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Staggered Capital Reduction – New Approach to Tax-Free Quarterly Dividends for NYSE-listed Swiss Companies

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1. Introduction

Over the last few months, several NYSE-listed companies have moved from off-shore jurisdictions (e.g. Bermuda, the Cayman Islands) to Switzerland, e.g. conglomerate, Tyco International Ltd.; oil-industry contractors, Foster Wheeler Ltd. and Weatherford International Ltd.; big offshore drillers, Transocean Inc. and Noble Corporation; and insurer, ACE Ltd.

Due to the NYSE listing of all these companies, their relocation was not only governed by Swiss corporate law, but they were also subject to the reporting requirements of the U.S. Securities and Exchange Commission, the mandate of the U.S. Sarbanes-Oxley Act and the corporate governance rules of the New York Stock Exchange.

The challenge of migrating a NYSE-listed company to Switzerland is the continuation of existing corporate concepts under the new legal regime. It is all about providing for structures that comply with Swiss corporate law and, at the same time, respect the specific requirements of a NYSE-listed company. The goal is clear: Nothing should change in the legal set-up of the company (e.g. with respect to corporate governance, flexibility, shareholders' rights or anti-takeover protection). It goes without saying that due to some mandatory Swiss corporate law concepts, it is not always possible to mirror the legal situation as it was prior to the company's move to Switzerland.

Although a relocation raises a myriad of quite interesting Swiss corporate law questions, this note concentrates on one important issue, namely quarterly tax-free dividends.

2. Quarterly Dividends

Many US-listed companies pay dividends on a quarterly basis. One might expect that these quarterly dividends reflect quarterly earnings performance and, therefore, might fluctuate widely from one quarter to the other. However, managers seem to be interested in the market having a clear expectation of a certain level of dividends. They therefore smooth quarterly dividend payments by not looking at just past earnings performance, but also by looking into the future, reflecting expected future earnings. Some US-listed companies have even established a historical dividend payment, to which they try to stick no matter what.

Swiss corporate law is designed for one annual dividend payment, to be approved by the shareholders at the annual general meeting based on audited financials of the preceding financial year. Recognizant of the need of some Swiss companies for a more flexible dividend regime, the Swiss corporate law community has established various approaches to break this rigid regime of one annual dividend (e.g. extraordinary dividends, à conto dividends, interim dividends)[1].

Even though these approaches might actually also be suitable for the NYSE-listed companies in Switzerland, they have one fundamental flaw: The relevant distribution is a dividend, triggering income tax liability for the

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1 Very recently Peter Forstmoser/Gaudenz G. Zindel/Valerie Meyer Bahar, Zulässigkeit der Interimsdividende im schweizerischen Recht, SJZ 2009, 205–214.

shareholder. However, the question is whether Swiss corporate law allows for a distribution to the shareholder on a quarterly basis that would not trigger such negative tax consequences.

3. Par Value Reduction: Tax Efficient (Quasi) Dividend

The repayment of share capital does not trigger income tax at the shareholders' level. From the shareholders' perspective, they just receive a dividend in the form of a par value reduction.

It does not come as a surprise, therefore, that all of the NYSE-listed companies that recently immigrated into Switzerland started with a very high registered share capital.[2] This should allow them various rounds of par value reductions and should bring them safely to 2011, when the Corporate Tax Reform II will come into force, allowing also the tax-free return of additional paid-in capital (APIC, Agio) to shareholders. Again, to no one's surprise, these companies carry very high amounts of APIC on their balance sheets and one might reasonably expect that they will start distributing APIC to their shareholders as soon as the new law comes into force.

4. Why Quarterly Reductions Do Not Do the Trick

Under Swiss corporate law, it is the shareholders who have to decide on a par-value reduction.[3] Accordingly, the board of directors could go back to the shareholders on a quarterly basis and, each time, have them resolve on a reduction of the par value. This approach might work for closely held companies, but certainly not for listed companies that are subject to very extensive reporting requirements, as compliance with such requirements on a quarterly basis is just too onerous.

5. Why a Single Reduction With Deferred Payments Also Does Not Do the Trick

Of course, the shareholders could resolve that the reduction of the par value be implemented in one single step, but the reduction amount be deferred and paid-out in quarterly installments.

> *Example A*: The shareholders approve the reduction of the par value from CHF 10 to CHF 9 per share, but pay out the total reduction amount of CHF 1 per share in four quarterly installments of CHF 0.25. The par value as stated in the articles of association and the commercial register would (after the two month period for the creditors' call) be reduced from CHF 10 to CHF 9 per share.

However, this approach does not reflect the fact that the company might increase its share capital during the payment period out of conditional and/or authorized share capital. In case of a capital increase out of conditional and/or authorized share capital, this method leads to unsatisfactory results: If the holders of options or conversion rights were still entitled to exercise their respective rights to receive shares at the old par value per share, the company's shares would have two different par values. In case these newly issued shares were to participate in the capital reduction amount, the old shareholders would become diluted because the same reduction amount would have to be distributed to more shareholders. Alternatively, the company could just have shares with dividend rights (i.e. the old shares) and without dividend rights (i.e. the newly issued shares), which makes trading impossible unless the stock exchange is familiar with the concept of two trading lines for the same security (shares with dividend rights; and shares without dividend rights).

