

Do you have Plan B for Financial Distress?



Do you have Plan B for Financial Distress?

to: Treasurer Swiss Holding

“Dear Ron,
Inc. Board has decided to file for Chapter XI. We shall direct group wide cash positions to maintain business operations.”

Best regards, Amy, Treasurer Inc.“

Response by the Swiss Treasurer:

“NO“

Further comment by the Treasurer:

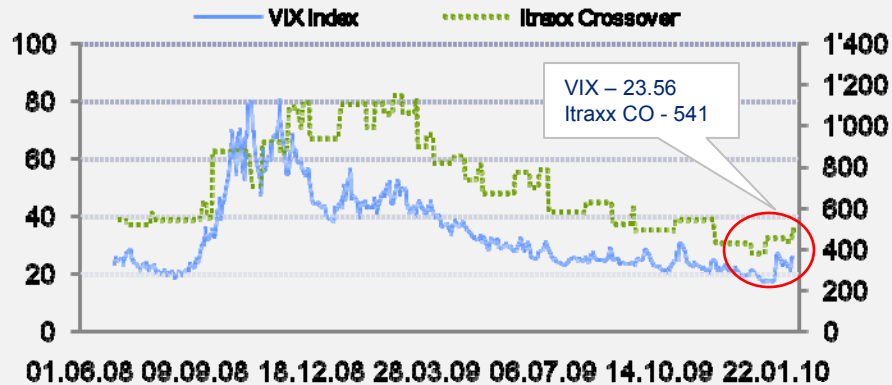
“Don’t worry, we are covered by a global D&O!”

Response:

„I have seen neither the insurance contract nor do I know the provider!“

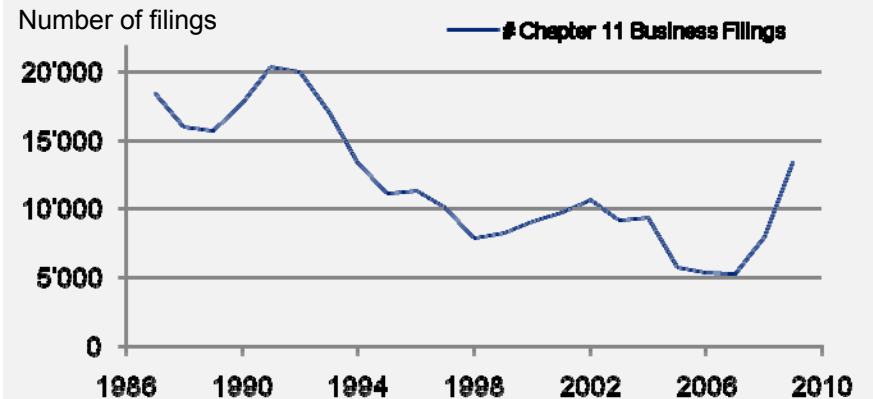
Market statistics

VIX vs. Itraxx Cross Over



Source: Bloomberg

Number of Chapter 11 business filings in the U.S. FY 1987 - 2009



Source: U.S. Bankruptcy Courts Statistics

Switzerland and the US



Switzerland is the 7th largest foreign direct investor in the US

- US\$ 163bn direct investment
- 560 Swiss companies operating in the US
- 310,000 direct jobs, approx 500,000 jobs in total



USA is the largest foreign direct investor in Switzerland

- US\$ 100bn direct investment
- 645 US companies operating in the CH
- 71,000 direct jobs, approx 120,000 jobs in total

Comments

- The Markit iTraxx Crossover index of mostly junk rated corporate debt and VIX, which tracks volatility on the S&P 500 and is known as Wall Steets fear gauge, had retreated through early January. Both jumped in the last couple of weeks.
- The number of chapter 11 proceedings has more than doubled since 2006. From a historic low of some 5,000 to more 13,000 proceedings
- Swiss subsidiaries often serves as the inter-mediary holding company for all European assets

Topics of today

- Who is running the show if your parent company is in financial distress?
- Unruly children, or what your subsidiary will say
- How to manage the reporting season - before somebody else does?

Panelists



Christoph Stäubli
Walder Wyss & Partners Ltd.

- Senior Partner, law firm of Walder Wyss & Partners Ltd
- Transaction lawyer with special focus on restructuring and cross-border insolvencies
- Member in numerous professional associations, including:
 - International Insolvency Institute, Washington, D.C;
 - Former Vice Chair, Insolvency and Creditors' Rights Committee, International Bar Association.
 - Deputy for Commission on Bankruptcy of Swiss Bar Association



Holger Erwin Heuking Kühn Lüer Wojtek

- Partner and head of the Zurich office of Heuking Kühn Lüer Wojtek Partnerschaft von Rechtsanwälten, Steuerberatern, Attorney-at-law
- Focus areas: M&A, Corporate, Restructuring, Corporate Compliance and Private Clients
- Recent involvements in US / pan-European intra-group financing arrangements
- Doctor of law (University of Tübingen) and M.Jur. (University of Oxford)



Urs Breitenstein
Deloitte AG

- Partner at Deloitte
- Head of Valuation Services in Switzerland
- Focus areas: M&A, Disputes, Fairness Opinions, Restructurings, Accounting related (US GAAP, IFRS, Swiss GAAPs) and Tax valuations
- Recent involvements in US/ Swiss and international (UK/ Iceland) proceedings
- Ph.d. (Dr. rer. pol.) in Economics and Finance (University of Basel and Study Center Gerzensee/Swiss National Bank)



Jan-Domink Remmen
Deloitte AG

- Director at Deloitte
- Head of Reorganization Services in Switzerland
- Member of the cross border insolvency/restructuring team
- Involved in various US, UK, German and Swiss proceedings
- Focus on multinational corporations, mid sized Swiss corporates and Private Equity/Opportunity funds
- MSc in Industrial Engineering (TU Berlin) and MSc in Finance (LBS)

Who is running the show if your
parent company is in financial
distress?

