Thouvenin Rechtsanwälte
Klausstrasse 33
CH-8034 Zürich

Phone +41 44 421 45 45
Fax +41 44 421 45 00
E-mail info@thouvenin.com

www.thouvenin.com

Insolvency Law Newsletter Switzerland

Director's Duties & Liabilities in Distressed Companies

What steps should a Board undertake when it realises that a company is in financial difficulties from a management perspective?

Introduction

Companies facing financial difficulties are faced with numerous challenges from all the various stake holders such as shareholders, affiliated companies, creditors, suppliers, customers, members of the board of directors, auditors as well as employees. In such a situation it is important to first recognize that the interests of these stake holders are not (always) aligned.

These guidelines are aimed at providing the members of the board of directors with guidance on how to best weather the storm. It is important to note that each company and the challenges imposed on a company in financial distress vary. The members of the board of directors are well advised seeking independent professional advice to determine potential pit falls and director liability issues at an early stage.

Obtain and prepare reliable financial information

Where the board is confronted with a distressed financial situation, the first and foremost duty of the board is to obtain reliable and up to date financial information. A carefully established accounting, financial control and financial planning system will be of great assistance to the board in obtaining such information. The obligation to establish an accounting, financial control and financial planning system is one of the non-delegable and inalienable duties of the board of directors under Swiss law.

The board is well advised to apply a healthy degree of scepticism towards the figures presented to it and to independently verify the most important positions. In particular sales forecasts must be viewed conservatively. Orders are only then to be considered, if and when there is an executed and binding order and the board has assured itself that the company may in fact fill such orders.

Positions on bank accounts, receivables etc. will also have to be verified with the respective counterparties and in the case of intragroup receivables, the financial situation of the group companies must be critically reviewed. In particular cash pooling arrangements may develop into a severe liability in the case of financial distress, in particular where the cash is pooled on account of an affiliate facing financial distress and no segregated accounts are maintained on behalf of the pooling companies. On the liability side, adequate provisions will have to be made for doubtful debt, contingent liabilities, currency losses, warranty claims as well as for claims for litigation and/or threatened liquidation.

Once the board is satisfied that it has reliable information on the company's financial status, assets, liabilities including liquidity, the board will need to analyse the financial situation, put in place a liquidity planning and pave the way for restructuring the company's balance sheet in case of an over indebtedness or liquidity squeeze.

Duty to establish an interim balance sheet

In case the board of directors, after having obtained reliable financial information, has reason to believe that the company has liabilities exceeding its assets, the board must have an interim balance sheet drawn up and submit it to the auditors for review.

Increase number of board meetings to at least weekly or bi-weekly and minutes must be carefully drawn up

Companies in financial difficulties require extraordinary measures and attention from the board of directors. To minimize personal liability of the board members regular meeting should be held at which the financial situation of the company is analysed and appropriate measures are being taken. Cash flow must be monitored on a daily basis. Such meetings should be recorded in minutes which should set out the reasons for the decisions taken by the board and should also record the views of the board members voicing a different opinion.

Note that in the case of insolvency such minutes will most likely be discoverable by any creditor and such minutes may provide helpful information to a creditor or the insolvency estate for bringing director liability claims, in the case the company later falls into bankruptcy. Careful attention to the wording of the minutes is therefore advised and the minutes should conspicuously state that they contain proprietary and confidential company information, the unauthorized use of which could greatly harm the company.

Implement cost cutting measures

Which cost cutting measures will provide the desired result, depends upon the company and the company's business. The board must consider and immediately take such measures as the termination of employees, consulting agreements, lease agreements and other agreements which lead to a cash drain.

Since in most cases, these cost cutting measures will not have an immediate impact due to notification periods, the board must make sure that the company is able to continue to honour its financial obligations during such period which means that the company must be able to generate a positive cash flow.

Accelerate collection of receivables

The collection of receivables should be given attention. Selling the receivables may also be an option to generate cash needed.

What steps should a Board undertake when it realises that a company's insolvency is likely? Please outline advice to be obtained, notifications to be made and meetings to be held.

Seek independent external professional advice

Directors should seek external professional advice as soon as they realise that a company is in financial difficulties. Directors should be aware of the potential conflict of interests that may exist amongst the directors, in particular between inside and outside directors and directors elected by the majority shareholder or shareholders.

Evaluate and rectify the financial situation within our outside the insolvency regime

When faced with financial difficulties and the interim balance sheet shows that the company is over indebted both on a going concern and liquidation basis, the board should in parallel with seeking methods to rectify the situation of over indebtedness, evaluate and consider the possibility of an insolvency filing, bankruptcy postponement, provisional moratorium or composition plan and prepare itself for the respective filings, in case the balance sheet situation cannot be restructured.