Provided the articles of association allow for capital increases out of conditional and/or authorized share capital, the company must be able to reduce the share capital gradually, always covering shares newly issued out of conditional and/or authorized share capital during the reduction process. The question is, however, whether Swiss corporate law allows for the shareholders to approve a staggered reduction of the par value in one single resolution, i.e. to gradually reduce the par value in various steps.

6. Can the Shareholders Resolve on a Staggered Par Value Reduction?

Can the shareholders resolve on a par value reduction by reducing the par value gradually over time?

> *Example B*: The shareholders approve the reduction of the par value from CHF 10 to CHF 9 per share and the implementation of the total amount of the par value reduction of CHF 1 per share in four quarterly installments of CHF 0.25. The par value as stated in the articles of association and the commercial register would thus be reduced gradually

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2 At the time of immigration to Switzerland, ACE Limited's share capital was CHF 11'311'110'325.34; Transocean Ltd.'s registered share capital was CHF 5'028'529'470.00; Tyco International Ltd.'s registered share capital was CHF 4'088'387'211.53; Noble Corporation's share capital was CHF 1'381'328'465.00; Weatherford International Ltd.'s registered share capital was CHF 845'487'611.96; and Foster Wheeler Ltd.'s registered share capital was CHF 379'247'742.00.

3 Article 732 CO.

	Number of shares	**Capital increase (shares new)**	**Par value per share**	**Share capital**	**Par value reduction amount per share**	**Reduction amount**
Prior to capital reduction	1,000 shares	--	CHF 10	CHF 10,000 (= 1,000 shares x CHF 10)	--	--
After 1st installment	1,000 shares	--	CHF 9.75	CHF 9,750 (=1,000 shares x CHF 9.75)	CHF 0.25	CHF 250 (= 1,000 shares x CHF 0.25)
After 2nd installment	1,000 shares	200 shares new	CHF 9.50	CHF 11,400 (=1,200 shares x CHF 9.50)	CHF 0.25	CHF 300 (= 1,200 shares x CHF 0.25)
After 3rd installment	1,200 shares	--	CHF 9.25	CHF 11,100 (=1,200 shares x CHF 9.25)	CHF 0.25	CHF 300 (= 1,200 shares x CHF 0.25)
After 4th installment	1,200 shares	300 shares new	CHF 9	CHF 13,500 (=1,500 shares x CHF 9)	CHF 0.25	CHF 375 (= 1,500 shares x CHF 0.25)
After capital reduction	1,500 shares	--	CHF 9	CHF 13,500 (=1,500 shares x CHF 9)	CHF 1	CHF 1,225 (= 1,000 shares x CHF 0.25 + 1,200 shares x CHF 0.25 + 1,200 shares x CHF 0.25 + 1,500 shares x CHF 0.25)

from CHF 10 to CHF 9.75 in the first quarter, then to CHF 9.50 in the second quarter, to CHF 9.25 in the third quarter and finally to CHF 9 in the fourth quarter. The shareholders would receive a repayment of par value in the amount of CHF 0.25 per quarter. In this scenario, the shareholders would resolve only once on the capital reduction.

Further, can the shareholders provide that any capital increase out of conditional and/or authorized share capital during the reduction process be implemented during the capital reduction process, i.e. that the new shareholder base, enlarged through the exercise of conditional and/or authorized share capital, be reflected in the following staggered reductions and thereby increase the total CHF reduction amount automatically?

Example C: This example is based on the par value reduction from CHF 10 to CHF 9 per share in quarterly installments of CHF 0.25 as described in Example B above. For the sake of the exercise,[4] we assume an initial share capital of CHF 10,000, divided into 1,000 shares each with a par value of CHF 10. The share capital will be increased through the exercise of 200 options during the second installment and through the exercise of 300 options during the fourth installment. The initial reduction amount of CHF 1,000 will consequently be increased to CHF 1,225.

Again, the shareholders would resolve on the capital reduction only once, but they would not directly approve the maximum reduction amount, since this amount would depend on the exercise of authorized and/or conditional share capital.

The Swiss Code of Obligations (CO) does not expressly stipulate that a capital reduction be carried out in one single step and legislative materials are also silent on

4 Albeit cognizant of the minimum capital requirement of article 621 CO.

that issue. Having reviewed the opinions of Swiss scholars, one might be tempted to identify a common understanding that the law only envisages a single step reduction. However, such an understanding misses out the inherent flexibility of Article 732 para. 3 CO granting the shareholders the discretion to decide on the ways and means of implementing a capital reduction. I am therefore of the opinion that shareholders are perfectly entitled to resolve on a staggered implementation of a capital reduction, always provided that - unlike the new capital range (*Kapitalband*) as suggested by the draft revision of the company and accounting legislation[5] - the board does not have any discretion as to whether or not to implement any of the reduction installments.

