

NKF Client News

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Insolvency law aspects in times of COVID-19

The worldwide measures taken in connection with the coronavirus pose a major, often even existential threat to numerous companies. What do Boards of Directors and management have to consider today?

1. Objectives: Avoiding illiquidity and overindebtedness

Avoiding illiquidity: Art. 190 para. 1 no. 2 of the Debt Enforcement and Bankruptcy Law (DEBL) stipulates that creditors of companies can file for the opening of bankruptcy proceedings against the company directly if the company ceases to make payments. Art. 191 para. 1 DEBL also allows for the company to file for its bankruptcy by declaring insolvency in court. The first objective is therefore to ensure that there is no illiquidity. A company is illiquid if it is not able to meet its payment obligations. Illiquidity must be a permanent, not merely a temporary "standstill" in payments. The Federal Supreme Court focuses in particular on the external impression, i.e. the cessation of payments. It describes cessation of payments as follows (BGer, 5a_790/2017, 3.9.2018, E. 3.2) (unofficial translation): *"Cessation of payments occurs if the debtor does not pay undisputed and due claims, if he allows debt collection proceedings against him to amass, if he systematically challenges the debt collection proceedings initiated against him, or stops paying even small amounts. With such behavior the debtor shows that he does not have sufficient liquid funds to meet his obligations."*

Especially against the background of the annual financial statements that are currently being prepared, the following should be noted: If the liquidity problems are so acute that a discontinuation of operations or parts thereof for the next twelve months from the balance sheet date is intended or probably inevitable, then there is a risk that the financial reports for the relevant company or parts of the company will have to be prepared on the basis of **liquidation values** instead of going concern values (Art. 958a para. 2 Swiss Code of Obligations, CO). Due to the correspondingly lower valuation of the assets, this increases the risk of overindebtedness.

Avoiding overindebtedness: If a company is overindebted, the responsible bodies must notify the court (Art. 725 para. 2 CO for the stock corporation). Overindebtedness exists if the balance sheet losses exceed the entire share capital and reserves, or in other words: if the company's assets no longer cover the liabilities. In times of economic turbulences, this can also happen relatively unexpectedly, especially if investments in subsidiaries or loans have to be value adjusted (Art. 960a para. 3 CO). The second objective is therefore to ensure that overindebtedness does not occur.

Importantly, Board of Directors must however also take action if the assets no longer cover half of the share capital and the statutory reserves (qualified capital loss). While Art. 725 para. 1 CO in principle requires action only if a qualified capital loss is established based on the latest annual balance sheet, it is not advisable to wait with restructuring efforts until the next annual balance sheet has been prepared if the qualified capital loss is not only of temporary nature.

In Germany, the Federal Ministry of Justice has announced that it is preparing a statutory regulation to suspend the obligation to file for insolvency in order to protect companies that get into financial difficulties as a result of the corona epidemic for a period until 30 September 2020. The precondition for suspension shall be that the reason for insolvency is based on the effects of the corona epidemic and that there are reasonable prospects of restructuring based on an application for public financial assistance or serious financing or restructuring negotiations. In Switzerland, there is currently no corresponding order by the Federal Council.

2. Measures to avoid illiquidity

To avoid illiquidity, the following (immediate) measures, among others, are conceivable:

- **Bank loans:** Negotiations can be conducted with banks regarding changes in credit conditions. Various banks have already announced that they will be supportive in these difficult times. The Federal Council informed on 20 March 2020 that persons that, due to the corona epidemic, suffer liquidity problems, may in an uncomplicated manner request loans from their principal bank up to an amount of CHF 20 million. Such bank loans up to an amount of CHF 500,000 will benefit from a full guarantee and loans in excess thereof will benefit from a guarantee of 85% of the loan amount, in each case issued by the Swiss Confederation to the respective bank.
- **Short-time work:** Up to around CHF 8 billion have been made available in the unemployment insurance fund for short-time work compensation. The waiting period for short-time work was reduced to one day from 13 March 2020 to 30 September 2020. This means that companies only have to bear the loss of one day's work by employees before they are entitled to unemployment insurance support. The Federal Council is also having an extension of the entitlement to short-time work compensation to employees with fixed-term (non-terminable) employment contracts and employees on temporary contracts examined. In addition to other measures to support the economy, the Federal Council is currently also expected to discuss an additional increase in funding for short-time work compensation.
- **Negotiation of payment terms:** Negotiations may be sought with the major creditors to agree on an extension of payment dates. Before doing so, the terms of existing credit and bond outstanding should be analysed as such negotiations may qualify as an event of default under the relevant documentation.