In doing so, the board will need to carefully assess the impact of an insolvency filing on the business of the company. An application for a moratorium in combination with a composition plan may give the company valuable time to seek buyers for parts of the company free from any time pressure and may therefore help to maximise the possible return for the company's creditors. On the other hand, if made public, this could destroy the company.

Notify the competent court in case the company's liabilities exceed its assets and the over indebtedness cannot be rectified in the short term

If the audited accounts reveal that the company's liabilities are not covered by sufficient assets, both on a going concern and liquidation basis valuation, the board is under an obligation to notify the competent court, unless the company's creditors have agreed to subordinate their claims in favour of the other creditors to the extent required to cover the amount by which the liabilities exceed the assets or the company can raise new capital to rectify the over indebtedness.

Where the board of directors, after having received reliable financial information, concludes that the company can be saved, then the board, prior to deposing the balance sheet with the competent court, has an informal "grace period" of approximately three weeks but in any event not more than two months to restructure the company's balance sheet. Such measures can consist in obtaining new capital, subordination agreements from creditors, merger with a third party or the sale of assets or a combination of all such measures.

Since also the auditors have an obligation to notify the competent court, the board usually has no more than three to four weeks after having received the audited interim accounts to notify the judge, before the company's auditors will notify the competent court. Generally, the auditors, who also may face personal liability if they do not notify the insolvency judge, are not prepared to wait for more than three to four weeks for the board to take appropriate action, unless the board can convincingly demonstrate that the company's financial situation can be rectified in the short term.

Call extraordinary shareholders meeting

Where it is apparent that 50% of the company's share capital is no longer covered or the company is over indebted, the board must immediately seek to rectify the financial situation by raising new capital or by obtaining declarations of subordination from the company creditors. The board is also under an obligation to call an extraordinary shareholders meeting and to propose restructuring measures to the shareholders meeting in case 50 % of the company's share capital is no longer covered by the company's assets.

Seek new capital to rectify liquidity squeeze and/or over indebtedness to secure the on-going business

Such actions may consist in raising new capital in combination with capital reduction, obtaining subordination agreements from existing creditors, merger, and sale of "crown jewels" and will have to be implemented within a period of three to four weeks, but in any event not more than two months from the receipt of the audited interim accounts confirming the company's over indebtedness.

In its attempt to save the company and to postpone or prevent an insolvency filing, the board of directors must walk a thin line. In case the measures proposed and implemented by the board fail to be effective, the board may face civil and even criminal liability for having delayed the insolvency filing and may become liable for wrongful trading. Also, the sale of "crown jewels" may leave the board exposed, in case the company cannot be rescued. A careful documentation of the board's resolutions and the basis for their decision taking is recommended.

When in doubt, the board is in general well advised to call upon the competent court and request a bankruptcy postponement or a provisional moratorium, which depending upon the actual circumstances, may not have to be published, and which might permit the company to be restructured under the auspices of the competent court or office holder, thereby reducing the directors risks.

Careful monitoring and prioritising of payments and collection of receivables

When a company is in financial distress, the board of directors must carefully make use of the remaining means available to satisfy debts outstanding. Where, it is already apparent to the board of directors that the company is over indebted, any payment made for debts already outstanding could result in a voidable preference and may also lead to personal liability of the members of the board of directors for favouring certain creditors over others.

The following lists certain payments which the board of directors should consider prioritising:

- Social Security;
- Taxes and levies;
- Salaries;
- Utilities and Communication (Telephone etc.);
- Lease payments.

Can directors be liable for their company's obligations?

As a rule, a director is not personally liable for the debts of a company, unless the director has given a guarantee for the liabilities of the company.

Can directors be liable for pre-insolvency transactions?

Yes, see below.

To whom do directors owe their obligations?

Where the company is solvent the board of directors owes a fiduciary duty to the company and the shareholders. When a company is insolvent or doubtfully solvent, the interests of the creditors (as a whole) intrude and will become the most significant element in determining how directors' duties should be discharged.

Selectively paying off certain creditors but not others may expose the directors to personal liability. Similarly satisfying shareholder claims by repaying shareholder loans or even distributing a dividend will expose the directors as well and may even entail criminal liability.

What are the potential claims which might be brought against directors?

