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NEWSLETTER

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The risks during company formation and with shelf corporations

Dear Sir or Madam,

The formation of companies and the selling and buying of corporations is an everyday occurrence. In most instances this happens without any glitches; however, there can also be pitfalls. With this newsletter we’d like to analyse the formation and sale of capital companies (Ltd. and plc).

Formation by cash subscription
Formation by cash subscription is the simplest method. Once the company (and thus its name) has been established, a capital payment account is opened at a bank. The founder members pay in per rata as agreed, or simply just one shareholder pays in. The bank then confirms the company has been credited with this money. More often than not this is CHF 20’000 for limited companies and CHF 100’000 for a plc. With this confirmation the company can officially be founded by a notary. The restricted deposit of the money at a bank allows the company to freely dispose of it. After the entry in the commercial register, the capital is available and the company can start using the money. With most banks it is necessary to open a new account, and the money, minus a processing fee, will be transferred to the new account of the plc. A few banks will just have the one account and will unlock it.

Any kind of business in accordance with the company’s purpose is possible. Any other kind of business is equally possible but may lead to liability claims by creditors and shareholders against the company (contestable business incompatible with the company’s objectives). Of course, any illicit business (drug dealings, etc.) will also be illegal.

Formation by contribution in kind
In this situation, tangible assets are brought to the company, in lieu of money or on top of cash payments. In such an instance the agreement on contribution in kind needs to be checked by an auditor who will then confirm compliance of the contribution in kind. After that, the company will be founded and the tangible assets, instead of cash, are property of the company.

Such a formation can be troublesome if the tangible assets have no intrinsic value and later lead to insolvency. In such a situation the founders’ liability of the board of directors and the auditor will come into effect.

Intended contracts with equity owners
If there is an intention to enter into contracts with associated parties, then these contracts are subject to a review by the auditors as well. If for example an entrepreneur (and owner of an individual enterprise) has also founded a capital company and now would like to sell some of the assets of the individual enterprise to the capital company, then the contract needs to be reviewed by auditors, who need to check whether the terms and conditions are fair and in line with the market. Even here the founder and the auditors are liable should the intrinsic value be drastically reduced. The aim is to ensure that the belief in the company's formation and the capital's existence are justified.

Capital procurement by the shareholder
Quite often shareholders need to scrape their money together for the formation of their company. Loans by relatives, taxes due, micro-credits and many other things do add up. The financial situation of a shareholder or a company member is irrelevant during the company's formation as long as the capital is at the company's disposal. A statutory provision according to which a founder needs to have assets that at least equal the share capital does not exist.

Contracts by the company to be formed
Quite often it is necessary for a company to sign contracts even before it is founded. The body shop to be founded signs a rental contract, the trading plc to be founded needs to buy a vehicle, the consultancy plc about to be founded is signing work contracts, and so on. Such contracts are allowed and normal. The articles of incorporation state that capital is at the free disposal of the company which does not at all exclude the possibility to enter into contracts beforehand. As long as these deals are made with third parties such contracts are permitted during the company's formation. As a result it could even be possible that less capital is then freely available, or even that capital is no longer available.

Use of liquidity at formation
Corporations often have a central administration for liquid funds. Sometimes it is even possible that individual companies, instead of having a bank account, then have a banking connection as paying agent. Another option is the banks offering cash pooling as a service. Under this model there are various bank accounts per company, with the bank consolidating all balances. Negative bottom lines and positive bottom lines balance each other out without incurring interest. Thus it is possible that capital coming out of this cash pool will be put at the company's free disposal, with the capital then returned to the cash pool immediately after the formation of the company. These loan relationships are permitted as long as by virtue of credit standings, the willingness to pay remains valid. Cash pooling is practical and cost-efficient. However, the grounding of Swissair revealed the disadvantages of this model. In case of bankruptcy the money is lost or rather it results only in claims in the third bankruptcy class.

What applies to major corporations should also be possible for private entrepreneurs. Essential under company law are the willingness to pay and financial solvency. However, problems will turn up once the credit standing of the debtor is resting on shaky foundations. If he is solvent then the company is not in jeopardy. Certain authorities criticise loans to shareholders or company members after a company's formation. According to this author's view, there should be no difference when a loan to a shareholder is granted. Only the credit standings and whether the economic capital

is at the company's disposal are essential. The Code of Obligations explicitly cites loans to shareholders as an investment category.

Fraudulent formations
A private person had founded 220 companies in a row (Federal Supreme Court 6B_748/2012 on 13/06/2013) in what was regarded as fraudulent formation. The core issue here was that the companies did not have any economic capital at their disposal.

Formation of subsidiary companies
A recently formed company can, directly after its formation, found a subsidiary company, and this one in turn can do so as well. So far there has been no judgement as to when this daisy-chain of formations becomes inadmissible. This example shows that the foundation capital very quickly in terms of liquidity is no longer at the company's disposal, which is a legally permitted procedure. It is only essential that the use of the capital complies with the company's objective.

Shelf corporations
Companies that are no longer active and in use are either liquidated or so-to-speak "shelved". Sometimes they still have money at their disposal and thus the formal capital, but often they are empty and have no business activity anymore. The balance generally looks as follows (example plc):
Current account shareholder: CHF 100'000
Company's capital: CHF 100'000

With a new owner, the purpose of the company, its name and its executive bodies (board of directors and managing director) change. One large school of thought supports the thesis that such a change of ownership is legal. A few company registers regard this kind of business as null and void and officially close down the company. A clarifying judgement by the Swiss Federal Supreme Court does not exist.

During change of ownership it must be taken into account that the new owner, by contract, takes over the debt towards the company. An equity payment undertaking agreement is required, together with the company's approval of the new debtor. Without this assumption of debt it is possible, should the company go bankrupt, that it (or the bankruptcy estate respectively) can fall back on the former (or rather still existing) debtor and make him liable.

From a fiscal point of view, there could be the issue that a shelf company, after being sold, makes profits subject to tax, due to previous losses being carried forward. If, for example, a shelf company has a capital of CHF 100'000 and old losses of CHF 50'000, then, from a fiscal point of view, during a change of hands, the capital is re-established, and we have a bottom line as described above (current account 100'000 and capital 100'000). Thus a profit of 50'000 is created that can be offset with losses carried forward. Should these losses be older than seven years offsetting is not possible anymore, resulting in a profit subject to tax. Thus it is recommended to reach a tax ruling with the tax authorities. Whichever way, all losses carried forward become void after a shelf deal.

Subject to interest: current account company member, loan to shareholder
Loans to shareholders are normal and permitted. Under corporate law these loans have a specific place in the balance sheet structure. Paying out loans is a legal business activity, and the company generates income with the interest. From a fiscal point of view this could be in breach of the civil ban on refund of contributions. The auditor needs to point this out. Under civil law this could create a liability for damages upon the shareholder.

Fiscally there are numerous examples. Debts lead to a duty to pay interest according to pre-set rates. If there are both loans and losses carried forward then a loan can be classified as profit distribution which is then subject to withholding tax. Loan amounts paid out too high could be classified as covert equity capital. Recently, loans with interests not duly paid have been classified as covert profit distribution (dividends).

Kind regards
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