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Article 725 *et seq.* CO: (Il-)Liquidity, Capital Loss and Over-Indebtedness – New Duties for Swiss Boards

Effective 1 January 2023, the revised Swiss Code of Obligations (**CO**) provides *inter alia* for certain new (and more stringent) duties, placed upon the members of the board of directors, regarding the financial condition of a Swiss Corporation (art. 725 *et seq.* CO). Directors will have to pay close attention to any threat of insolvency (illiquidity) and comply with short and non-extendable deadlines (90 days) when, in cases of over-indebtedness, pursuing restructuring measures in order to avoid filing for solvency proceedings. Putting the company back on a healthy footing can prove challenging, especially for venture / start-up companies.

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Overview

As part of the corporate law revision (*Aktienrechtsrevision*) adopted by the Swiss Federal Parliament on 19 June 2020, the regulations dealing with capital loss and over-indebtedness (art. 725 *et seq.* CO) have been revised. The new (to some extent adjusted) regime includes, in general, separate articles governing the following aspects:

- Liquidity monitoring and threat of insolvency/illiquidity (art. 725 CO)
- Capital loss (art. 725*a* CO)
- Over-indebtedness (art. 725*b* CO)
- Revaluation of properties and participation rights (art. 725*c* CO).

The rules become effective as of 1 January 2023 (subject to a transition period applicable to the amendment of existing legal documents, which has nevertheless little impact on the art. 725 *et seq.* CO regime).

The goal of the revision was to introduce a more flexible approach in case of financial distress and to prevent delaying bankruptcy proceedings (*Konkursverschleppung*). Such delay has become a frequent phenomenon these days when a company is slipping into financial distress. Ultimately, the new rules are meant to decrease board liability risks. While to some extent justified and helpful to enhance commitment by the relevant corporate bodies, part of the new regime is expected to pose new challenges, in particular to early-stage (venture) companies. These companies often generate little or no revenues, yet burn significant cash and pursue a financial plan stretching from one financing round to the next (mostly expected to be closed within 12-24 months). As fundraising can easily take 9 months or longer, prudent planning and a focus on execution, without crossing any red lines, are critical.

At the centre of the attention of the board of directors (the **Board**) are *cash flow* and *balance sheet* related information and actions. Non-compliance may result in personal liability (joint and several) of any member of the Board, a risk which is often ignored in practice but becomes imminent and material in a subsequent bankruptcy.

Liquidity Monitoring and Threat of Insolvency (art. 725 CO)

While financial control and planning has always been part of the non-transferrable duties of the Board (art. 716*a para.* 1 *cif.* 3 CO), the revised law explicitly clarifies that the Board must also monitor solvency (art. 725 *para.* 1 CO). Put differently, a system must be in place allowing the Board to monitor as to whether the company can meet its payment obligations on time when they become due. Accordingly, in practical terms, a company must have a liquidity plan, irrespective of the size or the financial condition of the company. Such a plan needs to be updated regularly, *i.e.* at least weekly during a crisis (in our view), and has to reflect both «cash-in» and «cash-out» items, as anticipated for the next 12 months (again in our view, also in line with art. 958*a para.* 2 CO). Future cash arising out of any financing may be taken into account to the extent effectively committed or at least likely to occur. Similar rules have existed for «going concern assessments» under art. 958*a para.* 2 CO. Said (accounting) rules provide that financial statements shall be based on *liquidation* values if the company's activity (or parts thereof) is intended to be discontinued (or becomes likely unavoidable) within the next 12 months from the balance sheet date. As a result, the values are mostly lower, thereby reducing the company's equity.

A new paragraph 2 addresses the threat of insolvency (*drohende Zahlungsunfähigkeit*). In such case, the Board, acting expeditiously (*in gebotener Eile*), must secure solvency. Art. 725 *para.* 2 CO does not provide for any further criteria, neither as to when a threat of insolvency exists, nor which actions must be taken. In line with court precedents and prevailing views by

practitioners on similar rules under the CO, the following can be used as a guideline, using a mix of a certain likelihood of an event and a defined forecast. First, a *temporary* liquidity squeeze (even if technically resulting in defaults) does not fall under art. 725 CO. The insolvency must be permanent, which means restructuring measures become unlikely. Second, over-indebtedness (see below), while frequently the result of a negative going concern assessment (as mentioned above), does not *per se* trigger illiquidity (over-indebtedness is a balance sheet (equity) based test; over-indebted companies may still have sufficient liquidity). As to the applicable time frame (forecast), a 12-month period applies, which is in line with the 12-month rule under art. 958*a para.* 2 CO (see above). Accordingly, a threat of insolvency occurs if it is *very likely* that within the next 12 months a company cannot fulfil its payment obligations when they become due and it becomes unlikely that restructuring measures (to remedy insolvency) can be taken.

In case of such a threat of insolvency, the Board must implement the necessary measures in an expedited manner. The typical measures may include the preparation and execution of cost reduction programs (*e.g.* layoffs), extension of maturity dates on debt and invoices (*e.g.* through standstill agreements), monetisation of receivables (factoring), sale of assets, and/or issuance of subordinated loans or any increase in equity (share issuance, injections into reserves). Even debt-equity swaps, while not having any direct impact on cash-flow, may be beneficial as a lower debt level helps convince creditors to provide debt financing.

