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Beware when Dealing with Shareholder Loans and Cash Pools

Based on first experiences in connection with the preparation and audit of the annual financial statements 2014, it becomes clear that a recent decision of the Swiss Federal Court, and in particular the interpretation thereof by EXPERTsuisse, has forced the handling of up-stream or cross-stream loans into a straightjacket that is difficult to manage in practice. The same applies to cash pool claims within a group.

1 INTRODUCTION

Shareholder loans from Swiss companies to their direct or indirect shareholders and/or parent companies (**up-stream**) or to their affiliates (**cross-stream**) are problematic from an equity protection and tax law perspective and are permissible only to a limited extent.

This normally also includes **receivables from intragroup cash pools**, in particular, when they are set up as physical zero balancing cash pools. However, also virtual *i.e.* notional cash pools can be delicate (see in this regard Schellenberg Wittmer Newsletter of November 2011). When subsequently referring to "**shareholder loan**" or "**intercompany loan**" for reasons of simplification, this includes all forms of up-stream and cross-stream loans, including claims against cash pools within the group.

In a recent judgment dated 16 October 2014 regarding *Swisscargo* the **Swiss Federal Court** clarified and tightened the requirements under corporate law for the permissibility of distribution of dividends in combination with the granting of intercompany up-stream and cross-stream loans.

Following this, the Swiss Institute of Certified Accountants and Tax Consultants (as from the 1 April 2015 operating under the name "**EXPERTsuisse**") supplemented and adjusted, with a publication dated 17 December 2014, their former guidelines in the Manual for Swiss Audit (MSA) regarding the assessment of intercompany claims, cash pooling and dividends.

Based on a broad interpretation and rough generalization of the issued considerations of the Federal Court in the case at hand, these recommendations and the **practice of the external auditors** based thereupon set the benchmark for handling shareholder loans even higher than the Federal Court. The companies concerned are subsequently confronted with problems that are hard to solve.

Despite the **widespread criticism** within the doctrine and practice that was provoked by the **Federal Court's decision**, Swiss companies will have to live with it for the time being. However, regarding the **guidelines of EXPERTsuisse** that go beyond the intended goal, a revision is necessary as soon as possible.

2 THE CASE ASSESSED BY THE FEDERAL COURT

In the case at hand, the Federal Court had to assess the question of whether **the external auditors** of Swisscargo AG, a Swiss company (in the meantime subject to liquidation by composition proceedings) belonging to the former Swissair group, committed a **breach of duty** giving rise to liability by confirming, in the course of the audit of the annual accounts, a **proposed dividend** to be in compliance with the law and the statutory requirements. Such breach and a resulting liability was affirmed on the ground that the auditors had failed to indicate in their audit report that the proposed dividend should have been reduced by the **existing loan receivables** against the grand-parent company of the group and against the Cash Pool master of the group, that were considered by the Federal Court to not have been at arm's length.

3 CONSEQUENCES WHEN DEALING WITH SHAREHOLDER LOANS

3.1 IN GENERAL

In particular CFOs and boards of directors of Swiss companies must deduce from the Swisscargo case certain important decisions for granting shareholder loans as well as for their potential effects on future dividend distributions. Regarding the recommendations of EXPERTsuisse that go beyond the Federal Court's considerations and their implementation in the audit practice, it is just as important to indicate which questions the Federal Court did **not** have to decide upon and for which **no** conclusions or instructions for the assessment of shareholder loans can be deduced from the decision.

In this Newsletter, we shall not comment on the **tax implications** of shareholder loans that are not at arm's length (see in this regard the overview in Schellenberg Wittmer Newsletter of November 2011 that is for the most part still accurate).

3.2 SHAREHOLDER LOANS THAT ARE NOT AT ARM'S LENGTH RESULT IN A FACTUAL BLOCKING OF THE FREE EQUITY

According to the Federal Court, **shareholder loans**, including receivables from intra-group cash pools, **that do not stand up to third-party comparison (so called at arm's length test)** result in a "**factual blocking of the free equity**" in the total amount of such loans.

As a result, the uncommitted capital that is available **for the distribution of dividends** (art. 675 para. 2 CO) as well as the unlocked capital with regard to the **prohibition of returning capital contributions** (art. 680 para. 2 CO) are **reduced** by the full amount of such loans.

