Bankruptcy and reorganisation trigger criteria: from a retrospective (balance sheet) to a prospective (cash flow) test

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Abstract

Under what circumstances should a business be allowed – or obliged – to take measures if it faces, or is likely to face, financial difficulties? Although a fundamental and universal issue,\(^1\) it is striking to note that there is no clear and generally accepted approach to the “trigger criteria” for reorganisation. In fact, we doubt that any legal system has yet addressed the issue satisfactorily. This short paper focuses on the Swiss approach and suggests solutions inspired by economical rational and international experience.

I. The Swiss Approach

In Switzerland the issue is dealt with in a somewhat puzzling manner:

(i) **from a creditor’s standpoint,** the test is that of pure insolvency, i.e. a company is declared bankrupt by the judge whenever it fails to pay any debt which is fallen due.\(^2\) Whether or not the company is *in bonis* (balance sheet test) or might prospectively become solvent in the foreseeable future (cash flow test) is irrelevant. Implicitly, the test is purely and instantaneously cash-based;

(ii) **from the company’s standpoint,** the board of directors (failing whom, the auditors) is required to file for bankruptcy as soon as debts exceed assets, i.e. as soon as the company has no (more) equity and is thus “overindebted”.\(^3\) The trigger is thus a pure balance sheet test. The rational is that the lack of equity triggers an unacceptable risk for the company’s creditors and that it therefore has to stop doing business. Before such stage is reached, the board of directors is required by law to take measures based on still another balance sheet test, namely


\(^2\) Arts. 171 and 172 of the Swiss law on Debt Collection and Bankruptcy.

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whether the company's equity is less than half of the par value of the company's share capital.\(^4\)

So, Swiss law provides two radically different tests for what is fundamentally the same issue. From a legal and certainly economic standpoint, this approach is highly questionable. Which test should prevail? Certainly not the balance sheet test, because when the criterion is met, it is usually too late. And sometimes, it is too early.\(^5\)

II. What Is the Appropriate Test?

In our opinion, the approach should be mainly financial; the solution should indeed be found by turning to economists rather than jurists. From the perspective of an economist, the issue is basically to know whether, under the circumstances, the going concern is or is not viable.\(^6\) Although this if often difficult to determine, instruments have been developed to enable an answer with a reasonable degree of accuracy. In any event, the following considerations should be taken into account:

(i) First and above all, the test should be prospective, not retrospective. What matters is whether the company is able to survive and possibly prosper, not – or at least not only – what has occurred so far;

(ii) the test should therefore not – or, if so, only marginally – be based on the company’s balance sheet. As the most recent UNCITRAL report suggests: “the balance sheet test (…) suffers from a number of disadvantages and should not be used as the single test”.\(^7\)

(iii) the test should not be based on the company’s profit and loss account. This financial statement is in fact nothing but a sub-account of the balance sheet, and it therefore measures the same criteria, i.e. the company’s equity and, more precisely, the degree of equity consumption. This

\(^4\) More accurately its share capital increased by part of its retained profit; see Art. 725 para. 1 of the Swiss Code of Obligations (“CO”).


\(^7\) UNCITRAL Legislative guide on insolvency law (2004), p. 60, N 29.
may have little to do with the company's survival prognosis, which, again, is essentially cash driven;

(iv) as venture capitalists worldwide clamour, the approach should be mostly cash flow-based. The principle parameter should thus be whether the company disposes of sufficient cash to pay its debts as they become due, and whether it is reasonable to believe that it will continue to do so in the foreseeable future.\(^8\) If so, the company should be allowed to survive. If not, it should cease activity, unless it can be financially restructured. Whether or not the company still has a positive net asset value is irrelevant in this regard.

