Swiss Federal Supreme Court Decision 5A_440/2024 of 31 March 2025: Lenders may end up empty-handed in case of bankruptcy – a thorough assessment before granting emergency loans is key

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Key takeaways

- **When a closely related party of a financially distressed company grants the latter a loan, the claim for repayment may - even without an explicit subordination agreement – be classified as subordinated in bankruptcy proceedings. The consequence of the subordination is that the lender typically receives no bankruptcy proceeds. In the Swiss Federal Supreme Court decision 5A_440/2024, Switzerland's highest court clarified the conditions under which such a loan shall be treated as subordinated.**
- **A loan may be considered subordinated in bankruptcy proceedings due to the prohibition of abuse of rights. This, however, requires the company to have been over-indebted when the loan was granted.**
- **Alternatively, the loan may also be subordinated based on an implied subordination. The latter requires concrete indications that the parties intended for the lender to subordinate its claim in favour of the company's other creditors.**
- **In light of the Swiss Federal Supreme Court's view that an abuse of rights presupposes an over-indebtedness, shareholders and closely related parties should carefully assess whether the company is over-indebted before granting a loan. Additionally, the parties should expressly state in the loan agreement that no subordination is intended to preclude the assumption of an implied subordination.**

What happened?

Between 2016 and 2018, several closely related parties (including shareholders, board members and a sister company) granted loans to a company. In 2018, the company went bankrupt.

In the bankruptcy proceedings, the loan claims were classified as third class claims subject to subordination. The cantonal courts dismissed the lawsuits and appeals brought by the lenders. The lenders requested the Federal Supreme Court to admit their claims without subordination.

What did the Federal Supreme Court consider?

The court began by stating that loans from closely related creditors to financially distressed companies are viewed critically in legal literature. Such loans enable a company to continue its business activities without a proper restructuring. This can harm existing and new creditors.

To address this issue, legal literature proposes various remedies. Some advocate for reclassifying such loans as equity under certain conditions. Others argue they should be treated as subordinated claims (i.e. ranked below the third-class claims).

At the outset, the court reiterated its previous rulings in which it rejected the reclassification of debt as equity. As this view was not challenged in this case, the Court examined whether the appellants' loans should be considered subordinated in the bankruptcy.

It first addressed the argument of the prohibition of abuse of rights. The Swiss Federal Supreme Court noted that if there is a justified concern for over-indebtedness, the board of directors must prepare an interim balance sheet and submit it to an auditor. If this balance sheet shows that the creditors' claims are not covered under going-concern or liquidation values, the board must notify the court — unless creditors subordinate their claims to the extent of the shortfall. Based on these statutory duties, according to the Swiss Federal Supreme Court, creditors may rely on the assumption that a company participating in the market is not over-indebted or that subordination has been declared. However, in the absence of over-indebtedness, creditors have no justified expectation that the company is not in financial difficulties. Therefore, if the company was not over-indebted when the loan was granted, asserting the loan claim in bankruptcy proceedings does not constitute an obvious abuse of rights.

The Court next examined the implied subordination claimed by the respondent. An implied subordination may arise from the actual or presumed intent of the parties. Regarding the presumed intent, the court noted that a subordination by the lender affects third parties who are not involved in the contract. Based on that, the Swiss Federal Supreme Court concluded that if the contracting parties' statements do not contain indications for such a presumed intent, one would not be in a position to assume that the lender had agreed to a burdensome subordination in favour of third parties.

Finally, the Court rejected the argument that subordination could result from a legislative gap. It held that the legislator had deliberately refrained from regulating this issue and viewed the prohibition of abuse of rights (Art. 2 para. 2 Swiss Civil Code) as a sufficient corrective tool in individual cases. This would represent a qualified legislative silence, leaving no room for judicial gap-filling.

Applying these principles to the case at hand, the court found that while the appellants were closely related to the company, no abuse of rights existed as the company was not over-indebted at the time the loans were granted. Moreover, there was no evidence of actual intent to subordinate, nor any indications for a presumed intent. The fact that the company's liquidity issues were well known from 2016 onwards, bankruptcy was a serious risk from late 2016, and that the appellants had granted the loans to ensure the company's continuation, did not alter this conclusion.

In summary, the Swiss Federal Supreme Court held that the disputed claims were not subordinated and ordered their admission as third-class claims.

Why is this decision important?

When a company is in financial distress, closely related parties often consider granting the company loans. Even without an explicit subordination agreement, such loans can be classified as subordinated in case of bankruptcy. Subordinated claims rank below all other claims with the consequence that lenders typically receive no bankruptcy dividend.

There has been legal uncertainty about when such loans shall be treated as subordinated. The Swiss Federal Supreme Court decision 5A_440/2024 clarifies key points:

- Legal bases for subordination are either the prohibition of abuse of rights or an implied subordination. There is no legislative gap that can be filled by courts.
- If a company is not overindebted when the loan is granted, asserting the claim in bankruptcy proceedings does not constitute an abuse of rights. The fact that the company was in financial difficulties, that an external party would not have granted such loans (the "third-party test"), or that only an equity contribution would have had a restructuring effect (the "restructuring test") is in itself not sufficient to assume an abuse of rights.
- An implied subordination cannot be assumed merely because the company's liquidity issues were notorious, bankruptcy was a serious risk, and the loans were intended to ensure continuation. Instead, there must be clear indications of the parties' (presumed) intent to subordinate the claim in favour of non-contracting creditors.

These clarifications are welcome. However, not all questions have been resolved by the Swiss Federal Supreme Court:

- In particular, it remains unclear whether (and if so, which) additional factors must exist in addition to overindebtedness when the loan was granted to establish an abuse of rights and justify subordination.
- Nor is there any conclusive answer as to whether an abuse of rights can exist if the company was over-indebted when the loan was granted, but there was a justified expectation under Article 725b(4)(2) Swiss Code of Obligations that the over-indebtedness

would be resolved within a reasonable period (at most 90 days after the audited interim statements) and creditors' claims would not be further endangered. Furthermore, if the over-indebtedness is temporarily resolved but the company still goes bankrupt later, it is unclear whether the loans should still be treated as subordinated.

- Nor is there any clarification as to whether subordinated loans must be considered when assessing the board of directors' duties in cases of over-indebtedness (Art. 725b Swiss Code of Obligations).

Practical advice for related parties:

- Carefully assess whether the company is over-indebted at the time of the granting of the loan. This assessment is often not straightforward or clear. In particular, it can be difficult to assess whether the company is still a going concern and should therefore be valued at going concern values, or whether the company is not a going concern and must be valued at liquidation values and therefore over-indebtedness must be assumed.
- Moreover, the loan agreement should expressly exclude subordination to avoid the risk of implied subordination.

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No legal or tax advice

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