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New limitations on cash pooling?

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Introduction

Cash pooling is often used within a group of companies for financial management optimisation purposes. However, a recent Zurich Commercial Court decision risks jeopardising the use of cash pooling by setting overly onerous standards for the characterisation of an intra-group payment in the cash pool as a legally permitted intra-group loan.

Under these harsh conditions, many existing cash pools involving Swiss group companies would violate Swiss law, and the legality of a large amount of dividends already paid by such group companies to their holding companies would be questionable and could even entail the personal liability of group company board members and management.

This decision is questionable under important legal doctrine and will be brought before the Federal Supreme Court for a final decision where it could get overturned. Until then the decision stands, and it must be considered for all cash-pooling systems involving group or parent companies.

Cash pooling

In a cash-pooling system the central management of available funds within a group of companies is organised by the parent company through a special financing company which acts as pool leader and operates the master bank account with a view to securing the liquidity of each individual group company.

All other group companies have their own cash pool member accounts with the same bank. The pool leader receives funds from the member accounts of the companies with surplus liquidity and redirects these as necessary. All further details of the cash-pooling system are agreed in a cash-pooling agreement between all participating companies.

The most common cash-pooling system is zero-balancing cash pooling, in which the balance of all member accounts is reset to zero by the master account at noon each banking day. Thus, the master account holds all available funds in the group, which can then:

- earn interest;
- be invested; or
- be used to honour liabilities of group companies.

Only if the whole group has insufficient funds available will the group parent need to obtain credit from the bank.

Decision

Creditors of an insolvent group company in debt restructuring liquidation and the insolvency estate claimed compensation from the insolvent group company's auditors for personal liability. The auditors had signed off on the distribution of dividends to the group parent, irrespective of the fact that the subsidiary had also used funds from a loan which the parent had paid back to the subsidiary through the cash-pooling system earlier in the business year.

The insolvency estate claimed that the dividends were too high. In calculating the equity available for dividend payments, the auditors did not take into account the funds owed to the insolvent group company by the cash pool at the end of the previous business year (ie, the only difference between the earnings and the claims of the insolvent group company against the cash pool would by then

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have been available for dividend payments to the parent during the following business year).

As the parent and cash-pool leader went bankrupt a few months later, the now insolvent group company lost a bankruptcy dividend of Sfr4 million from the cash-pool leader because of the earlier dividend payment coming in part from the cash-pool loan repayment by the parent.

Effects on cash pools

Cash-pool funding as loan or equity repayment

Cash pooling embodies a flow of funds in all directions in the group (eg, from a subsidiary to its parent company (known as 'up stream') or between subsidiaries (known as 'cross-stream')). This flow of funds is characterised as either a permitted loan (for as long as repayment is intended and commercially possible) or otherwise (ie, if there is no intention or commercial possibility of repayment, as a dividend distribution or repayment of equity to the parent shareholder). The latter two are legally forbidden if the respective company law formalities (in particular, involving a shareholders meeting) are not observed or if the respective substantive law prerequisites for such dividends or repayments of equity are not met.

In order to determine whether funds are meant to be paid back, the courts will look at the commercial ability of a group company recipient to pay back the funds. This ability is legally assumed – from a business perspective – if the recipient would have been granted the same loan terms and conditions by a third party (known the arm's-length test). Only when this is the case would funding be legally assumed to be a permitted loan.

However, in this case the court used the fact that there was no written agreement for the specific funding from the subsidiary to the parent at issue as an indicator, and found that the parent had failed the arm's-length test because a loan agreement with a third party could not be concluded without a written agreement. The court did not take into account that this funding was based on the general cash-pooling agreement in the group. According to the court, a specific written agreement is required for every loan. Based on this, the court concluded that the funding was a forbidden equity repayment to the shareholder.

This legal assumption could have been overturned by demonstrating that the funding subsidiary company had a valid claim for reimbursement or other advantages which would make up for the above and below-par lending conditions. However, in this case the loan had been paid by the parent to the subsidiary before the date of the auditing report. The court did not accept this prior loan repayment as a valid reason for the dividend payment, because the repayment had happened after the relevant balance-sheet date (at the end of the subsidiary's previous business year). The court also dismissed any arguments of advantages that the paying subsidiary enjoyed due its participation in the group cash-pooling system or its affiliation with the group in general.

The court characterised the subsidiary's dividend payment to the parent through the cash-pooling system as a forbidden hidden equity repayment to the shareholder (ie, illegal under the Code of Obligations).

No double use of funds in same business year

According to the court, the characterisation of the funding through the cash pool as repayment of equity meant that the parent's prior loan repayments were blocked from further use in the same business year (eg, for dividend payments). To prevent such double use in the same year, the court held that all funds paid back through the cash pool after the end date of the balance sheet should have been deducted from the free equity that was available to pay out dividends for the previous business year.

Since the auditors had confirmed the legality of the dividends without this deduction, the court concluded that they were liable for a breach of their duty to assess the legality of the planned dividend payment. Thus, the auditors had to pay damages to the insolvency estate for the additional money it could otherwise have claimed from the cash-pool leader's bankruptcy dividend.

Comment

Even though the decision mainly concerns the personal liability of the auditors, it may also have an affect on the personal liability of the board members and management of companies taking part in cash pools.

The decision calls the practical use of cash pooling into question by limiting the possibility of characterising a payment within the cash pool as an intra-group loan or loan repayment. Under these conditions, all cash pools would violate the law if they used funds received from the cash-pooling system for dividend payments in the same business year (ie, the legality of a large amount of dividends already paid would retroactively become questionable).

Thus, all board members and even the management of group companies which participate in a cash pool with a view to avoid any personal liability must meticulously scrutinise:

- all payments to the cash pool for possible infringements of the provisions for intra-group loans (which are permitted in all circumstances of the particular case and are commercially possible to be repaid by the recipient); and
- all dividend payments to the parent (for which it is prohibited to use funds received from the parent as loan repayments through the cash pool in the same business year for dividend payments to the

parent).

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