The new law (art. 725 *para.* 2 CO) also explicitly requires the Board to file a request for a moratorium under the Swiss Bankruptcy Law, if necessary. In our view, this is the case if the out-of-court restructuring measures are insufficient to remedy the threat of insolvency. However, in most of these cases, the Board must file for insolvency proceedings to comply with art. 725*b* CO (over-indebtedness; see below) and hence a request for a moratorium should be filed, if there are sound reasons to believe that, by entering into a composition agreement, a court protected restructuring is possible and the company can be saved. The Board may decide to request a moratorium even if not formally required to do so under art. 725 or 725*b* CO.

Overall, art. 725 CO clarifies and specifies select duties of the Board, some of which could be considered to already fall under the existing non-transferable and inalienable duties regarding financial control and overview (art. 716*a para.* 1 *cif.* 3 CO) combined with the general duty of care (art. 717 *para.* 1 CO).

Capital Loss (art. 725*a* CO)

As a second and separate legal layer in the context of financial distress situations, art. 725*a* CO addresses the so called «capital loss» (*Kapitalverlust*) situation. In substance, the provision reflects existing law, adding minor clarifications.

The relevant test is as follows: If 50% of the «protected equity» (*geschütztes Eigenkapital*), being the sum of (*i*) the nominal share capital (including participation capital, if any), (*ii*) the legal capital reserve (*geschützte Kapitalreserve*, art. 671 CO) and profit reserve (*gesetzliche Gewinnreserve*, art. 672 CO) which are *not repayable* as per art. 671 *para.* 2 and art. 672 *para.* 3 CO, as well as (*iii*) the (separate) legal profit reserve for treasury shares (held by the company or a controlled subsidiary, art. 659*b para.* 2 and art. 671 *para.* 4 CO) or arising out of the revaluation up to the fair market value (*Aufwertungsreserve*, art. 725*c para.* 3 CO), are no longer covered by the net assets (assets minus liabilities), then there is a capital loss (frequently referred to as «*hälftiger Kapitalverlust*»). In other words: There is a capital loss once equity is lower than 50% of the protected equity. Calculation example:

Item	*Equity*	*Protected Equity*
Share Capital (nominal amount)	*100,000*	*100,000*
Legal Capital Reserve + Profit Reserve	*200,000*	*50,000**
Reserve for Treasury Shares	*10,000*	*10,000*
Revaluation Reserve	*10,000*	*10,000*
Loss carried forward	*- 130,000*	
Annual Loss	*- 110,000*	
Total Equity	***80,000***	
Total Protected Equity		***170,000***
50% of Protected Equity		***85,000***
Capital Loss?	***Yes (80,000 < 85,000)***	

** Not distributabe amount (50% of share capital, 20% for holding companies)*

The relevant figures for the calculation are those shown in the most recent annual financial statements (Swiss statutory accounts under the CO; on a stand-alone basis, *i.e.* not consolidated), using going concern values (or liquidation values absent a going concern). It should be noted that irrespective of said historical financials, the Board must organize and run the calculation based on *interim* financials if there is a reasonable concern that a current capital loss exists!
If such capital loss is confirmed, the Board must implement measures to eliminate it in an expedited manner. For such purposes, the CO also allows for revaluation of fixed assets (*Grundstücke*) and participation rights (*Beteiligungen*) up to the fair market value (art. 725*c para.* 1 CO). Given the qualification as legal reserves, the amount of the revaluation must be twice the amount necessary to eliminate the capital loss (absent any other measures). Only to the extent necessary, the Board must (also) take restructuring measures (*Sanierungsmassnahmen*), typical through increases in equity (*e.g.* capital increases), operational measures to increase cash or decrease debt (thereby strengthening the company's equity) or measures to reduce the level of protected equity. The involvement of the shareholders' meeting is no longer required, unless the respective measure falls within its competence (*e.g.* ordinary capital increase).

Over-Indebtedness (art. 725*b* CO)

General

In line with the previously existing rules, art. 725*b* CO provides that if there is a reasonable concern (*begründete Besorgnis*) that the liabilities of the company (*Fremdkapital*) are no longer covered by the assets (over-indebtedness, *Überschuldung*), the Board must immediately prepare interim financial statements. If the over-indebtedness is confirmed the Board must notify the court (unless statutory exceptions apply, see below), which will then open bankruptcy proceedings or commence composition proceedings. Calculation example:

Item	*Equity*	*Protected Equity*
Share Capital (nominal amount)	*100,000*	*100,000*
Legal Capital Reserve + Profit Reserve	*200,000*	*50,000**
Reserve for Treasury Shares	*10,000*	*10,000*
Revaluation Reserve	*10,000*	*10,000*
Loss carried forward	*- 130,000*	
Annual Loss	*- 200,000*	
Total Equity	***-10,000***	
Total Protected Equity		***170,000***
Capital Loss?	***Yes (negative equity)***	

** Not distributabe amount (50% of share capital, 20% for holding companies)*

Preparation of Interim Financial Statements

If the Board has a reasonable concern that the liabilities of the company are no longer covered by the assets (*i.e.* negative equity) it must immediately prepare interim (statutory) financial statements both at going concern values and at liquidation values (the latter may be omitted when there is a positive going concern assessment and the interim financial statements at going concern values do not show any over-indebtedness). If the going concern assessment is negative, interim financial statements at liquidation values are sufficient. If these interim financial statements show a negative equity, the company is over-indebted.