Christoph Stäubli

Agenda

1. The Swiss legal environment
2. What are the conflicts?
3. Directors' responsibilities and personal liabilities
4. What are the tests?
5. Debtor protection

1. The Swiss legal environment

Stand alone vs. Group approach

- Territorial restraints for Chapter XI
- No COMI; local rules apply
- Isolation of Swiss company; no legal framework for group of companies

Resulting directors' responsibilities

- Segregation from group operation
- Protect interests of CH-entity; adversarial behaviour required
- Separation of assets
- Capital protection
- Protection of subsidiaries?

Factual corporate body

- Isolation of local directors?
- Material influence on decision making process may result in de facto directorship

The role of the auditor

- Action by statutory auditors in case of evident over-indebtedness and non-compliance of board
- Independent financial advisor?

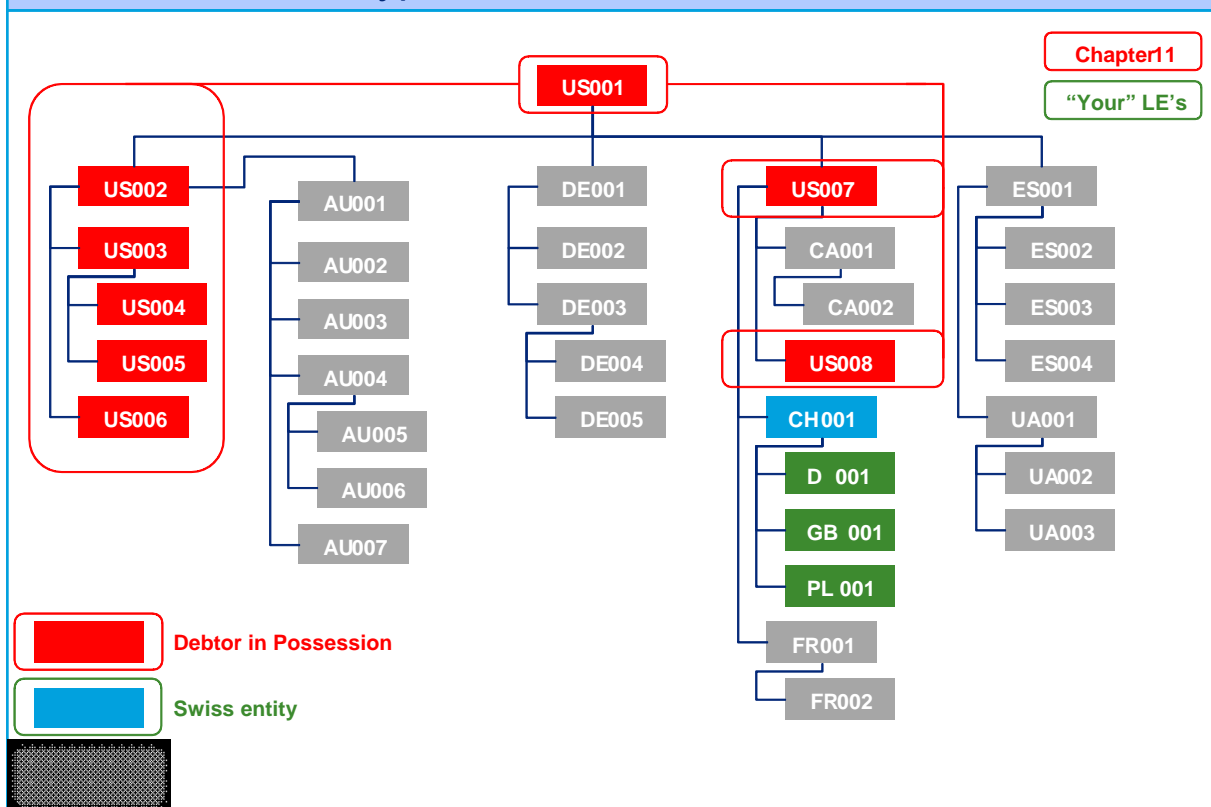
2. What are the conflicts?

What are the conflicts?



