Is a financially sound Swiss subsidiary allowed to participate in a foreign US court debtor in possession restructuring proceeding?

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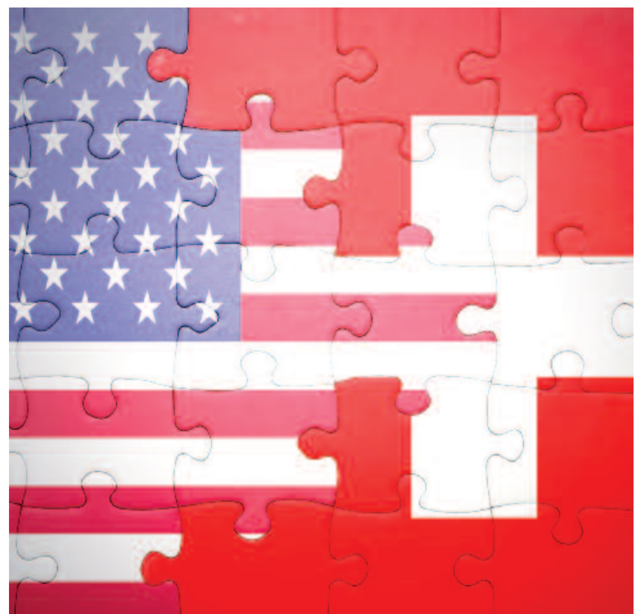
What issues are likely to be encountered by board members of a Swiss company with a US parent that faces financial constraints and considers filing for a US chapter 11 proceeding? We are looking at one of many Swiss companies[1] which has accumulated substantial retained earnings, is taking the function of a European holding or serves in a treasury function for a US controlled group of companies. More than 500 majority owned US affiliates are incorporated in Switzerland and contribute a very significant portion to the US Swiss trade.[2]

Due to such functions day-to-day operations are global and the business of the Swiss company touches upon several jurisdictions worldwide. Their operational and financial assets which are particularly exposed in case of a financial stress situation of a group of companies are investments in subsidiaries, intercompany loans and receivables, even inventories, intellectual property rights and cash; the latter is often tied up in a group-wide cash management arrangement (cash-pooling).

No Group Approach under Swiss Law

In contrast to such an inter-dependent business set up, under Swiss corporate law as well as under Swiss insolvency law or Swiss private international law, respectively, there is no consolidated group approach; rather each company is viewed as stand-alone entity. Swiss law requires that each legal entity pursues its own corporate scope independently of contradicting interests of its direct or indirect shareholders or non-subsidiary affiliates. In case of insolvency the Swiss company has to carry out its own main proceeding at its registered domicile, thereby isolating its own assets for the benefit its own creditors.



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General Duties of the Board

The primary duty of the board of directors is to safeguard and promote the interests of the company. The interests of the company is ultimately the yardstick for the board's entire activity, i.e. all decisions taken by the board of directors must focus on this interest. The guideline for determining the company's interest is not the short-term financial interest of the shareholders, but the long-term and sustainable increase in the company value for the benefit of all stakeholders.

Duties of the Board in case of Financial Distress

In the event of a crisis, the board is in particular obliged to take measures to safeguard the company's existence, i.e. to ensure liquidity, to strengthen earnings power through restructuring and also to restore equity.

However, the obligation to initiate restructuring steps in a crisis in order to preserve the company's existence shifts into the background if the company's reserves and equity capital are depleted by losses. At this point in time, in accordance with article 725 Swiss Code of Obligation (CO), the interest of creditors in a rapid bankruptcy liquidation of the company and the corresponding limitation of losses has primarily to be taken into account.

The duties of the board members are set out clearly in the event a Swiss company is on the verge of becoming over-indebted. Pursuant to article 725(1) CO if the last annual balance sheet shows that 50% of the share capital and the legal reserves is exhausted (so called 'capital loss') remedial measures must be proposed immediately to the shareholders by the board of directors. If the financial condition of the company has further deteriorated so that substantiated concerns of an over-indebtedness exist, an interim balance sheet must be prepared and be submitted to the auditors for verification (article 725 (2) CO). The auditors will then apply a dual test: the assets should be assessed first, at going concern value[3] and, second, at break-up value. If the auditors in their findings confirm over-indebtedness (and the over-indebtedness cannot be remedied with subordination of creditors' claims) the board of directors has the duty to apply for bankruptcy, in order to protect the company's creditors. If not, the auditors have the duty to file an application. Alternatively, debtor protection might be sought via a debt moratorium or a corporate moratorium proceeding. At this moment immediate action by the board is requested. It is generally accepted that the board has some breathing room of 4 to 6 weeks to take the required action and when this time is necessary to put a serious rescue plan in place. This concept leaves its tracks in the context of cross-border insolvency observations.[4]

Universal Approach in Swiss Main Insolvency Proceeding

As per its basic concept of adopting a universal approach assets of a Swiss debtor located abroad are part of the Swiss insolvent estate. With the opening of a Swiss main insolvency proceeding in Switzerland all of the debtors' assets form one sole worldwide bankrupt estate. The question is whether the laws of the foreign jurisdiction allow for a direct collection of the assets abroad by the receiver of the main proceeding or a local secondary proceeding needs to be put in place.[5] In the US the rules for such ancillary proceeding were adopted by way of introducing Chapter 15 in the US Bankruptcy Code on the basis of the UNCITRAL Model Law on Cross-Border Insolvency.

