COUNTRY UPDATE ON SWITZERLAND

New Impediments for Carve-out Restructurings

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Carve-out processes, i.e. the separation of certain business units from a company or group of companies, often occur in connection with M&A transactions, be it that the transaction itself is structured as a carve-out, or be it that a restructuring precedes or follows the transaction because the buyer is interested only in part of the target's business. Under recent decisional law, certain types of carve-out processes have become significantly more difficult in Switzerland

Not necessarily, but often a carve-out involves a dividend distribution. For instance, in the Swiss "old-style spin-off" a business unit is spun off by first contributing it to a newly founded subsidiary and then distributing the shares of that subsidiary to the shareholder (called "old-style" because it was the preeminent spin-off procedure before 2004, when the Swiss Merger Statute entered into force which allows direct formal spin-offs). The old-style spin-off is still quite popular because it offers certain advantages over the formal spin-off, in particular in terms of liability.

Another example is the asset transfer provided for by the Merger Statute in which a bundle of assets, liabilities and contracts is transferred; this operation also constitutes a dividend distribution, if and to the extent the transferor doers not receive adequate consideration.

As is probably the case in most jurisdictions, a Swiss company may distribute dividends only against balance sheet surplus. Any formal dividend distribution will accordingly reduce the balance sheet surplus. As a general matter, constructive dividends will also have that effect; a "constructive dividend" being any disbursement of the company for the benefit of its shareholder or another affiliate (other than a direct or indirect subsidiary of the company) which is not at arm's length.

Until recently it was undisputed that a loan to an affiliate could only constitute a constructive dividend in the amount of the "pricing difference" to the theoretical market loan, i.e. that amount by which the group loan is granted below the price which an independent third party lender would have charged (e.g. insufficient interest rate or lack of security where an outsider would have requested collateral). Only in the very special constellation where both lender and borrower in fact do not intend the "loan" to be repaid (and, consequently, no loan in the legal sense exists), the entire principal sum is to be qualified as a constructive dividend.

However, in a recent judgment the Swiss Federal Court, the highest Swiss judicial instance, held that a loan to an affiliate which does not fully satisfy the market test must be qualified *in its full amount* as a constructive dividend, even if the repayment as such is not in doubt.[1] As a consequence, if the loan agreement does not contain the financial covenants which a market loan in similar circumstances would usually provide for, or if the loan is not secured even though an independent third party would request this type of borrower to provide collateral, then not only the pricing difference to market, but the entire principal sum of the loan has to be treated as a constructive dividend. This has a significant impact on the dividend capability of Swiss companies because now the full amount of all outstanding "non-market" group loans has to be deducted from the distributable reserves before it can be determined whether and to which extent free balance sheet surplus is still available for a dividend distribution.

In addition, the court set the thresholds for market compatibility unrealistically high. In particular, the Federal Court seems to hold the view that loans to affiliates must as a general rule be secured by viable collateral in order to pass the market test. As a reaction, EXPERTsuisse, the professional organization of the Swiss audit firms, has issued new, restrictive guidelines for the assessment of the market compatibility of loans to shareholders, and the currently ongoing audit season shows that Swiss auditors take a conservative approach in this respect. While these guidelines are more differentiated than the market test which was applied by the court, it must still be expected that the terms and conditions of loans to affiliates, which until now were usual for Swiss companies, will often fail to pass this assessment and will thus reduce the dividend capability in the full amount of their principal sum.

As a consequence, the options for restructurings in connection with M&A transactions have become significantly more limited in Switzerland, and both sellers and buyers will often have to examine more complicated and less efficient alternatives

1. Decision of the Swiss Federal Court of October 16, 2014 (BGE 140 III 533).