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THE INS AND OUTS OF THE PROPOSED RESTRUCTURING REGIME FOR DISTRESSED COMPANIES

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1. Introduction and Scope of the Proposed New Regime

As set out in one of our previous blog entries, the Federal Council wants to modernise Swiss corporate law and, for this purpose, published its draft of the proposed new rules along with a dispatch on 23 November 2016.

Amongst other topics, the draft provides for a general overhaul of the restructuring regime for distressed companies in the Swiss Code of Obligations (CO) and, to a lesser degree, the Debt Enforcement and Bankruptcy Act (DEBA), aiming at creating incentives for distressed companies to take the necessary restructuring measures as early as possible.

The new regime would be applicable to stock companies and, by reference, to limited liability companies, cooperatives and, at least partially, certain associations and foundations.

2. New Restructuring Provisions Outside the Context of a Composition Moratorium

The new articles 725 – 725b CO form the centerpiece of the reform, replacing the existing art. 725 and 725a CO. These core articles of the new restructuring regime cater to three different situations. They are basically independent from each other, but more often than not will overlap if more than one of them are applicable to a company:

2.1. Imminent Insolvency (New Art. 725 CO)

The new art. 725 CO is applicable in cases of imminent insolvency (*drohende Zahlungsunfähigkeit*), which exists if there is reasonable concern that a company is not and will likely not be, within the next six months, in a position to honour its due liabilities, be it by paying them or by obtaining credit to pay them. For companies that are subject to a regular audit by operation of law, the relevant time horizon is twelve months.

As a consequence of imminent insolvency, the board of directors has to establish a liquidity plan (*Liquiditätsplan*), allowing for an assessment of the economic situation of the company. The liquidity plan as a prospective cash flow statement is a new instrument in Swiss corporate law. According to the draft provision and the dispatch, it has to set out the currently available liquid assets and the expected receipts and expenditures for the relevant timeframe (i.e. six or twelve months) and it may reflect the expected outcome of restructuring measures that are in the competence of the board of directors. The liquidity plan does not have to be audited nor does a general meeting of shareholders have to be convoked.

If the liquidity plan confirms that insolvency is imminent despite the measures reflected therein, the board of directors has to take further measures, in particular measures requiring the approval of the general meeting of shareholders, such as share capital reductions or increases. If necessary, the board of directors has to file for a composition moratorium (*Nachlassstundung*) with the competent judge. If the liquidity plan indicates that not only insolvency, but over-indebtedness is imminent, the new art. 725b CO is applicable instead of art. 725 CO.

There are no specific deadlines for taking these measures. The draft provision only states that the board has to act with the required urgency (*gebotene Eile*).

2.2. Capital Loss (New Art. 725a CO)

In contrast to the liquidity based notion of imminent insolvency, which is new to the Swiss corporate law landscape, the term "capital loss" is a familiar one. However, the new art. 725a CO, which deals with capital loss, now provides that a capital loss exists if, according to the last annual financial statement of a company, two thirds of the share capital, including statutory capital reserves (*gesetzliche Kapitalreserve*) and statutory retained earnings (*gesetzliche Gewinnreserve*) are no longer covered by assets; as opposed to fifty percent under current law. This means that a capital loss will kick in earlier under the proposed new regime than currently.

As a consequence of capital loss, the board of directors needs to assess the economic situation of the company in order to find out whether, other than suffering from capital loss, an insolvency or over-indebtedness of the company is imminent. If an insolvency is imminent, the obligations of new art. 725 and 725a CO apply cumulatively. If an over-indebtedness is imminent, the new art. 725b CO is applicable instead of art. 725a CO.

This assessment is not a formal status report (*Lagebericht*). However, as another novelty, the existence of a capital loss triggers the duty for unaudited companies to have their last annual financial statement audited prior to its approval by the general meeting in order to avoid an overly optimistic assessment of the economic situation by the board of directors. This obligation can be avoided by filing for a composition moratorium.

Other than that, the board of directors has to take necessary measures in order to cure the capital loss. As in the case of imminent insolvency, there are no specific deadlines for taking these measures but, in order to avoid any liability, the directors will have to act with the required urgency. In contrast to the existing law, the board of directors does not have to immediately convoke a general meeting of shareholders unless, of course, the measures intended by it to remedy the capital loss require the approval of the general meeting.