The test chosen in the 2004 UNICITRAL "Legislative Guide on Insolvency Law" states: "where the insolvency law adopts a single test, it should be based on the debtor's inability to pay debts as they mature (cessation of payments test) and not on the balance sheet test".\(^9\) In the words of the World Bank "Principle And Guidelines For Effective Insolvency and Creditor Rights System", 2001, "the preferred test for insolvency should be the debtors' inability to pay debts as they come due – known as the liquidity test".\(^10\) This is also the prevailing US approach.\(^11\)

We are firmly of the view that no test other than the cash flow test should be applied. Switzerland should thus get rid of its inappropriate and outdated balance sheet test, which shackles companies rather than providing any rescue;

(v) finally, to avoid any doubt, the so called "dual insolvency test"\(^12\) would not be an appropriate compromise. Pursuant to this test, both a balance sheet test (so called "bankruptcy insolvency") and a cash flow test (so called "equitable insolvency") should apply cumulatively.\(^13\) The short-

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\(^8\) UNICITRAL Legislative guide on insolvency law (2004), p.61, N 30. Numerous and sophisticated "survival tests" have been developed in that respect over the years. See \textit{inter alia} those mentioned in \textit{Henry Peter}, \textit{L'action révocatoire dans les groupes de sociétés}, Basel 1990, p. 126 to 128 and footnote 333.

\(^9\) UNICITRAL Legislative guide on insolvency law (2004), footnote 16, p. 82.


\(^11\) \textit{Leif M. Clark}, \textit{supra} footnote 1.


coming of this “dual” approach is that a combination of a good (insolvency) and a bad (overindebtedness) test is unable to provide a good solution. This test might be the right one when the issue is to know if dividends can be paid out, but not when the question is whether a company should or should not survive.

III. Is it Ever Too Early?

Whatever the test, its purpose is to determine when, at the latest, reorganisation measures must be taken. Another fundamental question is whether it should be possible to take measures earlier. The answer is quite clearly “yes”. Taking reorganisation measures can hardly occur too early. In other words a company should be allowed to take reorganisation measures at “too early” rather than at too late a stage.¹⁴ This is the US approach, pursuant to which Judge Clark reminds us that “Under the US Bankruptcy Code, an entity may file regardless of their financial condition”.¹⁵

Caution, however, is in order. Prematurely reorganising a business could represent an unsound business decision. And, if the law grants advantages to the company,¹⁶ these advantages could be unfair towards some stakeholders and competing companies. Under such circumstances, a reorganisation might constitute a so-called “abusive filing”, on which Judge Clark comments in his paper.¹⁷

¹⁴ PAUL OBERHAMMER, The Procedure According to the “Unternehmensreorganisationsgesetz” Under Austrian Law: A Failed Attempt of a Regulation on Pre-Insolvency Reorganisation, infra this volume; HANS CASPAR VON DER CRONE/BETTINA STUTZ/LOÏC PFISTER, Some Basic Theses Concerning Modern Swiss Reorganization Law, infra this volume; JOHN ARMOUR, Overview of the Treatment of Stakeholders in UK Corporate Insolvencies, infra this volume; GEORGES CAVALIER, Improvement of Bankruptcy Proceedings in France: The Right Step Towards Investors, infra this volume.

¹⁵ LEIF M. CLARK, supra footnote 1.

¹⁶ For instance, Chapter 11 of the U.S. Bankruptcy Code grants many such advantages.

¹⁷ LEIF M. CLARK, supra footnote 1.
IV. Conclusion

By preferring a cash flow test rather than a balance sheet (equity) test, one focuses on the only appropriate parameter. By adopting a prospective rather than retrospective view, the company anticipates its financial difficulties, rather than being the “deferred” victim thereof. This approach obliges the board of directors (and auditors) to answer proactively the only relevant question, i.e. is the business viable. It avoids unconstructive consideration of the old-fashioned, pointless balance sheet-share capital criteria that still prevails in Switzerland (Art. 725 CO).

Moreover, the cash flow test enables temporarily overindebted companies to pursue business activity in view of economic growth and positive cash flow on the horizon. This perspective meets the well understood interests of all stakeholders, whether shareholders, debt holders, employees, or even the overall economy. This approach is particularly appropriate for start-ups, but it applies equally well to any other kind of venture.