Breach of fiduciary duty

Directors are liable towards the company, its shareholders and creditors for all damages caused negligently or intentionally (misfeasance or breach of fiduciary duty). Whereas in the case of a solvent company the business judgement rule protects the directors from personal liability, in the case of a doubtfully solvent company or insolvent company, the foremost duty of the board is to preserve the assets for the creditors, not to create any new debts and if necessary, to apply for protection under insolvency laws. Where the company is insolvent the remedy to seek damages from a director will typically be for payment to the estate.

Fraudulent trading

In addition the Swiss Criminal Code sanctions certain acts such as fraudulent depletion of assets, waiver of rights without consideration (fraudulent trading), excessive speculation, and insufficient capitalisation as well as the preferential treatment of certain creditors (mostly insiders) over others.

Wrongful trading

Directors may also become liable for their failure to promptly notify the insolvency judge and the damage caused to the creditors due to a belated insolvency filing. This is the case, where the company takes on more liabilities by entering into new contracts and the costs to operate the company exceed the company's income from its activities (wrongful trading).

What steps should directors take to minimise their risk of liability?

See above.

Can directors be liable for fraud?

Directors can be liable for fraud, since fraud is always a breach of the fiduciary duty owed to the company. However, it must be demonstrated that the director's action or inaction lead to the company or creditor suffering a damage. In addition, in an insolvency situation fraudulent behaviour may be sanctioned by the Swiss Criminal Code, such as:

- Fraudulent insolvency which includes the hiding of assets and the recognition of inexistent liabilities (Art. 163 Swiss Criminal Code);.
- Transactions in fraud of creditors (Art. 164 Swiss Criminal Code.
- Fraudulent and wrongful trading which could include to trade without sufficient capital (Art. 165 Swiss Criminal Code).
- Failure to maintain proper books and records (Art. 166 Swiss Criminal Code).

What is the position of non-executive directors?

Non-executive directors have the same duties and liability as executive directors in the insolvency. Given the inherent conflict between executive and non-executive directors, non-executive directors should be empowered to retain their own independent counsel.

What is the position of shadow directors?

Director's liability also extends to de facto directors who - although not formally appointed as directors - take the decisions. This may also include banks, large creditors or in the context of a group of companies the ultimate parent company directing the business affairs. The Federal Supreme Court has found that in order to qualify as a de facto director, such person must take the decisions which are reserved for the board of directors or other executives and thus has a material impact on the decision making process.

Are there any different requirements and obligations for/on the directors of public companies in a pre-insolvency scenario?

Directors of listed companies have the same obligations as those of companies that are not listed. In addition, companies listed on a Swiss exchange must in particular comply with the listing rules in particular the rule on ad hoc publicity. Events which may materially impact the company's share price must be published. A planned or unplanned restructuring of the company due to financial distress certainly qualifies as an ad hoc publicity event. One must assume that the company's board will not have adequately discharged its duties in particular in respect of the financial planning, if such an event comes as a surprise.

Close and frequent contact with the company's financial and professional advisers at this stage is critical.

What is the ongoing role of directors once a company is in an insolvency process?

Their role is to primarily assist the office holder with his/her management of the company, the winding down of the activities or their continuance under the auspices of the office holder in the case of a moratorium with continuance of all or certain business activities, and includes the provision of all documents and information relating to the company. Once insolvency proceedings have been initiated and for instance a provisional moratorium has been granted.

What are the potential sanctions which may be brought against directors, including any disqualification procedures?

Besides liability for damages caused due to breach of fiduciary duty or violation of ad hoc publicity rules, a director may become criminally liable. In the case of regulated industry a criminal conviction may make a director unfit for taking office with an executive function in another regulated entity (unfit and improper for office). Note: executives of banks and other financial institutions must be proper and fit to guarantee a proper business conduct which will be assessed by the Swiss Financial Market Authority (FINMA).

Summary

- Be aware that the various stakeholders have often conflicting interests;
- Obtain independent professional advice;
- Increase number of Board Meetings and pay attention to the minutes;
- Obtain reliable financial information;
- Establish audited interim balance sheet and have it audited, in case the company is likely to be over indebted;
- Accelerate collection of receivables;
- Implement cost cutting measures;
- Prioritise payments;
- Identify assets that may be sold to improve the balance sheet and/or liquidity;
- In case over indebtedness is confirmed by the auditors, act quickly to restructure the company's balance sheet (3 - 4 weeks) by seeking subordination agreements, conversion of debt into equity, raising new capital, merger etc.
- Be prepared to file for insolvency, moratorium or bankruptcy postponement in case the balance sheet cannot be restructured.

For further information please contact Markus Alder (m.alder@thouvenin.com) or David Känzig (d.kaenzig@thouvenin.com)

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