Under the new law, the Board must prepare full financial interim statements, *i.e.* not only a balance sheet but also a profit and loss statement plus notes. In contrast to the old regime, the interim financial statements must now be reviewed (*geprüft*) by auditors (even in case of an opting-out). However, no full audit is required. Both the Board and the auditors must act expeditiously. As the relevant work streams can be time consuming, this process may take a few weeks until such financials are presented to the Board. If over-indebtedness is confirmed, the Board must notify the court unless one of the two exceptions mentioned in art. 725*b para.* 4 CO is applicable.

Exception 1: Subordination (art. 725*b para.* 4 *cif.* 1 CO)

The first exception applies if creditors of the company subordinate their claims to those of all other creditors in the extent of the over-indebtedness. This exception already existed under the previous version of the CO. However, some important changes have been introduced: The new law now clearly states that the subordination must cover the principal amount and any interest due during the period of over-indebtedness. As many subordination agreements omit (or exclude) interest, pre-existing subordination agreements lacking an explicit deferral of interests are likely to be considered insufficient under the new law. Due to the little leeway offered by the wording of the law, the Board should therefore agree on a corresponding amendment to pre-existing subordination agreements with creditors (in light of the transitional provision by 31 December 2024). We recommend not to rely on the idea that interests are now

deemed subordinated by operation of law. It should also be noted that at least in the guidance provided by Expert Suisse (*i.e.* the Swiss specialist association for auditing, taxes and fiduciary services), in sensitive cases (*heiklen Fällen*), the auditors may see the need to notify the court even before 31 December 2024, absent a proper subordination including interests. This poses a significant risk to all companies in financial distress but having otherwise solid subordinated debt (excluding interest) in place. Furthermore, to qualify as an effective exception under art. 725*b para.* 4 *cif.* 1 CO, the subordinated amount must be sufficiently high to cover the over-indebtedness amount plus anticipated future losses, there can be no repayment until over-indebtedness has been eliminated, the loan must be unsecured, and the lender's financial condition must be robust (to avoid invalidity of the subordination agreement under the «Pauliana» rules under Swiss Bankruptcy Law). If the over-indebtedness amounts shown in the financial statements at going concern values (assuming positive assessment) and at liquidation values are different, it is sufficient for the subordinated amount to cover the smaller of the two over-indebtedness amounts (typically the one in the financials at going concern values).

Exception 2: Out-of-Court Restructuring (art. 725*b para.* 4 *cif.* 2 CO)

The second exception provides that the notification of the court may be omitted as long as there is a reasonable prospect that the over-indebtedness will be remedied within a reasonable period of time and that the deficit will not increase significantly. In principle, this exception has already applied under case law by the Swiss Federal Supreme Court. In the course of the corporate law revision however, the lawmakers have disregarded prevailing practices and other court precedents (which have not provided for a firm deadline) as the revised rule now dictates a very rigid 90-day period during which the remediation needs to be completed. The period begins to run as soon as the audited interim financial statements are available, and it *cannot* be extended. Put into context, any company trying to make use of this exception will face significant challenges to get the restructuring in place, also putting an undue risk on the viability of partial restructuring measures which ultimately aim at a full remediation.

The deadline also imposes a risk to investors providing equity financing during that period which is not wired to a blocked account even if it is legally not required for capital surplus (*agio*) in the context of a capital increase. In breach of such deadline, any restructuring measure effectively eliminating over-indebtedness *after* such 90 days remains valid; hence, this route may be an option for the Board as long as such measures are taken shortly after the deadline and a subsequent bankruptcy can definitely be avoided (no damages would be incurred).

In practice, a Board, anticipating said deadline, will probably try to make use of vague rules on timing («in an expedited manner») to get audited interim financials in place. Also, it remains to be seen how courts will interpret the requirement «*and that the deficit will not increase significantly*». Under the current case law this means that creditors must not be much worse off than they would be if the court had been notified. Said rationale should still apply.

Entry into Force and Transition Period

The provisions addressed above will enter into force on 1 January 2023. The rules provide for a 2-year transition period for the amendment of existing legal documents, which in our view should apply to subordination agreements as well. As stated above, auditors may disregard this aspect.

To Dos

In light of the above and potential Board liability in case of non-compliance, it is advisable to be very well prepared to manoeuvre the revised articles. Members of a Board should pay close attention to the new regime, in particular regarding the rigid 90-day period and the requirements for subordination agreements. For future subordination agreements, it is critical for the subordination to include the interests and not only the principal amount. A review of internal control procedures regarding the assessment of the financial situation of the company is another action item.

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