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Cash pooling

In the light of Swiss corporate law, there are various hazards in cash pooling.

Cash pooling within a group of companies is a tool for liquidity management aimed at reducing financing costs. Under Swiss corporate law, however, there are various legal pitfalls to avoid.

Under Swiss law there is – with some minor exceptions – no specific law for affiliated companies. From a legal point of view, each company is legally, economically and organisationally independent. As a result of this, cash pooling arrangements have to be examined from the perspective of each participating company.

Cash pooling arrangements normally take the form of zero balancing or notional cash pooling arrangements. While zero balancing systems involve loans between affiliated companies, notional cash pooling arrangements usually provide for a reciprocal granting of security interests between the affiliated companies. If such loans or security interests are given to a direct or indirect parent company, they are referred to, respectively, as an upstream loan or an upstream security. The same principles apply to loans and security interests between sister companies, while downstream loans or security interests are not generally subject to the same restrictions.

Legal background

According to article 680(2) of the Swiss Code of Obligations (CO), no shareholder has the right to receive any repayments of the contributed capital. According to Swiss case law and doctrine, this rule must be given a very broad interpretation. It is a generally accepted view in Switzerland that this provision implies a prohibition to repay capital without going through the formal capital reduction proceedings or, in other words, a prohibition to make payments and/or to grant benefits directly or indirectly to shareholders. For that reason, a Swiss corporation may generally only make commitments for the benefit of its affiliated companies if these commitments are covered and can be satisfied by the free reserves of the company. Furthermore, any transaction of a corporation made for the benefit of its affiliated company resulting in a repayment of share capital (the hidden repayment of capital) is null and void from a corporate law perspective. This means that a Swiss corporation has no legal capacity to make any promises or to enter into any obligations that lead to a hidden repayment of capital.

It is important to stress the fact that, under Swiss law, the concept of prohibited hidden repayments of capital and the protection of the reserves (article 671(3)) is a very broad one. For instance, it is a violation for a Swiss subsidiary to guarantee liabilities of its affiliated companies or otherwise voluntarily acquire such liabilities, because the enforcement of these obligations by a third party would lead to a drawing of assets from the Swiss company, which in turn would result in the fixed share capital of the company being no longer covered. Broadly speaking, all transactions between a corporation and its affiliated companies that are not at arm's length are considered to be a distribution within the meaning of CO articles 680(2) and 671(3).

Some legal authors are of the opinion that any transaction with an affiliated company – even if done at "arm's length" – could be considered as being contrary to the provisions regarding contribution to the shareholders (CO articles 632 et seq), the provisions regarding protection of the nominal share capital (CO article 680(2)), and/or the provisions regarding the protection of the reserves (CO article 671(3)).

Duties of directors and managers

The directors of a company have fiduciary duties to the company and must avoid any actions that could harm the company (CO article 717). Particular care is required when a shareholder has a stake in a particular transaction as is often the case in companies with an affiliated group. In such cases, the transaction has to be at arm's length and the company providing a service (eg for payments in favour of an affiliate) should receive adequate consideration. The duties of care of the board members and directors also include the obligation to monitor the financial situation and to preserve the liquidity of the company.

A violation of the duty of care can lead to personal civil liability of the board members and the managers, according to CO article 754. In extreme cases, even criminal liability, within the meaning of article 158 of the Swiss Criminal Code, is possible.

Avoidance actions

Under Swiss bankruptcy law, several types of transaction occurring before the opening of bankruptcy proceedings or the granting of a moratorium can be challenged by the creditors. These transactions are as follows:

- First, article 286 of the Swiss Debt Enforcement and Bankruptcy Law (SchKG) states that gifts and transactions accepted by the company by way of contractual consideration, but which are disproportionate to its performance, are voidable if these gifts or transactions are made during the year before the opening of bankruptcy proceedings.

  Legal action to void a gift may become relevant if the company transfers assets to another company without obtaining adequate consideration. This action may also be relevant if a subsidiary provides securities to benefit an affiliated company, and either:

  (1) this security is not for the benefit of the subsidiary; or

  (2) it does not receive adequate compensation for it.

  Secondly, according to SchKG article 287, the following transactions are voidable if the company carried them out in the year prior to the opening of bankruptcy proceedings and was already over-indebted at that time:

  (1) granting collateral for existing obligations which the company was not obligated to collateralise;

  (2) settling a debt of money other than in cash or by other normal means of payment; and

  (3) paying a debt prior to its maturity date.

- Finally, SchKG article 288 declares voidable all transactions which the company carried out during the five years prior to the opening of bankruptcy proceedings with the intention, apparent to the other party, of disadvantaging its creditors or of favouring certain creditors to the disadvantage of others. The Federal Supreme Court has held several times that the repayment of a loan with the last remaining liquidity of a company, shortly before the opening of bankruptcy proceedings, amounts to favouring that particular creditor to the disadvantage of other creditors. Therefore, the board of directors must ensure that all creditors are equally repaid in a situation of financial distress.

