– Although discussing at arm's length-terms and several of their potential indications, and attaching considerable importance to collateralization, loan amount and financial conditions of the borrower, the SFSC failed to draw a line by establishing a reliable test of what exactly constitutes at arm's length-terms. We therefore expect to see more complex assessments of cash pools and similar arrangements and thus prolonged discussions with auditors on the terms of intra-group financing.

– If not at arm's length, up- and cross-stream loans may only be granted in an amount covered by freely distributable equity. Any such up- and cross-stream loan limits future distributions in a corresponding amount by de facto blocking freely distributable equity.

– Finally, distributions from paid-in surplus, including capital contributions reserves, may be made if and to the extent that such paid-in surplus exceeds, together with the other general reserves, one-half of the nominal share capital or twenty percent thereof for holding companies.

In consequence, as the decision does not manage to establish clear-cut standards for intra-group financing arrangements, we expect to see an increased complexity in liquidity planning and cash pooling arrangements for Swiss companies. Discussions with auditors will increase as existing cash pools will face elevated scrutiny and should be carefully re-assessed. Swiss companies participating or planning to participate in up- or cross-stream financing arrangements are well advised to review their loan documentation and, if appropriate, may consider introducing (tighter) collateralization, a suitable monitoring of the financial condition of any borrower and/or reducing excessive loan amounts.

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