

Briefing November 2016

Corporate Law Reform

The Swiss Federal Council presented to parliament its dispatch for a reform of Swiss corporate law. The draft Act amending the Swiss Code of Obligations (Draft Act) seeks to modernize corporate governance by strengthening shareholder rights and promoting gender equality on corporate boards and senior management. It also replaces the provisions of the (interim) Ordinance on Excessive Compensation (Minder-Ordinance) by a federal act of parliament with only a few changes. Furthermore, it aims to facilitate company formation, makes capital rules more flexible and reforms the rules on corporate restructurings. Finally, it introduces certain disclosure requirements for commodity firms.

The next step of the parliamentary process will be a review by the Legal Affairs Committee of the National Council, the lower chamber of the Swiss federal parliament. Depending on how parliament will receive this project, we expect the Draft Act to enter into force in 2019 at the earliest.

Executive Pay ('Minder')

The Draft Act **replaces the provisions of the Ordinance Against Excessive Compensation (Minder-Ordinance)**, which were issued by executive order. The core of the Minder-Ordinance remains unchanged; contrary to the preliminary draft of 2014, the Draft Act **makes only minor changes** to the Minder-Ordinance. This provides for legal certainty and means that companies do not have to substantially change their existing regime when it comes to executive compensation.

In comparison to the Minder-Ordinance, the following amendments are noteworthy:

- **Compensation for post-contractual non-compete undertakings may only amount to the average annual compensation over the last**

three years. This provides clear guidance on what may be agreed with respect to non-competes, although the Draft Act also expressly requires that compensation for non-competes must be commercially justified.

- The Draft Act clarifies that **sign-on bonuses may be paid only if they compensate for actual losses.**
- Companies choosing a **prospective compensation vote** (approving compensation for a future period) must have an **advisory vote on the compensation report.** This corresponds to the current practice of most Swiss companies.
- The compensation report must **disclose in which other companies the members of the board and executive management hold office** (including the name of the member, the function and the company).

- Contrary to the current regime, the articles **need not restrict the number of offices** of members of the board and executive management **in non-profit organizations without an economic purpose** (e.g. charitable foundations or associations).
- **Non-listed companies may partially or fully opt in** the executive pay provisions of the Draft Act.

Governance

Shareholders' Rights

The Draft Act contains new provisions regarding **shareholders' meetings** and shareholders' rights in general:

- The percentage of share capital or share votes that shareholders must represent to be able to request that the board of directors **call a general meeting is lowered for listed companies from 10% to 5%**. If the request is properly made, the board of directors must call the meeting within 60 days.
- The threshold that must be reached to give the shareholders the right to **ask for an item or motion be put on the agenda is lowered for listed companies from CHF 1 million par value to 0.5%** of the share capital or the voting rights. For non-listed companies, the relevant threshold is 5%. In addition, the shareholders must be given notice to exercise this right of no less than ten days. According to the dispatch, this notice can only be given once the annual report is published, which may have implications on the timing of the invitation process.
- The invitation to the meeting must also include a **brief explanation** of each motion of the board and, if so requested, of the relevant shareholders.

The Draft Act further provides **that shareholders holding at least 5% of the share capital or the voting rights of a non-listed company have a right to request information** from the board of directors or the auditors at any time during the year to the extent

necessary for the exercise of their shareholders' rights. The board of directors must respond to each legitimate information request within four months.

The Draft Act proposes to require **shareholders' approval for the delisting** of shares, departing from current practice which considers this to be a matter falling within the competence of the board of directors.

Gender Representation on Board of Directors and Executive Management

The Draft Act sets a **quota of female (and male) representation on the board of directors at 30% and on the executive management at 20%**. Failure to comply does not result in fines or other sanctions. Rather, the Draft Act provides for a **'comply or explain'** system requiring to justify any failures to meet such gender representation and to set out measures to promote the underrepresented gender in the compensation report. These provisions will, however, not be implemented immediately, but will be subject to a phasing-in period of five years for boards and ten years for the executive management.

Lawsuits by Shareholders and Creditors

The Draft Act generally does not facilitate the possibility of shareholders bringing lawsuits, as was initially proposed in the preliminary draft of 2014. In this context, the following should be noted:

- If **unjustified or hidden distributions** (including transactions that are obviously not at arm's length) are made **within a group of companies**, the Draft Act proposes to extend standing to sue derivatively for an action to reverse such distributions **to creditors**, even outside of bankruptcy. If this proposal were adopted (which we doubt), we would nevertheless expect the impact to be limited because such actions would result in significant costs for creditors but only limited benefits since the suit would benefit the company and only indirectly the creditors. In addition, risks in that regard could be mitigated by including appropriate corporate purpose clauses in the articles of association of the relevant group companies.