Group interests vs. Individual company: group relations are third party relations
Impact of multiple positions of directors: sandwich

Typical situation “illustrative”



Caveat: Group financing & financial assistance rules:

- The up-stream and cross-stream dilemma; capital protection
- Cash pool problem
- Continuation of sub-group financing/downstream loans
- Effect on asset valuation

3. Directors' responsibilities and personal liabilities

- Responsibilities and liabilities result from the Swiss legal environment: protection of individual company
- The concept of differentiated joint and several liability is applied.
- Typically, the following acts are critical in a crisis situation:
 - ▶ Cash flow control (cash flow insolvency /valuation issues)
 - ▶ Dealings with *entities*/ persons close to the company (group)
 - ▶ Building of cluster risks (no risk allocation)
 - ▶ Failure to keep proper accounts and reports
 - ▶ Entering into new obligations
 - ▶ Failure to timely initiate protective measures in case of capital loss
 - ▶ Failure to timely to notify the court in case of over-indebtedness (without delay) ?
- Specific personal liability:
 - ▶ Withholding taxes
 - ▶ Social security contributions
 - ▶ VAT?
- Criminal liability

4. What are the tests?

- Balance Sheet Test:
 - ▶ Adverse Balance Sheet/ “Capital Loss”:
- If last annual balance sheet shows that company assets still cover all debt, but 50 % of equity and legal reserves are no longer covered by net asset value remedial measures must be proposed to the shareholders (Art. 725 para 1 CO);
 - ▶ Threat of over-indebtedness
- In case of substantiated concern of over-indebtedness an interim balance sheet must be prepared and submitted to company’s auditor for verification. A dual valuation test is applied: at going concern and break-up value (Art. 725 para 2 CO) .
- Critical values are intercompany positions.
 - ▶ Test for going concern values [adequate financing for 12 consecutive months is obtainable; hidden liquidity test?]
- Deposition by board of directors of over-indebted balance sheet with the court

5. Debtor Protection

- Subordination Options?
- Prospects of rescue:
 - ▶ Corporate Moratorium
 - ▶ Composition Agreement

Unruly children, or what your
subsidiary will say

Holger Erwin

Agenda

1. What is on your local directors' minds?

- Which approach?
- Country test examples
- Personal liabilities of directors of subsidiaries civil/criminal
- Insurance cover D+O?
- Liability of HoldCo directors (shadow directors, de-facto directors, group of companies concepts)

2. Example of a problem area: Subsidiaries Cash Management

- Cash pool up-stream and cross-stream securities
- Clash of insolvency regimes timing how to cope?
- Different insolvency cultures

3. The “domino effect”

1. What is (should be) on your local directors minds?



In the EU alone there are 27 different

- ▶ tests for insolvency / distress
- ▶ insolvency regimes / proceedings
- ▶ Civil and criminal liability regimes

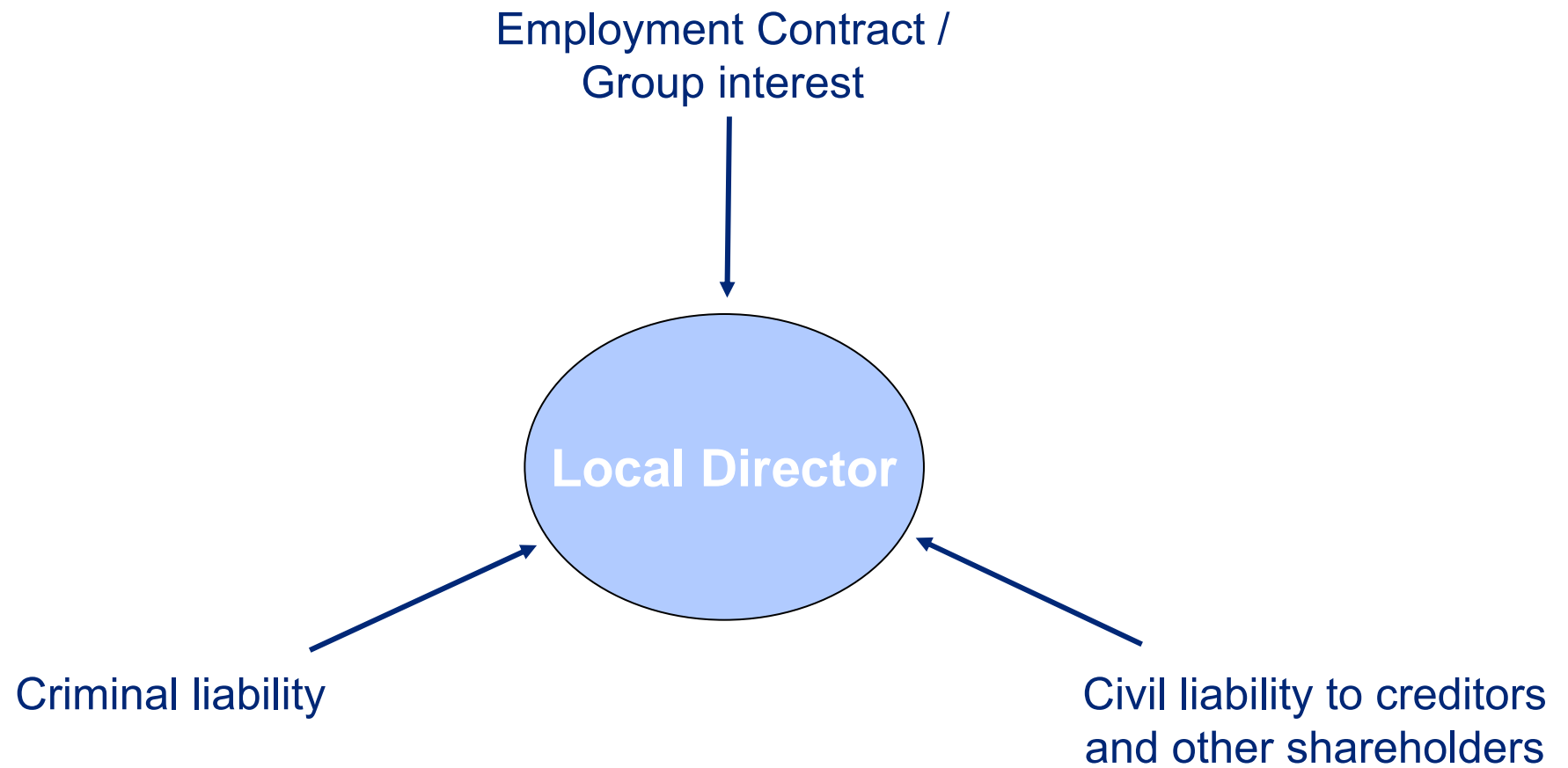
⇒ i.e. 27 individual regimes for local directors to take into account which all work more or less on a stand-alone-basis and

