

Company & Commercial - Switzerland

Clawback risks increase for board benefits of privately held Swiss companies

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Introduction

In two appeals the Federal Supreme Court recently clarified, under Article 678(2) of the Code of Obligations, when exactly board members and their close associates and affiliates must return benefits received from a Swiss company because they are manifestly disproportionate to the value of their related performance and the company's overall economic situation (SFCD 4A_195/2014 and 4A_197/2014).

In addition to the new ordinance against excessive salaries in listed companies (for further details please see "[Fat cat' initiative revisited – government implements ordinance](#)"), the Supreme Court also adopted a strict approach regarding non-listed companies. As a result, it is more likely that board members of non-listed companies – together with their close associates and affiliates – will also be faced with clawback claims in future. Such claims may be raised by the affected company within a five-year period after their payment.

Case history

In October 2009 the two board members of a privately held Swiss stock company (C-AG) decided to honour themselves with 1% of the proceeds from a sale of company shares. After the purchase was perfected by the new shareholders, C-AG claimed that the board members, A and B, received benefits which were manifestly disproportionate to the value of their related performance and the company's overall economic situation, and were thus subject to a clawback pursuant to Article 678(2).

The Solothurn Court of Appeal found that the board members' efforts for the sale of company shares were limited to one meeting with potential new shareholders in Geneva, a few emails and some telephone calls. Parties showing a real interest in purchasing the company's shares already pre-existed. Further, the court held that C-AG was in a dire business situation – the company would already have been bankrupt had several subordinated loans not been granted. For these reasons, the court held that the board members were liable to pay back Sfr44,000 to the company under Article 678(2). Both defendants appealed to the Federal Supreme Court.

Federal Court decision

On appeal, the Federal Supreme Court upheld the Solothurn Court of Appeal decision and stated that when applying Article 678(2), the discretion of a company regarding the payment of benefits is limited by the overall business situation on the circumstances of the particular case – subject to four mandatory conditions and criteria:

- Regarding the nature of the benefits possibly subject to clawback, the court took a 'content over form' approach, pursuant to which it is irrelevant how the payment in question is characterised from a legal perspective. This means that the application of Article 678(2) is not limited to hidden profit distributions but embodies all sorts of disproportionate benefit to board members and their close affiliates and associates.
- To determine the possible disproportionality, a particular situation must be analysed with regard to the specific performance (effort) of the recipient (the board members) and/or the specific profit out of their services for the company and compared with the payment or other benefit advanced to the recipient as a result. In this respect, a task which is within the usual function of a board member is covered by the remuneration agreed in advance for this function.
- The disproportionality under Article 678(2) is obvious if any non-biased, just and fair thinking person, reasonably sees the disproportionality of the situation at first glance.
- Finally, the board members (their close affiliates or associates) must have acted in bad faith (ie, they must have been aware of the manifest disproportionality of the received benefits).

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Other criteria and conditions were also discussed, but were either not applied or regarded as not decisive in their own right.

Provided that all four application criteria are duly met, the clawback right of a company exists irrespective of whether the shareholders knew about certain remuneration or other benefits to board members, their close affiliates or associates. Because a simple set of four pre-defined criteria and conditions in favour of the company is the rationale behind Article 678(2), the possible knowledge of its shareholders regarding the granting of benefits is irrelevant.

For the first time the Federal Supreme Court also specified that the overall economic situation of the company is not an additional condition by itself. Instead, pursuant to the court, it is more of a filter regarding the discretion of the company when it comes to distributing benefits. A company which is economically sound has wider discretion than a company with financial problems for which the threshold of allowed benefits is lower and the risk of judicial intervention into its remuneration policy is thereby higher.

Regarding the required bad faith of the recipients, the Federal Supreme Court did not rule on whether the existence of such bad faith is assumed (ie, according to general rules, the burden of proof for the existence of bad faith would lie with the company claimant). However, the court also held that if the first three conditions and criteria for an application of Article 678(2) are found to be met on the circumstances of the particular case, it is unlikely that the recipient defendants acted in good faith.

Based on all relevant circumstances, the court held that all requirements for an application of Article 678(2) were duly met and confirmed the Solothurn Court of Appeal decision regarding the Sfr44,000 repayment.

Comment

The court adopted a strict approach towards the clawback of benefits granted to board members, their close affiliates and associates by a Swiss company. In particular, the new broad definition of benefits possibly subject to such clawback widens its scope of application. Clawbacks under this provision are no longer limited to hidden profit distributions as previously discussed in doctrine and lower-court practice. Nevertheless, it remains at the discretion of shareholders whether they decide to abstain from discharging board members of their related liability in the shareholders' annual general meeting (AGM) and to mandate the board to start clawback proceedings.

Another part of the decision may become inconvenient for board members, their close affiliates and associates who receive benefits from a Swiss company. The court held that the knowledge of the shareholder regarding granted benefits is irrelevant. Thus, a clawback of moneys received is possible within the statutory five-year limitation period, even if a board member has already left the company. In the absence of a discharge from liability by the AGM in favour of a board member, his or her replacement may even be legally bound to start clawback proceedings against former board members if the foreseeable proceeds of such a claim exceed the related costs for the company.

A resigning board member could only try to overcome this problematic legal uncertainty by seeking advanced written waivers from important shareholders and independent board members of the company. However, unfortunately a later clawback claim would still be possible under Swiss company law.

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