Although the defendants in the above mentioned actions were the creditors receiving the voidable payments from the company, the Federal Supreme Court has ruled that a voidable transaction may also constitute a breach of obligations by a member of the board of directors. Not only are all these transactions voidable under the bankruptcy law and capable of rendering members of the board civilly liable but they can also – under certain circumstances – constitute criminal acts.

Agreements to be made

A cash pooling agreement is normally made between a bank and the pool leader, a specifically designated company within an affiliated group. The participating affiliates normally sign an accession agreement with the bank in which the participating affiliates declare that they have knowledge of the cash pooling agreement and that they will comply with it.

Furthermore, there must be an agreement between the pool leader and the affiliates setting out the details of the arrangements between the pool leader and the participating companies. As a zero balancing system leads to loans between the pool leader and the affiliated companies, the terms and conditions of these loans have to be in the agreement.

Loans at arm's length

It is very important that the reciprocal loans be given on an arm's-length basis. This means that the loans given under the cash pool arrangement must be the terms which an independent third party would accept. The phrase "at arm's length" encompasses both an adequate interest rate and the pool leader's creditworthiness. As the pool leader's creditworthiness normally depends on the financial standing of the group as a whole, every single affiliate must be able to assess the financial risk it accepts by giving a loan to the pool leader. The affiliate must, therefore, be adequately informed about the financial standing of the other cash pool participants.

Protection measures

Even though, according to the majority of legal scholars, inter-company agreements regarding loans are valid under corporate law if they are at arm's length, it seems preferable to limit the inclusion of an affiliate to a cash pool agreement to the amount exceeding the nominal capital and the reserves not freely disposable (gebundene Reserven).

Furthermore, it seems advisable to have a shareholders' resolution in place approving the cash pooling arrangements. Such a resolution could be helpful in circumstances where the cash pooling arrangements are considered as affecting the retained earnings of a participating affiliate, because it is within the competence of the shareholders' meeting rather than in the competence of the board of directors to decide in which way earnings are distributed. In this context, it is also advisable to amend the purpose article in the participating affiliate's articles of incorporation in order to explicitly allow for the granting of affiliate financing, even in cases where this is predominantly or solely for the benefit of the borrowing company.

Tax issues

The legal considerations set out above do not address any tax issues. This, however, does not imply that there are no such issues. The most important one is the payment of withholding tax and – depending on the case – the assumption of the Swiss revenue authorities of hidden equity (resulting in a disallowance of some or all of the interest deduction and maybe even in higher taxes that the company has to pay on its equity).

Additional tax issues may arise if more than 20 companies participate in a cash pooling system.

Conclusion

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Before entering into a cash pooling arrangement under Swiss law, it is advisable to consider carefully the restrictions and conditions described above. It should be particularly borne in mind that, in the absence of case law and because of the resulting uncertainty of the legal rules, each case requires a thorough analysis based on its own specific circumstances.

Ukraine

IPOs in Ukraine

A new age of financing

During 2005, several Ukrainian companies (namely Ukrproduct and XXI Century Investments) have tested a new method of financing their growing business needs through raising funds on international equity markets. They have resorted to what is commonly known as an IPO, or initial public offering.

An IPO is the process by which private companies begin trading their shares on a public market for the first time. During an IPO, the shareholders of a company or a group of companies sell their shares or allow a new share issuance to the general public, thus diluting their initial stake in the company. An IPO does not mean that 100% of shares in the company are sold to the public. On the contrary, it is common for the selling shareholders to retain a majority stake in the company. IPOs of companies from emerging markets have their own specific features, which often differ from classic IPOs of American and Western European companies.

Why would a Ukrainian company need to go public? There are several reasons for this. First of all, it is publicity for the company. By going public, the company becomes well known to international investors. An IPO also brings certain credibility to the company, especially if its shares trade well after the IPO. These two factors often make it easier for the company to obtain larger and cheaper debt financing. Secondly, an IPO may serve as an alternative means of financing the company. However, this is the case only when the cost of capital in the IPO will be lower than a debt borrowing. Thirdly, for companies with a high debt to equity ratio, an IPO may be the way to lower this ratio and open up new opportunities for debt financing. Fourthly, an IPO is often a good opportunity for majority shareholders to cash in their shares at a favourable price, while retaining control over the company. Finally, unlike interest payments in debt borrowings, dividends need not always be paid on shares. This may serve as an additional cost saving factor for the company.

The above advantages obviously entail certain financial and other costs. IPOs are generally more expensive compared to debt borrowings and even Eurobond issues. Apart from fees to underwriters, which normally come as a percentage of the funds raised in the IPO, the company will incur significant expenses for auditors, lawyers, experts and other professional advisers. In addition, the company will need to devote a great amount of its internal resources to work with IPO participants. Finally, IPOs inevitably require company transparency, good corporate governance procedures, regular reporting and accountability to public shareholders. The latter is especially important given the risk of possible litigation, which may be initiated by any of the public shareholders if the company's management has failed to disclose material information in the prospectus or does not abide by its corporate governance rules.