In this context, it can also be taken into account that on 18 March 2020, based on Art. 62 DEBL, the Federal Council ordered a **legal standstill for the initiation of debt collection proceedings** (*Betreibungen*). This applies to the whole of Switzerland, for the time being until midnight on 4 April 2020. Thereafter, the statutory debt collection vacation will begin, which will last until 19 April 2020. The legal standstill also applies to proceedings before the bankruptcy court. However, applications for seizure may still be submitted. They must be dealt with, and seizure orders will continue to be executed by the debt collection offices.

- **Factoring:** The sale of own claims to factoring providers can result in a timely inflow of cash.
- **Sale-and-lease-back transactions:** The sale and lease back of certain assets can provide additional liquidity. However, the legal and tax structuring takes some time.
- **Managing orders:** Inventories can be reduced before new orders are placed. Payment terms should be renegotiated if possible.
- **Acceleration of sales:** Conversely, in order to obtain liquidity, measures should be taken to sell of inventories more aggressively, if necessary, at a reduced price and new distribution channels such as through online trading (in particular at times where most stationary shops have been forced to close).

- **Online trading:** The governmental measures primarily affect stationary trading - from which online trading benefits. The implementation of an online business model with home deliveries should be evaluated in order to mitigate the loss of revenues in stationary trade somewhat.

3. Measures to avoid or eliminate overindebtedness

In order to avoid or eliminate overindebtedness, all restructuring measures available under Swiss corporate law must be considered (capital increase, contribution to reserves, subordination of claims, etc.). In order to quickly eliminate a qualified capital loss, the focus should also be on potential balance sheet restructurings such as by way of offsetting reserves against balance sheet losses or the revaluation of real estate and participations in accordance with Art. 670 CO.

4. What are the duties of the Board of Directors?

If there are justified concerns of overindebtedness, the Board of Directors must prepare an interim balance sheet and submit it to an approved auditor for audit. If the interim balance sheet shows that the claims of the company's creditors are not covered either at the going-concern values or at the liquidation values, the Board of Directors must notify the court, unless certain company creditors subordinate their claims (in the amount of at least the amount of overindebtedness) to all claims of all other creditors (Art. 725 para. 2 CO).

If the last annual balance sheet shows a qualified capital loss, the Board of Directors must promptly convene a shareholder meeting and propose restructuring measures. If the Board of Directors are aware of the existence of a qualified capital loss beforehand, action is nevertheless advisable – especially when it comes to initiating restructuring measures which may take longer to implement and become effective.

5. How long may the Board of Directors wait before filing for bankruptcy?

The law does not specify how long the Board of Directors has time to examine and implement restructuring measures before it has to file for bankruptcy. In practice, this depends on the individual case. As a rule, four to six weeks are accepted. In complicated circumstances, longer periods are also permitted as long as there is still a prospect of restructuring.

6. What liability risks do the Board of Directors and management have in the current situation?

In the event of illiquidity and/or overindebtedness, all payments by the company must be stopped. Otherwise, the persons concerned risk being prosecuted under civil and criminal law for damaging creditors or the preferential treatment of certain creditors. The members of the Board of Directors may also become liable (for "damage caused by delay") if they file for bankruptcy too late. A personal liability risk exists in the event of bankruptcy if social security contributions and taxes have not been paid.

7. What are the alternatives?

In addition to bankruptcy proceedings, there are also corporate law instruments (**stay of insolvency proceedings**) and insolvency law instruments (**composition proceedings**) to gain time for restructuring and avoid bankruptcy proceedings. These must be carefully examined by the Board of Directors and planned for at an early stage.

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