- The **liability of audit firms** as defendants in shareholder lawsuits is **several but not joint** if the audit firms' breach of duty was only negligent.
- The Draft Act expressly allows **arbitration clauses in the articles of association**, eliminating uncertainties under existing law about whether shareholders, directors and executive officers are bound by such a clause. The arbitration proceedings will, however, have to be governed by the Swiss Civil Procedure Code (as opposed to the rules on international arbitration in the Federal Act on Private International Law) with the effect that any award of the arbitral tribunal may be challenged before the Swiss Supreme Court and, depending on cantonal law, possibly also before a competent cantonal court.

Capital (including Increases and Reductions) and Dividends

The Draft Act **generally makes capital requirements more flexible**, although it maintains the concept of a fixed share capital and does not introduce shares without par value. The following proposals are noteworthy in particular:

Capital in General

- It is possible to state the **share capital in a foreign currency** (e.g. USD, EUR), provided that it is also the reporting currency used for the financial statements; shareholders may approve to switch the currency starting from the next financial year. The main benefit of such a switch is that it will further facilitate dividends and capital distributions in a foreign currency; it will also slightly facilitate capital increases paid in a foreign currency
- **The nominal value of shares can be any value greater than 0**, thus allowing it to go below the current limit of CHF 0.01. This will allow companies with low nominal share values to split shares without undue complications or tax burdens.
- **Participation certificates (non-voting stock)**

listed on a stock exchange may be issued in an **unlimited** amount. (Currently, they are capped at 200% of the share capital.)

- While **reverse share splits** currently require the unanimous approval of the shareholders, the Draft Act **facilitates reverse share splits for listed companies** by requiring only a two thirds supermajority of the votes (and more than half of the capital) at the general meeting.

Capital Increases

- **Ordinary capital increases are valid for up to six months** (rather than three months as provided for under the existing law).
- The concept of **authorized share capital is replaced by** what is called a '**capital band**'. Under a capital band, the articles may authorize the board to increase and/or reduce the capital within a pre-defined band. However, in substance the authorized capital remains in essence the same. One notable exception relates to the validity of the authorization, which **may last up to five years**. This is a significant extension of the existing two-year maximum period. However, if the general meeting approves certain capital changes, the capital band must be expressly renewed or else it lapses.
- The Draft Act clarifies the rules governing **conditional capital** in several respects, including to the effect that conditional capital may be used for **shareholder options**. The new provisions should arguably also allow the issuance of '**naked options**', which so far were not expressly permitted.
- If a company acquires assets from a related person after incorporation or a capital increase (so-called **acquisition in kind**), the current law imposes cumbersome requirements similar to a contribution in kind. The Draft Act **abolishes** these requirements. This substantially facilitates the acquisition of assets from related persons as long as it is consistent with the board's fiduciary duties and does not constitute a hidden distribution.

- Unfortunately, the Draft Act **does not relax the even more burdensome requirements for contributions in kind**. However, due to the abolishment of the special requirements for acquisitions in kind, these rules may **now be avoided** to a large extent by contributing in cash or converting reserves and acquiring assets immediately after a capital increase, as explained above.

Capital Reductions

- The rules on **capital reductions are simplified** in several respects (e.g. only one SHAB publication for creditor call is required; creditor call may take place prior to general meeting; one instead of two months period for creditor call; creditor claims need not be secured if it can be shown that the capital increase does not jeopardize the claims).
- Under the Draft Act, the board may conduct **'authorized capital reductions' under the capital band** (see above). The introduction of a capital band may require a creditor call and an audit report. However, individual capital increases under the capital band are exempt from these requirements. The only condition is that the board apply an 'insolvency test' to ensure that liabilities can be discharged despite the capital reduction.

Reserves and Dividends

- The Draft Act **codifies current practice for a distribution of capital contribution reserves** and, contrary to the preliminary draft of 2014, does not introduce more cumbersome audit requirements.
- **The capital and earnings reserves are simplified** and harmonized with the amendment regarding accounting and financial reporting that entered into force on 1 January 2013. In particular, the accounting of own shares codifies current practice.
- **Interim dividends (out of the current year's profits) are permissible** provided that they are allowed under the articles and are based on an audited interim balance sheet. This will effectively facilitate the distribution of interim dividends which, while in our view being lawful under the current

law, have so far not been widely accepted by audit firms. The new provisions do not affect the current practice of quarterly or extraordinary dividends, which continue to be allowed if they are based on the annual financial statements.

- **Repayment of capital through a capital reduction and distributions out of legal capital and earnings reserves** will no longer be permissible if the company shows **accrued losses** on its balance sheet. The Draft Act appears to prohibit such distributions regardless of the amount of accrued losses, which could force companies wishing to make such distributions to first set off losses against capital contribution reserves, which may have potentially adverse tax consequences. This should be amended to prohibit distributions *only to the extent* accrued losses exist.