⇒ which all will come to HoldCo with their individual issues

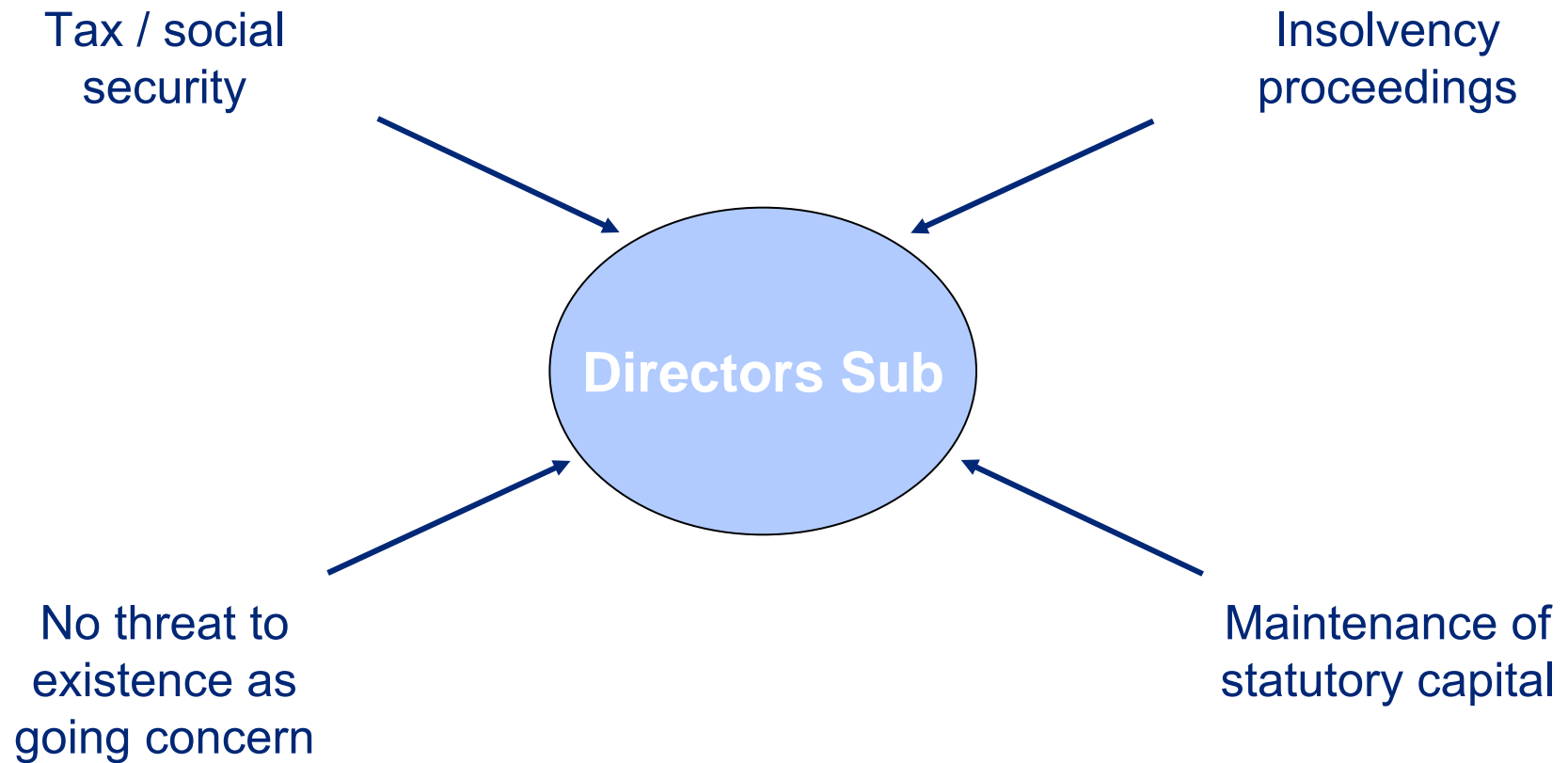
1.1 Just an example of what may come up ...

