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When corporations are in financial distress

Directors of such companies have a number of important obligations they must be careful to meet.

A financially distressed company may be in a position where it can no longer finance its business with new debt or equity. This may lead to illiquidity, under-capitalisation or even over-indebtedness. Either illiquidity or over-indebtedness can trigger bankruptcy proceedings in respect of the company. Apart from having less financial freedom, the board of directors also faces greater obligations as the company comes closer to bankruptcy. Because the breach of such obligations may render directors civilly or criminally liable, the company must navigate its way carefully through a time of financial distress. In this article we look at the most important obligations of the board of directors at such a moment.

According to article 754, paragraph 1, of the Swiss Code of Obligations (CO), the members of the board of directors and senior management are liable for damage which they cause wilfully or negligently. In order to become liable, a creditor or the company must prove that it incurred damage, which was caused by a wilful or negligent breach of obligations by a member of the board of directors or by senior management. Before discussing the specific obligations the directors have to fulfil, it should be said that such individuals can also be held liable if they do not have enough time to care about the company or enough knowledge to prevent such breach of obligations. The Federal Supreme Court has held that a lack of time or knowledge is no excuse, and that the negligence lies in the fact that such a person has nevertheless accepted the mandate as a member of the board of directors.

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General obligations

Broadly speaking, the board of directors must manage the business of the company to the extent that it has not delegated this job to the management (see article 716, paragraph 2 CO). It should be stressed, however, that the board has some non-transferable obligations – such as, for example, the setting-up of the corporate organisation and the company's organisation, the structuring of the accounting system, the financial control and the financial planning, together with certain obligations in the case of a loss of capital or over-indebtedness.

Under the obligation to establish the corporate organisation and manage the company, the board's responsibilities include safeguarding the value of the assets and finding an adequate structure to protect the assets and to create new value. So the board must define the new strategy as well as the restructuring measures such as cost cutting, streamlining the products and services, reorganising the company or even dismissing employees. In the case of a mass dismissal, the board of directors must fulfil specific consultation and notification procedures (see articles 335d et seq CO). Where there is a spin-off of certain parts of the company, the board must carefully consider the liabilities which are transferred by law, especially the employment relationships (see article 333 CO).

According to article 716a, paragraph 1, section 3 CO, the board of directors must structure the accounting system and the financial control, as well as the financial planning. In particular, financial planning is a core instrument for a company in financial distress. The board of directors must make sure that the company always has enough liquidity to conduct the business in accordance with the restructuring plan. This is a task that can only be fulfilled with an adequate financial forecast. In addition, the financial planning must also ensure that there is no preferential treatment of certain creditors, and be structured so as to minimise any perception of financial distress among non-financial creditors.

Loss of capital

Where there is a loss of capital as defined in article 725, paragraph 1 CO – ie if half of both the share capital and the legal reserves are no longer covered by valuable assets – the board of directors must promptly call a general shareholders' meeting and propose reorganisation measures. The relevant balance sheet for determining whether or not there is a loss of capital is the balance sheet of the last annual account. Nevertheless, the board of directors must prepare an interim balance sheet during the business year if it has a substantiated concern about a loss of capital since the last annual account.

Although the board of directors must propose reorganisation measures at the shareholders' meeting, this does not mean that the shareholders' meeting can decide on all reorganisation measures. The shareholders' meeting still has ordinary competences and cannot strip the board of its non-transferable and inalienable obligations under article 716a, paragraph 1 CO. On the other hand, the board must inform the shareholders' meeting of all reorganisation measures, even though the decision-making authority may ultimately lie with the board of directors and not with the shareholders' meeting.

The board of directors should call the shareholders' meeting as soon as possible and not wait until the next annual general meeting, unless the two meetings will take place at almost the same time. If the board of directors cannot call a general meeting soon enough because the preparation of the reorganisation measures takes too long, it should nevertheless call a meeting to inform the shareholders about the intended reorganisation.

All of these obligations of the board of directors also apply to the board of a subsidiary.

Over-indebtedness

In the case of a substantiated concern of over-indebtedness, the board of directors must prepare an interim balance sheet and submit it to the auditors for examination (see article 725, paragraph 2 CO). As a first step, the board must prepare an interim balance sheet on a going concern basis. If this shows an over-indebtedness, the board of directors must also prepare a balance sheet on the basis of liquidation values. Both balance sheets must be submitted to the auditors for examination. If both balance sheets show an over-indebtedness – ie if the liabilities of the

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company are no longer covered by its assets – the company is over-indebted as defined in article 725, paragraph 2 CO.

If the company is over-indebted (as defined), the board must file the balance sheet with the bankruptcy court in order to give notice of the over-indebtedness. Upon notification, the judge must open bankruptcy proceedings in relation to the company (see article 725a, paragraph 1 CO). The obligation to file for bankruptcy is the responsibility of the board of directors and not of an individual board member, even if he or she has single signatory power. Therefore, the board of directors must pass a resolution to file for bankruptcy. In the case of subsidiary companies, the board of each subsidiary must separately file for bankruptcy, otherwise its members may become liable to the company's creditors.

Instead of filing for bankruptcy, the board of directors may request the judge to postpone its adjudication if there is a prospect of financial reorganisation. In this case, the board must produce evidence that there is a prospect of financial reorganisation by providing the judge with appropriate documentation. The board may also submit a reasoned application and a draft agreement to the composition court in order to obtain a moratorium from the composition court (see articles 293 et seq of the Swiss Debt Enforcement and Bankruptcy Law (SchKG)).

The board of directors may postpone the bankruptcy filing if creditors subordinate their claims in an amount equal to at least the amount of the over-indebtedness. In such a case, the company must not repay – and the creditor must not demand repayment of – the claim until the company is no longer over-indebted.

Preferential treatment of creditors

The members of the board of directors may become liable for the preferential treatment of creditors. There are several types of transactions which should not be conducted during a prescribed period of time before the opening of bankruptcy proceedings.

§ First, article 286 SchKG states that gifts and transactions accepted by the company by way of contractual consideration, but which are out of proportion to its own performance, are voidable if such 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 all its assets to another company without obtaining adequate consideration. Furthermore, board members may face personal liability under this provision if they sell assets below market value in order to create additional liquidity. Finally, this action may be relevant if a subsidiary provides securities to the benefit of its parent or a sister company, and either (1) such security is not for the benefit of the subsidiary, or (2) it does not receive any compensation for it.

§ Secondly, according to article 287 SchKG, 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 from the beginning;
- (2) settling a debt of money in a manner other than in cash or by other normal means of payment; and
- (3) paying a debt prior to its maturity date.

Under this provision, the members of the board of directors may become liable if the company conducts a debt/asset swap within one year before the start of bankruptcy proceedings. Such transactions should only be conducted, therefore, if it can be ensured that the company is not over-indebted or that the over-indebtedness can be resolved by this restructuring measure.

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§ Finally, article 288 SchKG 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 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 satisfied in a situation of financial distress. Often, such equal treatment of creditors is only possible if the company enters into a standstill agreement with its financial creditors.

Although the defendants in the above mentioned actions are the creditors receiving such voidable performance from the company, the Federal Supreme Court has ruled that a voidable transaction also constitutes a breach of obligations by the members of the board of directors. But not only are all these transactions voidable under the bankruptcy law and capable of rendering members of the board civilly liable, they are also criminal acts. Consequently, at a time of financial distress, the board of directors should carefully consider the transactions it intends to conduct, otherwise its members risk criminal as well as civil liability.

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