Contrary to otherwise expressed opinions, the Federal Court does **not** rule in its decision that the required blocking of the free equity should take place in the form of a separately reported **special reserve**.

3.3 THE FACTUALLY BLOCKED QUOTA OF THE FREE EQUITY MUST NOT BE USED FOR DIVIDEND PAYMENTS

In the case judged by the Federal Court a distribution of dividends was made out of free equity, without first deducting the outstanding shareholder loans that were not considered to have been at arm's length.

As a consequence, the Federal Court ruled that the dividend did in the said amount **violate the provisions on the protection of reserves** and did thus constitute an **improper distribution of profits according to art. 675 para. 2 CO**. The Federal Court thus approved in principle the liability claims raised in that context against the external auditors.

3.4 STATIC ASSESSMENT AS OF THE BALANCE SHEET DATE

According to the Federal Court, the question of whether or to what extent shareholder loans, that are not at arm's length, result in a blocking of the free capital available for the distribution of dividends is to be assessed as **per the balance sheet date** of the relevant annual financial statements. Any subsequent developments, such as the repayment and/or new establishment of such loans occurring after the balance sheet date, remain irrelevant according to the Swisscargo decision.

Thus, there exists a **temptation** that has already been observed in the practice **to make use of this static approach** and to have such shareholder loans temporarily repaid shortly before the balance sheet date in order to grant them again under the same terms immediately afterwards. From a purely formal perspective, there is, in such a situation, no reason for a factual blocking of the own funds as of the balance sheet date and the lender's ability to distribute profits thus remains undiminished. However, such a course of action entails considerable risk and would not protect the responsible corporate bodies, including the external auditors, against potential liability claims when such arbitrary "loan gaps" are created and played on in order to allow for the dividending-up of otherwise blocked equity capital.

> "The actual recommendations of EXPERTsuisse for the handling of shareholder loans overshoot the mark."

3.5 HOW TO DETERMINE THAT A SHAREHOLDER LOAN IS (NOT) AT ARM'S LENGTH?

In its Swisscargo decision, the Federal Court held that the intercompany loans in question were not at arm's length essentially due to the **absence of security**. The Federal Court further indicated that the lender had been proven not to have addressed the borrower's solvency. The Federal Court explicitly **left open** the question of whether **the mere fact that a company gives all of its liquidity to a cash pool indicates that this is not at arm's length**. Apart therefrom, the Swisscargo decision does not allow for any binding conclusions on the relevant criteria for determining whether or not a shareholder loan is at arm's length.

However, a **detailed catalogue of criteria to determine the (non-) arm's length nature of shareholder loans** can be found in the mentioned recommendations of EXPERTsuisse. Thereafter, (i) **formal points** (in particular the existence of a written loan agreement and an adequate documentation regarding the performance of the at arm's length test), as well as the (ii) **loan terms** (in particular regarding interest rate, duration, termination possibilities, securities, amortization obligation) must be considered in order to determine whether or not a shareholder loan is at arm's length. Moreover, the (iii) **solvency of the borrower of the loan** must also be considered and various risk considerations (in particular regarding the **liquidity management** as well as the **avoidance of an undue risk concentration**) must be made.

These various elements and criteria must be weighted on a case by case basis, taking into account the specific facts, and be incorporated into a **global assessment**. Such assessment of whether or not a shareholder loan is at arm's length must be **periodically reviewed** regarding any potential changes in the legal and factual situation.

A rigid implementation of these criteria leads to the **rule of thumb** that up-stream and cross-stream loans, and in particular the participation in cash pools within the group, may be deemed to be at arms' length **only in a small number of exceptional cases**.

3.6 SHAREHOLDER LOANS THAT ARE NOT AT ARM'S LENGTH DO NOT AUTOMATICALLY CONSTITUTE "*DE FACTO* DIVIDENDS"

A detailed analysis of the Federal Court's decision reveals – contrary to the explanations given by EXPERTsuisse – **no** binding statement by the Federal Court that shareholder loans that are not at arm's length, automatically constitute "*de facto* dividends".

In other words, the Federal Court did **neither** have to examine the permissibility of not at arm's length shareholder loans as such, **nor** did it designate them as "*de facto* dividends". Primary bone of contention was rather the "*de jure*" dividend that was correctly resolved from a formal point of view, but which was to a large extent interfering with the "*de facto*" blocking of the free equity.

