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SUBORDINATION – WHAT HAS TO BE CONSIDERED

Subordination is a useful short term measure to avoid having to go to court in the event of over-indebtedness. What is behind this provision and what should be considered?

General information concerning subordination

If a company is over-indebted pursuant to article 725 of the Swiss Code of Obligations, this over-indebtedness can be eliminated in the short term by subordination. In the case of insolvency or liquidation, the creditor withdraws priority or declares a deferral of the capital claim.

Subordination is a written, unconditional, indefinite and irrevocable contract. The contract is clearly regulated and must be complied with, otherwise the subordination is invalid. The main elements of the agreement are the ban on securing (no preferential treatment to other creditors), standstill agreement (see below) and credit rating clause (the creditor must ensure that it is able to waive its claim, i.e. that it does not become over-indebted itself by waiving the claim).

Main aspects that must be considered

If debt has been recognised in subordination, the following must be noted:

- The amount of the subordination can be determined as follows:
  Amount of over-indebtedness at going concern values plus a
  reserve for future losses already foreseeable.
- Debts in subordination may not be repaid in full or in part, be redeemed through offsetting or renewal or be newly secured (part of the standstill agreement).
- It must be clearly defined whether any existing and future interest should be included in the subordination.
- The debts in subordination are to be shown in the balance sheet, in the appendix and in the audit report.
- The validity of the subordination begins with the signing of the agreement. Giving it legal effect prior to the date of signing is not possible.
- Subordination may only be revoked by means of a report from the statutory auditors confirming that all liabilities are covered by assets. This also applies to companies that are not subject to auditing or have chosen to opt out.
- However, if the over-indebtedness has been eliminated, the Board of Directors may cancel the subordination by means of a resolution protocol.
- Loans in subordination are considered as deemed equity. Therefore, interest paid on the loan is not tax deductible and is treated as concealed profit distribution, i.e. as dividends. The repayment of the loans after the over-indebtedness has been eliminated is tax free.

Alternatives to subordination

To forgo a subordination, there are the following alternatives:

- Capital increases
- Conversion of debt into equity
- Waiver of claims by the creditor
- à fund perdu contribution (non-repayable loan)
- Granting of a new loan with simultaneous subordination

These are long term measures to eliminate the over-indebtedness, by way of eliminating subordination.

Subordination does not eradicate the over-indebtedness, but represents a short term bridging in order to refrain from going to court for bankruptcy proceedings. We will be pleased to advise you on possible measures in case of over-indebtedness, the creation of a subordination agreement or alternatives to subordination.

For questions or queries, please contact the author.

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