	Germany	France	UK	PL
Solvency test	Dual: illiquidity or over-indebtedness (partly suspended)	Illiquidity (unable to pay debt)	No express tests, but leaning to illiquidity	Bankruptcy test
Grace Periods	Without undue delay, within three weeks latest	Within 45 days	No express obligation to act at a certain point, but liability for wrongful trading	Within two weeks
Insolvency of groups	No	No	No	No

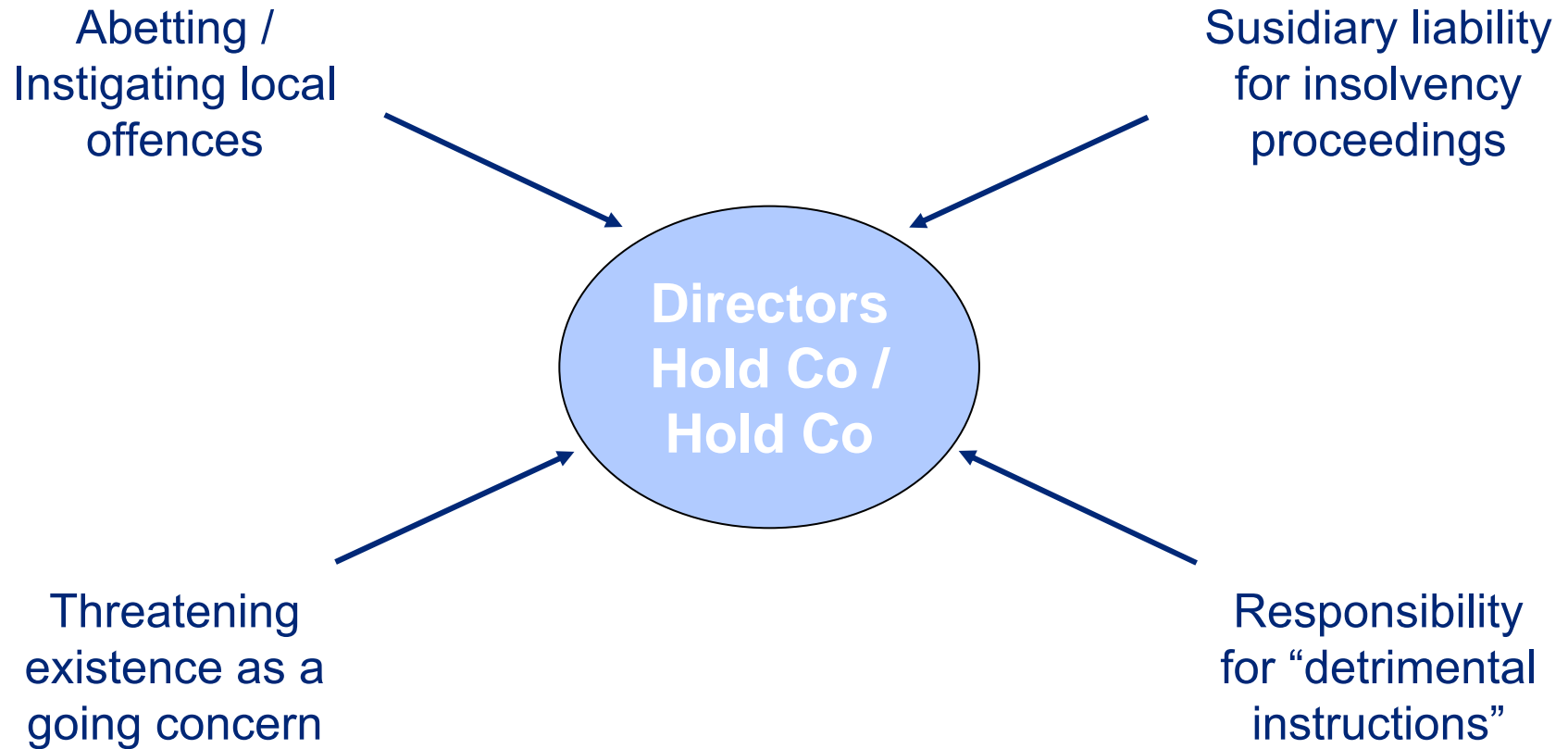
1.2 And the driver behind it is fear



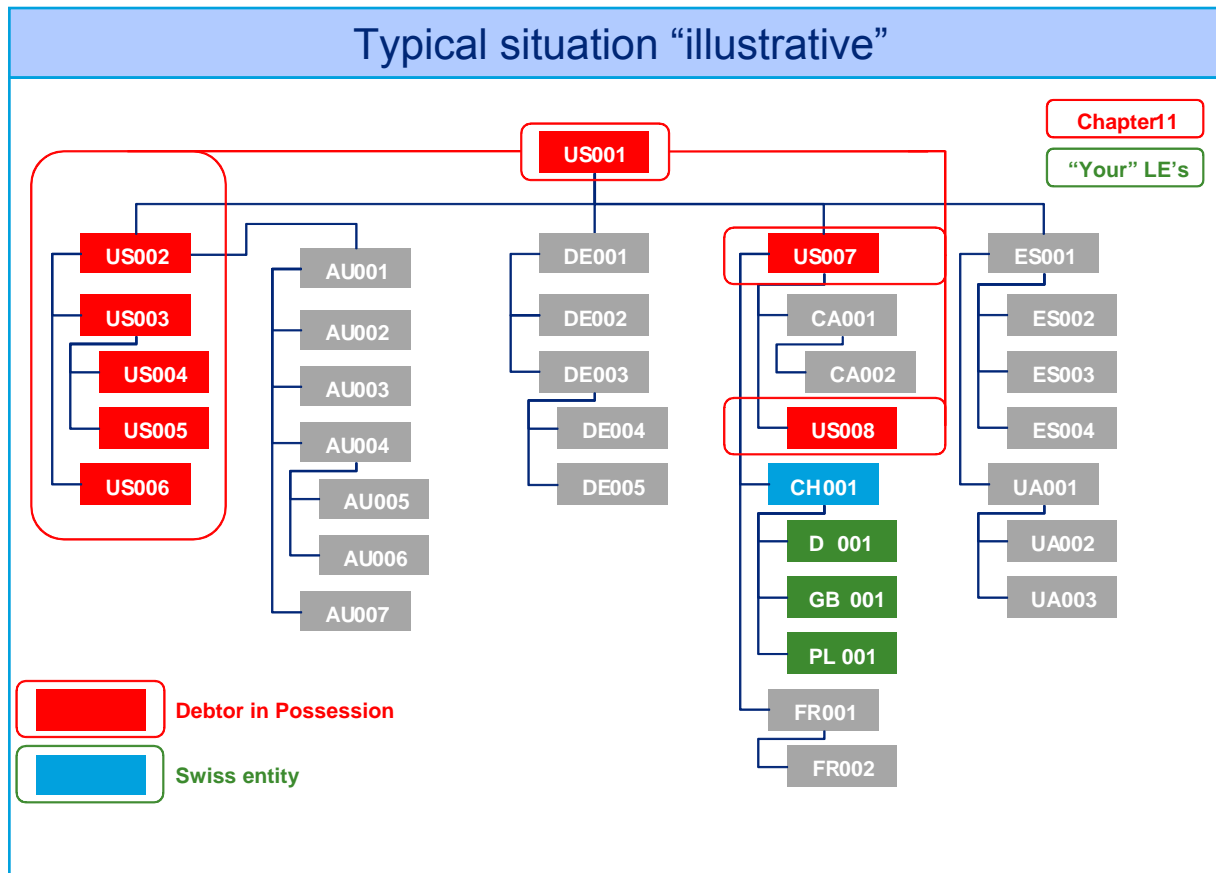
1.3 Liability of local directors (Germany as an example)



1.4 Liability does not stop at local level



2.1 Example of a problem area: Subsidiaries Cash Management – Cash Pool



- Standard instrument
 - ▶ Hold Co expects it
 - ▶ Banks expect it
 - ▶ Shareholders expect it
- But: many local pit-falls
 - ▶ Legality partly in question
 - ▶ Termination rights always an issue
 - ▶ Rights to know