3.7 SHAREHOLDER LOANS THAT ARE NOT AT ARM'S LENGTH AND THAT EXCEED THE FREE EQUITY ARE NOT AUTOMATICALLY IN BREACH OF ART. 680 PARA. 2 CO

The Federal Court also did **not** have to assess whether shareholder loans that are not at arm's length do *per se*, *i.e.* regardless of an effective distribution of dividends and independently from the borrower's ability and willingness to repay the loan, constitute a forbidden repayment of capital contributions according to art. 680 para. 2 CO as far as they are not covered by sufficient free equity.

The contrary conclusion deduced from the Swisscargo decision by EXPERTsuisse therefore goes astray: an **unauthorized repayment of capital contributions** can, already from a purely terminological perspective, only occur if the borrower is **not (or no longer) willing or in the position to repay the loan when due**, and/or if the loan is **fictitious** *i.e.* if "in reality a distribution of blocked equity capital to the shareholder occurs under the cover of a loan" (as stated by the Federal Court in consideration 4.2 of the Swisscargo decision).

Where the borrower is, however, financially healthy so that no doubts arise as to its willingness and ability to repay the granted shareholder loan, one **can and must not frivolously conclude that such a loan represents an inadmissible repayment of equity capital in the full amount of the loan**. Even if a shareholder loan was granted at non-arm's length terms to such a borrower, the question of a non-permissible repayment of capital contributions or of a deemed dividend may have to be raised at the most with regard to the value of the non-arm's length benefit, such as the difference of interest payments if the interest rate of the shareholder loan was below market.

Even a loan that is not at arm's length remains a loan and does not turn automatically into an unlawful return of capital contributions, as long as it is **not virtual** and that **the borrower is willing and able to repay the loan without limitation**.

Also in the light of the Swisscargo decision – it is thus still sufficient if the auditors refer, when applicable, in their audit reports to the **possibility** of an infringement of art. 680 para. 2 CO, should an existing shareholder loan prove not to be at arm's length and should it not be repaid.

The massively more stringent recommendations made by EXPERTsuisse in this regard, and the audit practice being established on that basis, can neither be justified by the Swisscargo decision nor by art. 680 para. 2 CO. Therefore, they must be revised.

4 SHARE PREMIUM DOES NOT FORM PART OF THE BLOCKED EQUITY CAPITAL

In its Swisscargo decision, the Federal Court clarifies that the so-called **share premium** (*i.e.* the difference between the nominal amount and the issue amount of the shares) is to be allocated to the general statutory reserves without any need of approval by the general assembly. **Share premium does thus not fall under the statutory blocked equity capital**. Once recorded in the books, share premium can be distributed to the shareholders as a dividend, subject to the general provisions on distribution.

> "A loan that is not at arm's length is and remains in principle a loan."

Thus, the Swisscargo decision brings an important clarification in a fundamental and highly controversial question of Swiss corporate law that is of importance far beyond the context of shareholder loans.

5 CONCLUSION

Following the Swisscargo decision, the **CFO and the board of directors** of a Swiss lender of **shareholder loans** must either strictly abide by the at arm's length principle or **block the free equity** in the amount of any shareholder loan not being at arm's length **and within such limitation not allow for any dividend distributions**.

However, the recommendations of EXPERTsuisse, to the extent that they go beyond the Federal Court's decision, must be rejected and corrected: Shareholder loans not being at arm's length do not, as such, automatically constitute a breach of art. 680 para. 2 CO when they exceed the available free equity.

With regard to a potential worst case scenario, a careful CFO and board of directors are, depending on the circumstances of a given case, nevertheless well advised to grant shareholder loans, that are not at arm's length, up to a maximum of the free equity only and to make non-operational excess cash available to the group by means of dividend distributions and not in the form of shareholder loans.

When granting and monitoring shareholder loans the **general due diligence obligations** continue to apply, such as, in particular, the **avoidance of an undue risk concentration** and a **cautious liquidity management**. Moreover, it is still advisable in a group relationship to expressly stipulate the **granting of shareholder loans** in the interests of the group in **the business purpose, as it is set forth in the articles of incorporation** of the lending entity (for details, see in this regard Schellenberg Wittmer Newsletter of November 2011).

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The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following persons:

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