7. The Mechanics of a Staggered Par Value Reduction

For a capital reduction, the CO requires:

- a confirmation by the company's statutory auditor, confirming that all claims of creditors are still fully covered after the reduction;[6]
- shareholders' approval;[7]
- Swiss Official Gazette of Commerce (SOGC) publications informing the creditors about the two-month notice period for filing requests for satisfaction or securing claims against the company;[8]
- confirmation by the company that all creditors' claims for satisfaction or security have been complied with;[9] and
- a public deed in accordance with Article 734 CO.

Various commercial registries have already approved staggered reductions. However, gathering from publicly available documents from these commercial registries, there does not seem to be a *unité de doctrine* on the mechanics and procedures.[10] In the following, I try to detail the mechanics and the procedure for a staggered par value reduction.

7.1 Shareholders' Resolution

The reduction of the par value is an inalienable right of the shareholders.[11] Subject to the details of the payment procedure (e.g. timing, conversion of the CHF reduction amount into USD), the shareholders must not, therefore, leave any discretion to the board with respect to implementing any of the staggered reductions. As a result, the shareholders must resolve on the following:

- the total amount of the par value reduction (in Example C: CHF 1 per share);
- the amounts of the installments (in Example C: CHF 0.25 per installment);
- the duration and timing (in Example C: quarterly installments);
- the various articles of association, reflecting each step in the reduction process (in Example C, four versions of the articles of association will be necessary, namely for the various par values of CHF 9.75; CHF 9.50; CHF 9.25, and CHF 9.00);
- the inclusion of capital increases out of conditional and/or authorized share capital during the reduction process, in particular, for every installment until the day of filing the application of the respective installment with the commercial registry; and
- that the implementation of any of the installments be dependent on the receipt of an updated auditor's report in accordance with Article 732 para 2 CO, confirming that claims of creditors are still fully covered even after the par value reduction of the respective installment.

The resolution on the potential increase of the capital reduction amount due to capital increases out of conditional and/or authorized share capital during the reduction process is necessary for leaving the company with perfect flexibility with respect to the granting of options and issuing of conversion rights.

The company would have to increase its share capital out of conditional and/or authorized share capital[12] just before the application of the respective installment of the reduction, i.e. on the day of filing the application with the commercial registry. The filing of the application would need to be the cut-off date, since it is not possible to include increases of share capital out of conditional and/or authorized share capital up to the registration of the relevant capital reduction in the commercial register.

7.2 Audit Reports

The following audit reports in accordance with Article 732 para. 2 CO are necessary:

- To be submitted to the shareholders' meeting approving the par value reduction: Audit confirmation for the full par value reduction, including the first installment.

5 BB1 2008, 1652 et seq.
6 Article 732 para 2 CO.
7 Article 732 para 1 CO.
8 Article 733 CO.
9 Article 734 CO and Article 55 para 1 b (3) Ordinance Commercial Register (*Handelsregisterverordnung HRegV*, SR332.411).
10 Rino Siffert/Florian Zihler, Herabsetzung des Aktienkapitals unter besonderer Berücksichtigung der gestaffelten Kapitalherabsetzung, Jusletter June 29, 2009, who both work for the Federal Commercial Register, now clarify a lot of the open issues.
11 Article 732 para 2 CO.

12 Articles 650 et seq. and Articles 653e et seq. CO.

- To be submitted to the board of directors prior to each reduction installment: Audit report for the par value reduction of the respective installment.

The CO requires that the audit reports according to Article 732 para. 2 CO be addressed to the shareholders' meeting resolving on the capital reduction and auditors have established standard wording and procedures for standard capital reductions. The staggered reduction, however, and in particular the relevant audit reports, require the auditor to move away from these standards and the safe harbor of the audit handbook, which is a challenge for the auditor and its risk management. Companies are thus well advised to coordinate the staggered reduction process, including the balance sheets underlying the various audit reports, the timing, and the delivery of these reports, very closely with the company's statutory auditor.

7.3 Creditors' Calls

The company has to inform its creditors about the two-month notice period for filing requests for the satisfaction of debts or securing claims against the company by publication of the contemplated capital reduction in the Swiss Official Gazette of Commerce (SOGC).[13]

In case of a staggered reduction, each reduction step triggers a new creditors' call. It has been argued that each creditors' call must refer to the whole capital reduction, and not only the relevant reduction step, as creditors need to know that a specific capital reduction is part of a series of capital reductions.[14] Although one could argue, to the contrary, that the creditors do not need such protection, as it is up to them to make their judgment call on whether or not to request security or satisfaction for each reduction step anew, one has to acknowledge the current precedents which, for reasons of transparency, disclose the full staggered reduction in each creditors' call. It is therefore fair to say that such disclosure now represents good corporate practice.

8. Conclusion

Staggered par value reductions allow Swiss companies to make distributions to shareholders that mirror constant quarterly dividends, with the benefit of tax-free income at the shareholder's level. Of course, staggered par value reductions are not designed to reflect the financial performance of just the preceding quarter, but they accommodate very well the aim of paying a constant dividend to shareholders. It is imperative that the shareholders resolve on the staggered reduction and do not leave anything to the board's discretion.

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13 Article 733 CO.

14 Rino Siffert/Florian Zihler, (FN 10), N 47.