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Typically, a Chapter 15 proceeding is based on a foreign (here Swiss) main proceeding whereby the main proceeding does not necessarily have to be a bankruptcy proceeding. It is designed to provide cooperation, coordination and relief sought by the foreign insolvency proceeding rather than by the board of directors of the Swiss company. Hence, the assistance coming from the Chapter 15 proceeding requires the existence of a main proceeding of a debtor outside of the US and a receiver of the main proceeding who initiates the proceeding.

Initiation of Insolvency Proceedings

Against this legal background the question arises whether the board of directors of a sound Swiss Company can at its own resolution subject the Swiss company to the US reorganisation proceeding under Chapter 11 of the US Bankruptcy Code as main proceeding with a debtor in possession capacity. This can be done either alone or as part of a co-debtor filing together with the US parent. Technically, from a US point of view this can be achieved easily. For purposes of constituting a debtor for the Chapter 11 proceeding the legal entity must have 'a domicile, a place of business, or property in the USA'.[6] To form US jurisdiction it may be sufficient to have a minimal deposit in a US bank account or provide a retainer for US counsel.

Often it is overlooked that for the filing of a voluntary insolvency proceeding in Switzerland actual over-indebtedness is not required; but as long as creditors' claims are still regularly paid when due and no protection by the court appears necessary the initiation of such proceeding is hardly considered to be in the best interest of the company. In consequence, it is unlikely that a board of directors of a Swiss company will voluntarily start a main insolvency proceeding in Switzerland in such circumstances risking that a receiver is appointed. But, is there an alternative by the Swiss board of directors to join the US parent filing for Chapter 11 as co-debtor?

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Characteristics of Chapter 11 Proceeding

At this point some basic features of a voluntary Chapter 11 proceeding should be looked at. A US debtor may petition a Chapter 11 case without being insolvent, be it on a cash flow or balance sheet basis. The purpose of a Chapter 11 is the rehabilitation and reorganisation to achieve a continued going concern situation of the debtor. If successful it ends with the approval of a reorganisation plan which most likely includes a 'haircut' of the claims impaired to allow continuation. Dissenting creditors or creditor classes will be subjected to a cram down procedure, which is binding on them. Typically, the proceeding leaves the debtor in possession ('DIP') whereas one or few creditor committees are supervising the process and support the work out of the reorganisation plan. The automatic stay granted by the bankruptcy court shields the debtor from enforcement and collection actions. Further, an early termination of hindering contracts may be ordered. The proceeding includes all assets and liabilities. In a radar view there are certain similarities between the Swiss (voluntary) main insolvency proceeding and the U.S. chapter 11.

Swiss Subsidiary as Co-Debtor under Chapter 11?

As co-debtor in a main US proceeding the Swiss board of directors is likely to face situations where they are no longer in capacity to properly protect the interest of the Swiss company, which is, however, their primary duty. Such situation could, as a result, probe their personal liability for violation of their duties of care and loyalty under Swiss law. The following are just a few features of the US proceeding which collide either with the interest of the company from a Swiss corporate law perspective or with the conduct of a main Swiss (insolvency) proceeding, to name a selected few:

- Broad, worldwide jurisdiction would be assumed by the U.S. bankruptcy court over all property of the Swiss debtor wherever located.

- The business of the Swiss company would be formed as bankrupt estate and for the duration of the Chapter 11 case be run by existing management of the debtor as 'debtor in possession' unless and until a trustee is appointed.

- The US bankruptcy court would apply US bankruptcy rules which are different from the regime of Swiss bankruptcy law (as example: the priority regime of claims, rules for avoidance action etc).

- The Swiss debtor is put under risk that the Chapter 11 proceeding before the US bankruptcy court is carried out on a consolidated group basis involving all 'co-debtors', i.e. affiliates who joined the filing rather than as an isolated proceeding for the Swiss debtor; the stand-alone concept will then not be respected.

- The Swiss debtor may be faced with a requirement to submit its cash positions to a collective control account thereby violating one of the board of director's primary duties which is to control and preserve the financial means of the Swiss company.

