DIRECTORS UNDER FIRE

WHEN INSOLVENCY MEETS FRAUD – A SWISS PERSPECTIVE

Authored by: Natalia Hidalgo (Counsel) & Edouard Kaiflin (Counsel) - Monfrini Bitton Klein

Bankruptcy is often perceived as the end of a company's story. For directors, however, it frequently marks the beginning of the most significant legal scrutiny. In Switzerland, the opening of insolvency proceedings may expose directors to a wide range of legal consequences, including civil liability and criminal investigations. While these proceedings are governed by different sets of rules and pursue different objectives, they often arise from the very same decisions taken during the final months before insolvency.

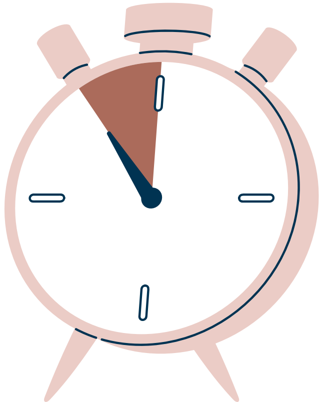
Financial Distress: The Board's Duty to Act Early

Among the many changes introduced by the revision of Swiss company law, adopted by the Swiss Federal Parliament on 19 June 2020 and effective since 1 January 2023, the rules governing directors' duties in situations of financial distress were strengthened. In particular, the provisions dealing with the monitoring of the company's liquidity, capital loss and over-indebtedness (Articles 725 et seq. Swiss Code of Obligations – 'SCO') were amended.

Under the revised Article 725 SCO, the board of directors is now expressly required to monitor the company's solvency. If there is a risk that the company may become insolvent, it must take appropriate measures to ensure the company's solvency. Where necessary, the board must implement necessary restructuring measures; if these fall under the general meeting jurisdiction, the board must propose them to the shareholders for approval. Where appropriate, the board must apply for a composition moratorium. The law expressly requires the board to act promptly.

The board's responsibilities do not end there. The law also imposes specific obligations where the company suffers a capital loss (Article 725a SCO) or becomes over-indebted (Article 725b SCO). In the event of a capital loss, the board must take appropriate measures to remedy the situation and, where necessary, implement or propose additional restructuring measures. Whereas in the event of over-indebtedness, the board must immediately prepare interim financial statements, have them audited and, if over-indebtedness is confirmed, notify the competent court unless one of the statutory exceptions applies.

The ratio legis behind the reform is to implement early warning systems to ensure an earlier intervention by the board of directors.



Failing to Act on Time

The practical significance of these duties, among many others, lies not only in corporate governance, but also in the potential consequences of failing to comply with them.

Once insolvency proceedings are opened, the board's conduct during the period preceding bankruptcy will often be examined in detail. A failure to properly monitor the company's financial position or to take timely restructuring measures may expose directors to several forms of liability.

Members of the board of directors may incur civil liability under Article 754 SCO. According to this provision, directors and all people involved in the business management or liquidation of the company are personally liable towards the company, its shareholders and its creditors for any losses caused from an intentional or negligent breach of their statutory duties. In practice, liability claims frequently arise where directors fail to comply with their statutory duties under Articles 725 et seq. SCO, in particular by reacting too late to a deteriorating financial situation, delaying appropriate restructuring measures or failing to notify the court where required. Such breaches constitute the foundation of the violation of duty required to establish liability under Article 754 SCO.

Criminal Exposure: Insolvency May Also Trigger Criminal Investigations

Civil liability is not the only risk faced by directors once insolvency proceedings have been opened. Bankruptcy frequently marks the starting point of criminal investigations into the conduct of the company's management.

Swiss criminal law contains a specific set of offences dealing with bankruptcy and debt enforcement (Articles 163 et seq. of the Swiss Penal Code – 'SPC'). These provisions are intended to protect creditors against fraudulent or abusive conduct committed before or during insolvency proceedings.

Depending on the circumstances, directors may be exposed to criminal liability where, for example, they fraudulently conceal, misrepresent, or dissipate assets to the detriment of creditors (Articles 163 and 164 SPC), where the company's insolvency has been caused or aggravated through grossly negligent or reckless management (Article 165 SPC), where accounting records have not been properly maintained or preserved (Article 166 SPC), or where certain creditors have been intentionally favoured over others shortly before bankruptcy (Article 167 SPC).

Although these offences each have their own constituent elements, they frequently arise in the context of corporate collapses. In practice, the Bankruptcy Office plays a pivotal role for creditors. Through its investigations, it may gain access to accounting records, corporate documents and other evidence that individual creditors would rarely be able to obtain on their own. For this reason, maintaining an active dialogue with the Bankruptcy Office is often crucial. Information gathered during the bankruptcy proceedings may provide the factual basis not only for civil liability claims but also for criminal complaints against the company's directors where offences under Articles 163 et seq. SPC are suspected.

Articles 163 to 167 SPC are indeed deemed to protect creditors. Consequently, creditors may apply to become private plaintiffs in the context of criminal proceedings initiated in connexion with those offences.

For directors, the practical consequence is clear: once a company enters financial distress, the focus should not only be on complying with the corporate law duties set out in Articles 725 et seq. SCO. Decisions taken during the final months preceding bankruptcy may subsequently be scrutinised under both civil and criminal law.