- In addition: intra-group securities
 - ▶ Legality partly in question
 - ▶ Which time is relevant
 - ▶ Limitation language

2.2 Example of a problem area: Subsidiaries Cash Management – Cash pool and intra-group securities

- Cash pool up-stream and cross-stream securities – is it legal?
- What are the requirements / limitations (examples)
- When to pull the plug?

3. The “domino effect”

Always bear in mind that

- the directors of your subsidiaries may have to pull the plug when you don't expect it
- that terminating inter-company financial arrangement by one subsidiary may topple the whole group
- local directors or auditors may have to initiate insolvency proceedings “out of the blue”



Any of the above might disrupt the group lending structure and bring down the entire group in the worst case scenario

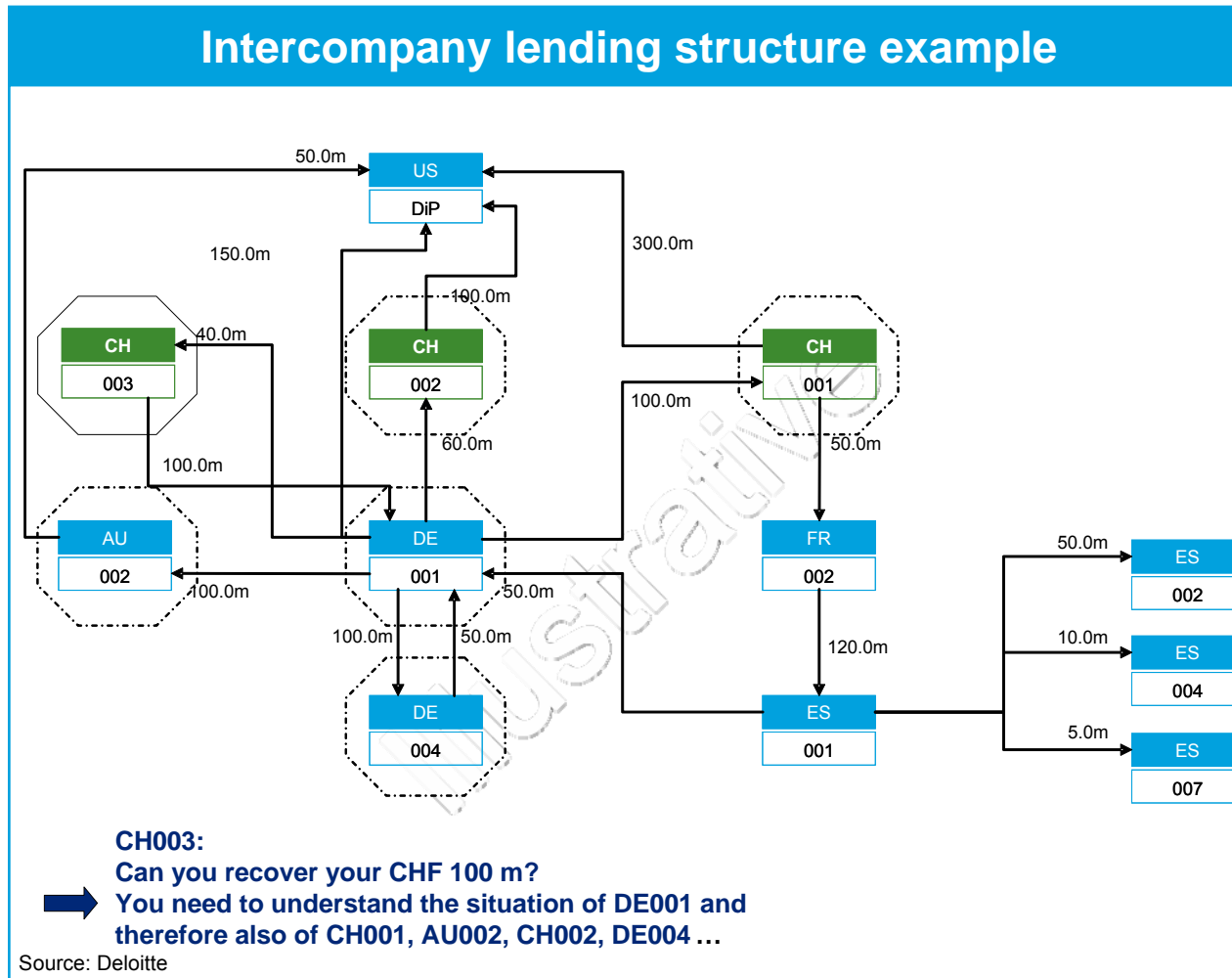
How to manage the reporting season -
before somebody else does?

