Debt financing for start-ups

In the last few years, the granting of loans – convertible, bridge, shareholder – has become increasingly popular in the venture capital business for several reasons: compared with equity financings, it's relatively fast, the agreements are shorter and simpler, and the overall transaction costs lower. Nevertheless, issuers should be aware at least of the following points when issuing loans.

Interest rates

Interest rates can not be agreed at its discretion; the Federal Tax Authority (FTA) publishes annual 'safe harbour' tax rates for (shareholder) loans in Swiss francs (or any other currency). Deviation from these interest rates must be well founded; if not, the portion that is too high is considered to be a hidden dividend distribution and the portion that is too low is considered to be a hidden capital contribution.

Thin capitalisation rule

According to our tax rules, the proportion between debt and equity must meet a certain ratio, also published by the FTA. Depending on the exact business purpose of the venture, it may be, for example, that the debt/equity ratio should not be more than 6:1. Again, if an issuer does not comply with such rules – i.e. higher debt financing than allowed – it may be deemed to be a hidden dividend distribution.

10 / 20 rule

If the issuer grants more than 10 loans with identical terms, or more than 20 loans with different terms, with a total principal amount of at least CHF 500,000, interest payments are subject to a 35 % withholding tax. Depending on where the lenders are located, such withholding tax may not be reclaimed in full or at all.

Convertible loans

If lenders are entitled to convert their loans into issuer shares, the issuer has to grant the preferential rights to subscribe for such convertible loans (und underlying shares) to all shareholders; they are entitled to subscribe for the full number of loans and underlying shares first, unless the issuer has justified reasons to exclude them from such rights. Furthermore, the board of directors of the issuer must ensure that in the event of a conversion, the required number of shares is immediately available, without having to consult shareholders first. Usually, this is done by implementing a conditional share capital before the issuance of the convertible loan. Finally, an issuance tax of 1 % may apply (if the issuer has already been equity-funded by at least CHF 1 million in the past).

Subordination

If subordinated, loans are treated economically as equity; i.e. the lenders agree to be paid, in the worst case of bankruptcy, as the very least in the same category as the shareholders. With subordinated loans, the board is not required to file for bankruptcy. Hence, subordination is not required by law, but may help the board in the future when structuring the loan.

Termination

In the absence of any specific provision in the agreement, each lender could terminate its loan with a notice period of six weeks (subject to subordination, of course). This may jeopardise the venture, since the maturity date will be known at too short notice to refinance such loans. In addition, even simple loan agreements contain clauses for early repayment or conversion in the event of certain events, such as bankruptcy of the borrower, exit or financing rounds.

Bearing these principles in mind makes debt financings a viable alternative to equity rounds. Careful drafting of loan agreements saves issuers and lenders alike from unforeseen legal and tax problems.

Wenger & Vieli Ltd.

We are a leading law firm with offices in Zurich and Zug. One of our strengths is in the area of venture capital (VC), where we advise investors, companies and founders alike through the whole life cycle: on tax-efficient fund structures, acquisition of portfolio companies, exit routes, etc. As a one-stop shop, we take care of intellectual property, regulatory, employment, general contract and corporate law. We offer the full range of all notarial services needed in the VC business.

Dr. Beat Speck, partner, attorney-at-law and civil law notary

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