2.3. Imminent Over-Indebtedness (New Art. 725b CO)

The definition of over-indebtedness (*Überschuldung*) is the same as under existing law: A company is over-indebted if its liabilities are no longer covered by assets. Furthermore, as under current law, if there is reasonable concern that a company is over-indebted (*begründete Besorgnis einer Überschuldung*), the board has to (i) immediately establish interim financial statements at going concern and liquidation values which have to be audited and, (ii) if the interim financial statements show that the company is actually over-indebted, notify the judge, who will then, depending on the request and his assessment, initiate bankruptcy proceedings or approve a composition moratorium.

As under the existing law, the board does not have to notify the judge if creditors agree to subordinate their claims in an amount sufficient to cover any shortfall. The new art. 725b para 4 (1) CO would explicitly state what is already applicable in practice for any subordination to avoid a notification of the judge: Not only must the creditor subordinate its claims and any interest accruing thereon to all other creditors, but also defer the repayment of such claims and interest for the duration of the over-indebtedness.

The real novelty of the new provision is to be found in the deadlines laid down in the new art. 725b para 4 (2) CO, which states that the notification of the judge may be deferred by 90 days provided that there are reasonable prospects (*begründete Aussicht*) that the over-indebtedness may be cured and, at the same time, that the over-indebtedness will not materially increase. The 90 days deadline starts with the availability of the audited interim financial statement. There is no specific deadline for the production of the audited interim financial statement, but in order to avoid any liability the directors and the auditors will have to act with the required urgency. In case that the 90 days are not sufficient to cure the over-indebtedness, the judge has to be notified. As the case may be, the restructuring can be continued in the framework of a composition moratorium.

2.4. Other Relevant Provisions

Other relevant draft provisions aiming at facilitating the restructuring of distressed companies are:

- the new art. 725c CO, which is identical to the existing art. 670 and 671b CO allowing the revaluation of real estate or equity participations, but now states that such revaluation may be made both in case of a capital loss *and* an over-indebtedness;
- the new art. 634a CO, allowing the conversion of claims into equity by set-off (*Verrechnungsliberierung*) even if the claim is not covered by assets (a question that is disputed amongst scholars under the existing law);
- the new art. 757 para 4 CO, stating that subordinated loans are not taken into account when calculating the damage in a D&O liability case (contrary to the current practice of the Federal Supreme Court); and
- the capital band pursuant to new art. 653s et seq. CO, which allows flexible share capital reductions (or increases) within the band.

3. New Restructuring Provisions Inside the Context of a Composition Moratorium

Upon approval of the provisional composition moratorium (*provisorische Nachlassstundung*) by the competent judge, a few modifications to the applicable proceedings set out in the DEBA (which were only modified in 2014) are contemplated by the draft:

- according to the new art. 173a para 2 DEBA, a judge who has been notified of the over-indebtedness of a company may renounce the opening of bankruptcy proceedings by office if there are reasonable prospects of an immediate restructuring. In this case, the judge will open composition moratorium proceedings instead;

- according to the new art. 285 para 4 DEBA (and subject to art. 298 para 2 DEBA which requires the approval of the competent judge for certain transactions), all liabilities incurred by the distressed company during the provisional composition memorandum that have been approved by the trustee (*Sachwalter*) shall be exempt from claw-back claims (*Anfechtungsklage*). Under current law, this is only true for liabilities entered into upon approval by the competent judge or the committee of creditors (*Gläubigerausschuss*). This is supposed to further facilitate taking loans during a composition moratorium;
- according to the new art. 293a para 2 DEBA, the provisional composition moratorium may be extended by the competent judge to a maximum of eight months in total (as opposed to four months under current law). This shall enable the company to benefit from the provisional composition moratorium for a longer period of time and thereby increase the chances of a successful restructuring, because upon request the judge will renounce the publication of the provisional composition moratorium. This provision is intended to replace the current art. 725a CO providing for the possibility of the judge to defer bankruptcy if notified of an over-indebtedness (*Konkursaufschub*).

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