- A Swiss co-debtor is likely to be burdened with substantial costs incurred in the U.S. Chapter 11 proceeding to the detriment of its own creditors.

- Decisions may be taken by creditors' committees which do not focus on the creditors of the Swiss debtor.

- Instruction orders may be given by the US bankruptcy judge which conflict with Swiss law and challenge the stand-alone concept. The automatic stay granted in the Chapter 11 proceeding to protect the property of the estate is likely to affect all creditors of the Swiss company, especially if supported by a contempt of court order not to enforce claims on a worldwide basis.

- It is an eminent duty of the board members of a Swiss company to preserve financial autonomy and in particular to protect the share capital and statutory reserves of the Swiss company. Actions violating such principle are considered void under Swiss law. Capital protection provisions become particularly relevant in the event the Swiss company participates in a group financing, typically in the role of a guarantor of a syndicated credit facility and/or provider of up- or side-stream security. Under Swiss law, such financial support must be limited to the distributable earnings of the Swiss company. There is no assurance that a US bankruptcy court would respect such limitation which is designed to protect the creditors of the Swiss company.[7]

- Arguably, the Swiss board of directors could take the position that the submission for a main proceeding in Switzerland (as required by law in case of over-indebtedness) as well as at the stage of the US Chapter 11 filing the company is not over-indebted. It is unclear, however, whether and under what conditions an exit from Chapter 11 would be possible under such circumstance. A debtor in possession is entitled to claim a termination of the Chapter 11 proceeding. But it is unlikely that with the opening of the main proceeding in Switzerland an unwinding of the temporary Chapter 11 proceeding would be possible. No specific rules are known which would apply to such situation. Likewise, it is unclear whether the US bankruptcy court could agree to a

conversion of its proceeding into a chapter 15 proceeding and with what consequences.

US bankruptcy courts, in the past, have accepted debtors for the Chapter 11 proceeding whose registered seat or Centre of Main Interest (COMI) had not been transferred to the USA. In consequence, the US court has assumed (and retained) jurisdiction to hear and determine all related matters.[8] With a proposed new legislation[9] Swiss government is seeking to improve the current legal basis for coordination and cooperation in cross-border insolvencies, but it will not resolve the inherent concept that the Swiss company has to stand alone.

In consequence, with a submission to the US bankruptcy court, the Swiss board of directors would seriously frustrate the conduct of a Swiss main proceeding (which could be followed by an ancillary proceeding under Chapter 15, as instigated by the then Swiss receiver). Also, depending on the individual case, there is a substantial risk that such submission would be considered as not being in the interest of the company.

Further Aspects: Implications from the Swiss Penal Code[10]

By voluntarily submitting the main proceeding to a foreign court the board members of a Swiss company could encounter another risk. For protection of the sovereignty of Switzerland article 271 SPC puts under criminal sanctions a person who undertakes actions on Swiss territory for a foreign state or who abets such actions which are reserved for Swiss authorities or officials. The reach of this legal provision is much debated notably regarding spying actions. But in a litigation context, the Swiss Federal Criminal Court recently confirmed[11] that absent of treaty relief the arrangement of a private service of process constitutes a violation of article 271 SPC as service of process in Switzerland is a sovereign act. Considering such verdict the board of directors could also become personally exposed to criminal sanctions. We have not heard that permission under article 271 SPC has been granted by Swiss authorities to a Swiss company to submit to a foreign court for a main insolvency proceeding. While the authors do not take the position that 271 SPC would come into play in any event, the board members should be aware of the potential risks involved in their decision.

Final Conclusion

As result, board members of a Swiss company – if they want to avoid unexpected personal liability – should not easily follow orders from the US parent company but carefully analyse the individual circumstances and consequences a decision to voluntarily submit their Swiss company to and participate in a US Chapter 11 proceeding could have.

Footnotes:

1 For the ease of reading 'company' refers in this discussion to a corporation according to article 620 et seq. Swiss Code of Obligation.
2 www.amcham.ch/news/downloads/170227_Swiss_Economic_Footprint_2017.pdf.
3 To preserve going concern value the company needs to demonstrate that it can carry on the business for the next reporting period (article 958 a CO).
4 For a more detailed discussion see Business Restructuring & Insolvency Report, Edition 2016, p. 67 et seq
5 Note in this context that the European Insolvency Regulations do not apply to a Swiss company.
6 Section 109 (a) U.S. Bankruptcy Code.
7 Unpaid withholding taxes on actual or constructive dividends may expose the board members to personal liability.
8 Cf. Xerium Technologies Inc. et al, Case No 10-11031 (KJC). District Court of Delaware, 10 April 2010.
9 Message and draft bill by Federal Council of 24 May 2017; BBl 2017.
10 'SPC'.
11 Order by Swiss Federal Criminal Court SK.2017.16, 6 October 2017.

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