Urs Breitenstein

Agenda

1. Entity lending structure affecting intercompany receivables and cash
2. Over-indebtedness – What is driving it?
3. 52 week Cash Flow plan: Theory vs. real life issues in financial distress as the basis for going concern valuation
4. Issues in valuation for debt, receivables and inventories
5. A two step approach to value intercompany and third party debt
6. Investments

1. Entity lending structure affecting intercompany receivables and cash



Commentary

- Financial interdependencies are often more complex than the legal entity structure due to InterCo lending agreements
- Appropriate assessment of the consequences of the fall of one company from the tree needs a detailed investigation of all lending interdependencies between all entities (cascading effect)

2. Over-indebtedness – What is driving it?

Swiss Legal Entity Balance Sheet

1.

Assets	Liabilities
Short Term Assets	Current Debt
InterCo. Receivables	InterCo. Payables
Long Term Assets	
Mother Co. Bonds	Long Term Debt
Investments	Bonds
	Other Liabilities
Other Assets	Equity & Reserves

2.

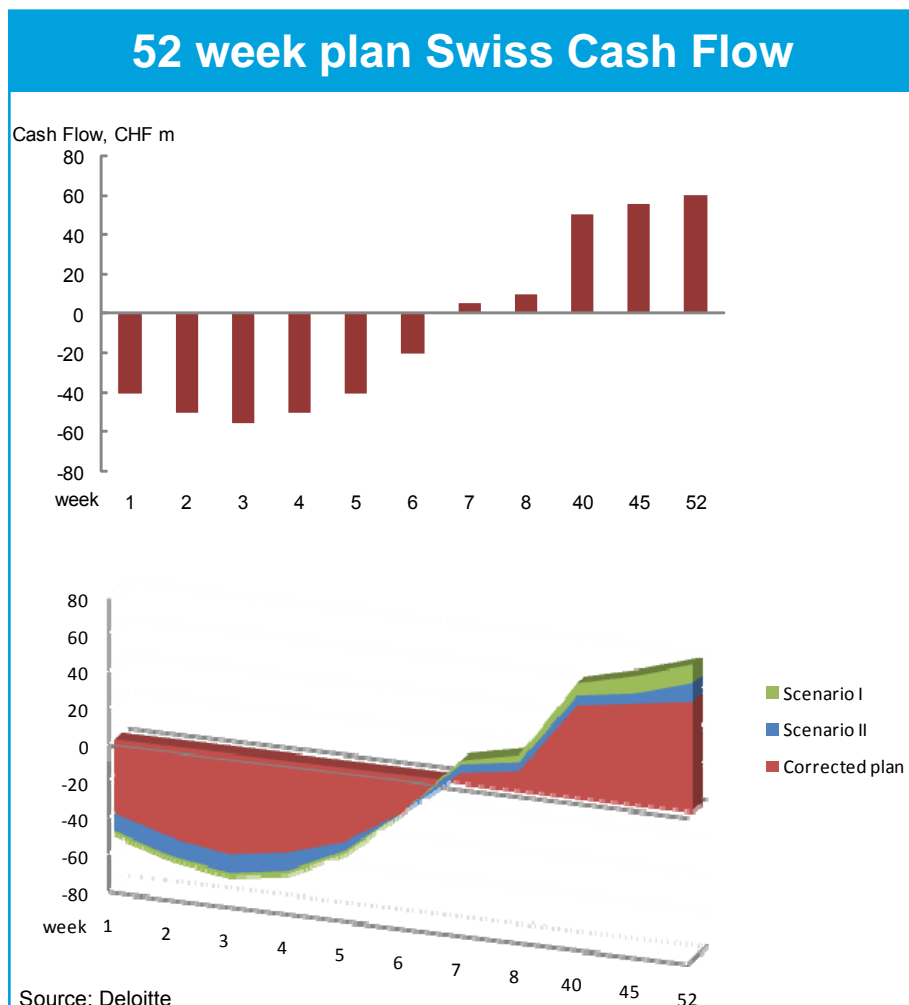
Assets	Liabilities
Short Term Assets	Current Debt
InterCo. Receivables	InterCo. Payables
Long Term Assets	Other Liabilities
Mother Co. Bonds	Long Term Debt
Investments	Bonds
Equity & Reserves	

