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(In-)Admissibility of Intercompany Loans

In a most recent decision (4A_138/2014 of 16 October 2014), the Swiss Federal Supreme Court has tightened up the criteria for distinguishing an upstream or cross-stream intercompany loan from a distribution by changing the criteria for the market conditions test. In particular, the intercompany loans created by zero balancing cash pooling and the funding of group companies by a group finance company are affected by this decision. Such change of practice will result in a more stringent review of intercompany loans by the auditors in the upcoming audit period.

What is the Problem?

Pursuant to Swiss corporate law, each company is treated as a stand-alone entity irrespective of whether its belonging to a group of companies. Therefore, any payment made to a parent company (upstream) or sister company (cross-stream) is subject to the distribution limitations of Swiss corporate law, in particular to sect. 680 para 2 Swiss Code of Obligations (CO) which prohibits a repayment of share capital to the shareholder. The distribution of retained earnings, however, does not constitute a repayment of share capital and neither does the payment under an arm's length contractual obligation constitute a distribution. The difficult task in respect of intercompany loans is to distinguish between a (refundable) loan and a (non-refundable) distribution by applying a market conditions test.

Previous Practice

Based on previous practice, a two steps approach was taken: In a first step it had to be established whether the intercompany loan was actually a loan or rather a hidden distribution. The loan character was accepted if the intention and the ability of the borrower to repay the loan could be demonstrated. In a second step the terms and conditions (in particular interest rate) had to pass the market conditions test, i.e. it had to be established whether the loan would have been granted on the same terms and conditions by a third party lender to this borrower. If such market conditions could not be established, the loan character was still accepted, but corrections from a tax perspective may had to be made (in particular in respect of interest rates).

Swiss Federal Supreme Court Decision

In 2000, Swisscargo AG was faced with a bankruptcy event following which the liquidator initiated a damage claim against the auditors of that company. Swisscargo AG had granted an (upstream) intercompany loan to its parent SAir Group and, as a consequence of participating in the zero balancing cash pool led by SAir Group Finance BV, a (cross-stream) intercompany loan to its sister SAir Group Finance BV. Prior to the bankruptcy event and consistent with previous practice, the auditors of Swisscargo AG had issued a report allowing Swisscargo AG to distribute a dividend to its parent based on a balance sheet which showed the amounts under the intercompany loans as accounts receivables and distributable earnings in the equivalent amount. By applying new and more stringent criteria for the market conditions test, the Federal Supreme Court argued that the up- und cross-stream intercompany loans had not been granted at arm's length terms and therefore a special reserve should have been made in the

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balance sheet of Swisscargo AG which would not have been available for distribution. Accordingly, the auditors were held liable, because the dividend distribution violated sect. 680 para 2 CO and caused damages to Swisscargo AG and its creditors.

New Practice

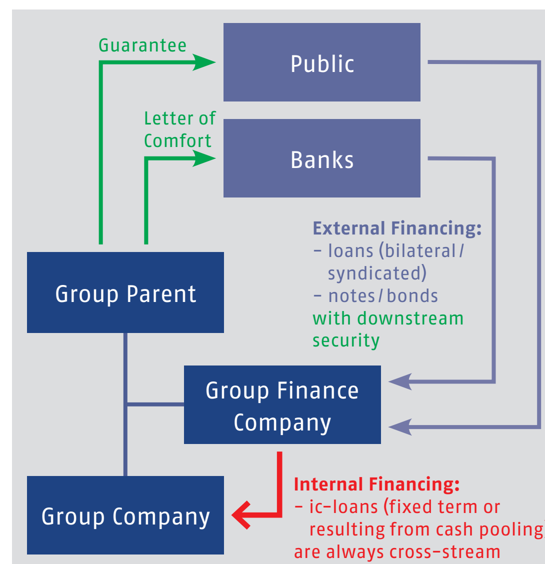
The new test consists only of one step whereby it must be established that the loan in its entirety is given at arm's length terms, meaning that each and every aspect of the loan must conform to market conditions. The criteria to be checked are many and include in particular:

- group clause (indicating that the company belongs to a group) and finance clause (allowing for group financing) in the articles of association of the lender
- written loan agreement
- solvency of the borrower
- no lump risk for the lender
- collateral
- interest rate and interest payments
- amortisation
- term and termination.

If such terms of an upstream or cross-stream intercompany loan are not conforming to market conditions, then the payment under the intercompany loan qualifies as a distribution and a special reserve must be made in the balance sheet of the lender. With respect to intercompany loans resulting from the participation of a group company in the zero balancing cash pool of the group, establishing market conditions may become indemonstrable before the following statement of the Federal Supreme Court: *"It is questionable from the outset whether a participation in the cash pool, by which the participant disposes of its liquidity, can pass the market conditions test at all"*.

And now What?

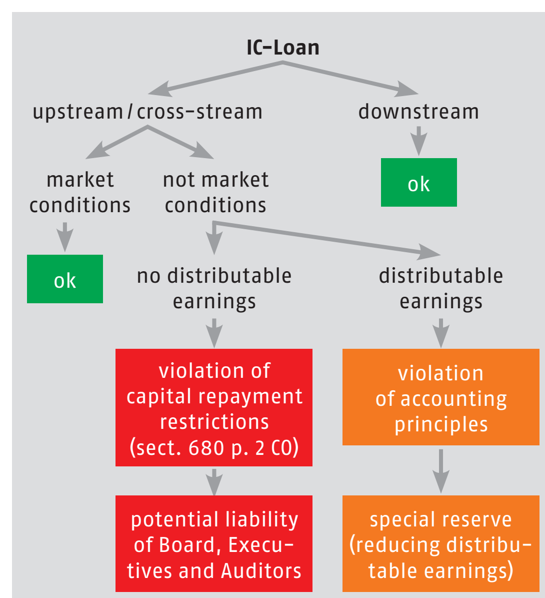
Needless to say that establishing market conditions is extremely difficult given the fact that in the market loans exist in all sorts of forms and under a wide variety of terms tailored to the specific risk profiles of the parties thereto. Auditors of Swiss intercompany lenders are therefore expected to take a prudent approach in assessing upstream or cross-stream intercompany loans, in particular those resulting from zero balancing cash pooling. In the upcoming audit, the auditors of Swiss group companies and in particular of Swiss finance companies will apply this new and more stringent test. It must be borne in mind that any lending of a finance company to group companies qualifies as a cross-stream loan and is therefore to be tested under sect. 680 para 2 CO:



It is advisable that Swiss group companies, and in particular Swiss group finance companies, take the following measures:

- assure that the articles of association contain a group and a finance clause;
- establish the possibility for lenders to assess the solvency of the borrower;
- introduce a credit rating for each group company and adapt the interest rate to such risk;
- allow for immediate termination of the loan in case of a material adverse change in the financial standing of the borrower;
- avoid large exposures or secure such with collateral;
- use the cash pool only for working capital but not for financing purposes.

And always remember that not only the auditors but also the board and the management of a Swiss company are subject to corporate liability claims.



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