Exemptions from Notarization for 'Companies in Simple Conditions'

- **'Companies in simple conditions' may be incorporated and dissolved and their articles may be amended without the need for notarization**. To qualify, companies must use articles that are limited to the minimum content ('one-page articles') and their share capital must be fully paid in CHF. Unfortunately, the first requirement is very restrictive, meaning that the procedure will apply only in very limited circumstances (e.g. a transfer restriction, as it is common for private or group companies, will be disqualifying). In addition, certain corporate actions will still require a notarization, such as a capital reduction. The exemption from notarization will not only apply to companies limited by shares (AG, SA) but also to limited liability companies (*GmbH, Sàrl*) and cooperatives (*Genossenschaften, coopératives*).

Restructuring

Debt-Equity Swaps

The Draft Act clarifies that **payment of the issue price by way of set-off of an existing debt is permissible in the full nominal value** of that debt

even if the company is overindebted, which so far has been disputed by some legal scholars. The legal uncertainty under current law had a chilling effect on such transactions, which will be eliminated by the proposal. On the other hand, the Draft Act newly requires that the articles must disclose the particulars of the payment of the issue price by set-off.

Pre-Insolvency Thresholds

The Draft Act seeks to nudge companies away from complacency in the run up to insolvency by **expanding the duties of the board of directors to initiate restructuring measures**. This part of the reform is questionable as we doubt that the benefit of the reform exceeds the costs it entails. The measures proposed include the following:

- The Draft Act introduces a **new duty for boards of directors relating to impending cash-flow insolvency**: If there are serious reasons to consider that a company will be insolvent within a six months period or, for companies subject to a full audit, a twelve months period, the board of directors will need to prepare a liquidity plan and consider the overall economic situation of the company. If the liquidity plan confirms the concerns regarding cash-flow insolvency, the board will need to take additional measures to avoid insolvency and, need be, file for a composition stay.
- On the **balance-sheet side**, the Draft Act proposes to trigger the duty for the board of directors to act if **two thirds of the capital and legal reserves** arising out profits is no longer covered (currently the threshold is reached if losses exceed more than half of its capital and the legal reserves). At the same time, the Draft Act no longer requires the board of directors to convene a general meeting but only requires companies that have opted out from an annual audit to have their financial statements reviewed by a licensed auditor.

Duties in case of Overindebtedness

The Draft Act does **not change fundamentally the final test of overindebtedness** or balance-sheet insolvency but clarifies some details:

- In case of **overindebtedness**, there is no obligation to file for bankruptcy or a moratorium if creditors accept to subordinate their claims, with **no requirement to stay interest** as well.
- The board of directors is **not required to file for bankruptcy if it has a well-founded reason to believe that it will be able to overcome the overindebtedness within 90 days** following the preparation of the interim balance-sheet, provided the overindebtedness does not increase substantially. While replacing the existing broad standard of overcoming the overindebtedness in the short-run into a bright line test may offer legal certainty, it is likely to lack flexibility in practice and force companies into bankruptcy if at the end of this period the restructuring does not fully come to fruition.
- The Draft Act **proposes to abolish the corporate law moratorium** and to consolidate all bankruptcy stays in the Federal Act on Debt Enforcement and Bankruptcy.

Relief from Avoidance Actions for Restructuring Loans

Finally, the Draft Act amends the Federal Act on Debt Enforcement and Bankruptcy by expressly providing that **actions taken with the approval of the composition administrator are not subject to avoidance actions**. This should facilitate the access to the equivalent of debtor-in-possession financings once composition proceedings have started.

However, the Federal Council decided **not** to recognize a statutory relief from avoidance actions **for restructuring loans outside** of formal bankruptcy or composition proceedings. At the same time, it also decided not introduce the doctrine of equitable subordination of loans by related persons.

Disclosure by Commodity Firms

The Draft Act states that companies operating a business for the purpose of exploiting minerals, oil, natural gas or clear-cutting primary forests must produce annually a special **report of payments**

made to public authorities. Failure to comply with the applicable rules is subject to criminal sanctions.

Outlook

With the publication of the dispatch, the corporate law reform project enters the parliamentary process. Although the matter is largely technical, some issues, such as gender equality and the rules on compensation, are likely to be challenged from the right and from the left, suggesting a lengthy process.

The next step will involve a review of the Draft Act by the Legal Affairs Committee of the National Council, the lower chamber of the Swiss federal parliament. It

will be followed by the deliberations of the National Council. If the National Council approves the draft act, it will move to the Legal Affairs Committee of the Council of States and the Council of States. Considering the scope of the project, it is likely to shuttle through both chambers and go through the 'elimination of differences' process. It is, therefore, unlikely that the Draft Act will be enacted and enter into force before 2019 and we expect more realistically that it will become effective only in 2020 or 2021.

In addition, several of the proposed amendments will be subject to transitional rules. As a result, there is no need to take immediate action, although the reform process should be monitored.

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