Assets potentially affected by Chapter 11 group companies

- Cash (in Cash Pool)
- InterCo Receivables
- InterCo Loans
- Investments (in Subsidiaries)

Source: Deloitte

3. 52 week Cash Flow plan: Theory vs. real life issues in financial distress as the basis for going concern valuation



- Going concern including sufficient liquidity needs to be demonstrated prior to any valuation work. In this context, a 52 week cash flow plan is helpful
- Issues related to 52 week Cash Flow plan
 - ▶ Plan to reflect latest view on business outlook in a fast changing environment
 - ▶ Quality of Cash Flow forecast in terms of accuracy and completeness
 - ▶ But is anyone hoarding the cash?
 - ▶ But what if group treasurer decides not to pay?
 - ▶ All documents already reflected in forecast?

4. Issues with the valuation of debt, receivables and investments

- Premise of Value: Going concern or liquidation approach for Interim Balance Sheet?
 - ▶ For InterCo Asset valuation it depends on situation of other group companies and specifically of Chapter 11 company/ies
 - ▶ How independent is your Swiss LE operationally? Should Chapter 11 companies finally fail – would your Swiss LE be able to survive operationally? Does an expected final liquidation of Chapter 11 companies automatically trigger a liquidation (approach) of your entire Swiss LE?
- Valuation concept: Prudence principle and not Fair Value principle!
- Legal entity view potentially different from accounting and internal reporting (valuation) concepts
- Complexity associated with the valuation of distressed companies

5. A two step approach to value intercompany and third party debt

①

Define remaining Enterprise Value for Chapter 11 (or intermediary legal entity)

②

Allocate likely recoverable amounts for all InterCo and third party debt classes in this company, depending on seniority and on existing pledges

- Bond valuation models usually not applicable and existing market prices for groups third party debt rarely exist.
- To determine recovery of your legal entity's InterCo assets, a two step approach may be required for the chap 11 group of companies plus for each legal entity which owes your Swiss legal entity money (directly or indirectly):
 - In a first step, the Enterprise Value (= value of total invested capital, which is equity and financial debt) is required
 - Use pre-existing Enterprise Valuations which were performed for other purposes?
- In a second step, Enterprise Value is compared with total amount of existing financial debt
- Recovery of different debt classes is determined
- Depends on seniority, pledges, covenants etc.

6. Investments (in Subsidiaries)

- Enterprise valuation of investments required
- What percentage of shareholdings do you still own?
 - ▶ Minority discounts and other discounts applicable?
 - ▶ Are the equities of the subsidiaries pledged?
 - ▶ Are the subsidiaries in the process of being sold by the M&A department of your mother company?

Recommendations

1. Recommendations – legal (pre crisis)

- Pre crisis – What does a Plan B entail?
- Continuous monitoring
- Assess (multiple) directorship positions; no pleasing the HQ
- Involvement in group reporting; right to be informed
- Assessment of financial covenants
- Active participation in conclusion of financial documents; limitation language
- Respect different cultures

2. Recommendations – legal (in crisis)

- Involvement in insolvency plan
- Secure cash, step out or limit cash pool
- No payments up or cross
- Secure coordinated procedure
- Role of general group counsel

3. Recommendations on financial documentation

- Understand lending arrangements including details and identify potential cascading effects
- 52 week Group Cash Flow plan: monitor development and relevance of planning assumptions
- Document ongoing solvency of your LE debtors (if appropriate)
- Discuss with your local and lead auditor potential impact of prudence principle
- Understand what will be their procedures
- Match reporting concept with LE structure to the extent possible
- Collect existing relevant valuations performed for debtor entities or organise new ones

Contacts

Contacts

Christoph Stäubli Walder Wyss & Partners Ltd.

Walder Wyss & Partners Ltd.
Seefeldstrasse 123
P.O. Box 1236
CH-8034 Zurich

T +41 (0)44 498 98 98
F +41 (0)44 498 98 99
cstaeubli@wyp.ch
<http://www.wyp.ch>

Holger Erwin Heuking Kühn Lüer Wojtek

HEUKING KÜHN LÜER WOJTEK
Partnerschaft von Rechtsanwälten,
Steuerberatern und Attorney-at-Law
Bahnhofstrasse 3
CH-8001 Zürich

T +41 (0)44 200 71 00
F +41 (0)44 200 71 01
h.erwin@heuking.ch
www.heuking.de

Urs Breitenstein Deloitte AG

Deloitte AG
General-Guisan Quai 38,
CH-8022 Zürich

T +41 (0)44 421 64 55
F +41 (0)44 421 66 00
ubreinsteinst@deloitte.ch
www.deloitte.ch

Jan-Domink Remmen Deloitte AG

Deloitte AG
General-Guisan Quai 38,
CH-8022 Zürich

T +41 (0)44 421 64 32
F +41 (0)44 421 66 33
jaremment@deloitte.ch
www.deloitte.ch

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